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## Additional restrictions of the debt of local self-government with state public debt growing : methods and grounds for restrictions

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**ADDITIONAL RESTRICTIONS OF THE DEBT OF LOCAL SELF-  
-GOVERNMENT WITH STATE PUBLIC DEBT GROWING.  
METHODS AND GROUNDS FOR RESTRICTIONS**

**Introduction**

The right to cover a part of their expenditure and outgoings with funds from various forms of public lending is a significant aspect of the financial independence of local self-government units (LSUs). These sources of funding (jointly referred to as repayable revenue) are available in the local self-government economy thanks to the state ensuring that they can take advantage of the instruments of the financial market and are in line with the provisions of the European Charter of Local Self-Government<sup>1</sup>.

The financing of local self-government activities from repayable sources has many advantages. However, it requires responsibility from local authorities, as excessive borrowing activity by LSUs contributes to i.e. increased intervention of public entities in the economy, expansion of the public finance sector (PFS) beyond its optimal volume, negative results of the sector, growing public debt, and restricted access to or worse terms of borrowing by private entities. Since excessive LSU debt<sup>2</sup> may have negative effects on public finance, state

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<sup>1</sup> European Charter of Local Self-Government drafted at Strasbourg on 15 October 1985, Journal of Laws Dz.U. 1994, No. 124, item 607 as amended, Art. 9 (8).

<sup>2</sup> Debt is commonly considered excessive if it exceeds 60 per cent of the actual income. There is no convincing evidence to show that beyond this percentage the financial standing of an LSU deteriorates. In practice, solvency may be jeopardised even with a lower debt-to-income ratio.

bodies allow LSUs to use repayable revenue while controlling their borrowing activity<sup>3</sup>.

The aim of this work is to present the actually used ways of limiting the debt of local self-governments and to try and answer the question of whether the scale of LSU debt in Poland is a sufficient ground for introducing into the Polish law new restrictions concerning self-government debt. By the scale of debt I mean the following: the amount of debt, its dynamics, purpose (type of expenditure financed with loans) and the relationship of the debt, including the expenses involved in its payment and service, to an LSU's budget income. The discussed empirical data illustrating the scale of self-government debt concern the period 2004–2010.

### **1. The reasons for and ways of limiting the amount of self-government debt in EU Member States**

Excessive budget deficit and debt of local self-government is dangerous from the perspective of LSUs and the state as a whole, therefore many states introduce either prohibitions against LSUs incurring liabilities or various restrictions on the ways in which they can borrow. Some authors, including myself, regard these restrictions as ways of reducing the financial independence of local self-government, which is why they have to be developed with caution and in liaison with those involved, i.e. LSUs. They should not be introduced provisionally: they ought to be characterised by certain stability, as only then self-government bodies will be able to conform to them and reflect their consequences in their budget policies.

State bodies introduce various restrictions (rules, limits) concerning local self-government debt, aimed at strengthening the financial discipline in a given LSU and, what follows, at strengthening fiscal discipline in the public sector finance as a whole<sup>4</sup>. A stronger discipline within an LSU is beneficial as far as the current needs of the residents are concerned – it reduces the amount of idle, from the point of view of the local community, budget expenditure for the ser-

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<sup>3</sup> L. Liu, M. Waibel, *Managing Subnational Credit and Default Risks*, The World Bank, "Policy Research Working Paper" 2010, Vol. 5362, p. 2.

<sup>4</sup> In the EU nomenclature – the *general government* sector (including both government and self-government).

vice of debt<sup>5</sup>. This strengthening is also reflected in an improved financial standing of the public finance sector (by reducing public spending, deficit, and public debt), which is important from the perspective of the observance of the Stability and Growth Pact, adopted together with the Maastricht Treaty. The introduction of the restrictions was also a political move: if local self-government is to be treated as a major public entity, it should also take on some of the responsibility for the situation of the public finance sector. What is also of importance here is that in the face of the public finance crisis, many governments are obliged to show the European Commission what they do to meet the convergence criteria.

Restrictions concerning various budgetary values are internationally referred to as fiscal rules. A fiscal rule means a permanent (or at least long-term) restriction on budget policy expressed in indicators characterising the situation of the public finance sector<sup>6</sup>. It has the form of an easy-to-apply numerical restriction of budgetary aggregates (income, expenditure, deficit, debt). This definition includes certain features of a fiscal rule: it specifies a quantitative (numerical) level of an aggregate, which needs to be achieved in a longer period of time in consequence of pursuing a specific fiscal policy. A rule needs to be clear, easy to put into practice, simple to explain to the public and it should be easy to monitor if it is observed and how effective it is<sup>7</sup>. Different kinds of limits (rules, restrictions), once turned into legal regulations, may be treated as instruments of control (*ex ante* and *ex post*) of public finance sector entities by state bodies.

In practice, there are various types of fiscal rules (see Table 1); here I address selected ones. Fiscal rules may have an international, national and local character. National rules can be introduced independently from solutions adopted by other states or to conform to international rules. The same applies to local rules. Rules may concern various budgetary values, both aggregated (e.g.

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<sup>5</sup> S. Owsiak, *Stabilność systemu zasilania finansowego a nowatorskie zarządzanie podmiotami publicznymi w warunkach kryzysu* [Stability of the financial support system and innovative public entity management in the face of crisis], in: *Nowe zarządzanie finansami publicznymi w warunkach kryzysu*, ed. Owsiak, S., PWE, Warsaw 2011, p. 27.

<sup>6</sup> G. Kopits, S. Symansky, *Fiscal Policy Rules*, International Monetary Fund, "Occasional Paper" 1998, No. 162, as quoted in: Braun, Tommasi, *Fiscal Rules For Subnational Governments. Some Organizing Principles and Latin American Experiences*, p. 2, [http://www.aep.org.ar/anales/works/works2002/braun\\_tommasi.pdf](http://www.aep.org.ar/anales/works/works2002/braun_tommasi.pdf) (2010–05–21).

<sup>7</sup> *Fiscal Rules – Anchoring Expectations for Sustainable Public Finances*, International Monetary Fund, December 2009, p. 4.

total expenditure) and individual groups or types of values (e.g. state budget expenditure on indemnities guarantees). Taking into account the entities concerned, we distinguish rules set out by state government concerning the budget of the state, local self-government units, social insurance funds and other entities/funds of the public finance sector. By definition, a rule should be applied in the long term; however, there are also rules introduced provisionally. The rules on local self-government debt, planned to be introduced in 2012, were supposed to be provisional.

Table 1

## Types of fiscal rules

Distinguishing criterion	Type of rule
territory of application	international rules state (national) rules local (self-government) rules
entities concerned	public finance sector state (concerning the budget policy pursued by state bodies) self-government public finance sub-sector only local-self government units other public finance sector entities, in particular the social insurance sub-sector
scope of application	universal (systemic) local/regional (non-systemic)
object of regulation	expenditure income budget financial result (deficit) debt
quantitative rule specification	minimal value maximal value
time of application	permanent (but verified and modified periodically) temporary (provisional)

Source: author's own work.

Recent years have seen an increase in the number of fiscal rules in operation. According to research conducted by the European Commission, in 1990–2008 the number of rules effective in EU Member States grew by 51 (from 16 to 67). Most states introduced more than one fiscal rule. According to the data for 2008, only three governments (those of Malta, Cyprus, and Greece) did not introduce any. Most commonly, the rules concern budget balance – in 2008 this

type of rules was in effect in 26 states. Debt rules were used in 18 states and expenditure rules in 17. Few governments decided to introduce income rules (only 6)<sup>8</sup>. In Table 2, I characterise the most frequent fiscal rules.

Table 2

Fiscal rules in European Union Member States<sup>a</sup>

Name	Contents (construction)				
budget balance rule	the golden rule of budget balance (5)	budget balance rule (10)	admissible deficit expressed in nominal terms <sup>b</sup> (7)	admissible deficit as a percentage of the GDP (1)	limit on structural deficit (3)
debt rule	limit on debt in nominal terms (5)	limit on debt in relation to the GDP (3)	limit on debt in relation to the possibility of its service (8)	other (2)	–
expenditure rule	limit on expenditure in nominal terms (5)	limit on expenditure in real terms (2)	specification of a nominal growth rate for budgetary expenditure (4)	specification of an actual growth rate for budgetary expenditure (3)	other (3)
income rule	specification of an admissible level of tax encumbrances in relations to the GDP (0)	rule concerning changing basic rates (1)	specification of the possibility and amount of allocation of any unplanned income (4)	other (1)	–

<sup>a</sup> The number in parentheses is the number of EU states enforcing a rule.

<sup>b</sup> In Poland, this type of rule is informally referred to as the budget anchor rule.

Source: own study based on: *Public Finance in EMU*, op. cit., p. 90.

At least some of the rules in Table 2 require a brief commentary. The construction of rules varies strongly from state to state. All of them may apply to the finance of various entities of the public finance sector, but most frequently they regulate the budget of the state or local self-governments. The budget balance rule and the golden fiscal rule are considered to be the oldest and the most

<sup>8</sup> *Public Finance in EMU*, European Commission, European Economy 2009, Vol. 5, p. 87–89.

common rules used to regulate the budget policy of a state<sup>9</sup>. Both are applied to enforce the observance of budget discipline. Under the budget balance rule, the entity concerned has to keep budgetary income and expenditure equal. The golden balance rule requires that current income be used to finance current expenditure; property expenditure should be financed from public loans. This indirectly amounts to a prohibition against incurring debt for current expenditure. Thus, budget balance rules are connected with debt rules<sup>10</sup>. The practical implications of budget balance rules are so important that they are counted among the so-called budget rules, which contain instructions on the desired features of a budget system. At present, both rules are applied more frequently to regulate the budget of local self-governments than state budgets<sup>11</sup>.

In Poland, the budget balance rule has applied to the budget of the State and local self-governments since 1999, but only under specified circumstances<sup>12</sup>: whenever the State public debt reaches the level of 60 per cent the GDP<sup>13</sup>. The golden rule of budget balance (the current balance rule) has had to be observed in the planning and execution of the budget of all the local self-government units since 2011 (a more detailed discussion of this issue is offered below). The law-makers provided for exceptions to the application of the two rules: they may be avoided in extraordinary circumstances related to expenditure, income or the external situation.

As I mentioned above, balance rules are linked to rules concerning admissible debt, which usually apply to gross debt. However, a rule may also concern net debt (gross debt minus financial assets of an entity). They are or may be applied separately from the debt of the State Treasury debt or other public finance sector entities, including local-self government<sup>14</sup>. Most commonly, public debt is limited by legal provisions specifying the following:

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<sup>9</sup> See more: P.M. Gaudemet, J. Molinier, *Finanse publiczne [Public Finance]*, PWE, Warsaw 2000, p. 180–181.

<sup>10</sup> From here on I consider budget balance rules as an indirect way of reducing the local self-government debt.

<sup>11</sup> *Public Finance in EMU*, op. cit., p. 89.

<sup>12</sup> In a sense, the balance rule applies also to the annual budget of the mentioned entities. It is manifested in the obligation to specify the sources of assets to finance planned deficit or the ways of disposing of any surplus in a Budget Act or a budget resolution. In this way, bodies preparing and enacting a budget are supposed to achieve balance *ex post*.

<sup>13</sup> The Public Finance Act of 27 August 2009, Journal of Laws Dz.U. No. 157, item 1240 as amended, Art. 86, 88. The rule was also included in previous Public Finance Acts of 1998 and 2005.

<sup>14</sup> K. Marchewka-Bartkowiak, *Reguły fiskalne [Fiscal Rules]*, Analizy BAS 2010, Vol. 7 (32) p. 5.

- a) admissible debt in relation to the capacity for the service of the debt,
- b) maximal amount of debt in nominal terms,
- c) the limit of debt in relation to the GDP.

## 2. Ways of reducing the debt of local self-government in Poland

State authorities are reducing self-government debt<sup>15</sup> directly and indirectly. Among the direct limits are two quantitative rules: the first concerns the total amount of self-government debt at the end of each quarter and financial year and the other sets a limit on the total amount of payments involved in the payment and service of debt. Both will be effective by the end of 2013. As of 2014, self-government debt will be reduced in another way: by calculating an indicator referring, generally speaking, to any operational surplus produced by a local self-government unit. Apart from quantitative rules, the State also imposes qualitative ones<sup>16</sup>, regulating the purposes for which liabilities are incurred and the conditions to be met by repayable instruments of financing the operations of local self-government<sup>17</sup>. The nature of all discussed restrictions is microeconomic, i.e. they concern only the budget of a given local self-government unit. However, the Polish law also includes a macroeconomic restriction: the amount of debt (and deficit) of local self-government units depends on the relation of the State public debt, which local self-government debt is a part of, to the GDP.

The direct restrictions, both micro- and macroeconomic, in operation now or in the future, have been widely discussed in the literature of the subject, therefore I only briefly characterise the indirect ways of limiting self-government debt. This category of rules includes the obligation to maintain bal-

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<sup>15</sup> Without elaborating on terminological differences, self-government debt is considered here as a synonym for the debt of local self-government entities.

<sup>16</sup> In the light of the definition of a fiscal rule, there are no grounds for distinguishing qualitative rules. The restrictions in effect in Poland on self-government units incurring liabilities, but concerning the currency of debt, the conversion of interest into principal, discount rate, or the information duties of self-government units cannot be called fiscal rules. They are supplementary restrictions accompanying fiscal rules.

<sup>17</sup> J. Przybylska, S. Kańduła, *Wpływ nowej konstrukcji wskaźnika zadłużenia na możliwości zaciągania zobowiązań przez jednostki samorządu terytorialnego (na przykładzie gmin wchodzących w skład powiatu poznańskiego)*, in: *Dylematy i wyzwania finansów publicznych [The effect of the new debt index construction on a local self-government unit's possibilities of incurring liabilities (example of communes in the Poznań County)]*, ed. T. Juja, the Research Bulletin of the Poznań University of Economics No. 141, Poznań 2010, p. 349.



ance in the current part of a self-government budget; consolidation of debt in the self-government sub-sector of the public finance sector; the new catalogue of types of debt that may be deemed state public debt, effective as of 2011; and restriction on the admissible amount of deficit in a self-government budget, currently under discussion.

*The obligation of (at least) maintaining a balance between current income and expenditure* in a planned and executed budget is a new indirect instrument for the state to control the volume of self-government debt, effective as of 2011. The legislators provided for exceptions for the current balance rule, related to any cumulated budgetary surplus from previous years or any disposable funds coming from the settlement of liabilities. Moreover, as regards the execution of a budget, current imbalance is allowed on condition that current deficit does not exceed current income minus the surplus, disposable funds, and any amounts involved in current expenditure co-financed from the so-called European funds (referred to in Art. 5 (3) of the Public Finance Act), where the funds were not transferred to the entity concerned in the current budget year<sup>18</sup>.

This rule aims at securing funds for current expenditures (part of which is recurrent) from incomes of the same nature. The rule is to make it impossible to cover current expenditures from incidental incomes (including funds acquired from property sale) and to limit (eliminate?) financing the expenditures from repayable incomes. According to some authors, this rule, when implemented, makes it impossible to incur liabilities in order to cover the loss of financial liquidity of a budget<sup>19</sup>, which however, in my opinion, violates the 2009 Public Finance Act which states that such liabilities can be incurred in order to cover temporary budget deficit of LSUs in a given year<sup>20</sup>. Some local government units had to take strong measures to increase current incomes or decrease current expenditures while planning the 2011 budget. Such *tightening the belt* will probably continue in the next years.

*Dept consolidation in local self-government subsector* means that from 2011 on, while determining acceptable level of LSU debt, payments on account of debt servicing should include liabilities of an association formed by a given

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<sup>18</sup> The Public Finance Act of 27<sup>th</sup> August 2009, op. cit., Art. 242.

<sup>19</sup> U. Wiktorowska, *Budżet jednostki samorządu terytorialnego*, in: *Nowa ustawa o finansach publicznych. Poradnik dla samorządów [A budget of a local self-government unit, in: New Public Finance Act. Guide for self-government officials]*. R. Drozdowski, M. Józwiak, U. Wiktorowska, P. Walczak, Muncypium Publishing House, Warsaw 2009, p. 126.

<sup>20</sup> The Public Finance Act of 27<sup>th</sup> August 2009, op. cit., Art. 89.

LSU which have to be repaid in a given fiscal year<sup>21</sup>. Including these liabilities in LSU debt aims at showing all (real and prospective) payments to be repaid by a given LSU. Such solution is debatable<sup>22</sup> but it should be born in mind that in case of any difficulties with repayment of liabilities by an association, the liabilities would be transferred to LSUs that form it anyway<sup>23</sup>.

*Types of debt.* Liabilities included in the public debt can be incurred with respect to the following<sup>24</sup>: 1) issued debt securities; 2) credits and loans taken out; 3) accepted deposits; 4) due liabilities: a) that result from separate acts and legally binding court decisions or final administrative decisions, b) deemed undisputable by a relevant unit of the public finance sector that is a debtor. From 2011 on liabilities arising on account of credits and loans also include any liabilities arising from agreements whose financial consequences make them similar to loan agreements, as well as any liabilities arising from issuing securities with limited transferability. Introduction of a new classification of debts enabled the finance minister to broaden the scope of local self-government's debt<sup>25</sup>. Local self-government officials claim that the new classification of debts

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<sup>21</sup> The Public Finance Act of 27<sup>th</sup> August 2009, op. cit., Art. 244; R. Trykozko, *Ustawa o finansach publicznych. Komentarz dla jednostek samorządu terytorialnego* [Public Finance Act. Commentary for local self-government units], TAXPRESS Publishing House, Warsaw 2010, p. 441.

<sup>22</sup> S. Kańduła, J. Urbaniak, *Zadłużenie jednostek samorządu terytorialnego w perspektywie zmian ustawowych (przypadek Łodzi)*, in: *Zarządzanie finansami w jednostkach samorządu terytorialnego* [Debt of local self-government units with respect to amendments of relevant bills (the case of Łódź)], in: *Finance management in local self-government units*, ed. E. Urbańczyk, Studies and Proceedings of Polish Association for Knowledge Management No. 30, Bydgoszcz 2010, p. 128; M. Bitner, *Wybrane problemy związane z definicją długu publicznego jednostek samorządu terytorialnego* [Selected problems related to the definition of a public debt of local self-government units], "Samorząd Terytorialny" 2010, No. 11, p. 15–16.

<sup>23</sup> J. Przybylska, S. Kańduła, *Wpływ nowej konstrukcji wskaźnika zadłużenia na możliwości zaciągania zobowiązań przez jednostki samorządu terytorialnego (na przykładzie gmin wchodzących w skład powiatu poznańskiego)* [Influence of a new construction of debt ratio on possibilities of incurring liabilities by local self-government units (the case of communes from Poznań county)], op. cit., p. 354.

<sup>24</sup> Public Finance Act of 27<sup>th</sup> August 2009, op. cit., Art. 72 and 73.

<sup>25</sup> Regulation of the Minister of Finance of 23<sup>rd</sup> December 2010 on a detailed classification of types of debts constituting a part of the national public debt, including the State Treasury debt, Journal of Laws No. 252, item 1692. More detailed evaluation of this regulation: *Jesteśmy za słabi, bo podzieleni* [We are too weak because we are not united], conversation of J. Król with R. Grobelny, the President of Poznań and the President of the Association of Polish Cities, „Wspólnota” No. 13/1019 of 26<sup>th</sup> March 2011, p. 10.

limits their financial independence and was introduced in breach of the legal order<sup>26</sup>.

In 2011 the finance minister suggested a new additional way of influencing debt of LSUs. This tool was to *limit the level of LSUs' budget deficit at the end of a year*. It has been suggested that from 2012 on the budget deficit of LSUs should be related to the incomes of a given LSU. In 2012 deficit was to exceed the incomes not more than by 4% of it (probably the actual incomes). Such relation was to be decreased by 1 percentage point per year in order to reach 1% of incomes in 2015. The government also stated that implementation of this rule would be accompanied by changes in task and income system of LSUs that could help local self-government units reach the assumed relation between their incomes and deficit<sup>27</sup>. It has also been suggested that from 2012 on LSU debt could not exceed that of a year 2009<sup>28</sup>. Both suggestions are convergent with the rules applied in other EU countries. Nevertheless, local self-governments protested strongly against them. As a result of talks between the finance minister and local self-governments both proposals have been abandoned<sup>29</sup>.

### 3. Debt of local self-government units in Poland

In order to decide whether implementing additional limits on deficit and debt of LSUs is justified, financial situation of the said entities should be analysed. Table 3 presents data illustrating the financial standing of local self-government units after 2003. In the analysed years the total incomes of the LSUs increased (as far as their nominal value is concerned). A substantial growth of LSUs' incomes was noted in the years 2005–2007 when they rose by over 12%. At that time positive effects of changes in the system of financing LSUs that were introduced in 2004 could be seen. The effects were additionally consolidated by the fast economic growth. In 2009 total LSUs' incomes were

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<sup>26</sup> More: M. Mitreğa, *Samorządowe finanse – bariera czy dźwignia rozwoju?* [*Self-government finance – a barrier or development impulse?*], “Europejski Doradca Samorządowy” 2011, No. 2 (17), p. 44.

<sup>27</sup> We do not know what changes are considered by the government. Suggestions of local self-government can be found in expert press: M. Szczubiał, *Zeznawać czy milczeć?* [*To testify or to remain silent?*], “Wspólnota” No. 7/1013 of 12<sup>th</sup> February 2011, p. 12.

<sup>28</sup> *Samorzady muszą zacisnąć pasa* [*Self-governments must tighten the belt*], article, ed. “Wspólnota” No. 5 of 29<sup>th</sup> January 2011, p. 55.

<sup>29</sup> A. Cieślak-Wróblewska, *Samorzady wygrały starcie z ministrem finansów* [*Self-governments won the battle with the finance minister*], “Rzeczpospolita” daily of 26<sup>th</sup> May 2011.

higher by 8.6% than in the previous year, but it was observed that for the first time the share of own incomes in total incomes decreased (by 3.9% on average)<sup>30</sup>.

In 2010 this disadvantageous tendency was reversed – own incomes in all LSUs went up by 4.3%. However, the decrease of their percentage share in provinces continued (by 10% in relation to 2009). The LSUs sector incomes constitute about 15% of consolidated incomes of public finance sector and about 11% of the GDP.

Table 3

Incomes, expenditures and budget results of local self-government units between 2004 and 2010 (in million of PLN and in relation to the GDP)

List	2004	2005	2006	2007	2008	2009	2010
incomes	91.504	102.912	117.040	131.380	142.569	154.842	162.797
incomes in relation to the GDP	10,5	11,0	11,2	11,2	11,5	11,5	10,5
expenditures	91.388	103.807	120.039	129.120	145.184	167.829	177.766
expenditures in relation to the GDP	10,6	11,3	11,0	11,4	12,5	12,6	10,6
budget results	116	-895	-2.999	2.260	-2.615	-12.987	-14.969
budget results in relation to LSU incomes	0,13	-0,87	-2,56	1,72	-1,83	-8,39	-9,19
budget results in relation to the GDP	0,01	-0,09	-0,28	0,19	-0,21	-0,97	-1,06

Source: author's own work based on *Informacja o wykonaniu budżetów jednostek samorządu terytorialnego* [Information on the execution of budgets of local self-government units] for specific years, <http://www.mf.gov.pl> (DOA 15.04.2011).

In recent years the share of LSUs' expenditures in the public finance sector expenditures has amounted to about 24% (after consolidation)<sup>31</sup>. LSUs' expen-

<sup>30</sup> In 2009 own revenues in communes were lower by 2.2%, in counties by 3.0%, in towns and cities with county rights by 3.2%, and in provinces by 14.8% (*Informacja o wykonaniu budżetów jednostek samorządu terytorialnego w 2009 r.*, [Information on the execution of budgets of local self-government units in 2009], the Council of Ministers, Warsaw 2010, <http://www.mf.gov.pl> (DOA 1.04.2011).

ditures constitute a bigger and bigger part of the GDP. Therefore these units are more and more vulnerable to so called external negative shocks related to financial and economic crises<sup>32</sup>. In the years 2004–2010 budget expenditures of LSUs rose by 94.6% mainly because of the inflow of the EU subsidies. This translated into investment expenditures (Table 1) which constituted 1/5 of total LSUs' expenditures in the last five years. The increase in investment expenditures was first caused by a good economic situation and an increase in budget incomes. Later investment expenditures were boosted by money from the EU funds and by assistance received from the EFTA states<sup>33</sup>. The necessity to gather own investment contribution as well as means for pre-financing affects demand of LSUs for money, which in turn increases the debt of LSUs.

Only 2004 and 2007 saw a positive total LSUs' budget balance. LSUs' budget deficit usually did not exceed 4% of the incomes of the said units. 2009–2010 reports showed exceptionally high deficit caused by a faster increase in budget expenditures than in budget incomes and by a decrease in total actual incomes that had been planned, and – in the case of provinces – also in their own incomes. In 2010 implementing budgets of LSUs resulted in a deficit of 15 billion PLN. For the first time the deficit of LSUs exceeded 9% of actual incomes of LSUs and 1% of the GDP. The lack of balance in budgets of LSUs affects imbalance of the whole PFS. Nevertheless, LSUs are far less responsible for the growing deficit than the government. In 2010 for example the deficit of state and local governmental institutions totalled 111.2 billion PLN (7.9% of the GDP) with the deficit of central institutions reaching 83.9 billion PLN (5.9% of the GDP), self-government institutions – 16,1 billion PLN (1.1% of the GDP) and social insurance funds – 11.2 billion PLN (0.8% of the GDP)<sup>34</sup>. LSUs 'are responsible' for about 14.5% of the deficit of the said sector.

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<sup>31</sup> The data given on the basis of the analysis of *Reports on the execution of the state budget in 2002–2009*, published on the official web sites of the Ministry of Finance.

<sup>32</sup> B. Guziejewska, *Finanse publiczne wobec wyzwań globalizacji* [Public finance and the challenges of globalisation], Poltext, Warsaw 2010, p. 132.

<sup>33</sup> S. Owsiak, *Polityka finansowa państwa w warunkach kryzysu gospodarczego z perspektywy samorządu terytorialnego w Polsce*, in: *Samorząd terytorialny w zintegrowanej Europie* [State finance policy during the economic crisis from the point of view of local self-governments in Poland], ed. B. Filipiak, A. Szewczuk, the Research Bulletin of the University of Szczecin No. 526, Economic problems of services No. 29, Szczecin 2009, p. 15–16.

<sup>34</sup> *Information on the deficit and debt of the governmental and self-governmental institutions in 2010*, <http://www.stat.gov.pl> (DOA 26.04.2011).

In the analysed years the debt of LSUs kept growing (Table 4), but between 2004 and 2008 the dynamics of the debt increase was moderate. The debt amounted to about 20% of the total incomes of LSUs and about 2% of the GDP. A significant growth of debt in these units happened in 2009 when it rose by 40% compared with the previous year. In 2010 debt dynamics slowed down a bit (increase of 36.7%). However, it is difficult to say whether this tendency will continue in the future. The relation between the debt of LSUs and their incomes has this year reached an unprecedented level of 33.8%,

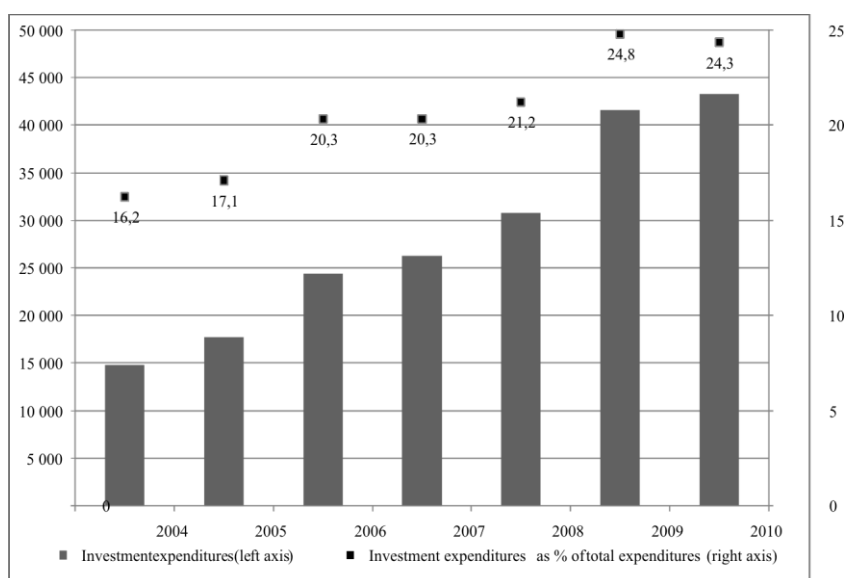


Chart 1. Investment expenditures of LSUs in 2004–2010 (in billion PLN and in relation to total expenditures)

Source: author's own work based on *Sprawozdania z wykonania budżetu państwa oraz budżetów jednostek samorządu terytorialnego* [Reports on the execution of the national budget and budgets of local self-government units] accessed via: <http://www.mf.gov.pl> (DOA 15.04.2011).

and the debt has amounted to almost 4% of the GDP. Yet, the debt of LSUs is much smaller than their share in financing public spending (in 2010 expenditures of LSUs totalled 12.6% of the GDP).

Debt is a common phenomenon that occurs on every level of local self-government but not in all units of it. Communes and towns with county rights incur debts most frequently. In recent years towns with county rights incurred 43% of total debt of LSUs, communes – 37–38%, counties – 10% and provinces – 7–8%. This debt structure is a derivative of the number of LSUs of a given level, the scope of their tasks and their ‘self-government experience’ understood as the time of their functioning in a local government structure. Moreover, the borrowing activity of big cities is determined by the level of their current expenditures<sup>35</sup>, their openness to investment and use of repayable financing resources.

Table 4

Debt of LSUs in 2004–2010 (before consolidation, in millions PLN, in relation to their incomes and the GDP)

List	2004	2005	2006	2007	2008	2009	2010
debt of LSUs before consolidation in millions PLN	19 105	21 181	24 949	25 876	28 775	40 294	55 094
debt as % of incomes	20.9	20.6	21.3	19.7	20.2	26.0	33.8
debt of LSUs as % of the GDP	2.1	2.2	2.4	2.2	2.3	3.0	3.9

Source: author’s own work based on: for years 1999–2007 – *Information on liabilities with respect to debt types and on amounts due to local self-government units in particular years*, <http://www.mf.gov.pl> (1.04.2011); for 2008 – *Report on activity of regional chambers of audit and on the execution of budgets by local self-government units in 2008*, National Council of Regional Chambers of Audit, Warsaw 2009, p. 137; for 2009 – *Report on activity of regional chambers of audit and on the execution of budgets by local self-government units in 2009*, National Council of Regional Chambers of Audit, Warsaw 2010, p. 147; for 2010 r. – *Report on the execution of national budget for the period from 1st January 2010 to 31st December 2010. Information on the execution of budgets by local self-government units*, the Council of Ministers, Warsaw 2011, p. 27, <http://www.mf.gov.pl> (17.06.2011).

<sup>35</sup> The costs of public services in these units are higher than in other communes because the services are performed also for the benefit of people and entities which do not participate – except for the payment for a service – in financing them by means of local levies.

Debt increase in LSUs in the last two years was caused by many factors. It is an outcome of the economic slowdown that decreased own incomes<sup>36</sup>. Additionally the units made a lot of investment (in 2009–2010 investment expenditures constituted about 24% of their total expenditures) thanks to non-repayable resources from the EU budget and the EFTA member states. This can be confirmed by the data on liabilities incurred in order to implement programmes and projects co-financed from the EU funds. In 2010 they amounted to 4950.9 million PLN and rose by 104.4% compared with the previous year. The debt increase cannot, however, be justified only by the inflow of the EU financial resources. In 2010 liabilities related to credits and loans went up by 44.3% (compared with 2009), but these were due liabilities that increased most – by 46.2%<sup>37</sup> – when compared with 2009. Moreover, only 12% of new credits and loans and only 3% of newly issued bonds were related to co-financing the EU projects<sup>38</sup>.

The debt increase of LSUs is also caused by a psychological factor. According to Poniatowicz, announcing new rules of determining acceptable debt level of LSUs and including them in the 2009 Public Finance Act caused a major concern among self-government officials, who were afraid that their LSUs would lose credit worthiness and a chance to take out new credits and loans. This in turn made them incur debts in line with ‘the old principles’<sup>39</sup>.

The economic slowdown affects debt increase of LSUs also in other ways. The debt of LSUs gets bigger also because of a difficult financial standing of various ‘contractors’ of these units, which translates into increasing liabilities to LSUs. For example, at the end of 2009 liabilities of LSUs included in the public debt were only 25% bigger than the amounts due to them. About 33% of this sum constituted amounts due and almost entirely concerned domestic entities, mainly from outside the PFS. In the same year amounts due to LSUs from enti-

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<sup>36</sup> The debt increased most significantly in towns and cities with county rights which suffered most from the economic slowdown.

<sup>37</sup> *Report on the execution of national budget for the period from 1st January 2010 to 31st December 2010. Information on the execution of budgets by local self-government units*, op. cit., p. 28–29.

<sup>38</sup> P. Swianiewicz, *Finanse samorządowe. Koncepcje, realizacja, polityki lokalne* [Self-government finance. Ideas, realization, regional policies], Municipium Publishing House, Warsaw 2011, p. 194.

<sup>39</sup> M. Poniatowicz, *Czy Polsce grozi kryzys zadłużeniowy sektora samorządowego?*, in: *Finanse publiczne a kryzys ekonomiczny* [Is Poland threatened by the debt crisis of local self-government?], in: *Public finance and the economic crisis*, ed. A. Alińska, B. Pietrzak, CeDeWu, Publishing House, Warsaw 2011, p. 100.



ties from PFS amounted 8.3% of total amounts due to LSUs<sup>40</sup>. Limiting debt of LSUs by deducting from it the amounts due to the units, especially from the entities from the PFS is worth considering. This of course would decrease the debt only artificially and on paper but such book-keeping practices have been used by the Ministry of Finance.

As has been stated before, the biggest part of debt structure is related to loans and credits. Increase of liabilities on account of loans and credits has been observed for some years now, but the phenomenon became especially noticeable in 2009. According to Kluza, it is a consequence of the financial crisis. Banks are more willing to grant loans to credible entities and LSUs are among them. As a result, since 2009 the number of banks taking part in tenders related to granting loans to LSUs has doubled. Moreover, the total sum of loans and credits granted to LSUs has increased significantly<sup>41</sup> and liabilities on account of such loans and credits have exceeded 89% (or even 90% in communes and counties) of total liabilities.

Analysing the level of debt of LSUs in the context of the structure of their budgetary expenses, it must be said that the debt is not a consumption debt (as opposed to the debt of the government sub-sector<sup>42</sup>) but a development-supporting debt. The investments of LSUs (especially communes, and towns with county rights) are desired in the times of crisis, as they contribute to pulling out of the crisis – and so they justify incurring debts<sup>43</sup>.

Once debts have been incurred, however, they must be paid back and serviced. Expenses related to debt servicing reveal a growing tendency but they generally do not exceed the level of 1% of the total expenditures of LSUs (ex-

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<sup>40</sup> Report on activity of regional chambers of audit and on the execution of budgets by local self-government units in 2009, op. cit., p. 148.

<sup>41</sup> K. Kluza, *Dostępność finansowania dla samorządów w okresie spowolnienia gospodarczego w latach 2008–2010*, in: *Finanse publiczne a kryzys ekonomiczny [Access to financing resources for local self-government units during the economic slowdown in 2008-2010]*, in: *Public finance and the economic crisis*, op. cit., p. 22–23.

<sup>42</sup> L. Patrzalek, *Dług podsektora samorządowego a samodzielność finansowa jednostki samorządu terytorialnego [Debt of the self-government sub-sector and the financial independence of a local self-government unit]*, in: *Finanse publiczne a kryzys ekonomiczny [Public finance and the economic crisis]*, op. cit, p. 84.

<sup>43</sup> D. Rynio, *Finansowe aspekty wychodzenia z kryzysu społeczno-gospodarczego na poziomie lokalnym [Financial aspects of pulling out of the crisis at the local level]*, in: *Znaczenie samorządu terytorialnego dla rozwoju regionalnego w Polsce, Niemczech i na Ukrainie [The significance of local self-government for regional development in Poland, Germany and Ukraine]*, ed. S. Flejterski, A. Szewczuk, M. Kogut-Jaworska, the Research Bulletin of the University of Szczecin No. 620, *Ekonomiczne Problemy Usług* No. 61, Szczecin 2010, p. 392–393.

cept in 2010). It is a good situation because growing costs of debt servicing could lead to a debt trap and threaten the execution of LSU tasks, because such costs must be paid in the first place.

Evaluating the borrowing activity of LSUs we must take into account the relation between LSUs' debts and incomes, which until 2013 is the basic value that formally limits the level of LSUs' debts (Chart 2).

In accordance with the applicable law, the total amount of debt as of the end of a year may not exceed 60% of the generated income of a given LSU. The average level of LSU debt is still not high. In none of the analysed years the LSU debt exceeded the reference value. The biggest debt burden was recorded in 2010, when the total amount of the LSU debt was at the level of about 33.8% of the income of these entities. In all the years, the highest level of debt in relation to the income was recorded in large cities, whose debts account for the greatest percentage of the total debt of LSUs. Those LSUs whose financial standing is the weakest also have the lowest level of debt. Therefore, it may be claimed that there is a relation between the level of debt and the wealth of a particular local government unit.

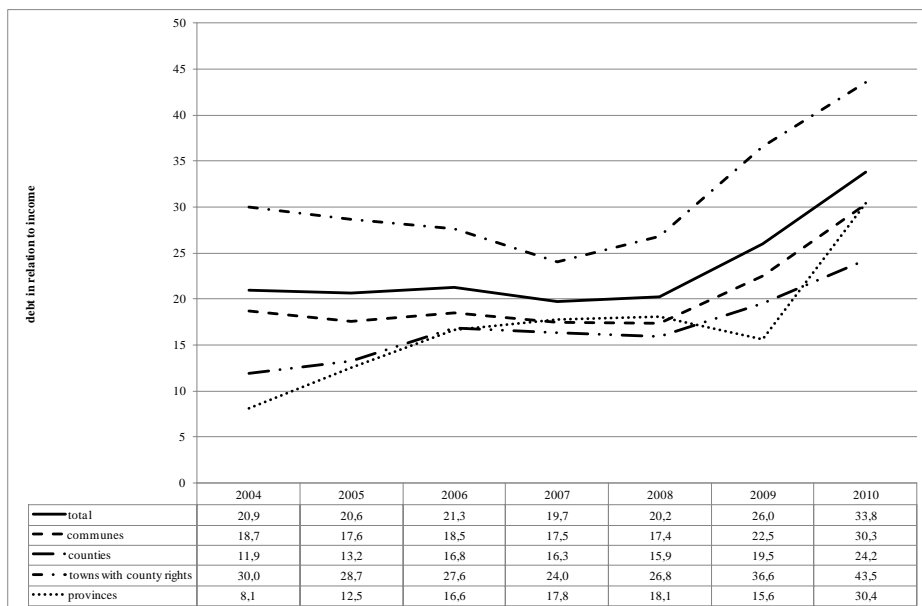


Chart 2. LSUs' debts in 2004–2010 in relation to their generated incomes

Source: as with Table 4.

The majority of local self-government units pursue a reasonable policy when it comes to incurring debts. The relatively low level of debt in relation to income and a low level of expenses for the debt servicing in the total of expenditures indicate the ability to correctly evaluate the safe level of debt for a particular local self-government unit (conditioned by the ability to repay and service it).

In reality, however, it does happen that LSUs exceed the limit of 60% (Table 5). Basing on the data presented for selected years it is impossible to draw any decisive conclusions concerning the loosening of the borrowing policy of LSUs. In 2010 the level of debt acceptable by the state was exceeded by 68 communes, 1 county and 2 towns with county rights. The cases of excessive debt are rare – at least from a formal perspective<sup>44</sup> – but in 2010 the number of units not complying with the statutory criterion was four times higher as the year before.

<sup>44</sup> The safe level of debt means here the situation when a LSU timely repays the borrowed capital and the interest, and the execution of its current tasks is not threatened.

Table 5

Number of indebted local self-government units in 2009–2010, taking into account their types and the relation of debts to generated incomes.

Year	Type of LSU	No liabilities	Total number of indebted LSUs							
			total	debt ratio						
				below 10%	10%–20%	20%–30%	30%–40%	40%–50%	50%–60%	over 60%
2009	total	145	2663	660	722	594	399	200	71	17
	communes	141	2272	579	607	504	339	165	64	14
	counties	3	311	72	102	69	44	20	3	1
	towns with counties rights	0	65	3	8	18	16	14	4	2
	provinces	1	15	6	5	3	0	1	0	0
2010	total	66	2743	333	510	624	567	436	203	70
	communes	63	2351	280	428	523	483	386	183	68
	counties	3	311	47	78	85	57	33	11	0
	towns with counties rights	0	65	3	3	13	20	16	8	2
	provinces	0	16	3	1	3	7	1	1	0

Source: as with Table 4.

Not all the LSUs exceeded the acceptable level of debt, as the data in Table 5 concern the total LSU debt, including the debt incurred in order to cofinance projects supported from the EU funds, which is not counted as part of the statutory limited level of debt. Once you eliminate this type of debt, in 2010 the ratio of 60% was exceeded by only 17 communes (0.6% of all the indebted LSUs). It is, however, worth noticing that in the analysed years the number of LSUs whose debt exceeded 20% of their generated incomes increased, which indicates an intensified use of debt instruments.

The state controls and limits the debts of LSUs in order to protect them from insolvency and in order to control the level of debt in the whole PFS, i.e. the public debt. Table 6 shows the level of LSU debt in the context of the public debt, i.e. after consolidation.

Table 6

PFS debt after consolidation in 2004–2010 (according to the nominal value, in billions of PLN)

Specification	2004	2005	2006	2007	2008	2009	2010
PFS debt	431,43	466,59	506,26	527,44	597,76	669,88	747,89
1. Debt of government sub-sector, including:	402,97	439,33	477,92	500,21	566,88	623,59	692,36
treasury	401,38	438,42	476,55	498,96	565,46	622,39	691,21
2. Debt of local self-government sub-sector, including:	18,40	20,17	23,28	24,48	28,11	39,32	53,51
LSUs and their associations	15,36	17,16	19,99	21,20	24,97	36,37	50,56
self-government earmarked funds with legal personality	0,00	0,00	0,01	0,01	0,01	0,02	0,00
self-government independent public health care institutions	2,98	2,95	3,23	3,20	3,09	2,92	2,87
self-government cultural institutions	0,02	0,03	0,06	0,05	0,02	0,03	0,06
other self-government legal persons founded on the basis of statutes – other than the Public Finance Act – in order to perform public tasks <sup>a</sup>	0,04	0,04	0,01	0,01	0,01	0,01	0,02
3. Debt of the social insurance sector	10,07	7,08	5,06	2,74	2,77	6,96	2,02

<sup>a</sup> With the exception of enterprises, banks and commercial companies.

Source: *Debts of the public finance sector*, time series, <http://www.mf.gov.pl> (DOA 20.06.2011).

In 2004–2010 Poland's public debt increased by about 73% and reached the amount of 747.9 billion PLN. The dynamics of the increase in debt is not homogeneous for particular entities of the public finance sector. It must be admitted that in the analysed period the debt of the Treasury grew by “only” 163%, whereas the debt of LSU and their associations by 229%. Nevertheless, local self-government units and their associations' contribution to the increasing of the amount of the debt is insignificant. Over the past two years, when the

LSU debt grew significantly, their and their associations' debts accounted for only 5.4% and 6.8% of the state's public debt. A slightly higher percentage of the state's public debt is the debt of the whole self-government sub-sector of the PFS. It must be noted that the growth in the LSU debt in 2009–2010 coincided with a decrease in the debt of local self-government independent health care institutions, which was partly a result of their liquidation, also in order to establish a company to run a non-public health care facility. The liquidations are stimulated by means of financial incentives prepared by the government.

It would be interesting to extract from the amount of the LSU debt those liabilities that have been incurred due to the necessity to provide own contribution and to pre-finance expenditures. Such liabilities are not taken into account when calculating the debt ratios for LSUs. It would be worth carrying out a similar operation when calculating the state's public debt (especially that there have already been attempts at calculating the debt associated with the state's pension obligations).

## **Conclusion**

The construction of the existing and planned restrictions aimed at direct or indirect limitation of the LSU debt in Poland is modelled on the construction of fiscal rules existing in other EU countries. At the same time, it is emphasised that there is willingness to further link the debt with LSUs' budgetary results.

The increase in the LSU debt in 2009–2010 coincided with the increase in the debt of the Treasury, state higher schools, public independent health care institutions and public cultural institutions. The borrowing activity of these entities was reflected in the fast increase in the state's public debt. The growth of the relation of this debt to the GDP raised concerns of the finance minister, who started to look for ways of inhibiting the further growth of the public debt. One of such ways was the plan to introduce additional restrictions on the LSU debt. As of June 2011, it seems unlikely that the restrictions will be introduced. The abandonment of the plan to establish additional restrictions on local self-government units is – in my opinion – justified for the following reasons:

1. In most cases LSUs incur liabilities carefully, taking into account the real possibilities of repaying and servicing them. This is confirmed by the data on the number of LSUs whose debts did not exceed 60% of their incomes.

2. Despite dynamic development, the debts of local self-government units account for an insignificant percentage of the state's public debt – they do not exceed 7% of this debt. At the same time, the negative influence of these units' debts on the macroeconomic conditions is also insignificant<sup>45</sup>.
3. The self-government debt – as opposed to the debt of the Treasury – is aimed at investments, which is evidenced by a high percentage of expenses on investments in the budgets of LSUs.
4. The introduction of new restrictions is unfair especially for those local self-government units that so far have not had high budgetary deficits and debts, as they have been still working on investment programmes. Moreover, new regulations were to apply to all LSUs in the same way, regardless of whether they have budgetary deficits and are highly indebted or not<sup>46</sup>.
5. The introduction of new restrictions would unnecessarily limit the possibilities of financing local and regional development. This is especially dangerous in the final period of using European funds earmarked for Poland in the EU financial perspective for 2007–2013. Limiting the development may have long-term negative consequences for the whole country, because – as it is stressed by S. Owsiak – the activities of LSUs may play a positive role in weakening the effects of the crisis of the Polish economy and create impulses to economic development<sup>47</sup>.
6. The introduction of the new limit is both socially and politically harmful. As it is emphasized by R. Grobelny, limiting investments “will cause the increase in the unemployment rate and as a result – will have a negative impact on the public mood... This will significantly undermine the trust of the public to the authorities (who will be regarded as failing to fulfil their promises) and will become part of the election campaign”<sup>48</sup>.

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<sup>45</sup> P. Swianiewicz, *Finanse samorządowe. Koncepcje, realizacja, polityki lokalne* [Self-government finance. Ideas, execution, local policies], op. cit., p. 204.

<sup>46</sup> R. Grobelny, *Hamowanie bez sensu* [Inhibiting without sense], “Rzeczpospolita” daily of April 11<sup>th</sup>, 2011.

<sup>47</sup> S. Owsiak, *Polityka finansowa państwa w warunkach kryzysu gospodarczego z perspektywy samorządu terytorialnego w Polsce*, w: *Samorząd terytorialny w zintegrowanej Europie* [State finance policy during the economic crisis from the point of view of local self-governments in Poland], in: *Local self-government in integrated Europe*, op. cit., p. 24.

<sup>48</sup> R. Grobelny, *Hamowanie bez sensu*, op. cit.

7. The introduction of restrictions on budget deficits would not decrease budget expenditures in those LSUs, where investments are being executed. Reducing the investments would require breaking the signed contracts, which in turn would mean the necessity to pay damages to the contractors.
8. Introducing new restrictions is unnecessary as the budgetary deficit of LSUs will be limited – albeit not sooner than from 2014 – by a new debt ratio and since 2011 it has been limited by the requirement to keep the current balance.
9. Also, it should be remembered that studies conducted in various countries have shown that if local bodies are subjected to statutory restrictions when it comes to debts, state bodies tend to become more and more indebted. This is due to the fact that when LSU bodies may not incur debts under their own powers they exercise pressure on the central government to borrow funds on their behalf<sup>49</sup> and make the resources available to local communities in the form of transfers.

**DODATKOWE OGRANICZENIA W PROCESIE ZADŁUŻANIA SIĘ  
JEDNOSTEK SAMORZĄDU TERYTORIALNEGO  
W OBLICZU ROSNĄCEGO DŁUGU PUBLICZNEGO.  
METODY I UWARUNKOWANIA RESTRYKCJI**

**Streszczenie**

Celem artykułu jest przybliżenie sposobów limitowania zadłużenia jednostek samorządowych szczebla lokalnego i próba odpowiedzi na pytanie, czy poziom zadłużenia jednostek samorządu terytorialnego w Polsce jest wystarczającym powodem do tego, aby wprowadzić nowe restrykcje w zakresie limitowania poziomu zadłużenia JST. Poprzez skalę zadłużenia rozumiana jest: kwota zadłużenia, dynamika długu oraz cel

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<sup>49</sup> J. von Hagen, B.J. Eichengreen, *Budget Processes and Commitment to Fiscal Discipline*, IMF Working Papers, Waszyngton 1996, quoted: M. Hallerberg, J. von Hagen, *Organizacja procesu budżetowego w Polsce. Reguły budżetowe a stabilność finansowa i gospodarcza [The organisation of budgetary process in Poland. Budgetary rules and financial and economic stability]*, a report prepared as part of the programme “Sprawne Państwo” (“Efficient State”) financed by Ernst & Young, Warsaw 2006, p. 18.



(rodzaj wydatków współfinansowanych z udziałem długu) i relacja długu z uwzględnieniem kosztów jego obsługi w stosunku do dochodów budżetowych JST. Dane empiryczne ilustrujące poziom zadłużenia JST dotyczą okresu 2004–2010.

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