Zeszyty Naukowe UNIWERSYTETU PRZYRODNICZO-HUMANISTYCZNEGO w SIEDLCACH Nr 118
Seria: Administracja i Zarządzanie (45) 2018
ISSN 2082-5501

OPERATING SURPLUS IN FINANCIAL MANAGEMENT OF POLISH LOCAL GOVERNMENT UNITS

NADWYŻKA OPERACYJNA W GOSPODARCE FINANSOWEJ JEDNOSTEK SAMORZĄDU TERYTORIALNEGO W POLSCE

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Abstract. The aim of the article is to assess the currently effective limiting mechanisms for debt incurrence capability of Polish local government units (LGU), which is based on the size of the generated operating surplus. Moreover, the article includes a verification of a hypothesis stating that from 2011, the level of operating surplus significantly influences the investment decisions of LGUs. The article also skeptically scrutinizes the introduction of the operating surplus generation imperative with reference to the LGU subsector (a legal ban of deficit in the current part for LGUs) without similar restrictions regarding the central subsector, which was responsible for about 93% of total public debt in 2001-2016. The methodology applied includes statistical data analysis, as well as a dogmatic-legal method. The dependence of debt incurrence capability on generated operating surplus is to be positively appraised – the financial ratio which incorporates the size of the surplus is an indicator that defines a safe level of debt and therefore accurately reflects the financial condition and credit capabilities of LGUs. This value determines, not only the formal, but also the real credit capability of the unit. The reform of the LGU finance system without any additional constraints on the central level will not lead to the general rejuvenation of the public finance..
Keywords: operating surplus, local government units, debt, golden rule

Streszczenie. Celem niniejszego artykułu jest ocena obecnych rozwiązań uzależniających możliwość generowania długu samorządowego od wielkości wypracowanej nadwyżki operacyjnej i weryfikacja hipotezy, że od 2011 roku, a więc od momentu faktycznego obowiązywania „złotej reguły” (zakazu deficytu budżetowego w części bieżącej jednostek samorządu terytorialnego, dalej: JST, wyrażonego w art. 242 ustawy o finansach publicznych) oraz indywidualnego wskaźnika zadłużenia, poziom nadwyżki operacyjnej wywiera istotny wpływ na decyzje inwestycyjne JST. Dodatkowo w wątpliwość podana została zasadność wprowadzenia obowiązku generowania nadwyżki operacyjnej (zakazu deficytu w części bieżącej JST) w odniesieniu do podsektora samorządowego, bez podobnych restrykcji nałożonych na podsektor centralny, odpowiedzialny w latach 2001-2016 średnio za blisko 93 proc. zadłużenia całego sektora finansów publicznych. W badaniach wykorzystano analizę danych statystycznych, a także metodę dogmatyczno-prawną. Uzależnienie zdolności do zaciągania zobowiązań od poziomu wypracowanej nadwyżki operacyjnej należy ocenić pozytywnie. Oparty na niej wskaźnik pozwala urealnić określenie bezpiecznego poziomu długu, rzetelniej odzwierciedlając kondycję finansową oraz zdolności kredytowe poszczególnych JST. Wartość ta decyduje więc o faktycznej, a nie tylko formalnej zdolności kredytowej. Reforma systemu finansów JST, bez wprowadzenia dodatkowych restrykcyjnych ograniczeń na szczeblu centralnym, nie uzdrowi całego sektora finansów publicznych kraju.
Słowa kluczowe: nadwyżka operacyjna, JST, zadłużenie, „złota reguła”

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Introduction

The new regulation that rendered the debt incurrence capabilities of Polish local government units (LGU) dependent on the size of generated operating surplus within the preceding three years (increased by revenues from the sale of assets), was part of a broader LGU reform that was introduced by a 2009 Public Finance Law (PFL). Apart from the abovementioned changes, the Public Finance Law of 27 August 2009 (Journal of Laws No. 157, position 1240 with later amendments) also introduced a new LGU management system that included a multi-year financial planning, prohibition of a budget deficit in the current part and an extended control of budget execution (Sawicka, 2012). Two universal indicators that were previously effective for all LGUs that limited debt level up to 60% of the current year total annual budget revenues and costs of debt financing up to 15% of budget revenues, met severe criticism in source literature (Błażuk, 2014, pp. 12-13; Wiewióra, 2009, pp. 27-31; Dylewski 2009). Inclusion of new LGU debt limiting rules constituted part of a broader, extensive LGU reform and one of its main goals was to harness growth of total public debt. The purpose of this article is to assess the currently effective limiting mechanisms for the debt incurrence capability of Polish local government units, which is based on the size of the generated operating surplus. Moreover, the article includes a verification of a hypothesis stating that the level of operating surplus significantly influences the investment decisions of LGUs (starting from 2011, the year when the individual debt ratio, as well as the “golden rule” were introduced). The ,,golden rule” formally entered into force in 2010 and the individual debt ratio in 2014. However, the first impact of the ratio could be noticed in 2011, as it exerted a significant disciplinary effect – the levels of operating surplus generated in and after 2011 influenced the capability of incurring debt in 2014. Thus the research hypothesis adopts 2011 as a base year, although two of the abovementioned regulations were effective, albeit informally. The article also skeptically scrutinises introduction of the positive operating surplus generation imperative with reference to the LGU subsector (legal ban of deficit in the current part for LGUs) without similar restrictions regarding the central subsector, which was responsible for about 93% of total public debt in 2001-2016.

Material and methods

In order to achieve the research goals, statistical data provided by the Ministry of Finance, i.e. information on the LGUs total budget execution – aggregated, as well as partitioned by distinct types of LGUs (communes, cities with poviat rights, poviats, voivodships) for all quarters of a given year and data of the Polish Statistical Office were employed. The range of the data source also covers "Reports of state-budget implementation for selected years" and "Operating surplus in local government units in selected years". A dogmatic-legal method based on an analysis of the binding law and legal doctrine was applied. The achievements of the doctrine and case law of broadly understood LGU financial management were also taken into account. In order to verify the research hypothesis and to illustrate the statistical relationship between the basic variables, the following Pearson's correlation coefficients were computed: between (a) operating surplus and capital expenditures; (b) operating surplus and investment expenditures; (c) operating surplus and total liabilities; (d) investment expenditures and total liabilities; (e) capital expenditures and total liabilities. Correlation coefficients for variables a), c) and e) were presented by Dylewski (2017). The author analyzed the period 2001-2015, i.e. a much wider time range.

Results and discussion

The Public Finance Law of 2009 does not provide a legal definition of the operating surplus. It is generally understood as a positive difference between current (operating) revenues and current expenditures. Correspondingly, a negative current result is called an operating deficit.

The compulsion of dividing revenues and expenditures into current and capital parts was introduced in the PFL of 2005 by the amendment of 2006 and was practically applied for the first time in preparation of the 2008 budget resolution (Salachna, 2014, p. 103). The abovementioned separation was introduced due to the necessity of higher budget transparency as well as to incorporate proposals of local governments. As J. Salachna notes (2014, p. 103), the objective initially set was evaluated and now it is the basic instrument for the newly established legal and financial institutions rationalising the financial management of local government units – it covers in particular the introduction of the "golden financial rule" into the local government economy, as well as the individualised debt ratio.

The distinction between the two types of revenues and expenditures is based on the convention of establishing a closed catalogue of capital revenues and expenditures. Thus current revenues of the LGU's budget are defined as budget revenues that are not capital revenues (Article 235(2) PFL). Capital revenues include (Article 235(3) PFL): grants and investment pools; asset sale generated income; revenues from the transformation of perpetual usufruct rights into ownership rights. Likewise, in accordance with Art. 236 (2) PFL, current expenditures of LGUs are understood as budget expenditures that are not capital expenditures, while the latter category, in accordance with Art. 236(4), includes investment expenditures and investment purchases; the purchase and acquisition of shares; stocks and contributions to companies subject to commercial law.

The Public Finance Law of 2009 introduced two important regulations that render local government units' investment decisions dependent on the level of the generated operating surplus. The first one was expressed in Article 243 of the Public Finance Law - the individual debt ratio, defined as below. It states that for the *n*th year the relation of financial outflows to total revenues cannot exceed the three year average relation of current revenues plus revenues from sales of assets minus current expenditures to total revenues.

$$\left(\frac{R+O}{D}\right)_n \leq \frac{1}{3} * \left(\frac{Db_{n-1} + Sm_{n-1} - Wb_{n-1}}{D_{n-1}} + \frac{Db_{n-2} + Sm_{n-2} - Wb_{n-2}}{D_{n-2}} + \frac{Db_{n-3} + Sm_{n-3} - Wb_{n-3}}{D_{n-3}}\right)$$

where the variables are defined as below:

R+O – financial outflows
D – total revenues
Db – current revenues
Sm – revenues from sales of assets
Wb – current expenditures

The formula above utilises historical variables (representing factual unit financial performance) with a span of three years preceding the financial year which the ratio is computed for. Therefore, despite the fact that the new indicator entered into force under transitional rules in 2014, it already had had a significant disciplinary impact on the financial management of local government units three years earlier, as the size of the operating surplus generated since 2011 was one of the factors determining maximal value of liabilities which could be maintained in 2014. Therefore, the indicator forced highly indebted LGUs to take disciplinary actions in the form of a deficit reduction and current surplus generation. The main role of the indicator, as seen by the legislator, contrary to rigid and universal limits is to reflect the economic capability of units to repay their liabilities, based only on financial (budgetary) data. Its essence was to link the debt limit of a given LGU with its individual level of generated cash flows, which constitute a basis of debt repayment.

The second major *novum* was the introduction of the "golden financial rule" to LGU management. The definition of ,,the golden rule" is provided in Art. 242 PFL. It had been applied for the first time to 2011 LGU budget resolutions. This rule is also known as the principle of current budget balancing - although this interpretation raises some disputes in the doctrine (Smoleń, 2012, p. 1071). According to the "golden rule", the decision-making body of an LGU may not adopt or implement a budget in which current expenditures are higher than current revenues increased by a budget surplus from previous years and disposable funds resulting from the settlement of liabilities (understood as the surplus of cash on the current account of the LGU's budget, resulting from settlements of issued securities, credits and loans from previous years). The breach of this rule may only be related to delays in obtaining refunds referring to the implementation of projects financed by EU funds. The restrictions mentioned concern both planning and implementation phases of the budget. In other words, this rule prohibits deficit in the current (operational) part of the budget, allowing at the same time to incur debt only to finance capital expenditures, and thus mainly investment expenditures.

The indicator's reliance on the operating surplus brings it closer to the borrowing and repayment (including interest and commissions) capability assessment methodologies deployed by credit rating agencies and financial institutions. Therefore, it seems that the introduction of the indicator should eliminate stringent restrictions for local government units with significant development potential, disciplining those entities which do not demonstrate this potential or do not have actual creditworthiness, as it was in the case of the "old limits".

It should be noted that although the indicator mentioned in Article 243 of the Public Finance Law takes into account elements of financial, operational and investment flows, it diverges significantly from the concept of an operating surplus.

Achieving a high level of operating surplus is particularly difficult during the financial crisis and economic slowdown which results in depriving local government units of the capability to borrow.

However, the compulsion to generate an operating surplus and the prohibition of deficit in the current part of the budget apply only to budgets of local government units in Poland and not to the state budget and the central (government) sector. It is worth noting that from 2000 to 2005 the state budget never showed neither gross operating surplus (understood as the difference between total revenues and current expenditures) nor operating surplus (understood as the difference between current revenues and current expenditures), and in 2006-2009, when the new law on public finances was passed, the government subsector only once, in 2007, reported an operating surplus. For comparison, in 2004-2009, local government units presented both types of surpluses in each of the years, with the average gross operating surplus generated by LGUs in that period amounting to nearly PLN 24 billion, and an average operating surplus of over PLN 13 billion. These data are shown in Tables 1 and 2 below.

Table 1. Gross operating surplus and state budget operating surplus in 2000-2005 and in the whole government sub-sector in 2006-2009, PLN billion

	The State budget						**Government sub-sector**			
Years	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross operating surplus (Gross operating deficit)	-10	-28	-34	-30	-32	-19	-6	13	9	7
Operating surplus (Operating deficit)	-10	-28	-33	-30	-32	-19	-6	4	-7	-26

Source: own calculations based on data of the Ministry of Finance: Reports on budget implementation (annual) in certain years. The data presented take into account the elimination of internal transfers. Due to the inconsistency of the statistics presented by the Ministry of Finance in the reports, it was not possible to present a single time series covering the 2000-2009 period, referring either to the state budget or to the government sub-sector.

Table 2. Gross operating surplus and operating surplus in 2004-2009, Polish LGUs (PLN billion)

Years	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Gross operating surplus	15	18	22	29	29	30
Operating surplus	10	10	12	18	18	12

Source: own calculations on the basis of data from the Ministry of Finance: Operating surplus in local government units in selected years. The data published by the Ministry of Finance covers budgetary figures for 2004 and subsequent years.

As the following data show (Figure 1), since 2011 the level of operating surplus generated by LGUs in Poland has significantly increased. The average annual growth rate in all units over the 2011-2017 period amounted to 11.5 %. The highest growth rate (14.7%), can be observed in cities with poviat rights, with the least in voivodeships (7.7%) and poviats (8.5%). A higher operating surplus increases the LGU's ability to accomplish new investment projects, both directly – by allocating this amount to investments – and indirectly – by repaying previously incurred liabilities for investment purposes. The operating surplus may therefore, in particular, be used to finance capital expenditures and the repayment of debts. The historical values of the abovementioned three variables, i.e. operating surplus, total capital expenditures and total liabilities of LGUs over the 2011-2017 period, is presented in Figure 2. Throughout the whole period considered, only the operating surplus shows a steady upward trend.

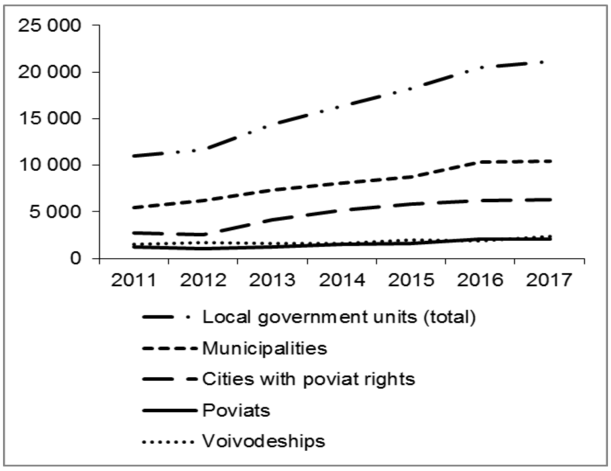

Figure 1. Total operating surplus in Polish local government units in 2011-2017, PLN million
Source: own calculations based on the Ministry of Finance data.

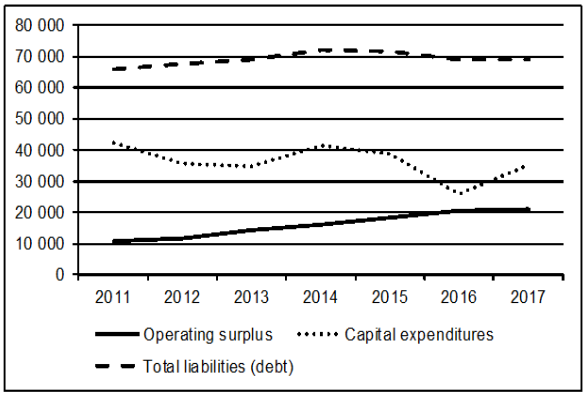

Figure 2. Operating surplus, capital expenditures and total liabilities of Polish local government units in 2011-2017, PLN million
Source: own calculations based on the Ministry of Finance data

Table 3. Correlation coefficients for specific variables over the 2011-2017 period

	Pearson's coefficient				
	Operating surplus/ Capital expenditures	**Operating surplus/ Investment expenditures**	**Operating surplus/ Total liabilities (debt)**	**Investment expenditures/ Total liabilities (debt)**	**Capital expenditures/ Total liabilities (debt)**
LGUs, total	-0.536	-0.555	0.518	0.023	0.032
Municipalities (communes)	-0.450	-0.449	-0.785	0.538	0.538
Cities with poviat rights	-0.496	-0.532	0.928	-0.343	-0.313
Poviats (Counties)	0.179	0.167	-0.886	0.267	0.255
Voivodeships	-0.490	-0.525	0.041	0.325	0.326

Source: own calculations based on the data provided by the Ministry of Finance.

From all the categories covered by Table 3, the results for cities with poviat rights and poviats yield the most evident conclusions. The operating surplus generated by the first group has a significant impact in the acquisition of new debt (in accordance with Article 243 of the Public Finance Law) and allows maintaining a higher debt (level of the coefficient: 0.928). The debt of these entities constituted 47% of the total debt of local government units in 2017. These units may not increase capital expenditures due to their high indebtedness. On the other hand, as the data show, poviats in good financial condition (with a higher operating surplus) are not financed by debt (level of the coefficient: -0.886).

According to the data presented in Table 3, at the level of all LGUs there is no linear dependence between the level of capital expenditures and total liabilities, as well as between the amount of investment expenditures (in 2011-2017, investment expenditures accounted on average for 96% of total capital expenditures within the sector of Polish local government units) and total liabilities. Therefore, it seems that the amount of the operating surplus generated by LGUs is sufficient to cover the capital expenses over a whole financial year. A moderate relation (the highest level of the coefficient: 0.538) can be observed in municipalities. There, the operating surplus may not be sufficient to cover capital and investment expenditures. Such a situation renders use of debt instruments necessary.

A positive correlation of moderate strength also exists between the level of operating surplus and total liabilities at the level of all LGUs in Poland. A higher level of operating surplus resulted in a greater capability of acquiring debt instruments. The highest correlation between the two variables can be noticed with reference to cities with poviat rights (Pearson coefficient equal to 0.928), i.e. entities with the highest investment capability. Based on these results, it is not possible to confirm any linear correlation between these variables in the case of voivodeships.

Surprisingly, the data show a negative correlation between the level of operating surplus and capital or investment expenditures. This regularity concerns both local government units in general and their distinct categories with the exception of poviats. Statistically speaking, a higher level of operating surplus results in lower capital and investment expenditures. One can thus conclude that the operating surplus is to a greater extent devoted to repayment of liabilities.

Due to the fact that the individual debt ratio has been introduced relatively recently, the span of the statistical data employed covers only 7 years. Nevertheless, basing the analysis on such a time span has already yielded the first empirical results. It therefore indicates that performing such an analysis once again in the future, when longer application of the indicator will have generated deeper and more long-term effects, might provide new results and insight on the local economy and financial management.

Conclusions

Dependence of the debt incurrence capability on the generated operating surplus is to be positively appraised – the financial ratio which incorporates the size of the surplus is an indicator that defines a safe level of debt and thus accurately reflects the financial condition and credit capabilities of LGUs. This value determines thus not only the formal but also the real credit capability of the unit. The level of the current surplus is determined by the amount of financial resources maintained by a given LGU, which may be allocated for investments or debt repayment. Therefore, one can hardly agree with the frequent arguments put forward that the new ratio causes a decrease in the creditworthiness of poviats and small communes, on the contrary, it reveals the unit's lack of such creditworthiness. Such a potential was not displayed by the "old limits" of the Public Finance Law of 2005.

It might also be important to advocate the introduction of more restrictive rules also at the central level, where the debt incurred to finance the deficit may more easily be disbursed on financing such current tasks which might often prove excessive or unproductive. A different situation occurs at local government level, where the majority of debt, due to legal restrictions, is employed to finance investment projects. The reform of the LGU finance system without any additional constraints on the central level will not lead to the general rejuvenation of the public finance sector.

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