Chapter 30

Eastern and Central Europe Poland

National policies and a difficult economy slow but do not halt the growing use of credit markets by local governments.

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Lessons

By most measures Poland has made a successful transition from a centrally planned economy to a decentralized, market-based system. This success is the product of several factors. Fiscal management problems inherited from the centrally planned system were reversed by a combination of technical assistance from Europe and the United States, the incentives for reform created by the desire for accession to the European Union (EU), and laws enacted to satisfy EU criteria for public finance and organization. Just as for Mexico and the North American Free Trade Area, the proximity to the EU and the increasing integration with the EU economy have provided incentives for well-framed regulatory reform and for competent and conservative fiscal management. These factors, together with Poland's robust economic performance over the past decade, provide a stable foundation for developing local government capital markets.

Although political decentralization in Poland has been methodical and reasonably well supported by the central government, it is not complete. The process has emphasized devolution of spending responsibilities and limits on local own-source revenues. For the typical urban powiat (major city), the local government with the most fiscal autonomy, own-source revenues amount to only a third of the total. Stability in local fiscal management has been enforced by legislation that limits local debt and encourages fiscal prudence. This preference for prudence over fiscal flexibility has restricted local governments' ability to use debt to meet capital spending needs.

Short case studies of several Polish cities provide an overview of the fiscal situation of local governments and their experience with subnational borrowing. Key fiscal characteristics include low revenue flexibility, high operating expenditures relative to total expenditure, increased spending responsibilities not fully supported by central transfers, and significant infrastructure needs. Local governments face strict statutory limits on borrowing, which make no distinction between operating deficits and capital expenditure financing. Nonetheless, several Polish cities have borrowed in the markets and carry international credit ratings, though foreign currency issues were prohibited by law as of 2002.

Most local financing comes from bank loans initiated through technical assistance and government financial institutions. Municipal bond issues have grown substantially since 2001 as a cheaper alternative for financing extensive capital spending in the current climate of tight budgets. These early steps in a well-regulated and closely monitored environment suggest that the prospects are good for further development of Poland's municipal capital market and its ultimate integration with the EU financial markets.

In the transition from a centralized economy to a decentralized, market-based economy, Poland had a jump start over many of its Eastern European neighbors. In the mid- to late 1990s Poland had among the highest economic growth rates in the region (GDP grew 5 percent a year in 1990–2000), demonstrating the rewards of a successful transition. Structural reforms, macroeconomic stabilization policies, and a dynamic private sector all combined to make the transition one of the most successful in Eastern Europe.

In the early part of the present decade the economy underwent a marked downward shift. High growth rates, strong domestic demand, and high inflation gave way to low (though still positive) real growth, weak demand, high unemployment, rapidly falling inflation, high real interest rates, and a significant appreciation of the zloty. The zloty's appreciation reduced external competitiveness and slowed economic growth, necessitating cost cutting by firms and thus worsening unemployment. Meanwhile, high interest rates increased the cost of servicing domestic debt, which accounts for 55 percent of all public debt. In 2002 debt service costs for domestic borrowing were four times those for foreign debt.

The poor economic environment led to a need for more public sector spending, resulting in deteriorating finances and budgetary problems. The general government deficit for all governments increased sharply, to 6 percent of GDP in 2001, reversing what had been a steady decline in general government debt. Meanwhile, fiscal tightening exposed fiscal management problems at the national level. The 2001 budget proved unrealistic. It was based on poorly informed assumptions about future revenues and on uncontrolled spending increases. To address this lack of fiscal discipline, the minister of finance had proposed limiting nominal spending increases by pegging them to inflation, starting with the 2003 budget. However, in 2002 the Parliament circumvented this proposal by increasing spending beyond the proposed limits. The struggle to rein in deficits extended into 2003, and the future of a framework for limiting spending remains uncertain. Poland needs to restore fiscal balance on its way to accession to the European Union (EU), planned for 2007. In the process it needs to free up 31 billon zloty (PLN), or about $8 billion, to contribute to the EU budget and billions more to meet matching requirements on EU grants (Reed 2003).

Placing further pressure on fiscal resources, political influence has hampered the ability to cut back certain expenditures (particularly sensitive are insurance for farmers and pension payments). Around 80 percent of state spending is in the form of entitlements and is not discretionary, undercutting prudent fiscal behavior.[1] Nonetheless, the Polish fiscal system includes a measure of discipline—statutory restrictions on deficit levels that are triggered when government debt reaches specified limits. These restrictions, coupled with the need to adhere to the membership requirements of the European Union for future accession, may impose a tangible spending ceiling and provide a measure of fiscal stability. The legislative framework, crafted in an atmosphere of dominant fiscal demands and stress at the national level, has supported conservative fiscal and debt management practices at the local level. While the framework is effective in maintaining fiscal prudence, it has also slowed the use of debt by local governments and constrained their efforts to address the nation's infrastructure needs.

Local Government System and Decentralization

The political upheaval that greeted the early 1980s in Poland (and led to the imposition of martial law) forced a rethinking of the country's economic and political system.[2] A combination of communism and market-based democracy emerged that, by the late 1980s, had planted the seeds of decentralization.

Earlier Poland had a unitary government structure. The government was segmented into several different spheres: the central level, 17 voivodships (regions), 330 powiats (intermediate-level administrations), and nearly 3,700 gminas (municipalities and towns), all acting as an arm of the central government within their geographic reach. By the late 1970s powiats had been abolished and their functions assumed by the voivodships. The unrest of the 1980s led to further reorganization of government and the introduction of some power sharing among different levels—and fostered the goal of improving fiscal mechanisms.

The devolution of fiscal authority that followed allowed voivodships to hold own-source revenues for the first time, substantially increasing their financial autonomy in handling such responsibilities as health, welfare, and regional transport. By the late 1980s there had been a significant shift of power to the voivodships, in large part because of the political limitations of central intervention. State-owned enterprises also were given a measure of autonomy, but because they were not exposed to competition and hard budget constraints, the gains in operational efficiency were limited. Gminas received greater responsibilities for sanitation and public housing maintenance, but this proved to be little more than deconcentration; control remained with the central government. In the end the reforms stalled, in part because the centrally planned system precluded the establishment of property rights. Without these, the incentives for fiscal discipline could not be fostered.

Indeed, intergovernmental relations remained murky and devoid of incentives. Revenue allocations were based on bargaining between the local and national levels, and the reforms of the 1980s served only to weaken central control. Unsurprisingly, local governments (and higher levels) lacked a good understanding of sound financial management. These factors made the need for new, strongly enforced fiscal rules clearly apparent. However, the existing intergovernmental system hampered further reform and would plague the transition to come. The incomplete reform and the exposure to market forces combined to create economic upheaval in the late 1980s. The result was hyperinflation.

Transition

In 1990, after the communist collapse, Poland held its first democratic elections. At this time public service provision was inefficient and still highly centralized. Local governments faced difficult challenges—such as the obscure legal status of state enterprises, a distorted budgetary revenue structure, and the question of what to do with massive stocks of public housing. The newly elected government began to address these issues through new laws.

The Law on Local Self-Government of 1990 embedded decentralization into the country's governance structure, establishing legally protected local autonomy for gminas and clear responsibilities for local public functions. A new legal framework separated local budgets from the center and eliminated extrabudgetary arrangements. The framework, put fully in place a year after the first law was enacted, included the Act on Local Revenues and Rules of Financing of 1990, the Budget Law Act of 1991, and the Act on Taxes and Local Fees of 1991. Responsibilities assigned to local governments included health, housing, energy, education, sanitation, water supply, local transport, and social assistance. These responsibilities were typically financed by a combination of own-source revenues, shared taxes, and transfers from the center.

In areas such as public transport, gminas were likely to have autonomy in pricing and provision, while in such areas as education their autonomy tended to be fairly limited. Moreover, the extent of local control depended on the gmina. Some were granted substantial fiscal autonomy, while others had little more than tasks delegated by the center. Indeed, decentralization proved to be necessarily conditioned by a gmina's political, financial, and technical realities. To facilitate the process of decentralization, the Office of Public Administration Reform was established to coordinate the sharing of information between levels of government during the early years of the transition.

Despite these efforts, the new rules of the game were vague. Echoing the historical murkiness in local-central relations, ambiguities in the assignment of responsibilities reduced accountability and limited the benefits of decentralization (Barbone and Hicks 1995). Even so, there were notable successes, particularly in public transport, where local governments achieved high cost recovery, and in centrally legislated welfare programs, where local administration increased efficiency.

Present Framework

Decentralization in Poland continues to move forward. Recent legislation has reduced the local administrative presence of the central government. The re-creation of urban and rural powiats, through the Law on Local Government Revenues of 1999, has led to further devolution of revenues and expenditures. Urban powiats, which include the larger cities, have both gmina and powiat responsibilities (table 30.1). The gminas, the lowest level of government, have achieved the greatest fiscal autonomy as a result of their expanded authority to set tax rates. However, fiscal autonomy at all levels remains low; for example, the central government places caps on tax rates set by gminas.

While public expenditures have been highly decentralized, revenues have not been decentralized at an equal pace. Still, this has not imposed an undue burden on most local governments, because the central government has tended to provide the means for meeting their growing expenditure responsibilities. However, there are some notable exceptions. Some local governments have not received matching funds and have had to use tariffs to make up the shortfall, such as for water supply in the early 1990s. More recently, education responsibilities given to urban powiats have not led to matching transfers from the central government, which has necessitated moving resources earmarked for other uses to make up the shortfall. In an apparent paradox, as expenditure responsibilities and own-source revenues have increased, they have fallen as a share of total revenue, as the case of Szczecin illustrates (figure 30.1).

The current intergovernmental arrangement for revenue sharing and expenditure responsibilities was supposed to last two years (1999–2000), but in 2002 it was simply extended. Decentralization is likely to deepen in the

Table 30.1. Current Structure of Subnational Government, Poland

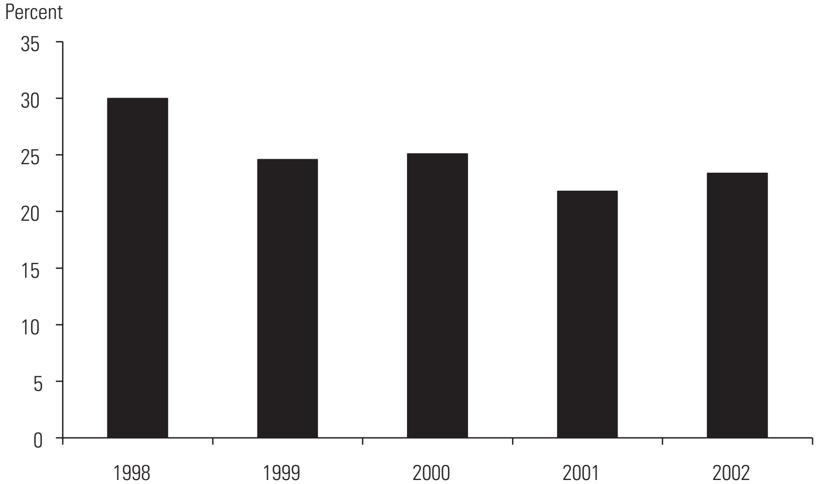
Level of government	Main responsibilities	Revenue sources	Financial authority
Voivodships (16 regions)	Regional economy, international economic relations, social welfare	• Subsidies tied to regional tax revenues (source of the largest share of revenue) • 1.5 percent share of local personal income tax • 0.5 percent share of local corporate tax	Borrowing capacity and extensive infrastructure responsibilities
Powiats (373 intermediate administrations)	Secondary education, social welfare, public order and security, public health, county roads, flood and fire response	• 1 percent share of local personal income tax • Subsidies tied to: – Powiat tax revenues (source of the largest share of revenue) – Social welfare expenses – Equalization component	No tax collection or rate setting authority but large expenditure responsibilities
Gminas (around 2,500 towns and municipalities)	Land development, municipal roads, water provision, sewerage, heating and electricity, waste disposal, local public transport, primary health care and social welfare, municipal housing, primary education	• 27.6 percent share of local personal income tax • 5 percent share of corporate tax • Subsidies tied to local conditions with progressive component for gminas with low own-source revenues	Can set local taxes and fees (property tax is most important) for 35 percent of total revenue, but maximums are set by central government

Source: Standard & Poor's 1999.

coming years, with more revenue independence for voivodships and powiats expected.[3] For cities (urban powiats), however, changes in the revenue structure are not expected to be significant.

Banking and the Financial Markets

Poland's banks have been the most important source of credit since municipal borrowing took off in the mid-1990s. Their stability and maturity are crucial for developing Poland's local credit market. As Poland's financial system deepens, it will more readily and efficiently provide funding for market-oriented credit instruments such as bond issues.



Source: Moody's Investors Service.

Figure 30.1. Own-Source Revenue as a Share of Total Revenue, Szczecin, 1998–2002

Banking

Poland's banking sector, made up of many small banks and a handful of larger ones, is relatively small compared with those of other countries.[4] Bank assets were equal to only 60 percent of GDP in 2000 (by comparison, in Spain the ratio is well over 100 percent), and a third of Poles do not use banks (Fitch Ratings 2000). Thus there is an obvious need for greater expansion and deepening of the banking sector, although this may also mean consolidation of the many small banks. Despite a large foreign bank presence, some banks continue to be at least partially state owned, and political interference in their operations in the past has undermined a long-term corporate strategy. Corporate governance has been weak, and the legal framework for banks has not fully clarified issues relating to ownership, rights, and duties. These problems have been exacerbated by lack of transparency in some banking group structures.

To strengthen the Polish banking system, partial foreign ownership of banks has been permitted. Because of political sensitivity, however, foreign participation has been limited, and thus so too have been the restructuring and modernization of Poland's banks. Despite public reluctance, foreign participation in banking will increase in the coming years and, through greater competition, probably will induce significant consolidation in the sector.

The supervision of banking in Poland (by the General Inspectorate of Banking Supervision) earns favorable reports. However, ensuring continued success will require a legal framework for supervision of consolidated entities. Tellingly, a recent bank failure (Bank Staropolski) points to the need for greater transparency and for further measures to allow effective supervision. Nevertheless, most current prudential regulations are in line with EU directives, and the rest are moving toward convergence. The Banking Act of 1997 outlines the regulatory framework for bank operations, including audits and disclosure requirements. Its roots lie in the Act on Accounting of 1994, which established a basic accounting framework for companies in accordance with EU directives. Poland's central bank is charged (by the National Bank of Poland Act) with establishing detailed regulations for banks.

Financial Markets

Poland's equities market is the largest in Central Europe. In 2000 there were 200 large and 26 small entities listed on the national exchange, the Warsaw Stock Exchange. The capitalization of the equities market in 2000, at 25 percent of GDP, was smaller than banking sector assets, reflecting its relative immaturity. The market is regulated by the Law on Public Trading and Securities of 1997.

The asset-backed securities debt market remains at an early stage of development, in part because of uncertainties in the legal framework. By early 2003, however, the growth of mortgage lending and mutual funds appeared to herald a much stronger and more diversified financial market.[5] A corporate bond market exists, but provisions in the corporate bond law mandating bank representation for debt issues have limited the use of debt because of banks' unwillingness to take on the risk. Until recently the law permitted the issuance of only specific-purpose debt. However, a new bond act in effect since August 2000 has liberalized bond issues, and the use of bonds is growing.

As in many transitioning and emerging market economies, in Poland the concept of a bond market for municipal obligations developed on the margins, following the earlier efforts to establish markets for corporate securities and national government obligations. With no history of local government bond issues since the 1930s, Poland had little practical experience on which to build. Nonetheless, technical assistance provided a major boost,[6] and by the mid-1990s commercial interest had emerged among both domestic and foreign banking and investment firms (Fitch Ratings 2000). With the aid of technical assistance, the Polish Securities Commission designed registration requirements and disclosure guidelines for local government securities that were adopted by the Parliament in 1998. However, the requirements for listing securities on the exchange proved to be too rigorous and expensive for municipal issuers, and few have opted to pursue such a listing.

Subnational Borrowing Experience

Transition and decentralization have opened new financing options. Western-style public finance instruments began to emerge in the early 1990s, including a more decentralized tax regime and government financial institutions oriented toward assisting localities. Among the most important of these institutions was ECOBANK, which provided funds for local governments through the Environment Fund.

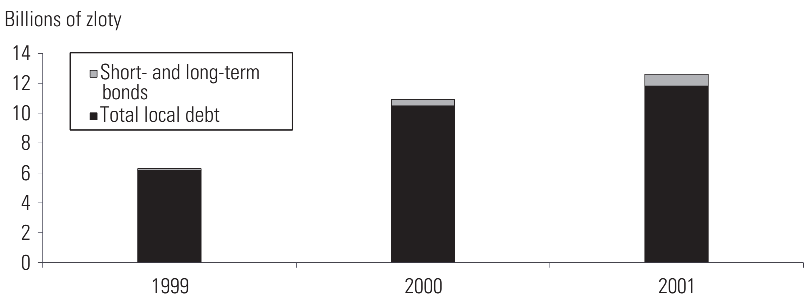
The relative stability in fiscal relations between the central and local governments in the early 1990s prompted the introduction of legislation in 1994 allowing local governments to access domestic capital markets. Initially the national government appeared to be willing to provide guarantees for borrowing by local governments as long as their debt service did not exceed 15 percent of their revenue and they pledged appropriate fiscal transfers as collateral. However, this provision was never activated, and only a handful of gminas ever applied (World Bank 2001c). Nevertheless, several large cities tried to enter the bond markets, both domestic and international, in the mid-1990s. Meanwhile, bank loans (often in the form of privately placed bond issues) were a major source of funding.

Trends in Subnational Borrowing

In 1990–95 the local government sector in Poland grew rapidly as devolution took hold. The Law on Municipal Finance of 1993 gave localities a general right to issue securities, though it restricted issuance by limiting debt service to 15 percent of regular revenues on issues and loans not secured by real property. In 1995 municipal issuance was further regulated by the Law on Bonds. A subnational credit market began to emerge with the privatization of commercial bank lending to larger cities, and a few pioneering bond issues began to appear (see Bitner 1998). These early bond issues had short maturities (two to three years) and high interest rates (more than 20 percent), reflecting the inflation rates of the period. Despite the active interest in selling bonds, the provision of credit was dominated by direct bank lending and by concessionary financing from state and voivodship environmental lending programs.

More recently, maturities have been extended to up to 15 years. Krakow, Lodz, and 25 other large and medium-size cities have sold bond issues, and five Polish cities carry international bond ratings. The slowdown in the economy and in the international credit markets has curbed the growth in the bond market, but total municipal credit, estimated at only 0.6 percent of GDP in 1996, has expanded to around 2 percent of GDP.[7] Credit appears to have grown quite rapidly since 1998, in part because of the new responsibilities putting pressure on local budgets.

Municipal interest in bonds has also been steadily increasing. Although commercial bank credits and loans accounted for 75 percent of municipal debt in 2001, that year saw a marked jump in municipal bond issues. The value of the subnational bond market increased from around PLN 860 million in 2000 to PLN 1,463 million in 2001, and the number of issuers from 89 to 140, with PKO Bank Polski the largest lead manager of municipal bond issues.[8] According to the Central European Rating Agency, gminas have become increasingly interested in issuing debt. At the end of 2001 some 35 gminas (including Czestochowa, Lublin, Poznan, Rzeszow, Szczecin, Walbrzych, and Wroclaw), 5 powiats, and 2 voivodships planned to issue bonds. The growing interest reflected the cost advantage of selling bonds over taking direct loans.[9] Nonetheless, bond issues still make up a relatively small share of total municipal debt (figure 30.2).



Note: The credit values reported by the International Monetary Fund are lower than those reported by Fitch Polska and cited in the text. But the data from both sources illustrate the positive trend in bond financing.

Source: International Monetary Fund, Government Finance Statistics database.

Figure 30.2. Local Government Debt by Source, Poland, 1999–2001

Regulatory Limits

The early efforts in Poland to develop a legal and regulatory framework for bond issuance, with the Polish Securities Commission attempting to devise securities regulations and disclosure guidelines suited to the issuance of subnational debt, helped lay the foundations for market development. Many of the requirements, however, proved to be burdensome for localities (Bitner 1998, p. 80). A 1999 law prohibited issuance of debt denominated in foreign currencies, even though Krakow had successfully issued a bond denominated in deutsche marks in 1998 (Standard & Poor's 1999).

The Public Finance Law of 1998, reflecting a desire to meet EU standards, clearly limits general government debt to an absolute maximum of 60 percent of GDP. It limits local government debt to 60 percent of total revenue and local debt service to 15 percent of total revenue. The law includes triggers to avoid exceeding the 60 percent target at the national level. If combined government debt reaches 50 percent of GDP, local governments are prohibited from approving budgets with a higher deficit-to-revenue ratio the following year. If debt reaches 55 percent of GDP, the state budget cannot result in an increase in state debt, local governments must reduce their deficits, and the limit on local governments' annual debt service drops from 15 percent of revenue to 12 percent. If debt rises to 60 percent of GDP, there can be no deficits and borrowing stops. In addition, the government must create a strategy for reducing the debt and present that strategy to the Parliament.[10] As the city case studies in this chapter illustrate, this fiscal prudence has been passed on to local governments. In some cases a city will impose even stricter controls on its borrowing than those set forth by the central government.

Outlook for Subnational Borrowing

As Poland's cities have seen their expenditure responsibilities increase, their own-source revenues have not kept up. Cities face increasingly pressing infrastructure needs, but they have little revenue flexibility. Indeed, many Polish cities have already reached the centrally imposed limit on local rates and thus have no further revenue flexibility in local taxes and fees. Future debt financing needs are evident. The major credit rating agencies now rate at least half a dozen Polish cities (despite the present ban on foreign borrowing), clearly viewing the upcoming EU accession as a promising development for Polish city finances. EU assistance will ease the financial burden on local governments by providing targeted funds that should reduce dependence on the center. This increase in own-source revenues also should also expand future borrowing capacity.

With the economy sputtering in the past couple of years, tax receipts have fallen and economic woes have added to the fiscal burden of Polish cities. For urban powiats this increased burden has been exacerbated by new education responsibilities that have not been met with matching support from the central government. Cities' flexibility in operational expenditures has been particularly weakened because salaries now make up a large part of total spending (as much as 60 percent in some cases). The large wage component of the budget makes it more difficult to vary expenditures because employees (who also vote) object to being laid off or given lower wages. In contrast, a road, bridge, or sewer that goes years without repair is less noisy about the neglect. Nonetheless, for the most part Polish cities have been able to manage the new responsibilities. Indeed, the well-designed and well-functioning regulatory framework for subnational borrowing and the conservative fiscal practices of local officials minimize the dangers of subnational overborrowing and fiscal collapse. Credit ratings, as monitors of financial health, provide added incentives for fiscal discipline.

Polish cities tend to have fairly narrow operating surpluses because of their relatively large current spending needs, such as in education and social services. In the Czech Republic and Hungary, where capital outlays are more prominent in local budgets, cities tend to have larger operating margins. For Polish cities the less capital-intensive nature of their operations means that debt service will make up a smaller share of their annual budgets. The large demands of current expenditures on their budgets probably mean that, in time, Polish localities may find it more attractive to borrow as a means of financing capital improvements.

Key Definitions

The limits imposed on local deficits mean that Poland's regulatory scheme for local governments has had to contend with the question of what an appropriate measure of a deficit is at the local level. This definition is important in formulating regulations.

Public budgeting usually makes a distinction between recurring (current) and nonrecurring revenues and expenditures. Current revenues and expenditures are perceived as growing smoothly and changing fairly slowly. In contrast, capital expenses are more volatile and cyclical because of elections, changes in mandates, and episodic needs for replacement (because of deterioration, emergencies, or the demands of growth). Capital spending can also vary from year to year because of changes in the economic environment, such as in inflation, economic growth, and interest rates. Capital outlays can be postponed, one reason that capital spending is often insufficient during periods of sustained fiscal pressure.

Capital spending can change dramatically from one year to the next. For example, a small town that replaces its investments only at intervals of several years may decide to build a new town hall. This decision will lead to a big jump in its total spending and in its debt and debt service. How should the financial health of the town—its margin of safety in financing the new expenditure—be judged?

The surplus from current operations is often seen as the best way to assess the financial capacity of a local authority to absorb extra expenditures without putting great stress on its revenues or existing spending. The operating surplus (current operating revenue minus operating expenditure) represents the margin of safety for the following outlays:

- Repayment of existing debt (and the future debt to be incurred).
- Emergency increases in spending (rebuilding after a natural disaster, for example).
- Financing of current capital needs (since it provides resources for financing facilities that need not be financed by debt).
- A carryover of funds to the next fiscal period (if sufficient, a source of funding that may permit revenues to be reduced).

Capital spending is usually financed by a mix of current-period revenue financing, grants, and borrowing from various sources. Financing investments from current-period revenues relies on there being funds left over after operations that are not used for paying debt service on outstanding debt. This is called the *net* surplus from operations and *after* the payment of debt service. The *gross* surplus—the amount left over after operations and *before* the subtraction of any payment for debt service (both principal and interest)—is called *funds available* for debt service.[11]

Figure 30.3 shows how the surplus (both gross and net) from a government's current operations is derived from the flow of revenues and expenditures. The gross surplus after current operation expenditures are met can be used to pay capital account costs (that is, loan redemption and investment outlays) or it can be saved by placing it in reserves.[12] The net surplus from operations, calculated after payment of debt service, is available to meet investment outlays (along with borrowing proceeds and targeted funds) or can be placed in reserves (which may be used to fund investment outlays or to cover any future operating deficits). Nomenclatures can vary.

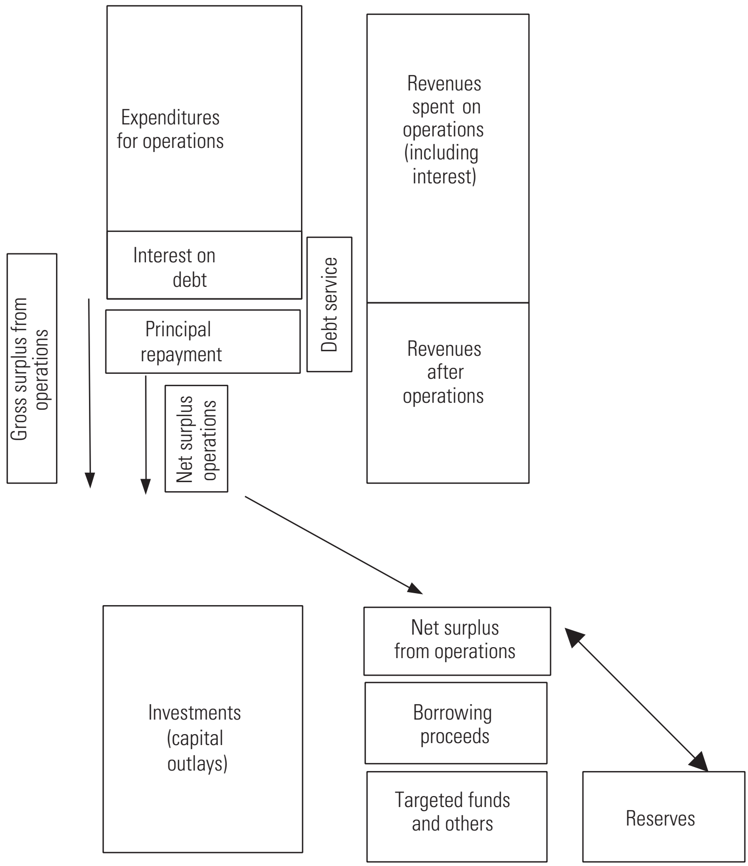


Figure 30.3. Concepts of Surplus from Operating Revenues as a Source of Funds for Capital Spending

For example, the term *gross fiscal balance* refers to all revenues (both recurring and nonrecurring) after the subtraction of all expenditures (both current and investment). Thus a city that is borrowing or selling off assets may run a significant negative fiscal balance but enjoy a substantial net operating surplus. Over time, however, current revenues need to grow to pay the debt service on the funds that are borrowed as well as to preserve the margins of safety described above.

Polish cities have traditionally financed investment outlays through central government grants or from current surpluses. Until recently there was little borrowing for infrastructure investments except by a few of the larger local governments or from specialized central government agencies and regional banks, in part because of the inherent conservatism of local authorities. The surge of interest in borrowing in domestic and foreign bond markets in the mid-1990s has been moderated by the recent recessionary conditions and by the restrictions on local government borrowing arising from the Maastricht protocols and the EU accession requirements. The European treaty (article 104, revised) requires a limit on the public deficit and the outstanding public sector debt.[13] A 1993 protocol defines the two quantitative limits as a maximum of 3 percent for the ratio of the deficit to GDP and a maximum of 60 percent for the ratio of debt outstanding to GDP. The protocol was written with the aim of achieving convergence in the fiscal policies of the countries entering the European Monetary Union.

These restrictions on debt do not distinguish between borrowing for capital needs and borrowing to fund operating deficits. Thus, any capital outlays by a local government that exceed its net operating surplus and capital grants (that is, any capital spending supported by net borrowing) count as increasing overall government debt and press against the accession limits. This has had a dampening effect on local governments' planning for the use of debt. Also contributing to the reduced use of debt is the prospect of the EU supplying capital funds, which will mean lower costs if local authorities can defer needs until these funds are available.

Local Financial Reporting

The Ministry of Finance and the Polish statistical agency both have requirements for local financial reporting and regularly collect data from gminas. The data collected by the Ministry of Finance are used primarily for tallying local government debt. They are timely, of good quality, and capable of supporting much more analysis of financial performance and condition. However, no entity in the central government is charged with performing that analysis, and the information, still treated as confidential under archaic rules, is not disseminated in a disaggregated form. So, as sometimes happens in developing markets, the information needed may be gathered, but lack of funds and good policy may preclude its being fully used (Petersen and Chomentowski 1999).

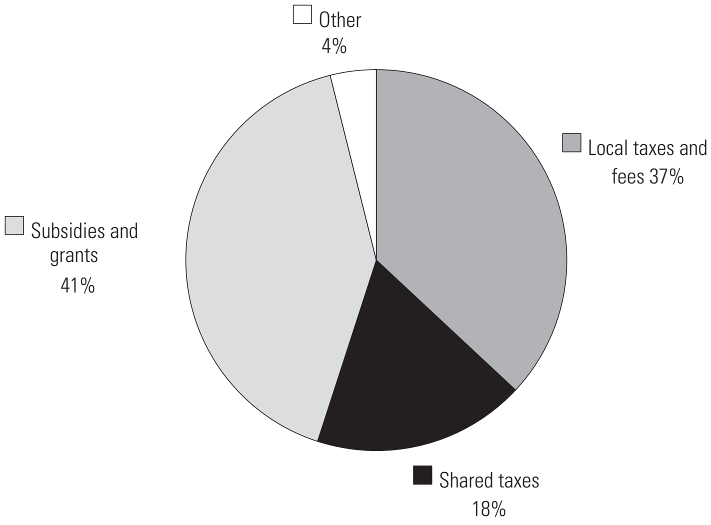
Five Cities, Five Experiences with Municipal Debt

Most of the five Polish cities with international bond ratings are struggling to keep operating costs in line with operating revenues. Overall, however, the experience in these five case studies is positive. Each case study highlights a different aspect of debt financing as practiced by Polish cities. They are based largely on 2002 reports by credit rating agencies, which perform ongoing review and analysis of outstanding debt for the local governments that are rated.[14]

Wroclaw: The Challenge of Managing a Fiscal Deficit

Wroclaw has a well-diversified economy and is one of Poland's wealthiest cities (in terms of average worker salary). As an urban powiat, it has access to own-source revenues. In 2001 these accounted for 55 percent of operating revenue. Wroclaw still relies on central government funding, which provided 41 percent of operating revenue in 2001 (figure 30.4). Wroclaw's revenue structure is fairly similar to that of many urban powiats. Moreover, like many other Polish cities, it has reached the upper limit on its local tax rate. Remaining sources of revenue flexibility include asset sales and self-supporting tariff entities such as housing rental and public transport.

Investment in infrastructure is a key part of Wroclaw's development strategy. With little revenue raising flexibility and an important capital spending program (equal to 15 percent of total revenue in 2001 and set to



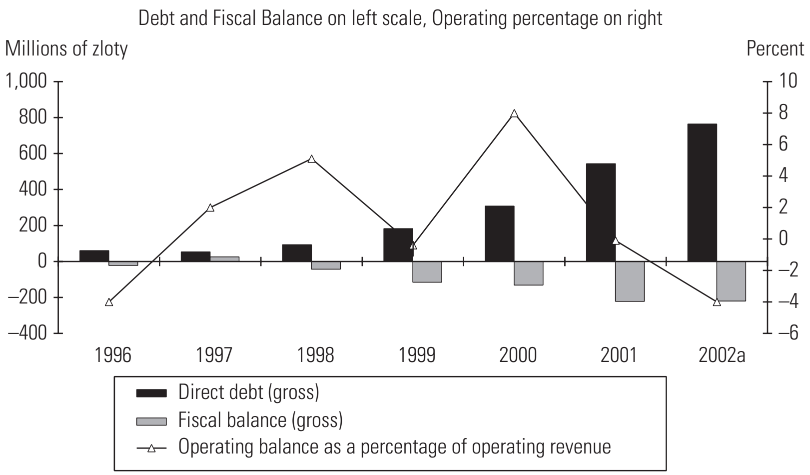
Source: Esters and De Heredia 2002.

Figure 30.4. Structure of Operating Revenue, Wroclaw, 2001

expand with investments in road building and waste management), the city has little choice but to use debt financing. The city has been running a growing gross budget deficit (that is, the fiscal balance, which includes all spending, including capital outlays financed by borrowing and asset sales) and assuming progressively more debt (figure 30.5).

Despite its growth, the debt burden is considered relatively moderate. At 38 percent of operating revenue in 2001, debt outstanding was well below the 60 percent statutory limit. After a projected increase in debt outstanding to 56 percent of operating revenue in 2002, the city expects much slower growth in the following years (with debt projected to reach 58 percent at the start of 2006). Even with the 60 percent limit on the ratio of debt to operating revenue, the city may allow the ratio to rise to 70 percent of operating revenue as long as capital revenue remains in line with projected averages. Consistent with the increase in debt, a negative gross fiscal balance is expected to persist, but projections show a progressive decline based on an ambitious goal to cut operating spending.

Interest payments on the debt were expected to amount to 3 percent of operating revenue in 2002, and total debt service to 9.3 percent. As the



a. Budgeted or projected.
Source: Esters and De Heredia 2002.

Figure 30.5. Budget and Debt, Wroclaw, 1996–2002

debt burden has increased, so too has the share of expenditures devoted to debt service. However, because the city is expected to maintain prudent fiscal management and to control spending, the growth in debt has not raised red flags. Even so, creditors and credit rating agencies will closely monitor the city's future fiscal behavior.

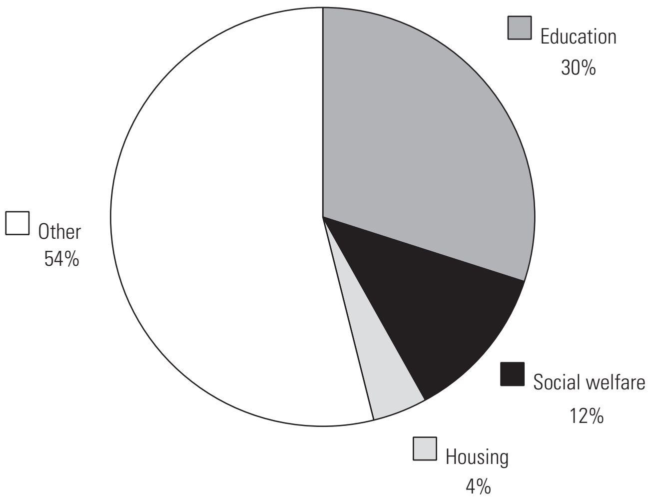
Lodz: Budget Pressures and the Use of Loan Financing

Wroclaw's basic story of cyclical budgetary performance and a growing debt burden is equally applicable to Lodz and, indeed, to most Polish cities (figure 30.6). Lodz is plagued by a higher than average unemployment rate that strains social spending and by a concentration of labor in manufacturing. Because of these factors, its revenues and expenditures are more sensitive to poor economic conditions than are those of a diverse economy such as Wroclaw's.

Lodz faces an expenditure structure similar to that of many urban powiats, with education and social welfare typically around 40 to 60 percent of expenditure (figure 30.7). As noted, the expansion of municipal responsibilities in 1999 widened the gap that municipalities claim already existed between revenues and expenditures. Education responsibilities proved especially burdensome in 2000, when new legislation raised teachers' salaries. Lodz financed the resulting cash shortfall with debt. The flexibility of education and social welfare spending is clearly very limited, and Lodz and many other Polish cities also contend with this low flexibility in meeting pressing infrastructure needs.

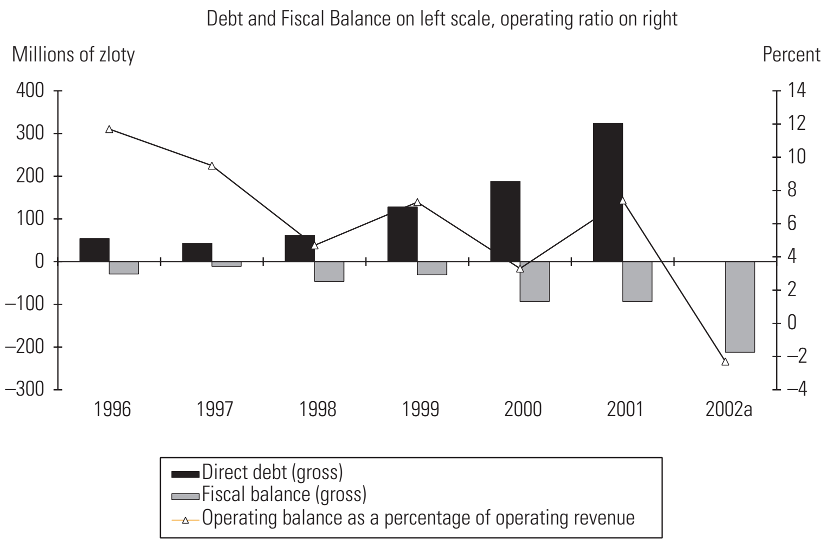
Lodz has a debt burden far smaller than that of many of its peers, with projections putting it at 27 percent of operating revenue at the end of 2002 (figure 30.8). However, the debt burden is likely to increase with the city's ambitious infrastructure improvement program. The debt service burden is also modest (6 percent of operating revenue in 2002), in part because a large share of the city's loans come from national or voivodship environmental funds that have fixed interest rates below the rate of inflation. Some of the other loans are with foreign banks and have floating interest rates, and a significant 29 percent of loans are denominated in euros and are not hedged.

Despite these risk factors (and those endemic to local governments in Poland), the expectation is that the city will exercise prudent budget management and not expose itself to unsupportable debt. In the short term it has the capacity to make up shortfalls with increased debt. More important, the city has the budgetary means to freeze spending if needed, al-



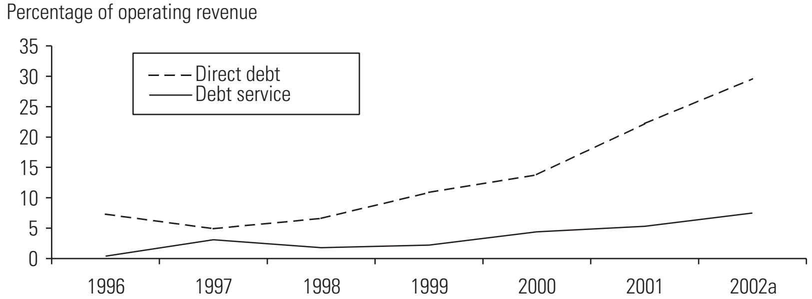
Source: De Heredia and Esters 2002a.

Figure 30.6. Structure of Operating Expenditure, Lodz, 2001



Note: Data on direct debt unavailable for 2002.
a. Budgeted or projected.
Source: De Heredia and Esters 2002a.

Figure 30.7. Budget and Debt, Lodz, 1996–2002



a. Budgeted or projected.
Source: De Heredia and Esters 2002a.

Figure 30.8. Debt Burden as a Share of Operating Revenue, Lodz, 1996–2002

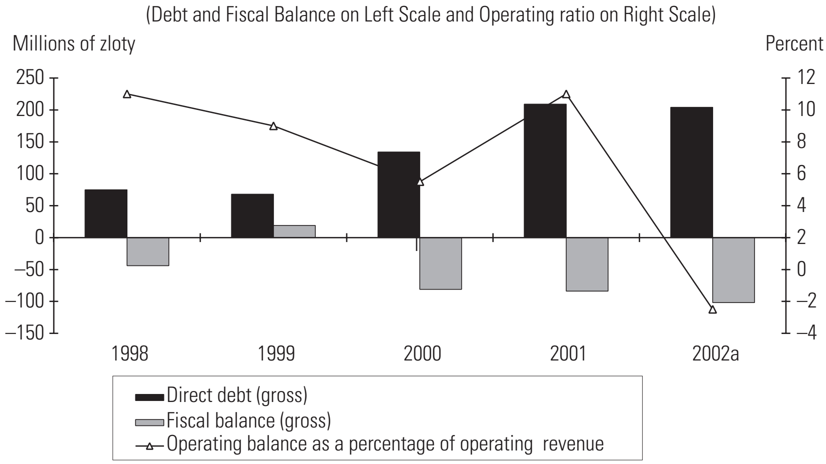
though it will have to make structural changes to its budget to avoid unsustainable debt in the long term. The recent deterioration in its fiscal balance, together with its undiversified economy and higher than average unemployment rate, has earned the city a lower rating (BBB– from Standard & Poor's) than that of many of its peers in Poland.

Szczecin: A Move Away from Commercial Bank Credit

Szczecin is one of Poland's most developed cities. Located close to the border with Germany, it has good transport links with Western Europe that have encouraged substantial foreign investment. However, the Zachodniopomorskie voivodship of which it is a part is relatively rural and underdeveloped and has not attracted comparable attention from foreign investors.

The Szczecin city budget has been well managed, with annual operating balances at a comfortable margin until the projected deficit in 2002 (figure 30.9). Even the projected deficit in 2002 was expected to be alleviated by the sale of an asset. Though the city can similarly cover future deficits and thereby mitigate future debt pressures, it will need to control spending, particularly investment spending, to sustain the budget balance.

Szczecin's debt has been growing relatively rapidly in the past few years (figure 30.10). The rise after 1999 reflects the increasing demands imposed on the city budget by the creation of urban powiats and the new intergovernmental arrangements. Even so, Szczecin's debt has grown more slowly than that of other Polish cities; debt outstanding, projected to be 26 per-



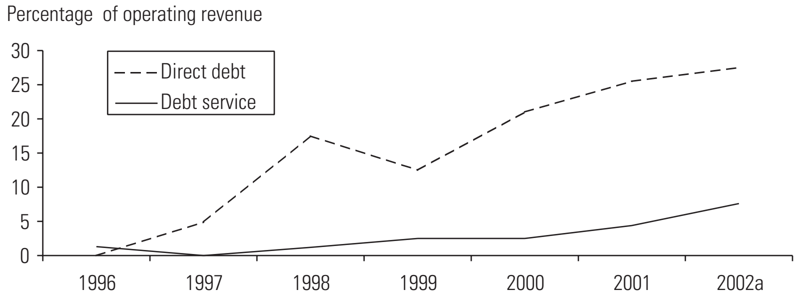
Note: Data for the operating balance as a percentage of operating revenue are approximate.
a. Budgeted or projected.
Source: De Heredia and Esters 2002b.

Figure 30.9. Budget Balance and Debt, Szczecin, 1998–2002

cent of operating revenue in 2002, is still small. Debt service costs are similarly modest, at 4.4 percent of operating revenue in 2001. Because of the city's continuing need for improvements in infrastructure, debt is expected to continue to rise in the medium term.

In 2001 Szczecin launched three bond issues representing 29 percent of the city's outstanding debt. In discussing the bond issues, the city president reported that the debt strategy was to move away from commercial credit and toward bonds. Some PLN 60 million worth of financing was issued. For the first issue—PLN 30 million, 10-year, fixed rate bonds—four offers from banks were considered. A consortium consisting of Bank Prsemyslowo-Handlowy and Bankgesellschaft Berlin was chosen as issue administrator. For the second and third issues (8- and 9-year bonds with variable interest, amounting to PLN 15 million each), which attracted interest from seven banks and six banks, respectively, PKO Bank Polski was chosen as issue administrator.[15]

Despite the city's recent use of bonds for debt financing, bank loans still accounted for 70 percent of its outstanding debt in 2001. The rest of the financing takes the form of preferential loans. Some 15 percent of Szczecin's



Note: Data are estimates.
a. Budgeted or projected.
Source: De Heredia and Esters 2002b.

Figure 30.10. Debt and Debt Service as a Share of Operating Revenue, Szczecin, 1996–2002

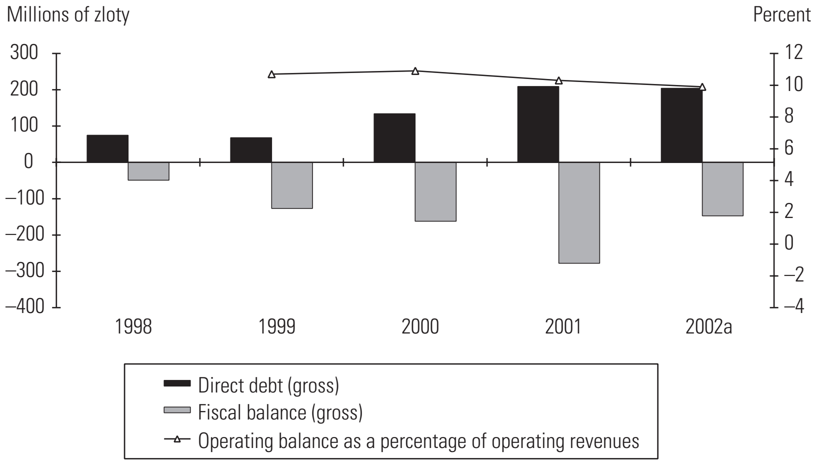
debt is fixed rate, and its floating rate debt is linked to Polish treasury bills. More than a quarter of the debt is denominated in foreign currency (euros).

Even with the amount of debt expected to increase, Szczecin's stable financial situation is expected to endure, earning the city a BBB/stable rating from Standard & Poor's. According to the rating agency, an important reason for this credit rating, besides the small debt burden and the operating surpluses, is that Szczecin's fiscal managers have acted prudently and are expected to continue to do so.

Krakow: Foreign Bond Issuance and Municipal Companies

Krakow's position as one of the most important cities in Poland is reflected in its sovereign-level credit rating. With a diverse and wealthy economy and a high level of international investment, the city has been riding out the recent budget squeeze surprisingly well (figure 30.11). In 2002, however, it faced large budget deficits and increasingly limited financial flexibility. Nonetheless, a history of prudent fiscal management suggested that the city would be able to cut its costs, meet its budget targets, and contain the growth of debt.

The city was an early innovator in municipal credit. In 1997 it floated a bond issue of PLN 15 million, sold to local banks after competitive bidding.[16] In 1998 the city issued Poland's first municipal bond in the foreign market, with a value of 66 million deutsche marks. A two-year floating rate note, the issue was used to finance the city's rapid tramway system. Despite the success of this foreign bond issue, in 1999 the central government



a. Budgeted or projected.
Source: De Heredia 2002c.

Figure 30.11. Budget and Debt, Krakow, 1998–2002

banned such issues. The tramway project was expected to be completed by 2002 but was delayed by a related project; the expected completion date is now 2004. By improving transport in the city, the project is expected to attract more foreign investment.

Krakow owns several companies that provide public services—a transport company, an electricity utility, and a water and sewerage utility. Only the transport company is unprofitable, largely because the city government keeps transport tariffs low, transferring budgetary funds to the company to make up the shortfall. Improvements to Krakow's sewerage infrastructure will be financed in large part with European pre-accession funds, which will cover 70 percent of the investment needs. The rest of the financing will come primarily from soft loans through domestic environmental protection funds. While the public service companies will incur more debt, most will be self-supporting. The loss-making transport company has no debt.

Poznan: Strict Borrowing Controls

Poznan is the second most important banking center in Poland. The basic story told for the other cities—good fiscal management, rising debt, and a falling operating surplus—is equally applicable to its case.

Poznan's credit experience has an interesting regulatory side. The city has enacted tougher limits on borrowing than those required by national law. Outstanding debt cannot exceed 30 percent of year-end revenue, and debt service cannot exceed 10 percent of revenue. The city intends to conform to these debt limits until 2005. The other interesting feature of Poznan's debt experience is that its debt consists entirely of domestic bank loans with floating interest rates. This means that it has no currency risk but is exposed to domestic interest rate risk. Among the city's existing capital sources, all of its self-supporting municipal companies have incurred debt. As sole owner, the city effectively acts as the guarantor of the debt, adding to its risk burden.

Notes

1. For example, the farmers' social security plan is noncontributory for farm owners and accounts for $4 billion a year in subsidies. With a ratio of workers to nonworkers of 51 percent, Poland has the lowest employment ratio of any OECD country (Reed 2003).

2. This section draws on Barbone and Hicks (1995) and Standard & Poor's (1999).

3. According to Moody's ratings reports from 2002, the Ministry of Finance was considering replacing the gmina property tax with a value-added tax, which would significantly increase local revenues.

4. This section draws on Fitch Ratings (2000).

5. Polish mutual fund assets doubled between 2001 and 2002 as consumers, responding to the low interest rate environment and changes in taxation, shifted from savings deposits to the higher-yielding funds (Spiro 2003).

6. Poland has received substantial technical assistance on municipal bonds, with early efforts centered on the Municipal Development Account, sited in the Ministry of Finance. Technical and financial assistance from the U.S. Agency for International Development and the U.K. Phare fund aided the effort, which involved both local governments and the domestic banking and finance sectors (Bitner 1998, pp. 79–80).

7. Based on the International Monetary Fund's Government Finance Statistics database and the World Bank's Global Development Finance and World Development Indicators databases.

8. Data are drawn from Fitch Polska reports.

9. Data are drawn from Fitch Polska reports.

10. A major difficulty is that these limits are defined using a cash basis and a global concept of deficit, making no distinction between borrowing for operating deficits and that for capital outlays. See Petersen and Chomentowski (1999, p. 16).

11. There are different conventions in calculating the net surplus from operations. Normally in a cash-based system the interest component of debt service is not included in the operating costs (as in the formal full accrual model), and the net operating surplus (minus interest costs) is treated as "funds available" for debt service. Debt service coverage is often calculated as the ratio of these "funds available" to annual debt service. In addition, convention subtracts nonrecurring revenues from operating revenues, such as receipts from asset sales or restricted or one-time grants.

12. The term *investment* is typically used to identify public capital expenditures in Europe. In the United States the expression is usually *capital outlay*. They mean the same thing.

13. Council of the European Community Regulation 3605/93 of 22 November 1993.

14. All 2002 figures cited are budgeted or projected estimates. These studies are based in part on rating analyses by Standard & Poor's.

15. From an interview with Edmund Runowicz, the president of Szczecin [http://www.regional-business.com.pl/nr4_47/czas_gb.html].

16. The bond award was very competitive. Local banks, intent on keeping the city's business, bid aggressively for the small bond issue, which ended up carrying a variable interest rate based in and with no markup over the rate on the government's 52-week treasury bills.