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The main goal is to enhance the quality and quantity of intellectual exchange among researchers, educators, scholars and practitioners dealing with major issues of public administration and public policy in the Central and East European regions.

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Fiscal Capacity, Equalization and the Budget Process with the New Law on Financing LSG

Marjan Nikolov

Abstract

The public, the donor community and the political subjects in Macedonia are occupied with the issues of decentralization. The bills package on territorial division, financing LSG and the status of the capital Skopje have passed the government/parliament procedure. In this paper some recent developments and challenges on the newly enacted law on financing LSG will be presented. We will make an attempt to estimate the fiscal capacity of LSG by using three techniques: revenue collection, GDP per LSG and the representative tax system with regression analyses. The deficiency here is the availability of data. Namely, revenue data are available for only the NUTS 4 level which is the 34 LSG from before the 1996 territorial organization. Estimation is conducted for the unconditional horizontal equalization formula in accordance with the new law on financing LSG. Also, key dates for the budget process are illustrated as well.

Key words: Fiscal decentralization, fiscal capacity, equalization, economies of scale, expenditure assignment, source revenues, intergovernmental transfers.

Assignment of the new expenditure responsibilities

Interesting enough for the case of Macedonia is that first the bill on financing the LSG was set for government procedure and then the law on territorial division. Usually it is more logical first to know how many municipalities there will be so that certain simulations and analyses regarding the financing can be done. Nevertheless, the assignment of expenditures will be based on the gradual shifting of responsibilities to municipalities through a phased approach.

The monitoring of the overall development of the financing system will be the responsibility of a commission set up by the government (article 15 from the law).

The commission will be responsible for:

- Monitoring implementation of the criteria for the central government transfers;
- Giving recommendations for improving the system and overcoming deviations identified;
- Keeping a watchful eye on transparency; and
- Giving opinions on the formula for transferring unconditional grants from the VAT and about the methodology for distribution of block grants.

The commission has representatives from the Ministry of LSG, as well as representatives of the finance, science and education and labor and social policy sectors each assigning one representative and five representatives from ZELS. However, this commission will have no decision making power. For each phase of the decentralization process there will be separate commissions that will determine whether conditions are met for each respectful phase (article 45 and 46).

Thus, one should differentiate among three commissions:

- The commission for the overall monitoring of the system;
- The commission responsible for the first phase conditions; and
- The commission responsible for the second phase conditions.

1 Marjan Nikolov is a mechanical engineer. He completed an M.Sc. in International Economics and Finance in Reykjavik in 2000. He has experience in working on different projects and with different donors. He formerly worked as Senior Economist for the USAID’s Fiscal Reform Project. He is founder and a President of the Center for Economic Analysis – CEA.
This two-step phased approach of assigning responsibility is illustrated in the next table:

<table>
<thead>
<tr>
<th>Phase</th>
<th>Starting date</th>
<th>Assignment of responsibility</th>
<th>Condition</th>
</tr>
</thead>
</table>
| Phase 1 | July 1\textsuperscript{st} 2005 | 1. Transferring revenues from tax sources (the PIT sharing) to municipalities (GOV)  
2. Developing a methodology for transferring the capital and earmarking (GOV)  
3. The LSG will start with the planned implementation of solving the liabilities and arrears up to 31\textsuperscript{st} of January 2001 (LSG) | If 90% of the total municipalities comprising 90% of the total population will provide:  
1. At least 2 financial officers; and  
2. At least 3 tax experts |
| Phase 2 | Conditional | Assignment of responsibilities (for the block transfers):  
1. Culture  
2. Social welfare and child protection (pre-schools and homes for elderly)  
3. Education (primary and secondary school)  
4. Healthcare (public health organizations and primary care) | 1. All the conditions from phase 1 are satisfied  
2. A proper capacity for financial officers (this is already stated in the previous phase)  
3. Viable results within 24 months for on time and regular reporting confirmed by the Ministry of Finance  
4. There are no accounts payable than usual ones  
5. The phase commission will evaluate if all the conditions are satisfied  
6. There is a written request from the municipalities to the proper ministry and the Ministry of Finance for block transfers after all the conditions are satisfied. |

Quantitative analysis of the expenditure responsibilities

The vertical fiscal balance in Macedonia, illustrated as expenditures by different levels of government, is illustrated in the next table (as a percentage of 2003 GDP. The central government budget includes transfers to off-budget funds. As a result, the sum of central, local and off-budget expenditures exceeds the total.):

<table>
<thead>
<tr>
<th></th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Government</td>
<td>35.88%</td>
</tr>
<tr>
<td>Central Government</td>
<td>26.90%</td>
</tr>
<tr>
<td>Extra-budgetary funds</td>
<td>20.63%</td>
</tr>
<tr>
<td>Local Governments</td>
<td>2.66% (only 0.9% in 2001 and 1.38% in 2002)</td>
</tr>
</tbody>
</table>

The mere 2.66% of GDP expenditures from the LSG in Macedonia compared with the 26.90% of GDP expenditures from the central government places Macedonia on the list as one of the most centralized countries in the world. The new proposed law will change the situation as presented in the next table:

<table>
<thead>
<tr>
<th>LSG revenue sources as per the new Law on financing LSG from 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Government</strong></td>
</tr>
<tr>
<td><strong>Central Government</strong></td>
</tr>
<tr>
<td><strong>Extra-budgetary funds</strong></td>
</tr>
<tr>
<td><strong>Local Governments</strong></td>
</tr>
</tbody>
</table>

In the Republic of Macedonia we can note a high fiscal dependency of LSG on the central government as well (67% of municipal revenues derived directly from the national government; the comparable “dependency ratio” for local governments in the average EU country is 45%).
Budget process

The budget process is illustrated in the next figure.
Measuring fiscal capacity

Fiscal capacity can be defined as ability of the LSG to raise revenues from its own sources in order to be able to cover a standardized set of public goods and services. It is a challenge to measure the fiscal capacity of the Macedonian LSG.

Here we will demonstrate three measurements of fiscal capacity for Macedonia and illustrate a comparison in the table below.

<table>
<thead>
<tr>
<th>PROS</th>
<th>CONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue collection</td>
<td>1. Different level of enforcement</td>
</tr>
<tr>
<td>1. Data readily available (at least for</td>
<td>2. Different level of compliance</td>
</tr>
<tr>
<td>30 LSG in accordance with the PRO</td>
<td>3. Different tax rates</td>
</tr>
<tr>
<td>organization)</td>
<td>4. Low level of incentives</td>
</tr>
<tr>
<td>2. Easy to understand and transparent</td>
<td></td>
</tr>
<tr>
<td>3. Easy manipulation of data</td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>1. Data availability (last time 1995</td>
</tr>
<tr>
<td>1. Total value of goods and services</td>
<td>Gross Social Product from the State</td>
</tr>
<tr>
<td>produced in the LSG</td>
<td>Statistical Office; this year for the first</td>
</tr>
<tr>
<td></td>
<td>time GDP for 1998 and 2002 UNDP project)</td>
</tr>
<tr>
<td>Representative Tax System with</td>
<td>1. Fiscal data requirements</td>
</tr>
<tr>
<td>regression analyses</td>
<td>2. Less transparent and difficult to</td>
</tr>
<tr>
<td>1. When insufficient data are</td>
<td>understand</td>
</tr>
<tr>
<td>available for conventional RTS system</td>
<td></td>
</tr>
<tr>
<td>Total Taxable Resources (not used in this</td>
<td>1. Data requirements</td>
</tr>
<tr>
<td>paper)</td>
<td>2. Complex data manipulation</td>
</tr>
</tbody>
</table>

1. Revenue collection

For the purpose of estimating fiscal capacity, we can use tax revenues (property tax, transfer of property, gift and inheritance tax and communal tax) and their actual collection or assessment. The advantage is that we can get readily available and timely data from the PRO (at least for the 30 LSG). The disadvantage is that incentives are reduced for LSG to collect revenues. One other disadvantage is the variability of enforcement and compliance within different local units of PRO. At the moment, one disadvantage of the property tax system is self-assessment and lack of audit.

The methodology usually requires adjusting the actual revenue collection with the population and the price levels among LSG. Since Macedonia is a small country, the price level is similar across LSG; thus, we will only use the per capita revenue collection.

2. Gross Domestic Product per capita

Data for GDP are available for 1998 and 2002, based on the UNDP project on improving the statistical information system for the LSG. It is a good measure because it is irrespective of the residence of the worker and/or the company.

3. Representative tax system with regression analyses

With this technique we will estimate the effect of the size of the LSG tax base on revenue collections by using the OLS regression technique. We will use the total revenue collection among the 30 PRO local units as dependent variable. The independent variable will be the GDP per capita for 2002. The algebraic representation of the OLS estimation is:

$$Revenue\ collection = \alpha + \beta \cdot GMP + \epsilon$$

where the term $\epsilon$ can be interpreted as the result of the different levels of fiscal effort among the LSG.

<table>
<thead>
<tr>
<th>Dependent Variable: REV, Method: Least Squares,</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date: 10/14/04, Time: 19:34, Sample: 1 30</td>
</tr>
<tr>
<td>Included observations: 30, REV=C(1)+C(2)*GMP</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Coefficient</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>C(1)</td>
</tr>
<tr>
<td>C(2)</td>
</tr>
<tr>
<td>R-squared</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
</tr>
<tr>
<td>S.E. of regression</td>
</tr>
<tr>
<td>Sum squared resid</td>
</tr>
<tr>
<td>Log likelihood</td>
</tr>
</tbody>
</table>
The results from the estimation are presented in the next table:\(^2\):

The coefficient of determination is very low. The estimated parameter however is statistically significant. Fiscal capacity will be defined as the proxies from the prediction of the above equation on the basis of the tax base (GDP).

<table>
<thead>
<tr>
<th>LSG</th>
<th>Revenue collection per capita (available for 30 PRO units)</th>
<th>GMP per capita PPP based (available for 123 LSG 2002)</th>
<th>Representative tax system with regression analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Level</td>
<td>Rank</td>
<td>Level</td>
</tr>
<tr>
<td>Kicevo</td>
<td>239</td>
<td>12</td>
<td>172,562</td>
</tr>
<tr>
<td>Gostivar</td>
<td>303</td>
<td>20</td>
<td>184,745</td>
</tr>
<tr>
<td>TETOVO</td>
<td>388</td>
<td>25</td>
<td>190,836</td>
</tr>
<tr>
<td>Debar</td>
<td>251</td>
<td>15</td>
<td>195,761</td>
</tr>
<tr>
<td>K.Palanka</td>
<td>251</td>
<td>14</td>
<td>207,101</td>
</tr>
<tr>
<td>Probistip</td>
<td>225</td>
<td>10</td>
<td>213,257</td>
</tr>
<tr>
<td>Struga</td>
<td>436</td>
<td>26</td>
<td>219,283</td>
</tr>
<tr>
<td>Kumanovo</td>
<td>324</td>
<td>23</td>
<td>219,413</td>
</tr>
<tr>
<td>Valandovo</td>
<td>280</td>
<td>18</td>
<td>222,134</td>
</tr>
<tr>
<td>Kocani</td>
<td>199</td>
<td>8</td>
<td>248,638</td>
</tr>
<tr>
<td>Kratovo</td>
<td>173</td>
<td>4</td>
<td>251,683</td>
</tr>
<tr>
<td>Delcevo</td>
<td>186</td>
<td>7</td>
<td>253,044</td>
</tr>
<tr>
<td>M.Brod</td>
<td>162</td>
<td>3</td>
<td>267,041</td>
</tr>
<tr>
<td>Vinica</td>
<td>173</td>
<td>5</td>
<td>271,382</td>
</tr>
<tr>
<td>Krusevo</td>
<td>161</td>
<td>2</td>
<td>305,662</td>
</tr>
<tr>
<td>Kavadere</td>
<td>352</td>
<td>24</td>
<td>318,816</td>
</tr>
<tr>
<td>Berovo</td>
<td>235</td>
<td>11</td>
<td>324,000</td>
</tr>
<tr>
<td>PRILEP</td>
<td>158</td>
<td>1</td>
<td>330,156</td>
</tr>
<tr>
<td>Ohrid</td>
<td>1,015</td>
<td>30</td>
<td>333,655</td>
</tr>
<tr>
<td>Negotino</td>
<td>253</td>
<td>16</td>
<td>342,662</td>
</tr>
<tr>
<td>Resen</td>
<td>495</td>
<td>27</td>
<td>343,505</td>
</tr>
<tr>
<td>Veles</td>
<td>219</td>
<td>9</td>
<td>352,318</td>
</tr>
<tr>
<td>STRUMICA</td>
<td>321</td>
<td>22</td>
<td>362,426</td>
</tr>
<tr>
<td>STIP</td>
<td>317</td>
<td>21</td>
<td>377,914</td>
</tr>
<tr>
<td>Gevgelija</td>
<td>249</td>
<td>13</td>
<td>415,174</td>
</tr>
<tr>
<td>Radovis</td>
<td>264</td>
<td>17</td>
<td>435,197</td>
</tr>
<tr>
<td>BITOLA</td>
<td>561</td>
<td>28</td>
<td>448,092</td>
</tr>
<tr>
<td>D.Hisar</td>
<td>185</td>
<td>6</td>
<td>457,423</td>
</tr>
<tr>
<td>Sv.Nikole</td>
<td>285</td>
<td>19</td>
<td>461,052</td>
</tr>
<tr>
<td>SKOPJE 01</td>
<td>756</td>
<td>29</td>
<td>999,151</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Level</th>
<th>Rank</th>
<th>Level</th>
<th>Rank</th>
<th>Level</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min</td>
<td>158</td>
<td></td>
<td>172,562</td>
<td></td>
<td>233</td>
<td></td>
</tr>
<tr>
<td>Max</td>
<td>1,015</td>
<td></td>
<td>999,151</td>
<td></td>
<td>672</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>314</td>
<td></td>
<td>324,136</td>
<td></td>
<td>314</td>
<td></td>
</tr>
<tr>
<td>Coefficient of variation</td>
<td>59</td>
<td>48</td>
<td>26</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^2\) E-Views software package estimation.
The correlation coefficients for the alternative measures of fiscal capacity for the Macedonian LSG are presented in the next table.

<table>
<thead>
<tr>
<th>Correlation</th>
<th>RA</th>
<th>GMP</th>
<th>RTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>RA</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GMP</td>
<td>0.44</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>RTS</td>
<td>0.44</td>
<td>1.00</td>
<td>1</td>
</tr>
</tbody>
</table>

We can conclude that there is relative consistency with one another on the three measures of fiscal capacity. The correlation for the RTS and the GMP is understandable because it is a regression of these two variables and the predicted scores we are using.

The recommendation, therefore, is a strong statistical unit within the state statistical office and separate departments for LSG within the Ministry of Finance and the ministry of LSG in order to achieve quality in the statistical information system.

At the moment we can benefit from the favorable circumstance for fiscal capacity estimation by using the TTR system because the GDP PPP data are available for 2002 and the census data are for 2002. But this is a separate, complex research project that requires additional precise and exact data (the problem is origin-based and HQ-based businesses and personal income tax payments and all the subsidies and transfers adjustment for social and pension and other contributions) that can be calculated. On the other side, the RTS with the regression analyses is less transparent and less understandable for policy makers.

Thus, Macedonia can, in the beginning, start with the RA system adjusted for the information from the pilot projects (see the table below) and to build capacity in the state statistical office for regular GDP calculation per LSG and other necessarily data for the TTR system to be in use. Still, it is up to the government to set up clear objectives on what they want to achieve because a different measure of fiscal capacity can give different ranks to the LSG relative to one on another.

Consider the LSG Demir Hisar from the above table. Demir Hisar ranks very well as per GDP (28th) but has a very bad ranking as per revenue collection (only 6th). The situation is ambiguous and this ambiguity comes from the fact that this LSG is high in forestry natural resources and this results in a high GDP per capita but low tax base for revenue collection. This is why it ranks very bad. Maybe a solution could be for the concessions on natural resources to be transferred to the LSG and/or maybe to use a variable on natural resources in the equalization formula. It is arguable, but it depends on what the government wants to achieve.

One interesting program is that which started this year: the pilot project for devolving the administration of property tax to LSG for 2005 taxation. The four pilot projects comprise the LSGs: Veles, Gostivar, Sveti Nikole and Struga (four LSGs from before the 1996 organization but 19 LSGs from the 123 LSGs). The most recent information on the collection efficiency improvement is illustrated in the next table:

| Increase of the collection by taxes for the period Jan-Sep 2004 after devolution of administration |
|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
| Property tax                      | Transfer of property tax           | Inheritance and gift tax          | Communal tax                     |
| 41.9 %                            | 195 %                             | 106.4 %                          | 16.6 %                           |
| Forecast of the collection for the end of the 2004 (CEA forecast) |
| 56 %                              | 260 %                             | 142 %                            | 22 %                             |

Equalization issues

With the new law, the unconditional equalization fund (from the VAT transfers) will depend at least 50% on the population. The formula will be defined within the Ministry of Finance and approved by the commission responsible for the monitoring of the development of the finance system. With the new law, the cap system will be abolished as a source for equalization and it is my opinion that the agency for underdeveloped regions should be abolished as well and transformed into a capital investment agency that would deal with capital grants.

In the next table and figure we estimate and simulate the unconditional equalization transfers to the LSG as if it depends 100% on the population. Also, we use the data on increased revenue collection from the pilot project’s LSG and map the appropriate increase to all LSGs.

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3 I would like to thank Mr. Ace Kocevski, the mayor of Veles, for the data provided.
We can see from the coefficient of variation that the formula is successful in equalizing. However, there are three which stand out: Skopje, Ohrid and Bitola.

Additional improvements can be made in the formula but this will require additional research. One step could be to exclude those which stand out by taking a zero population count for those LSGs.

Municipal revenue per capita
own revenue distribution and distribution after allocating the unconditional
Conclusion

1. The process of decentralization in Macedonia started first with the revenue assignment of the LSG and the expenditure assignments were loosely assumed. There were no analyses done on the efficiency of the newly enacted boundaries since it was a heavily politically-driven process. There were no discussions on the administrative or on the fiscal capacity of the LSG.

2. The expenditure assignments in Macedonia will be conducted in a two stage process monitored by a government commission.

3. Macedonia is a highly centralized country with high vertical imbalance with LSG expenditure.

4. With the new law on financing LSGs, there will be only one equalization scheme with an unconditional grant from the VAT. We suggest that the agency for underdeveloped regions become an agency for capital investment.

5. Three techniques for measuring fiscal capacity are introduced. At the moment, it seems reasonable to use the revenue collection approach (easy to understand and to get data) while internalizing experience from pilot projects for devolving the administration of property tax. In the longer term, the total taxable resources could be used since the state statistical office will be capable of estimating the GDP by LSG and it can provide the other required data as well.

6. We recommend that a horizontal equalization scheme use 100% as the number of the population for the first year since it is simple and equalizes well (lower coefficient of variation). Within one year, the government should conduct additional research and simulations.

7. We also recommend more focus on the statistical information system. The state statistical office is ready to assume some responsibility from a capacity point of view. There is a need for a new systematization in the Ministry of Finance and the need for LSG department is more than a need; it is essential. Only two people working within the budget department (responsible for LSG) when the process is at the very beginning and has high priority status is unacceptable and not serious.

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Plato, (360 BC), “Laws” and “Republic”


Laws and regulations in the Republic of Macedonia.
The Problems of Developing the Municipal Debt Market in Poland

Agnieszka Kopańska ¹

Abstract
Polish local government, practically throughout its history, has had the power to use debt instruments in its financial policy. The important questions are whether local government has used this possibility properly and what the main determinants of local debt are. This paper presents historical data of the common capital market in Poland and legal framework thereof. The analysis focuses on the years 1994 – 2003 and it is shown that an immature market and a new democracy create special and unique problems for local debt which are only partly present in developed countries. The phenomenon of the Polish case was that even though they had the legal and financial power to borrow, a strongly competitive capital market and also special communal credit institutions, Polish gminas were very (maybe too) conservative in their debt policy. This paper proposes to find reasons for that situation; reasons which are closely related with the youth of the market and democracy.

JEL Code: H74; H77
Key words: local government debt, decentralization in Poland

Introduction
All entities in the economy, including the local government, face problems related to finding sources of capital needed to expand their operations. This issue was (and still is) of particular significance in Poland and other countries in transition, where long decades of negligence have resulted in enormous investment needs in the scope of public infrastructure. One of the ways of acquiring additional financial resources is the use of debt instruments. Similar to other entities, local governments (LG) contract credit, loans, and issue bonds. However, due to the scope of competence and duties of local government, its loan-contracting policies must be considered from a different perspective.

In the first chapter of this paper, I present the discussion on factors which, according to theory, could influence local government debt behavior. A short theoretical review, therefore, is needed in order to analyze problems of local government borrowing in Poland in the decade from 1994 – 2003². I will prove that an immature market and the new democracy created special and unique problems which are only partly present in developed countries. To achieve this goal, the second chapter of this paper presents basic information about Polish LGs in 1994 – 2003, both considering the financial and legal situations. In this chapter, the legal framework of local debt in Poland during these years is also presented. The final part of the paper analyzes the historical data of municipal debt, the amount of debt and the main creditors, i.e., banks, special purpose funds and the bond market. The main indicators of the Polish common capital market are also shown.

The analysis presented in this paper was prepared based on numerous interviews and questionnaires which I made in previous years with LGs authorities, representatives of banks, special credit organizations, stock market institutions and others who create the capital communal market. In the analysis for the years 1993 – 1998, I also used estimates of municipal debt which I received from the National Bank of Poland, the Regional Chamber Offices and the National Environment Protection and Water Management Funds³ – precise data of municipal debt is known from 1999.

² These years are of special interest because they cover two full cadences. Additionally, before 1994, LG debt was close to zero. In 2004, the new law for local government revenues was established and this single year could not compare with the rest of period.
³ This data was collected thanks to cooperation with USAID.

¹ Faculty of Economic Science, Warsaw University, Warsaw, Poland.
1. Local government as a borrower

There are theoretical arguments that long term debt is a just, efficient and optimum method for financing local investments but it is not a proper method to finance operational expenditures. There are also microeconomic and macroeconomic problems related to local government borrowing.

LG units are a part of the public sector. This sector, as opposed to the private sector, does not operate for financial benefit but rather operates to fulfill social needs. This means that public sector units should exist even if its financial situation is bad, and that the horizon of operating a local unit is theoretically endless. It must be stressed that an inability to meet financial obligations can not be reason to liquidate a local government unit; it can not be cross off the map! This creates problems on the side of local authorities and also on the creditors – they believe that “somebody” will help local units repay debt. Furthermore, such help – bail-outs – is quite often offered by central or regional government. It might be said that for a public unit to go bankrupt is politically unacceptable [Dafflon; 1996]. The aforementioned problems create a tendency to not calculate the creditworthiness of LG’s units and/or incorrect investment planning [Kornai; 1986]. In the last part of my paper, I suggest that problems which are explained by bail-out literature may also occur because of over-competition among banks and this is related not only to potential transfers with local authorities, but also to an immature capital market.

Generally, it might be said that local government borrowing is very often a political rather than a business choice. This can be found in a sort of theoretical and practical analysis of local government debt and general local government financial policy such as:

- A political business cycle or electoral business cycle [Nordhouse (1975); Rogoff (1987)] suggests that public authorities spend more on items visible to voters (and increase deficit and debt) in a pre-election period and generally spend less after the election. [An analysis at the local level was presented, e.g., by Veiga (2004); Pettersson 2003]. What is interesting is that such behaviors are much more visible in a new democracy [Brender, Drazen 2004].
- Strategic use of debt consideration is closely related to the business cycle. This implies that the authorities choose and higher level of debt if they expect to be defeated in the next election. There are studies which show that such practices are visible only in right-wing governments [Pettersson (2001)] and on both the left and the right [Alesina; Tabellini 1990].

In the last part of this paper, I will try to answer the question of whether the behavior of local authorities was visible in Poland. In my analysis, I will differentiate different sources of debt/credits from commercial banks, municipal bonds and low-priced loans offered by special institutions. All these types of loans have different characteristics and the perception of these debt instruments could be different among local authorities and voters.

It is worth noticing that the microeconomic danger of a political business cycle and of “strategic use of debt” is related to potential excessive debt of some local governments which may lead to serious difficulties in re-payment of loans and may jeopardize the provision of vital public services. The macroeconomic limitation is related to the fact that LG debt is an important part of public debt and this may have a negative effect on the economy. And expression of these fears is Article 109 J of the Maastricht Treaty which set up limits on public debt (it can not exceed 60% of GDP).

These arguments are the reason for the existence of different kinds of legal limitations and legal regulations related to local government debt, such as:

- Bankruptcy law for municipalities;
- Obligatory audits of the local financial situation, with special focus on local debt; and
- Limits of amount, method and purpose of going into debt.

In most countries, a mix of the above limits and regulations is chosen and they are important characteristics of the common capital market in one country. Nevertheless, to
describe this market, it is also worth analyzing the general financial situation of local governments. A description of the Polish LG system and legal framework of local debt in Poland for the years 1994 – 2003 will be shown in the next chapter.

2. Local government in Poland

2.1 Organizational framework

LGs were reinstated in Poland in 1990. Gminas were established as the basic LG units in 1990. By law, gminas became legal entities with the right to act on their own behalf and responsibility, to own assets and enjoy financial independence (with their own budgets and independent financial management). 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 Law enumerates the most important tasks. 5

These basic assumptions on the profile of a gmina were highlighted by the Constitution in 1997. Additionally, the Constitution states that local or regional government units other than gminas are to be established under separate specific laws. More importantly, Article 3 of the Constitution introduces Poland as a Unitary State. LGs may not establish their own financial regime or impose and develop their own taxes presently, other than those specified by legislative acts.

Gminas operated as a sole LG level until 1998, when poviats – or LGs at the supra-gmina level – were introduced, along with voivodships, or regional governments. 6 Additionally, 65 gminas were given the status of municipal-city with poviat rights, i.e., units performing both gmina and poviat tasks. Like gminas, all these new units have become legal entities with asset ownership, their own budget and separate accounts.

Unlike a gmina, which is subject to the presumption of competence, the scope of a poviat’s responsibilities is strictly defined. 7 A poviat is responsible for public tasks of a supra-gmina nature. The primary responsibilities of voivodships are aimed at the regional development by defining measures and development goals in what is called a “voivodship development strategy.” 8 Furthermore, voivodships are responsible for public tasks of a regional nature that gminas or poviats are unable to fulfill.

Local officials at all levels are elected by direct universal election. They establish legislative and supervisory bodies: councils in gminas and poviats and local assemblies in voivodships. Executive bodies elected by the councils/assemblies are boards headed by a wojt or mayor (president) in gminas, a starosta in poviats and a marshal in voivodships.

2.2 The financial system of a Polish LG

a) Revenues

In Poland, an LG had (and has) relatively large revenues which account for roughly 20% of all public revenues and represented approximately 9% of the GDP.

Data presented in Table 1 indicates that Poland’s gminas in the years analyzed enjoyed a relatively high degree of autonomy on the expenditure side (due to the share in revenues, they are authorized to spend them on their own – local taxes, shared taxes and subsidies) 9. Furthermore, a comparison of initial and final figures for the period under

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5 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.

6 Today, there are 16 voivodships and 314 poviats. On average, a poviat is inhabited by some 125,000 residents with an area of approximately 1,000 sq. km, while the population of an “average” voivodship is roughly 2.4 million people living in an area of approximately 20,000 sq. km.


9 For the first time, direct elections of wojts, mayors and presidents, serving as one-man executive bodies for gminas, were held in September 2002.

10 The problem, of course, is discretion of such spending which is determined by different kinds of norms and standards in Poland. For example, the heaviest for local budgets are spending related to teacher salaries (approximately 20% of all gmina expenditures) which are decided mostly at the central level; this limited gmina autonomy on the expenditure side.
review indicates that the autonomy of gminas has increased and for 6 years has remained at a similar level (i.e., their own revenues and subsidies account for roughly 85% of total revenue). Gminas enjoyed less freedom on the revenue side. In fact, only one third of LG revenues can be classified as their “own.” Moreover, LGs are deprived of any meaningful powers to determine tax and fee rates, as these are subject to statutory limits. In practice, maximum and minimum rates are applied while gmina’s tax powers involved mainly exemptions granted to specific taxpayers. Undoubtedly, this has adversely affected the flexibility of their financial policies.

The Problems of Developing the Municipal ...
increased after reform and in 2001, LG expenditures were 25.29% of all public expenditures and 8.6% of the GDP.

Of special importance are capital investment-related expenditures which account for a significant portion of total expenses. Capital expenditures of Poland’s LGs represented approximately 60% of total capital expenditures in the public sector. This means that LGs are major capital investors in that sector, unlike the central government sector, which focuses primarily on current expenditures. Each year, local capital investments accounted for no less than 15% of total expenditures incurred at that specific level (see Table 3) while, at the central level, they represented around 4%.

Such a huge capital investment effort by LGs is associated with serious underdevelopment of the municipal infrastructure inherited from the past. Due to the magnitude of existing needs, the amount allocated to capital projects is relatively stable in Poland, unlike in developed countries, where local capital budgets tend to fluctuate. However, capital expenditures fell over the examined years (see Table 3). Unfortunately, this decrease can be explained by a worse financial situation for LGs rather than by satisfaction of needs in this area. Although LG revenues increased in real terms, their burden from new responsibilities grew even faster.

2.3 Limiting local debt in Poland

An important method to regulate local unit debt is to set limits for:
- Purpose of debt;
- Amount of debt; and
- Method of borrowing.

a) Limits of debt purpose

The most important limit for local borrowing is related to purpose of debt. The “golden rule” of local government finance says that borrowing is allowed for capital projects but prohibited for current purposes (pay-as-you-use financing as opposed to pay-as-you-go) [Musgrave 1989]. In Poland, the law defines two types of debt that LG units are authorized to have. First, the debt associated with local budget deficit occurring during a year has to be repaid within the current year. Second, the debt contracted to cover the budget deficit of an LG unit that has to be specified in that unit’s budget. 11 Accordingly, the laws distinguish between short-term current debt and long-term debt. It should be noted, however, that the aforementioned regulations do not explicitly provide for the purpose of long-term debts. Both capital and current expenses are eligible under the existing legal framework.

b) Limits of amount of debt

In Poland there are two limits for the amount of debt:

- The laws states that “the total amount of loan/credit installments to be repaid in a particular budgetary year and potentially payable amounts under any collateral extended by an 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). 12 Furthermore, total debt as of budgetary year end may not exceed 60% of revenues in that particular budgetary year (Art. 114) (this limit has been in effect since 1999).

11 Public Finance Law, Art. 48 and 49, but copied from the previous law (Gminas revenues Law, 1990).

12 This limit was copied from the previous law with a small (but important) change: loans with collateral on gmina’s property were excluded from these limits in the previous law.
debt. Obviously, these statutory limits fail to reflect the actual financial situation of an LG unit. For more affluent units, exceeding the statutory 60% or 15% limits is not a problem, but in others, even a small debt may seriously impair their solvency. Nevertheless, a number of Polish LG and creditors assess financial security in terms of these statutory limits.

It is also worth adding that the limit which ties local debt to central debt was established in Polish law in 1999. The regulation is intended to be a tool to avoid potential macroeconomic problems of local debt. The total amount of public debt is calculated as the nominal amount of liabilities other than mutual liabilities of public sector entities. The Minister of Finance is responsible for ensuring compliance with debt level thusly calculated and in the event that the amount of public debt plus potentially due collateral and guarantees granted by sector entities exceeds 50% of the GDP, then so-called prudential and improvement measures are enacted. The mechanism for these measures is 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 the state budget for that particular year. More restrictive limitations occur once the public debt is in excess of 55% and 60% of the GDP.

c) Limits on methods of borrowing

The second group of limits is the limits regarding the method of borrowing. As postulates the 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 this means that local units can borrow, like other entities – on commercial terms – contract credits in banks and issue bonds; in Poland all these methods are accessible to local units.

In most countries, specific regulations are related to foreign currency debt. In Poland before the end of 1998, there were no special guidelines for this. From 1999, there is regulation which says that the maximum 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.

Upon analysis of method of borrowing, it is worth saying a few words about preferential loans. For years, special purpose institutions of communal debt were operated in some West European countries such as France and Belgium. In the USA, the tax rules for municipal bonds make muni-bonds a cheaper way of borrowing. The argument for creating such preferential debt is expanding of funds for local investments. But on the other hand, there are a lot of problems related with special purpose institutions [Davey 1988].

In Poland there are no institutions specifically established to provide support to local government’s capital projects. Nevertheless, Environment Protection and Water Management Funds (FOŚ) for years filled this gap to a significant extent. They operate on the basis of public off-the-budget funds, mainly revenues from environmental fees and fines. Since a vast proportion of local governments’ tasks are associated with environmental protection, a significant part of the funds’ assistance was directed to that sector.

Today, there are four types of environmental funds: national, voivodship (16), poviat and gmina funds. The national and voivodship funds are considered legal entities and make discretionary decisions on the projects to be funded, related instruments and terms and conditions of their offers. The instruments include grants and loans which are subject to partial or total waivers as well as subsidies to interest on soft credits extended by banks under special agreements. Gmina and poviat funds are not considered to be legal entities and the assistance they provide is limited to grants. The Funds offer was, to a great degree, targeted at local governments and competes with commercial credits. The cost of funds borrowed from Environmental Funds was lower by a few to several percentage points as opposed to credits from banks.

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13 Public Finance Law, Art. 10.1 and Art. 36.1.
14 Public Finance Law, Art. 45.
15 The structure of Funds was changed in 1999 according to changes in local government structure. Before 1999, there were three types of Funds: national, voivodship (49), and gmina.
At the end of discussion of local government debt limits in Poland, it is worth noting that according to Polish law, local units can not go bankrupt. There is no special regulation which says what should be done when an LG unit has a problem with financial obligations. The lack of such regulation gives space for potential “special grants” for localities with such problems. Unfortunately in 2004 for the first time, several local units received loan to fulfill their liabilities; so bail-out problems are present in Poland.

Another important element of regulation for local debt in Poland is the lack of obligatory audits of local units. There exist Regional Chamber Offices, but they control only the legality of local policy, not the creditworthiness.

3. The use of debt instruments by Poland’s local government units

The municipal debt market is growing very fast. In the early 90s, local governments didn’t use any debt instruments, while in 2003 the amount of debt was more then 17 bil PLN (4 bil USD – see Figure 1). Debt has suddenly risen, especially in the last five years of the period analyzed.

The debt of local governments grew, and was expressed as a percentage of their income, from 9.5% in 1999 to 18.5% in 2002. Cities with poviats and gminas account for the bulk of the total debt (52.1% and 39.3% of total debt, respectively). Cities with poviats rights are the most heavily indebted units, with debt/income ratios of 12.3% in 1999 and 32.6% in 2003. Nevertheless, local governments are far from reaching the debt-to-income ratio of 60%, as stipulated in 1999 by the Public Finance Law (Table 4).

![Figure 1](image-url)

**Outstanding debt of LGs from 1995 – 2003 (in prices as of 2003)**

Source: Calculation based on data from the Ministry of Finance, the National Bank of Poland, the National Environmental Funds and Regional Chamber Offices.

### Table 4

**Outstanding debt by LG level in 1999 – 2003**

<table>
<thead>
<tr>
<th></th>
<th>a-in mil Pln</th>
<th>All units</th>
<th>Gminas</th>
<th>Cities with poviats rights</th>
<th>Poviats</th>
<th>Voivodships</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>a 6 187.30</td>
<td>3 723.4</td>
<td>2 385.4</td>
<td>55.1</td>
<td>23.4</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b 9.53%</td>
<td>11.51%</td>
<td>12.30%</td>
<td>0.56%</td>
<td>0.71%</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>a 9 377.10</td>
<td>5 132.6</td>
<td>3 761.8</td>
<td>378.1</td>
<td>104.6</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b 12.91%</td>
<td>14.84%</td>
<td>17.28%</td>
<td>3.01%</td>
<td>2.82%</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>a 12 266.37</td>
<td>6 248.11</td>
<td>5 209.38</td>
<td>531.09</td>
<td>277.79</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b 15.41%</td>
<td>16.76%</td>
<td>22.01%</td>
<td>3.78%</td>
<td>6.04%</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>a 15 358.39</td>
<td>6 039.34</td>
<td>7 994.90</td>
<td>890.56</td>
<td>433.58</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b 18.45%</td>
<td>14.90%</td>
<td>31.30%</td>
<td>6.97%</td>
<td>9.84%</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>a 17 276.84</td>
<td>6 617.89</td>
<td>8 789.31</td>
<td>1 225.22</td>
<td>642.42</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b 22.02%</td>
<td>18.50%</td>
<td>32.62%</td>
<td>11.09%</td>
<td>14.14%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Calculation based on data from the Ministry of Finance, the National Bank of Poland, the National Environmental Funds and Regional Chamber Offices
Looking at the relatively stable situation of Polish gminas in 90s and the huge investments needs, it is worth asking why debt was rarely used and why local units mostly used their own current revenues for capital projects.

One important factor should be noted which influenced capital market in the 90s and which mostly is historical today. It is necessary to remember that the 90s were years of radical economic change and even more radical uncertainty about the effects of this change. This uncertainty made any financial planning extremely difficult; difficulties that were compounded by extremely high inflation rates (70 percent in 1991 falling to 20 percent in 1995) and the high cost of credit. Nevertheless, the price of credit and macroeconomic problems were not the only factors influencing the situation on the Polish common capital market.

Before studying the different parts of this market (loans from banks and communal bonds as well as “soft-money” loans) it is worth studying local government deficits (which could be an estimation of level of debt) in any “election cycle.”

Elections were in Poland in 1994, 1998 and 2002. As could be seen at Figure 2, during election years the level of deficit was the highest, while the lowest level was recorded the year after an election. This correlates with the electoral business cycle theory. During the pre-election period, local authorities spend more than in other years. The question is how this is connected to the level of different kinds of debts.

### Figure 2
**Deficit to revenue ratio in Polish gminas and cities (1995 – 2003)**

![Graph showing deficit to revenue ratio](image)

Source: Calculation based on data from the Ministry of Finance,
3.1 Commercial credits contracted by Poland’s local governments

Unlike in many transition countries, Polish local governments are not required to keep their cash holdings in sub-accounts of the national treasury system. Instead, they are free to place their deposits with, or borrow from, any of the country’s commercial banks. This has facilitated an organic linkage between local governments and the banking sector. Over the course of the 1990s, local governments progressively overcame their reluctance to deal with commercial banks [Kopanska, Levitas 2004]. (See Fig. 3)

**Figure 3**

*LG’s credits in commercial bank portfolios (1994 – 2003)*

![Figure 3](image)

*Source: NBP data*

**Figure 4**

*Year to year changes of LG debt to commercial banks in 1994 – 200316*

![Figure 4](image)

*Source: Calculation based on NBP data*

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16 Calculation was made using the formula: \( \frac{\text{Debt}_t - \text{Debt}_{t-1}}{\text{Debt}_{t-1}} \)
To analyze the correspondence of local debt to the electoral cycle, it is worth showing the dynamic of communal debt. The increase of debt is not steady and it corresponds to an election cycle. As can be seen in Fig. 4, the slowest increase of debt to commercial banks occurs one year after elections (1995, 1999 and 2003). A higher level of increase occurs in the second year after election and then it comes down, and what is the most interesting, this is lower in pre-election period than in the previous year. This means that new debt is taken mostly in the middle of an election period. The least new debt and probably the most repayment occurred in the post-election time and partly during the election year. (It must be noted that during the period analyzed, the maturity of commercial debt was generally no longer than 5 years [Kopanska 2001].

The reason for the above relationship is that LG’s are concerned about running into commercial debt. These concerns arise mainly from the fact that such decisions are considered inappropriate and the debt, especially offered on market terms, is perceived as a sign of mismanagement. The debates, which took place during the last election, confirm this suggestion. In many local newspapers, candidates for councillorships criticized the former authorities for the credits and loans, and suggested that this debt is unfair because it burdens future budgets. These arguments appeared even in the city of Ostrow Wielkopolski, which is famous in Poland for being the first to issue public muni-bonds, and Ostrow’s presidents were, for years, set as an example of modern and smart governors.

The above discussion is related to the idea of “strategic use of debt.” But the reasons and the effect of this “strategic use” are different than in old democracies. In the Pettersson 2001 and Alesina, Tabellini 1990 studies, governors who do not expect reelection increase debt which will weigh heavily on their successors. In Poland when councilors closed the session, repaid their credits and prepared the budget for the next year, they did not plan new commercial debt. The reason is that politicians are afraid that the accusation of excessive debt would ruin their reputation. [Swianiewicz, 2004]

Furthermore, this worry is caused by the fact that 16 years after creation, there are still local units which have never taken long term (investment) credits from commercial bank. (See Table 6 below).

<table>
<thead>
<tr>
<th>Table 6</th>
<th>Number of Local Governments with No, or almost No, Debt in 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of local governments who had no debt</td>
</tr>
<tr>
<td>gminas</td>
<td>149</td>
</tr>
<tr>
<td>povias</td>
<td>13</td>
</tr>
<tr>
<td>Cities with povias rights</td>
<td>0</td>
</tr>
<tr>
<td>voivodships</td>
<td>0</td>
</tr>
</tbody>
</table>

*Source: Own calculations based on the Ministry of Finance Reports*

It must be noted that soft money was much more accepted (more about this problem in the next part of this paper), but still, especially in small units, the most popular method of financing investment was an LGs own budget funds. The result of a good financial situation in the 90s was a gmina’s ability to complete capital projects without external sources. These circumstances resulted in the financial position of gminas being progressively worse (after 1999) because they just did not know how to cooperate with banks. This was visible, for example in 2002, when small rural gminas were looking for sources needed to receive EU – SAPARD grants. The banks offered them so called bridge-loans. But gmina’s representatives were truly surprised that banks wanted to charge interest and that they expected debt to be repaid at regular rates [Bogucka 2002].

17 The elections take place in the last few months of the year and old new councilors decide on the budget for the first year for newly elected council members.
One the other hand, as was seen in Tables 4 and 5 and Fig. 1.3, at the end of the period examined, LG debt had grown very fast, including debt to commercial banks. The worse financial situation, which is quite obvious but also dangerous, pushed LG into debt. It must be noted that banks strongly compete on the common capital market and that spoils the market. There are a few reasons for this competition: first, banking laws regulating credit risk rates gives LG obligation good weight; second, according to the law, an LG unit can not go bankrupt; and third, in the last few years LGs were punctual in re-paying debt (contrary to other creditors 18). Last, but not least, after accession, a Polish LG can now contract their debt to foreign banks. This competition creates a strange situation where banks decide to lend money even without deep analysis of an LG’s budget or financial plans, and with almost preferential treatment. This must be defined as a short-sighted and “half baked” policy, especially if one looks at general financial problems and growing LGs overdue liabilities – – not against banks, but other creditors. 19 [Kopanska, Levitas 2004]

The next problem is highly politicized governing of local authorities, which is caused by the so called majority method of election. It is visible in the above correlation between debt and the election cycle. Also, bank representatives confirm that it is easier for them to deal with smaller – – usually less politicized – – municipalities where financial decisions are smoother and quicker [Kopanska 2001]. These tendencies were also seen on the bond market, but the effect is different.

3.2 Municipal bonds issued by local governments

The Polish law does not provide any separate regulations to address municipal bond issues. The provisions of the Bond Law dated June 29, 1995 deal with these issues, although only in a general way and some articles of that law specify matters related to local government bond issues (Art. 2.2 enumerates local government units – gminas, poviat, voivodships as well as joint municipalities and the capital city of Warsaw – – as potential issuers of municipal bonds). Several gminas, as well as poviat and voivodships have already taken advantage of the possibility to issue bonds. Smaller gminas account for a vast majority of all bond issues. Consequently, the size of most issues is relatively small (between PLN 2 million to PLN 5 million). (See Figures 5 and 6 below)

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**Figure 5**

Number of Municipal Bond Issued in years 1997 – 2004

![Graph showing number of municipal bond issues from 1997 to 2004.](image)

**Source:** Calculations on the basis of data from Fitch Ratings Poland

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18 In the first half of 2001, approximately 20 percent of all bank loans were officially classified as risky or risk debt because debtors had missed debt service payments. At the same time, however, only 0.01 percent of all local government debt had been so classified.

19 In 2001, 7% of gminas’ liabilities were overdue; the situation is worse in poviat (12.5%) and voivodships (10.5%)
As such issues are unlikely to be publicly traded, all previous bond issues were closed-ended (in accordance with Art. 9.1.2 of the Bond Law). Only two gminas (Ostrów Wielkopolski in 1997 and Rybnik in 2004) introduced its securities to public trade on the regulated off-stock exchange market (CETO). As a result, the vast majority of municipal bonds (small and private placement) have stayed within the portfolios of the banks that have organized and underwritten the issues. For example in 2001, banks held 72 percent of all bonds issued by gminas, 92 percent of those issued by poviat and 100 percent of those issued by voivodships. Most of the bonds that have been sold to outside investors have been from the larger issues of cities with poviat rights. Banks held 68 percent of the bonds; other domestic investors 20 percent, and 12 percent were bought by foreign investors. As a result, bonds in most cases were a special form of credit extended to local governments. As already mentioned above, the banks competed strongly on the municipal market and did their best to attract municipal customers. Banks did not disclose most issue-related costs (spread) to the public, but it is generally believed they offer even dumping prices. As a result, competition amongst banks spoiled the bond market in Poland, and that is also the reason why an LG used to expect special treatment from the banks and/or preferential prices.

It is also worth noting that bonds, contrary to banks credits, are understood as a modern method of borrowing. That is why usually the new issues are started during a pre-election period, and as is visible in Figure 5, in the years 1997 and 1998; 2001 and 2002 the increased of number of issues was the greatest.

### 3.3 Soft loans to local governments

In Poland there were no special loan funds for municipalities, but important “soft creditors” for Polish LGs were Environmental Funds. There were also other institutions that offered soft credits and loans to local governments, such as the Foundation for the Assistance to Water Supply in Rural Areas, the European Fund for Rural Development in Poland or international financial institutions (the World Bank, the European Bank for Reconstruction and Development and the Nordic Investment Bank).

Information obtained from commercial banks

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20 Only information about bond yield is available in sufficient detail; this is based on the return on 52–week treasury notes plus a margin of approx. 1%.

21 Figure 5 shows there are a general number of issues present on the market – not new issues.

22 In 2004, such special funds were created, but today they are not important on the market yet.
(acting as originators of loans from credit lines opened by these institutions) provides some insight into such loans. According to my surveys, the volume of loans extended directly by these institutions does not significantly influence the image of Poland’s municipal capital market [Kopanska 2001].

The existence of FOŚ, and their policy, could explain the overrepresentation of investment in municipal infrastructure in the 90s (see table below).

Table 7
LG capital expenditure by sector (%) in 1997 – 2001

<table>
<thead>
<tr>
<th>Year</th>
<th>Agriculture</th>
<th>Transport</th>
<th>Municipal economy</th>
<th>Housing</th>
<th>Education</th>
<th>Health</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>8.5</td>
<td>4.3</td>
<td>53.1</td>
<td>7.4</td>
<td>15.3</td>
<td>2.1</td>
<td>9.4</td>
</tr>
<tr>
<td>1998</td>
<td>6.9</td>
<td>4.6</td>
<td>53.8</td>
<td>7.4</td>
<td>15.1</td>
<td>2.2</td>
<td>10.0</td>
</tr>
<tr>
<td>1999</td>
<td>8.0</td>
<td>17.9</td>
<td>35.2</td>
<td>6.7</td>
<td>14.1</td>
<td>7.5</td>
<td>10.7</td>
</tr>
<tr>
<td>2000</td>
<td>6.6</td>
<td>22.8</td>
<td>31.7</td>
<td>5.7</td>
<td>14.8</td>
<td>7.5</td>
<td>10.8</td>
</tr>
<tr>
<td>2001</td>
<td>6.6</td>
<td>31.6</td>
<td>19.0</td>
<td>5.8</td>
<td>16.1</td>
<td>8.1</td>
<td>12.9</td>
</tr>
</tbody>
</table>

Source: RIO Report

These infrastructure projects were mostly environmental projects like sewage and water supplies, sewage treatment plants, etc. In the 90s, most of the gminas received a huge amount of grants and preferential loans for their projects. It must be noticed once more that preferential loans (and of course grants) were much more popular because they were understood to be acquired money and this had a good connotation in election terms. But it also exemplifies the next problem which influenced the common capital market in Poland during the period analyzed – namely, the lack of real financial and investment strategy, and even lack of understanding of the necessity of their creation. The realization of projects was not an outcome of the deep and real analysis of needs, but of accessible money. In the 90s, there was money from FOŚ. The politics of FOŚ started to be more strict and demanding in the 21st century 23, and LGs changed their orientation to roads and transport, partly financed by Phare and other EU grants 24. The preparation of an LG to consume grants from EU funds is another illustration of misunderstanding of the idea of strategic planning. Before 2002, only small portion of Polish LGs had strategy documents; today every unit has a strategy because it is needed for EU grant.

It is worth noting that the above problems are partly related to the fly-paper effect – “stick money where it hits.” But the problem with lack of knowledge of financial policy rules among LGs authorities seems to be the most important reason for bad use of debt and inefficient (badly planned) spending.

4. Conclusions

The analyzed decade of the common capital market in Poland was a period of growing use of debt instruments by LGs. The period 1994 – 2003 could be called the “infancy” of this market, but as I prove, we did see tendencies which are present on mature markets. The general data about level and sources of local debt in Poland show that deficits and debt were closely related with the election cycle. Polish politicians, like in other countries, used debt as a strategic instrument. But the reason and the effect of this “strategic use” is different than in old democracies and is related to concerns among local officials of running into debt. On one hand, this worry can be seen as a good element of local financial policy, but correlated with other problems which were described in this paper, could create be dangerous for the future of this market. These impediments are:

- Lack of knowledge about building long range financial and investment policy (also among banks which have too much trust in LG creditworthiness);
- Misunderstanding the basic rules of local finance (pay-as-you-go finance);
- Highly politicized governing of local authorities; and

23 Less grant, more loans but rarer promises of partial forgiveness of these loans, and also better collateral.
24 More important spending for transport after 99 might also be explained by changes in budget classification, but according to RIO, only partly. Finanse Komunalne 4/2001 p. 61
• Too competitive creditors.

The above impediments are partly present in every country, but most of them are related to immature democracy and capital market. And that is why the trends which describe developed markets should be carefully implemented in transition countries.

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1. Council of Ministers’ Ordinance dated July 19, 2000 on the amendment of the Ordinance on specific cases of exemption from restrictions on incurring financial liabilities by local government units and public finance entities other than the State Treasury.
Information for Contributors

The Occasional Papers are devoted to public administration and public policy issues based on empirical research carried out in Central and Eastern Europe.

Papers
Decisions about the publication of a manuscript are based on the recommendation of the main editor and an additional review process conducted by two appropriate specialists from a relevant field. The main editor and/or deputy editor selects these specialists. Submissions should not have been published previously and should not be under consideration for publication elsewhere. Papers presented at a professional conference qualify for consideration. The submission of manuscripts that have undergone substantial revision after having been presented at a professional meeting is encouraged.

Components of a Policy Paper

Presentation of the Issue
What is the problem that requires action?

Scope of the Problem
What is the history and current context of the issue? How did it become an issue? Who is affected and how severely?

Consultations
What are the views or positions of groups who will be significantly affected? What are the concerns of other ministries/agencies who will be affected?

Options for Consideration
What three or four distinct options should be considered? What are their implications? What are their advantages and disadvantages?

Additional Issues:
Consistency with the government’s priorities; the effectiveness of available options in addressing the issue; the economic cost-benefit; the effects on taxpayers; the impact on the private sector; environmental impacts; the fiscal impact on the government; the disproportionate impact on various groups or regions; the complexity and timing of implementation; public perception; and constraints raised by legal, trade, or jurisdictional issues.

Recommendation(s)
What is the proposed course of action? Why was it chosen over other possibilities?

Implementation Issues
What are the financial impacts of the proposed course of action? What are the implications for government operations? Will the proposal require regulatory or legislative changes? What is the proposed means of evaluation?

Communications Analysis
What is the current public environment? What are the key issues of contention, and how can they be addressed? What is the position of key stakeholders, both inside and outside the government, on the proposal, and what communication vehicles should be used for each? How does the proposal relate to government reform priorities? What is the objective of communication on this issue? What is the key message?

Structure of a Paper

Title
The title should be a brief phrase adequately describing the content of the paper.

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An abstract is a summary of the information in a document. The abstract should not exceed 250 words. It should be designed to clearly define the contents of the paper. The abstract should: (i) state the principal objectives and scope of the research; (ii) describe the methodology employed; (iii) summarise results and findings; and (iv) state the principal conclusions. References to literature, bibliographic information, figures or tables should not be included in the abstract.

Introduction
The introduction should supply sufficient background information on the topic and also provide the rationale for the present study. Suggested guidelines are as follows: (i) the introduction should first clearly present the nature and scope of the problem that was researched; (ii) it should provide an overview of the pertinent literature used; (iii) it should state the research methodology employed and, if necessary, the reasons for using a particular method; and (iv) the principal results of the investigation should be stated.

Results
This section should contain an overall description of the topic and present data gathered during the research project. The manuscript should utilise representative data rather than repetitive information. Data that will be referenced several times in the text should be provided in tables or graphs. All data, repetitive or otherwise, should be meaningful. Results must be clearly and simply stated as the section comprises innovative research findings for an international community of academics and practitioners.

Discussion
This section presents principles, relationships, and generalisations indicated by the researcher’s findings. This should not restate information present in the results section, but should: (i) point out any exceptions or lack of correlation; (ii) define unresolved issues; (iii) show how the results and interpretations agree (or contrast) with previously published work; (iv) discuss the theoretical implications of the work, and any possible practical applications; and (v) summarise the evidence for each conclusion. The primary purpose of the discussion section is to show the relationships among facts that have been observed during the course of research. The discussion section should end with a short summary or conclusion regarding the significance of the work.

Acknowledgements
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References
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