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INSTRUMENTS FOR MAINTAINING THE FINANCIAL STABILITY OF TERRITORIAL SELF-GOVERNMENT ENTITIES

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Summary: Considerations related to the stability of a financial system include the issue of public finance stability. However, such considerations are often characterised by the inconsistency of terminology, which results from the fact that the concept of public finance stability is used as a synonym of fiscal stability, and, in addition to that, the term is not defined. Undoubtedly, fiscal stability is assessed in the context of the debt limits and deficit levels of the public finance sector. A rapid increase in the indebtedness of territorial self-government entities (part of the total public debt) resulted, among others, from economic slowdown, which indicated that more attention should be given to the financial stability of local government entities. The paper is an attempt to discuss the concept of the financial stability of territorial self-government entities; it proposes a broader approach to the financial stability of territorial self-government entities, and it presents the effectiveness of selected instruments which affect financial stability in Poland.

Keywords: financial stability of territorial self-government entities, economic instruments, administrative instruments.

Streszczenie: Rozważania nad stabilnością systemu finansowego implikują kwestie związane ze stabilnością systemu finansów publicznych. Jednakże rozważaniom tym towarzyszy chaos terminologiczny wynikający z faktu, że pojęcie stabilności finansów publicznych jest zamiennie stosowane z pojęciem stabilności fiskalnej przy jednoczesnym braku jego zdefiniowania. Z pewnością można przyjąć, że stabilność fiskalną ocenia się w odniesieniu do limitów długu i deficytu sektora finansów publicznych. Wzrost zadłużenia jednostek samorządu terytorialnego będącego częścią długu publicznego wynikał m.in. ze spowolnienia gospodarczego i przyczynił się do położenia większego nacisku także na problem stabilności finansowej jednostek samorządu terytorialnego. Artykuł stanowi próbę odniesienia się do pojęcia stabilności finansowej jednostek samorządu terytorialnego, zawiera propozycję szersze-

go podejścia do tego pojęcia, jak też omawia skuteczność wybranych instrumentów mających wpływ na stabilność finansową w Polsce.

Słowa kluczowe: stabilność finansowa jednostek samorządu terytorialnego, instrumenty ekonomiczne, instrumenty administracyjne.

1. Introduction

The literature tackling the issue of financial stability has presented its various dimensions, showing different degrees of interest in this area. The issue aroused a much greater interest in the context of the 21st century global financial crisis. Moreover, the new environment sheds new light on the universal concept of financial stability referring to various financial institutions which, on an increasing scale, rely on the stability of a financial system – its macroeconomic national and global dimensions. The experience of a number of countries, including EU member states, indicates that the stability of a financial system is founded on the stability of public finance. This is defined as a government's ability to maintain, in the long run, the current level of expenditure, tax policies and related policies in a way which protects the state against the threat of insolvency and enables it to meet all financial obligations and cover approved expenditure [European Commission]. Moreover, as already stated, the stability of public finance is one of the conditions of long-term economic stability and the stability of a financial system. It is also treated as an instrument for achieving sustainable and sustained social and economic development [Wójtowicz 2019, p. 44]. The use of the concept of financial stability can be viewed as less transparent in light of the idea of fiscal stability – the term used by a number of authors. Fiscal stability is used as a synonym of the stability of public finance, and, in addition to that, fiscal stability is not defined in an unambiguous and commonly accepted manner [Wójtowicz 2019, p. 44]. In most general terms, fiscal stability can be assessed in the context of debt limits and deficit levels of the public finance sector [Malinowska-Misiąg 2017, p. 32]. Therefore, it can be stated that fiscal stability is a narrower concept – a component of financial stability. This interpretation is confirmed by the fact that the achievement of fiscal stability, understood as above, is difficult or impossible without the existence of the stability of public finance.

The economic slowdown in Poland in 2008-2009 caused by the global financial crisis, resulted in a rapid increase in local government debt, posing a threat to financial stability. This was reflected in a number of economic analyses and studies in the area of the fiscal stability of territorial government entities, not accompanied, however, by a clear definition of the fiscal stability of these entities. Difficulties in defining and interpreting this term can be justified and attributed to the specific character of local governments as components of the public finance system as well as to their legal and systemic status. This issue concerns, in particular, the asymmetry resulting from the

classification of public finance entities as those belonging to the central government subsector compared with those which are part of local government structures.

This problem can be best illustrated by the legal restrictions concerning the purpose of debt financing. Government debt usually finances current expenditure while local governments borrow funds to finance investment projects. This is one of the reasons for adopting a different approach to financial stability and, more precisely, maintaining this stability by the central and local government sector.

Debates over the understanding of public finance stability, including the financial stability of local government entities, were accompanied by the development of stability strengthening instruments. With regard to territorial government entities, such instruments were recommended by the legislator in the form of financial stabilising norms [The Act of 27 August 2009] including debt limits, budget balance regulations, and expenditure regulations.

In this context the paper aims to present the issue of the fiscal stability of territorial self-government entities and to analyse and assess the selected stabilising instruments.

2. The concept of the financial stability of territorial self-government entities

Interest in the problem of the stability of financial systems increases in periods of financial crises (see: [Crockett 1997]), but after the 21st century global financial crisis this issue is seen in its new dimension. The crisis not only disrupted the functioning of financial markets, but it also revealed its inefficiency reflected in the instability of the financial system including the public finance sector. Consequently, it can be assumed that a financial system is stable when it is not affected by crisis. However, a literature review indicates the lack of a uniform approach to the definition of the stability of a financial system, offered by various authors and institutions which influence and analyse the functioning of financial systems. Financial stability is a broad concept which is usually referred *a contrario* to the situation of financial instability [Chant et al. 2003]. Therefore, any proposed definitions should consider different aspects of finance. This is stressed by Houben, Kakes, and Schinasi, who also refer to the practical and operational aspects of financial stability. In general, it can be assumed that financial stability is a situation in a financial system which creates appropriate conditions for carrying out activities, managing risk and absorbing shocks [Houben et al. 2004]. The National Bank of Poland, in its annual publication, defines financial stability as a condition in which it performs its functions in a continuous and effective way, even in the case of unexpected and unfavourable large scale phenomena with a low probability of occurrence [NBP 2018]. Due to the financial crisis, financial stability became a component of state policies, and stability is regarded as a public good [Alińska, Wasiak 2014]. This results from the response of society which requires the state (government) to engage in crisis situations and take preventive

measures. This approach is also determined by the fact that financial system entities perform the role of institutions of public trust. Hence society's expectations with regard to state regulation (law making), supervision functions, and intervention in the activities of financial institutions and, in a broad sense, the financial sector.

Leaving aside the terminology of financial stability, one can take a closer look at the problem of public finance stability and the financial stability of local government entities. The starting point of the analysis is the reference to the concept of public finance stability, discussed by many authors and presented in the literature, and the reason for this is the fact that the local government system (sector) is one of its components. An in-depth analysis of public finance stability indicates that this term should be distinguished from maintaining fiscal sustainability. Consequently, public finance stability is considered from a narrow and broad perspective. In a narrow approach, public finance stability is often identified with fiscal sustainability, indicating the adoption of a sustainable fiscal policy aimed to maintain the budget deficit and public debt at lower levels than those required by the criteria set forth in the Treaty of Maastricht. On the other and, public finance stability understood in a broad sense indicates carrying out specific activities related to fiscal policies, budgetary discipline and the values and/or dynamics of public debt [Alińska 2016]. It should be noted that the 21st century global financial crisis increased the awareness of the need for measuring and controlling public finance stability, including the assessment of central and local government activities. The potential income – debt levels – and providing services are thus seen as the factors which not only characterise the system of public finance, but also perform the function of the measures of its stability at a local level (see: [Rodriguez-Bolivar et al. 2019]).

The above considerations lead to the conclusion that public finance stability is defined in various ways and, in addition to that, a new term came into use in the second half of the 20th century: "fiscal sustainability", which is also defined in many ways. These terms are used alternatively. K. Wójtowicz points out that one of the difficulties in interpreting this term relates to the Polish equivalent of *fiscal sustainability* [Wójtowicz 2019, p. 44].

Territorial government entities in Poland belong to the public finance sector and as such to the self-government sector/system. Despite the fact that they operate at local levels (communes [Pl. 'gmina'], cities with county ['powiat'] rights, country districts) and regional levels (voivodeships), it is not government bodies but local self-governments that satisfy the social needs of key significance to society and general development. Taking into account the aforementioned remarks on public finance stability it can be concluded that the financial stability of territorial self-government entities should be understood in the following way:

- firstly, an attempt to maintain the current level of budget deficit and local debt, or to lower this level (stability *sensu stricto*),
- secondly, activities aimed to maintain budgetary discipline/balance and safe local debt levels (stability *sensu largo*),

- thirdly, local governments' ability to perform their assigned functions – implementing and financing their own tasks, and to meet current, mid and long-term financial obligations, and, consequently, to ensure solvency.

Financial stability defined in this way is a broader concept which is not confined to formal (numerical) criteria, which integrates financial stability with income categories assigned to territorial self-government entities (the systems of financing) – some of them being transfers form the central budget – as well as with the scope of authority of local governments in performing public tasks, and local government debt limits.

3. The instruments for influencing the financial stability of the territorial self-government entities

The financial stability of territorial governments is ensured through various instruments which are employed in diversified conditions. Financial stability in such entities is dependent on a number of factors which can be generally classified as exogenic factors (e.g. economic growth, inflation) and endogenous factors inherent to the principles of managing public funds. Such principles are set forth in the regulations which govern this area of local government activities. Therefore, frequent and superficial changes in the legal and economic environment do not contribute to maintaining financial stability. In general, instability refers to the sources of providing funds for territorial government entities. Another challenge is posed by frequent changes in the scope of authority of local governments in performing public tasks, as well as the debt limits imposed on such entities. Nevertheless, Polish legal solutions offer a wide range of instruments for stabilising (protecting) local government finances. They include the following instruments [Owsiak 2017]: 1) systemic (the scope of the public finance sector including the local government sector, public debt dynamics and structure including local government debt, public finance transparency including local government finances); 2) legal (basic acts and others); 3) economic (caution and reform procedures, fiscal regulations, equilibrium maintaining instruments); 4) technical (classical and new budget planning methods, budget performance reports); 5) control (control and supervision bodies); 6) administrative (improvement programmes, central budget loans).

The issue of the financial stability of territorial self-government entities is part of the concept of the financial security of such entities – a component of public finance security. M. Redo, K. Wójtowicz and J.M. Ciak refer to the systems ensuring local government financial security based on the limited or increased autonomy of local government entities. Limited autonomy relies on legal and institutional regulations and instruments such as direct administrative control, centrally or locally imposed fiscal regulations, or cooperation systems. In the latter case, the lack of formal restrictions implies the adoption of a market discipline system [Redo et al. 2018, pp. 92-93]. Attention should be given to the significant differences between direct

administrative control and fiscal regulations. Usually, from the state's perspective, direct administrative control instruments indicate exercising direct control over macroeconomic and fiscal policies, while fiscal regulations are very effective in achieving specific objectives. From a local government's perspective, direct administrative control results in the total elimination of its decision-making authority in the area of the character and debt limits, while fiscal regulations create conditions for finding loopholes or stiffening budget policies.

In the context of the above differentiation of the types of financial stability of territorial government entities, and the confining of the subject of this paper to local debt, the instruments which ensure stability should be divided into two categories:

- economic instruments – fiscal regulations stabilising the indebtedness of territorial government entities;
- administrative instruments – improvement/recovery or caution programmes (including central budget loans).

4. The effectiveness of instruments affecting the financial stability of territorial self-government entities

The above considerations indicate that instruments affecting the financial stability of territorial self-government entities include economic instruments (fiscal regulations) and administrative instruments.

One of the fiscal regulations is the equilibrium of the current part of local government budgets, regulated by Art. 242 [The Act of 27 August 2009], referred to as the golden rule of finance, and implemented for the first time in the budgets approved for 2011. According to this rule, the unit of a territorial government may not approve a budget in which the planned current expenditure exceeds the planned current revenue increased by a budget surplus from previous years and free funds defined by the legislator in art. 217 section 2 point 6 [The Act of 27 August 2009]. This fiscal rule applies both to the planning and performance of the budget. There are two exemptions from this principle. At the budget approval stage the planned expenditure may exceed the planned current expenditure when financing is based on the surplus of previous years and free funds (defined by the Act in art. 217 section 2 points 5 and 6). At the budget performance stage, exemptions from the principle apply to a situation when current expenditure includes funds defined by the legislator (art. 5 section 3 – funds from the EU budget and non-refundable aid from EFTA member states).

The golden rule of finance causes much controversy in the subject literature. It should be noted that because of the adopted period of analysis the interpretation of art. 242 is based on the regulations in force up to 31 December 2018. According to the new wording effective as of 1 January 2019 [The Act of 14 December 2018], the body of a territorial government entity may not approve a budget in which planned current expenditure exceeds planned current revenue increased by those set

forth in art. 217 section 2 points 5,7 and 8 [The Act of 27 August 2009], excluding free funds (debt-related funds are not engaged in financing current expenditure). However, according to legal interpretations, it is still not possible to finance current expenditure from refundable funds. Budget deficits in territorial governments, covered by refundable funds, only apply to capital expenses. This implies that the legislator approves generating public debt in the case of capital expenses [Misiąg (ed.) 2019, pp. 793-794].

Table 1. The number of territorial self-government entities implementing the golden rule of finance in 2014-2018

Year	2014		2015		2016		2017		2018	
Result	Deficit	Surplus	Deficit	Surplus	Deficit	Surplus	Deficit	Surplus	Deficit	Surplus
Communes ['gmina']	47	2366	44	2368	13	2399	14	2399	13	2399
The capital city of Warsaw	–	1	–	1	–	1	–	1	–	1
Cities with county ['powiat'] rights	1	64	–	65	–	65	1	65	–	65
Counties ['powiat']	6	308	2	312	3	311	2	311	9	305
Voivodeships	1	15	–	16	–	16	–	16	–	16

Source: [Krajowa Rada Regionalnych Izb Obrachunkowych 2017, p. 267; Krajowa Rada Regionalnych Izb Obrachunkowych 2019, p. 289].

The effectiveness of the implemented principle is confirmed by the decrease in the number of entities which do not comply with it.

The second fiscal rule relates to the formal and legal cap on debt generation. Assessing the effectiveness of this solution, one should stress that two such caps were introduced in 2010-2013: a cap on the costs of debt servicing (principal plus interest could not exceed 15%), and debt limitations (liabilities to debt could not exceed 60% of revenue). The individual debt ratio was introduced in 2014, which allowed for determining safe debt levels (a mathematical formula). Art. 243 of the Act on Public Finance states that a territorial government entity cannot approve the budget if its performance leads to the following situation: in the budget year and in each subsequent year the value of liabilities along with servicing costs (debt repayments along with payable interest in a given year; redemption of securities along with payable interest and discount securities; potential repayments resulting from sureties and guarantees) to total budget revenue exceeds the arithmetic mean. The arithmetic mean indicates the mean value (calculated for the last three years) of

the relation between current revenues, increased by proceeds from the liquidation of assets and reduced by current expenditure, to total budget revenues [The Act of 27 August 2009]. The calculation of the individual debt ratio does not include amounts/debt for implementing programmes, projects and tasks co-financed by EU funds and EFTA aid programmes in periods not exceeding 90 days after completion of programmes, projects and tasks, and receipt of refunds. It should be stressed that debt levels in territorial self-government entities, including the relation referred to in art. 243, and debt financing methods, are the components of long-term financial forecasts. Debt forecasts apply to the periods of the actual and planned liabilities [The Act of 27 August 2009].

This interpretation of the ratio, legally binding in 2014-2018, received some criticism. It mainly referred to the short periods as the basis for determining the value of the ratio (the impact of business cycles and incidental financial events) as well as the inclusion of changeable values in determining the level of income. Moreover, this construction of the ratio does not allow for debt restructuring or repayment. The efforts aimed to change the ratio ultimately led to making amendments to the Act on Public Finance [The Act of 14 December 2018]. The amendments aim to rationalise the process of borrowing by offering repayment opportunities and introducing debt discipline measures (stricter debt supervision including the use of non-standard financial instruments).

The effectiveness of the individual debt ratio is presented in Tables 2 and 3. There is a decrease in the number of territorial government entities which do not achieve the individual debt ratio. The presented data points to the stabilisation of and a slight decrease in territorial government debt levels.

Table 2. The number of territorial self-government entities which do not comply with the recommendation of art. 243 in 2018-2021

Description	2018	2019*	2020*	2021*
Communes [‘gminas’]	20	9	9	9
Cities with county [‘powiat’] rights	0	0	0	0
Counties [‘powiats’]	5	5	6	5
Voivodeships	0	0	0	0

Note: the 2018 ratio is based on the performance of budgets in territorial governments in 2015-2017. In the remaining cases data comes from long-term financial forecasts for 2018-2021.*Forecast.

Source: [Rada Ministrów 2019, p. 34].

In 2018, 25 territorial self-government entities did not achieve the target of individual debt, accounting for 0.9% of the total number of entities. Starting from 2019, the number of non-complying entities is expected to decrease.

Table 3. The debt repayment rate, legally binding in preparing territorial government budgets in 2014-2019

Year	2014	2015	2016	2017	2018	2019*
Number of entities	2809	2809	2808	2808	2808	2807
Below 0.0%	9	11	8	8	6	2
0.0%-3.0%	128	69	65	63	46	50
3.0%-6.0%	779	640	525	544	532	591
6.0%-9.0%	990	1027	1031	1011	1021	1064
9.0%-12%	549	641	703	698	711	662
12%-15%	219	272	303	304	320	271
Above 15%	135	149	173	180	172	167

*2018 data affects individual repayment rates for 2019.

Source: author's research based on the National Council of Clearing Chambers.

According to the data presented in the above table, by 2018 the number of entities which could plan debt repayments at a level not exceeding 6% has decreased. In 2019 the number of entities which could plan repayments and a level not exceeding 6% and 9% increased, while in the other categories this number decreased. According to the regulations, the construction of the ratio based on the average values of the last three years gives consideration to the following data: 1) for the year preceding the budget year – the planned values presented in the performance report for three quarters, 2) for calculating relations for the previous two years – the actually achieved values presented in annual reports.

In relation to the above and in accordance with the recommendations, in order to avoid the deterioration in total combined maximum repayment limits, territorial entities should make efforts to achieve budget performance in which the annual rate, being a component of the average value, is at least at the same level as planned [Krajowa Rada Regionalnych Izb Obrachunkowych 2019, p. 290].

Pursuant to art. 240a [The Act of 27 August 2009], if a territorial self-government entity fails to approve a long-term financial forecast or budget (art. 242-244 – fiscal rules), or if the performance of public tasks is threatened, the college of the regional clearing chamber demands that the territorial self-government entity develop and approve a recovery programme within 45 days after receipt of the demand. The recovery programme may anticipate applying for a central budget loan, pursuant to art. 224 of the above Act.

Leaving aside the interpretation of recovery programme regulations, one should note that the regulation concerning the reasons for implementing recovery programmes are frequently criticised for their lack of transparency. A paradoxical threat to the

performance of territorial governments' tasks is posed by large investment projects and the resulting high debt levels, as well as educational outlays and decreased proceeds from the liquidation of assets [Najwyższa Izba Kontroli 2018].

It should be noted that in accordance with Polish regulations in force, a territorial self-government entity may not file for insolvency [The Act on Insolvency Law 2003]. There is a possibility of applying property foreclosure procedures, which does not prevent a local government from performing its public tasks.

In accordance with the current regulations [The Act of 27 August 2009], the State Treasury may extend interest-bearing loans to territorial entities under recovery and caution programmes, within the scope of the Budget Act, which does not imply that an entity implementing a recovery programme is obliged to apply for a central budget loan. In 2017, compared to 2010, receivables resulting from extended loans increased (Table 1). With regard to the type of entity, most borrowers are communes ['gminas']. Other borrowers include counties ['powiats'] (since 2010: Kłodzki, Poddębicki, Strzelecko-Drezdenecki, Tucholski, Łaski, Wałecki, Kamieński, Świebodziński, Gorzowski), and the Mazowsze voivodeship (since 2014).

Table 4. Receivables resulting from central budget loans extended to territorial self-government entities in 2010-2017 (PLN millions)

Year	2010	2011	2012	2013	2014	2015	2016	2017
Amount	32.3	53.3	69.9	123.8	399.8	421.5	551.1	495.4

Source: Budget performance reports for particular years.

The effectiveness of the recovery programmes implemented by territorial self-governments was analysed by the Superior Chamber of Control (NIK) [*Skuteczność programów naprawczych jednostek samorządu terytorialnego* 2018]. In 2012-2017 the number of entities implementing such programmes increased six-fold from 10 to 60. In 2012-2016, territorial entities received central budget loans to the amount of PLN 298.1m, and recovery programmes comprised 2% of entities. NIK inspections covered 14 entities implementing 15 recovery programmes, and three of them were granted central budget loans to the amount of PLN 26.6m. The results of the NIK controls point to the high effectiveness of most recovery activities – up to 12 programmes, accounting for 80% of the inspected entities. A major problem was the reliability of the programmes - 40%, and 6 out of the 15 inspected programmes. A programme is regarded to be reliable when it includes the provisions set forth by the legislator [art. 240a section 3 of the Act of 27 August 2019].

K. Kluza believes that the above recovery and caution programme regulations, from the perspective of the financing institutions, considerably mitigated the risks involved in financing territorial self-government entities. Such risks are also reduced by banks' moderate capital requirements with regard to receivables from

local governments (20%). This implies that local governments are regarded to be very reliable debtors. Moreover, excessive debt levels are prevented by relevant restrictions on external financing as well as by debt limits [Kluza 2019, pp. 33-34].

5. Conclusion

Literature reviews lead to the conclusion that scientific disputes over the concept of financial stability are likely to continue in the future, yet there is a number of instruments which contribute to maintaining financial stability. Such instruments also ensure the security of public finance. Clearly, the terms "the security of public finance" and "stability" are correlated, but there is no doubt that one of the main indications of a threat to the security of public finance is persistent fiscal disequilibrium [Redo et al. 2018, pp. 21-22].

The classifications proposed by the authors are not uniform. For example, the presented classification distinguishes economic and administrative instruments; both categories are regulated (the Act on Public Finance).

The analysed instruments which affect the financial stability of territorial self-government entities perform their functions, apart from a number of deficiencies referred to in the literature. If a territorial entity faces financial problems which may pose a threat to performing public tasks, they result from non-compliance with the requirements set forth in art. 242-243 [The Act of 27 August 2019], and this, in turn, leads to implementing recovery programmes. The framework of the financial system of territorial governments aimed to ensure stability has been additionally supported by amendments to the Act on Public Finance [The Act of 14 December 2018]. The approved changes are designed to rationalise the debt generation processes, increase the flexibility of financial management and strengthen the legal mechanisms aimed to increase financial security [Misiąg (ed.) 2019, p. 806].

The last global financial crisis has aroused increased interest in the problem of financial stability as well as fiscal rules and their effectiveness [see: Franek, Postuła 2019]. Among the regulations which recommend institutional solutions for creating the framework of fiscal policies, it is the fiscal rules that perform the function of structuring, integrating and stabilising public finance [Próchnicki 2013, p. 29]. Undertaking the analyses of their effectiveness – a positive impact on public (local) finance, is a real challenge for researchers.

Another issue related to creating conditions for financial stability, only touched upon in this paper, is the problem of the stability of revenue in territorial self-government entities. The observed changes, for example those related to taxation, are introduced for other reasons (stimulating the economy, correcting income distribution in society), and they do not give sufficient attention to income-related implications for territorial government entities [Unia Metropolii Polskich 2019]. Undoubtedly, this issue requires further research.

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