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Introduction

Local governments (LGs) are the largest investor in the public sector. Their stock and capital expenditure, which for the most part is investment related, is twice the expenditure of the State budget (see Fig. 1.). When financing investment projects, local governments often utilise outside funds: loans, bonds and long-term credit. The necessity to incur debt flows chiefly from the enormous size of the needs. In comparison with the countries of the ‘Old Union’, Polish local governments suffer from a large infrastructure gap or the inadequate availability of infrastructure facilities and equipment. This gap will continue

Figure 1. Stock and capital expenditure of local governments, and of the state budget (pln m)

Source: Compiled by the authors from aggregated data on budget implementation by local governments and central government.

Second, the demand for outside funds flows from the need to ensure the adequate cofinancing of EU projects. The financial plan of the National Strategic Reference Framework (National Cohesion Strategy) provides for expending EUR 11.86 billion (at 2004 price levels) from national public funds on cofinancing projects that are also financed with structural funds and by the Cohesion Fund. Of this sum, half is to come from the State budget and half from local governments. For local governments, this means that they have to raise finance at an average annual level of over PLN 3.0 billion, i.e. on a level that represents the outlays on cofinancing in the record year 2006.

The purpose of this report is to investigate the degree to which local governments have developed the structures and procedures necessary to effectively manage debt. The first part of this report presents a model of effective debt management that was developed using best international practices and the authors’ experience gathered over many years of working with local governments. The authors have focused particularly on those practices that are followed in selected
EU countries, and on the US market - the largest and best-developed municipal capital market.

The development of this model is a pioneering achievement in public debt literature. It should be stressed that whereas the questions of standards and good practices in relation to treasury debt management (debts of the State Treasury, central government, and the State) have been dealt with in foreign and domestic literature for many years (a case in point here is the public debt management guidelines issued by the International Monetary Fund and the World Bank in 2001), the management of municipal debt has not received the attention it deserves.

The report distinguishes twelve major standards, which have an impact on effective debt management, and then groups these standards into three areas:

- long-term financial planning with respect to debt;
- organizational methods that are conducive to effective debt management;
- technical instruments that aid effective debt management.

The second (empirical) part of the report examines the degree to which Polish local governments meet best practice criteria. The examination was carried out on a sample of 92 local governments that include all those local governments that took credit or loans in 2004-2006 (except for loans for prefinancing) exceeding PLN 2.0 million, or issued bonds to raise finance for investment projects, and that, at the same time, used funds from structural funds and the Cohesion Fund to finance such projects.

The results are based chiefly on data obtained by sending out questionnaires to local governments, and on information from a database containing financial reports that local governments are obliged to file with the Ministry of Finance. The authors drafted and sent two detailed questionnaires to over 150 local governments. The questionnaires were concerned with finance and debt management, and the raising of funds for investment projects. In addition, the report made use of information obtained from telephone interviews, information found in the publications of rating agencies and the MTS-CeTO, announcements in the Public Procurement Bulletin, as well as data and information to be found on the web pages of the Public Information Bulletins of individual local governments.
The study identified a number of phenomena, which, if removed, could significantly improve the effectiveness of the management of outside funds, and make local governments’ finances more open and transparent. The most important detrimental phenomena identified in the study are as follows:

- In relation to long-term financial planning: only one in two local governments has financial and investment plans of over three years; while almost two-thirds of local governments draft only a single version of such plans;
- In relation to the organizational methods of management: only one local government in three had a developed debt management policy, and only one in ten had a debt management unit or position, a rating, or a formal programme for relations with investors;
- In relation to technical instruments for management: practically no local government – with only one exception – took any advantage of derivative instruments to control the risk related to incurring debt.

The authors indicate several reasons why local governments meet best practice standards in such a limited way:

- Failure of legal regulations and guidelines on the implementation of operational programmes to suit the development of the municipal capital market (in loan funds), and increase the presence of local governments on this market;
- The structure of the municipal capital market, which is not conducive to the wider use of the instruments defined in the report, due primarily to the excess liquidity of the banking sector. There is, therefore, no correlation between the creditworthiness of local governments and the quality of debt management, on the one part, and the actual cost they would incur on raising loan funds, on the other.
- The absence of central government authority stimuli to make the presence of local governments on the capital market more pronounced. Central government activity has instead focused on the development of new soft, and very soft, financing.
- The absence of common, easily available and credible information on current developments on the municipal capital market, and the absence of tools that aid municipal debt management.

The report makes several recommendations, the implementation of which, by the coordinated efforts of central authorities and local governments, will improve the effectiveness of raising outside funds to finance local government investments.
The most important proposals put to the central authorities include:

- Intervention, by the legislator (regulator), to incur standards and principles for drafting long-term financial plans (LFPs) and long-term investment plans (CIPs) and to popularize them;
- Phasing out of State subsidies that use national funds for local projects cofinanced with Community funds. Facilitating the financial engineering of EU projects - by developing instruments of ‘soft’ financing – has, in the long-run, a detrimental effect on the absorption capacity of local governments;
- Making debt management standards more popular, either by imposing a statutory obligation to adhere to them, or by giving certain ‘privileges’ to local governments in the forefront in their adherence to the standards (for instance, the statutory indebtedness limits for local governments, suggested in the Public Finance Act, could be applied only where there is no rating or debt policy).
- Introducing a duty to publish, in the Public Information Bulletin, all data that relates to the material terms and conditions of contracts made by local governments, and other documents embodying liabilities burdening future budgets. In the long run, this could greatly increase the popularity of good practice in debt management.

The most important recommendations for local governments include:

- Coordinating debt management – in particular, the choice of form and manner, and determining the amount and structure of debt – with long-term financial and investment planning. Each local government should be asked to develop a long-term debt management strategy in the form of a document that sets out the issues related to a given local government’s presence on the capital market and the circumstances justifying the incurring of the debt.
- Creating separate units or positions devoted to debt management within the organizational structures of those local government municipal offices for which the capital market is a significant source of finance.
- Setting up information banks that contain good codes of practice and examples of debt management, disseminating credible information on current market developments, and defining tools to aid debt management.
Effectiveness model

The study makes use of a debt management effectiveness model that was customised for the purposes of the study. The design of the model is based on identifying standards of conduct that are consistent with best international practices in three fields related to debt management: (i) long-term financial planning; (ii) organizational management methods; and (iii) debt management tools. For each standard, criteria were developed to assess the degree to which the standard is maintained.

The standards and criteria were developed in reliance on the experience of EU countries and that of the best-developed municipal capital market; namely the US. What has been made use of in the first place is not only the experience of local governments themselves, their organizations and local government employee associations, but also the assessment methodologies applied by rating agencies and the publications of individual financial institutions.

Long-term financial planning was selected as the first area related to debt management, as it is crucial for the effective management of finances. Rational long-term financial planning makes the effective raising of funds more likely. In this area, four criteria were formulated, which concern defining the minimum period for planning local government finances and raising investment funds, laying down requirements concerning the form of such plans (approval of a local government Council), providing different versions of a plan, and specifying the period and nature of any debt forecast (whether this applies only to existing debt or to existing and planned debts). The meeting of each criterion is assessed on a scale of 1 to 3; except for the long term financial and investment plans, which is assessed on a scale of 1 to 4.

In the second area - organizational management methods - five criteria were formulated concerning the permanent presence of local governments on the capital market (the treating of debt as an ordinary means of raising investment finances), the development of a debt management strategy, the designation, in a local government office, of a unit, or person, to be responsible for debt management, the possession of a rating, and the relationships between local government and investors (possession of a formal programme or a generally accessible database of information on the experience gathered, procedures applied and recommendations relating thereto). Three criteria were assessed on a scale of 1 to 3; and one (debt management unit) - of 1 to 2.
In the third area - instruments to aid effective debt management - three criteria were adopted, with one concerning risk management and safeguards against the risk inherent in incurring a debt; while the other two concern issuing bonds and raising credit. The first alternative criterion concerns the nature of a bond issue (public or non-public) and the credit currency (national or foreign); whereas, the second refers to cooperation with the bond issuing house (the scope of its obligations) and the criteria for selecting a creditor. Each of the criteria is assessed on a scale of 1 to 2.

**Standards and criteria concerning long-term financial planning**

Long-term financial planning must be deemed necessary for two major reasons. The first is the need to determine the amount of funds available for the future financing of a local government’s basic activities. The second is the necessity to adjust the size and schedule of investment expenditure and related cash flow in order for a local government to maintain its long-term ability to pay (budget liquidity).

**Standard 1:** It is desirable for a local government to have a long-term financial plan (LFP) and a long-term capital investment plan (CIP), for at least seven years.

An LFP facilitates the achieving of long-term objectives and the implementing of ideas and operational programmes included in a commune’s (gmina) strategy and included in sectoral strategies, by raising the necessary finance and, at the same time, providing funds for carrying out the commune’s statutory tasks (Schroeder, 1996). An LFP is first a long-term forecast of own and outside incomes, revenues, investment and current expenditure, as well as debt proceeds. Second, an LFP represents a definite plan of action related to the financing of the most effective investment projects, a specific schedule for carrying out individual tasks, and alternative scenarios for their financing.

An CIP is a tool that allows local government to systematize the execution of the investment tasks planned in the strategy. An CIP specifies the order in which tasks are to be executed and their material scope, and allocates funds to tasks that are to be completed in successive years (also for individual divisions of the budget classification). For these reasons, the drafting of an CIP is a condition for success in the drawing up of an LFP. An CIP defines the optimum financing path for investment tasks planned for a commune; for instance, for 2007-2013. The path may be defined as a programme for executing investment tasks with maximum total expenditure on investments in a given period, which may be carried out, taking into
account the costs of raising loans and credit and maintaining the financial liquidity of the budget (Cichocki, 2004).

For both an LFP and an CIP, it is crucial to estimate the maximum acceptable level of investment expenditure and debt in each successive year covered by the plans. Due to excessive investment expenditure and the excessively high debt incurred by communes in the past, already after a year – or two at the latest – the local government (most often a commune) has to make large cuts in investment expenditure, several years in a row (3-4 years). Moreover, and which has to be stressed, all suggested indebtedness levels and investment expenditure ceilings must be set individually, taking into account the specific character of a given local government’s budget and its debt liabilities, as well as the income and expenditure structure.

The financial planning horizon, in all operational programmes that entail the procurement of EU funds, is the period 2007-2013, which corresponds to the financial framework term adopted in the Interinstitutional Agreement of 2006. This should also be the minimum period for local government financial planning. Furthermore, if we assume that investment tasks are planned for three years and that the incurred debt matures in four years at the latest, then, to know the financial consequences of the execution of tasks planned for three years, we need to plan finances for a minimum of seven years. By way of example, if we plan tasks for 2008-2010, the debt incurred in 2010 will still be in the process of being repaid in 2014.

Possible values for the standard
a) LFP/CIP covers ≥ 7 years
b) LFP/CIP covers > 3 but < 7 years
c) LFP/CIP covers ≤ 3 years
d) LFP/CIP is nonexistent.

Standard 2: It is desirable for a local government to have a long-term financial plan and a long-term investment plan, which have been adopted by a constitutive body (local government council).

The possession of a long-term plan adopted by a local government council after consultations with residents, is a measure of respect for sectoral programmes and tasks included in the Strategy and earlier agreed upon in consultations with residents. Abiding by legal procedures, and the participation of residents in the drafting of an LFP/CIP, are important elements in the effective management and support for the development of civil society. Of utmost importance is the appropriate legal regulations that provide the legal basis for such
documents as the LFP/CIP. The regulations in force are neither fully compatible with one another, nor absolutely clear. The legal regulations in force on LFPs/CIPs differ from the provisions laid down in the guidelines, recommendations and enforcement provisions that relate to the procurement of EU funds, which are closer to today’s practice.

It is worth observing in this context that adopting an CIP in the manner provided for by statute (i.e., as a document approved by the constitutive body of a local government) does not currently have any legal consequences. A local government that implements a programme does not acquire any additional rights through the adoption of an CIP; in particular, any authority to assume obligations related to the implementation of the programme (Gilowska, Misiąg, 1999). Moreover, no detailed guidelines have been issued on the methodology for drawing up such plans. The Public Finance Act actually treats the adoption of a long-term investment programme as a declaration by a local government council on how it spends the budget funds.

The basic legal regulations on CIPs are laid down in the Public Finance Act. In Sec. 117, the Act permits local governments to adopt CIPs as schedules to budget resolutions. Under para. 3 of the said section, the elements of an CIP, as a schedule appended to a budget resolution, include the name of the programme and its objectives, the tasks to be financed from the local government budget, the organizational unit that implements or coordinates the programme, the implementation period, and the total financial outlays and expenditure in the budget year and the two following years.

If the appropriate legal solutions were applied to CIPs and LFPs, it would be possible to make the system for planning and financing local government investments more uniform, and would improve the status of such documents and facilitate the assessment of the current and projected economic situation of local governments. The latter is important in applying for funds from EU Structural Funds in the 2013 time horizon. A good solution, for instance, is a proposal, included in the Public Finance Bill, which makes the spending schedule specified in an CIP binding in the event that there has been no resolution to discontinue the investment project.

Possible values for the standard
a) The LFP/CIP is approved by a council resolution
b) The LFP/CIP is an approved document (by resolution of a committee or by another document)
c) The LFP/CIP has not been approved by the council or any committee.
Standard 3: It is desirable for a local government to draw up different versions of the LFP and CIP; for instance, optimistic, growth-oriented or conservative.

It is best to draw up an LFP and an CIP in several versions (scenarios) with an alternative financing of tasks covered by the plans for at least seven years (Cichocki, 2004). Actually, it is worth presenting, for instance, three alternative scenarios for the development of a local government. Individual scenarios may differ from one another in the amount of funds the commune potentially receives from the European Union for the execution of investment tasks. Such funds form part of the commune’s budget income. The scenarios may also differ in terms of the assumptions concerning the rate of economic growth and inflation in the economy, and thus assume different growth rates for local government income. For each version, a determination is made of the highest level of investment expenditure that it is possible to finance from the budget. An adjusted safe level of debt is also set, which guarantees the financial liquidity of the budget.

It can be assumed that we are to analyze three versions of a local government budget and the level of debt and investment expenditure: optimistic, growth-oriented and conservative. Two versions of task financing planned for 2007-2013 should set the bottom and top levels of local government investment. It should follow from an analysis of the versions of the financing of an CIP, and planned debt obligations, that the suggested solutions are consistent with the legal regulations in force; this means, for instance, that the ratios of debt servicing to total revenue, and total indebtedness to total revenue, in local governments, are lower than the limits set in the Public Finance Act.

An alternative long-term plan would allow local governments to consider different versions of investment spending (different amounts of annual expenditure on investments). Moreover, it would enable quick reaction to changes concerning, for instance, European funds received (or not), and the sequence of executing investment tasks or abandoning some of them.

Possible values for the standard:
- a) The LFP/CIP exists in at least three versions
- b) The LFP/CIP exists in two versions
- c) The LFP/CIP exists in one version only.

Standard 4: It is desirable for a local government to have a debt forecast for at least seven years, which covers existing and planned debts.
A debt forecast is one of those standards that reveal the quality of local government long-term financial planning. Where a debt forecast covers only an existing debt or where it is made for less than seven years (matures before 2013), long-term planning can be deemed ineffective. In particular, where a forecast covers only an existing debt, it is not possible to plan the financing of future investment tasks or draw up an LFP or an CIP. Where the repayment of a debt is planned for less than seven years, this means, for instance, that investment tasks have been planned for three years and the incurred debt matures in four years, at the earliest.

It is worth stressing that under currently binding law a debt forecast is the only document that must be drafted and which is related to strategic debt management. The problem, however, is that the Public Finance Act is unclear as to whether a forecast should concern the repayment of an existing debt or if it should also concern a debt to be incurred in the future.

Another controversial issue concerns the concept of ‘planning.’ Planning, in the strict sense, is in place only when a constitutive local government body adopts a formalized document known as a financial (investment) plan, which sets out a detailed list of investment tasks and sources of finance to carry them out, which must be balanced against the budget. Meanwhile, in management that is based on the so-called ‘ideal treasurer’ model, such a plan does not need to be formalized in any way. In local governments, in which a debt forecast covers only existing debt, in most cases a methodologically correct system for long-term financial planning that also covers investment expenditure, is not used. Thus, all CIPs, being a mandatory element in some planning documents, especially in communes, are to a high degree ‘wish lists.’

More importantly, the use of an index concerning the nature of a debt forecast makes conclusions on the quality of long-term planning more credible than would be with the use of indices that rely directly on the terms for which the CIPs are drawn. This is so because most local governments that use long-term financial planning, which not infrequently covers over a decade (because of the necessity to plan debt repayment), adopt CIPs in accordance with the literal wording of the Public Finance Act, i.e. as planned expenditure amounts in a budget year and in the following two years (i.e., only for three years - for a three-year planning horizon).

Standard 4, which refers to a debt forecast for a term longer than seven years for both existing and planned debt, is a measure of how
much Standard 1 is respected, and how much determinations in other long-term documents, such as the Strategy or a development plan, are adhered to. When a debt forecast covers only an existing debt, or when it is made for a term shorter than seven years, then long-term planning may be deemed ineffective. In particular, when a forecast covers only an existing debt, it is not possible to plan the financing of future investment tasks or to draft an CIP or an LFP.

Possible values for the standard:

a) The debt forecast concerns existing and future debt, and covers ≥ 7 years.
b) The debt forecast concerns existing and future debt, and covers < 7 years.
c) The debt forecast concerns only existing debt.

Standards and criteria concerning the organization of debt management

When it comes to formulating standards concerning the organization of debt management, a fundamental conviction is that local governments should treat loan funds as a standard source of finance for planned investments. A local government should, therefore – similar to the State Treasury – take continual advantage of the possibility of raising funds on the capital market. This approach justifies making certain changes in the organization of the local government office (a unit for debt management) and in budget planning (indebtedness policy) as well as striving to build or improve the image of a local government as a credible, predictable and reasonable partner for potential creditors (rating, investor relations programme).

Standard 5: It is desirable for a local government to maintain a permanent presence on the capital market.

A permanent presence on the capital market is reflected in an experienced manager behaviour who skilfully and safely takes advantage of all available sources of investment finance. Systematically availing oneself of debt necessitates overcoming the psychological barrier caused by local government managers transferring experience acquired in their private lives to the public sphere. From the perspective of managing personal finance, a debt is something extraordinary and exceptional, the systematic use of which is proof that the virtue of frugality is missing. The active use of available financial instruments calls above all for an understanding of the different functions and meaning of debt in public finance – local finance in particular – and treating loan funds as one of the standard sources of finance for
planned investments, which are a necessary supplement for public levy revenue, transfers from the State budget, and income from local government property.

Successive incurring of debt is important, especially in the case of municipal bonds, and allows potential investors to ‘grow accustomed’ to operating on the capital market; namely, to get to know a given issuer and the financing terms it offers (Kurish, Tigue, 1993; Joseph, 1994; Method of Sale, GFOA 1994). The one-off incurring of debt is not only a source of negative arbitrage risk, but, in the first place, it does not make a local government a long-term collaboration partner for financial and credit institutions interested in investing in the financial liabilities of local governments.

Much more praise is reserved for the systematic, spread over time, raising of loan funds, preferably with similar financial parameters. This is one of the basic conditions for the potentially successful selection of a lender (a creditor or underwriter of a bond issue) with the use of competition-based methods, i.e., a tender or other form of competitive bidding. In Poland, the need to follow public procurement law, in the case of a bank loan, makes managers try instead to minimize transaction costs by cumulating their loan needs in time. From this point of view, there are more advantages in a bond issue programme spread over time or carried out several times a year in accordance with current needs.

The degree to which the standard is met by local governments is measured using the criterion of revenues from incurring debts – the occurrence of revenues from incurring debts in 2004-2007. Under the Public Finance Act, revenues from the incurring of debt include revenues the source of which is credits or loans that have been incurred (excluding loans for prefinancing) and the issuing of securities.

Possible values for the standard:
a) Revenues from incurring a debt occur in each of the three years (2004-2007)
b) Revenues from incurring a debt in 2004-2007 occur in two years.
c) Revenues from incurring a debt in 2004-2007 occur in one year.

Standard 6: It is desirable for a local government to develop a debt policy (debt management strategy).

The raising of loan funds entails exposure to different risks; beginning with purely financial risks (interest rate, exchange rate) to risks of a rather social nature (risk of lack of acceptance by the local
Achieving the goal of reducing the costs of incurring and servicing debts in the long run depends on being aware of these risks, and assessing and monitoring them. This requirement is satisfied above all by a clear formulation of goals and methods for managing risks inherent in debts, in a document commonly known as the debt management strategy.

The necessity to develop and release a debt management strategy at a central level is widely acknowledged in OECD countries (IMF, WB Guidelines; Sundararajan, Lay, 2002), and has been legally sanctioned in Poland since 1999. Under the version of the Public Finance Act currently in force, the three-year strategy for managing State Treasury debt and exerting influence on the State public debt (debts of the other public finance sector units) should cover the following:

- a debt management environment that relates to the macroeconomic stability of the economy;
- an analysis of the level of State public debt;
- a forecast of the level of State public debt and State Treasury debt;
- a forecast of the servicing cost of State Treasury debt;
- a debt structure model.

In countries where local government access to the capital market is greatest, there is no question about the need, on a local level, for a (strategy) debt management policy in the form of a single document (Kurish, Tigue, 1993; Debt Policy Handbook, 1994; Development of a Debt Policy and Analyzing Debt Capacity and Establishing Debt Limits, GFOA 1995; Advance Refunding, GFOA 1995; Leonard, 1996; Miranda, Picur, Straley, 1997; Arens, 1998; Tigue, 1998; Debt Management Policy, GFOA 2003). If a debt management strategy is in place, there is a guarantee that the objectives of the management are going to be perceived in the same way by local government authorities (the executive and constitutive bodies), persons professionally involved in debt management, and any consultants in this field.

Furthermore, the strategy facilitates the decision-making process, identifies and sets objectives, explains the structure of indebtedness, and forms an important condition for correct long-term financial planning. The purpose of any debt policy is to define the reasons that justify incurring a debt, to identify the kinds and forms of a debt that may be used, and to formulate debt structuring guidelines. Following U.S. standards (Debt Management Policy, GFOA 2003), a debt management strategy - as a document adopted by local government authorities - should be reviewed and supplemented annually.
In order to assess the degree to which the standard is met, it has been assumed that a debt policy (debt management strategy) means a document drawn up in any form and specifying at least the following aspects: objectives that justify raising revenue from incurring a debt, the maximum maturity (repayment) date of the debt, the decision-making process relating to the choice of the form of debt, and the ways of limiting the financial risks inherent in incurring debt. This relatively broad meaning of a strategy, as a document setting out the basic aspects of debt management, follows from the absence of any significant experience in this field in Poland.

Possible values for the standard:

a) In the local government, a debt policy (debt management strategy) that has been adopted by a resolution of the constitutive body.

b) In the local government, a debt policy (debt management strategy) that has been formulated in a document that is not a constitutive body resolution.

c) In the local government, there is no debt policy (debt management strategy).

Standard 7: It is desirable for a local government to designate a unit for debt management.

A permanent presence on the capital market and a strategic approach to debt structuring justify designating a competence centre for debt management within a local government. Because of the role of such a centre in budget planning, and the need for close collaboration with units responsible for debt forecasting, it would appear best to place such a centre in the financial (budget) departments and make it report directly to the treasurer. In the majority of U.S. municipalities, debt management falls within the remit of the treasurer, but related technical functions are carried out by a specific employee responsible to the treasurer.

Concentration of experience related to operating on the market should ultimately result in the down-playing of the role of intermediaries (consulting companies) in the centre's relationships with rating agencies and credit and financial institutions, with respect to incurring debt. The organization and size of such a centre should of course depend on the scope of the debt management strategy, and the volume and structure of the incurred debt. In the case of small local governments, with a small budget, a dedicated debt management position would suffice; in larger cities that use more complex debt management techniques (public issue, non-standard issue terms, credit denominated in foreign currencies, and use of derivatives) a dedicated
unit seems feasible. For comparison purposes, the Department of Public Debt in the Ministry of Finance, which has a similar scope of authority - on a macro scale - employs about 50 people.

For the purpose of the study, it has been assumed that the standard is met if at least one employee is dedicated to debt management, specifically drafts and updates debt policies (strategies), drafts debt forecasts, participates in the drafting of an LFP, coordinates collaboration with a rating agency, implements a programme of contacts with investors, and oversees the application of debt management technical standards.

Possible values for the standard:
a) In the local government, there is a debt management unit.
b) In the local government, there is no debt management unit.

**Standard 8: It is desirable for a local government to have a rating.**

Next to budget liquidity and investment profitability, investment security is a key issue on which potential investors’ investment decisions depend. In the case of liabilities that arise from bank credit and general obligation bonds (other than revenue bonds), for which a debtor is liable with all its assets, investment security depends directly on the creditworthiness of the local government. From this perspective, improving creditworthiness and building an image of a credible market player should be an essential element in any debt management strategy. In building a local government’s image as a credible borrower, the following two factors are crucial: (i) rating, both international and - to a slightly lesser degree - domestic, and (ii) an investor relations programme (see next Standard).

The function of rating agencies is to stimulate investors by making professional appraisals of issuers as debtors and assessing any related credit risk. The basic purpose of a rating is to assess the credibility of an issuer as a debtor, i.e. by drawing up a due performance forecast, complete and on time, of the obligations that arise from the terms of issue. This is done after an inquiry that covers the financial and economic situation of the issuer, and the security, if any.

There are three basic advantages of a local government being rated (SEC report, 2003). First, a rating is an independent outside professional assessment of all the operations of the local government; in particular, its financial management and the management of its assets and liabilities. A rating is, thus, an important supplement to a legal analysis, performed by regional audit chambers, and to an
internal audit. Ratings should provide guidance for reforming the local government’s operations.

Second, a rating allows a local government to reduce its debt servicing costs, and in some cases, its absence may bar access to the capital market. This is particularly true in relation to the debt securities market: the majority of investors, especially large institutional investors, strongly prefer to invest in papers covered by a rating (Büschgen, Everling, 1996; Dziawgo, 1997). A rating is also a very important factor, although not decisive, in commercial banks making credit decisions. The role of rating agencies has been acknowledged by the Basel Committee on Banking Supervision (Reisen, 2002; Mulder, 2004). The Committee (Basel II, 2004) recommends two methodologies for assessing credit risk; one relies on standard methods, which take advantage of outside rating agencies. In formulating the regulations for the capital of credit institutions, the Committee, therefore, assigned rating agencies a distinctive role in determining risk weights that refer to minimum capital write-offs for individual debtor categories. Risk weights determine, in turn, the costs of credit operations, as banks must maintain the appropriate level of capital in relation to risk-weighted assets.

Third, a rating fulfills an important information and promotional function, as it gives the general public access to professionally formatted information on the operations of a local government and is a benchmark for ranking local governments worldwide in accordance with their creditworthiness. A rating, thus, partially removes information asymmetry between a future debtor and a future creditor, which contributes to the success of incurring debt in a pioneering way (Access to International Capital Markets, 2003).

It has been assumed in the study that the standard is met if the local government was assessed by a credit rating agency. As there are no domestic (and for the most part no foreign) regulations in this respect, by a rating agency one should understand an agency commonly accepted on the international market.

Possible values for the standard:
a) The local government has an international rating given to it by at least one rating agency.
b) The local government has a domestic rating given to it by at least one rating agency.
c) The local government has no rating.
Standard 9: It is desirable for a local government to develop an investor relations programme.

Providing potential lenders, investors, financial institutions and other market players with full and credible information on its finances and operations should be a continual worry for every local government with a permanent presence on the capital market (Disclosure Handbook, 1992). American standards (Using a Web-Site for Disclosure GFOA, 2002; Maintaining an Investor Relations Program, GFOA, 2003) provide for the drafting of a programme of relations with investors; which includes, in particular:

- designating employees to be responsible for current contacts with investors,
- setting up an “information council” (consisting, for instance, of the treasurer, persons responsible for debt management, a representative of the constitutive body, a legal advisor, and a secretary), which takes periodic decisions on the scope of information needed to be disclosed,
- maintaining a database of potential lenders,
- defining methods for releasing information, with particular attention given to the Internet (web pages).

Possible values for the standard:

a) The local government has a formal Investor Relations Programme.
b) The local government does not have a formal Investor Relations Programme; however, all official financial documents are available through a web page.
c) The local government does not have a formal Investor Relations Programme, and access to official financial documents is restricted.

Technical standards for debt management

The major objective of debt management in local governments should be to minimize the costs of debt servicing while ensuring the correct level of financing at the right time. Apart from meeting the above standards, which refer to long-term planning and management organization, local governments that incur debt should apply management techniques conducive to reaching this objective. The techniques include debt structuring and determining its boundary conditions, choosing the right form of debt and the right market, as well as limiting the financial risks inherent in incurring debt. In most cases, no general principles can be formulated in this respect: the choice of technique depends on many factors related to the specific situation of
the given local government. Nevertheless, relying on local government experience, one can recommend three principles:

- try to minimize the effective cost of a debt when selecting an offer from a financial institution (Standard 10 in two versions: for bonds and for credit),
- try to increase the number of potential investors or lenders (Standard 11, also in two versions), and
- attempt to limit the risk of interest rate or foreign exchange rate (as the need may be).

**Standard 10a:** It is desirable that the issuing house (underwriter) be obliged to guarantee the sale of bonds not bought by investors, with a local government official participating in all operations related to the structuring of the issue, fixing the issue price and monitoring the sale; or that the issuing house be obliged to buy the entire new issue.

The success of a bond issue depends greatly on the method of collaboration with the issuing house (underwriter). There are two basic ways to place an issue. First, its success is guaranteed by an issuing house that undertakes to buy (guarantees the purchase of) all those securities that are not bought by investors: Second, the entire issue is bought by the issuing house (underwriter) (in the case of a public offering. The first form is known as an investment subissue, while the other is known as a service subissue).

To build a portfolio of subscribers, one has to ask potential investors what price they are willing to pay for specific securities (bonds). First, one has to identify a group of potential buyers and then collect credible data on the debtor’s financial situation. It is necessary to draw up extensive information material on the structure and terms of issue, and the issuer’s projected ability to repay the debt on time. Such information is given to institutions that may be interested in subscribing for the issue, together with a question asking what yield would make them buy the issue. Competition comes into play in the setting of a margin above the base rate, which would be acceptable to the issuer. In mature markets, suggesting a price and a coupon (interest) is left to the decision of investors. The highest bidders buy the issue. In Poland, however, in non-public offers, a ‘market’ created by the underwriter is restricted to a maximum of 100 entities (in reality, this number is much smaller), and the threshold yield depends on the profile of the underwriter’s clientele.

An alternative manner for issuing securities involves the underwriter buying the entire issue and then selling it at his own risk to third parties.
This method allows the issuer to choose an underwriter in accordance with the criterion of actual total cost of debt servicing; however, this entails the risk of overestimating the yield and an obvious loss to the issuer; or conversely, underestimating it and leaving the securities in the underwriter’s pocket. The risk is balanced by the advantage of knowing – already by the time the choice of underwriter is made – the costs of bond servicing. Any advantages of the model that involve the underwriter buying an entire issue depend greatly on the interest shown by credit institutions in a local government offer (i.e. on the number of bids).

Following the standards that prevail on developed markets (Method of Sale, GFOA 1994), the appropriate method should be determined on the occasion of each issue, taking into account market and financial conditions, characteristics of the issuer and the potential risks involved in each method. The sale of securities based on competitive bidding is recommended when the following conditions are met:

- the issuer is an entity known to market players and regularly raises finance on the capital market,
- an active and broad secondary market is in place,
- the issuer is rated at the average investment level (A), or the issue is secured,
- the issue is not too small (to attract investor attention) or too big (to be able to be placed on the market),
- the issue has no novel features or hitherto unknown features.

If the above conditions are not met, a negotiated sale is recommended, which observes the following two basic standards:

- the functions of financial advisor and underwriter should not be combined, as this may give rise to a conflict of interest;
- in all operations related to the structuring of an issue, fixing a price and monitoring sales, a local government official should participate (or an outside professional), who is well-versed in the intricacies of the municipal capital market.

Whether or not Standard 10a is met is established by checking the type of obligation incurred by the underwriter under the contract with the local government.

Possible values for the standard:
(a) The issuing house (underwriter) is obliged to guarantee the sale of bonds not bought by investors; with a local government official participating in all operations related to the structuring of the issue, fixing the issue price and monitoring the sale; or that the issuing house is obliged to buy the entire new issue.
(b) The obligations of the issuing house (underwriter) do not cover the duties specified in (a).

Standard 10b: It is desirable for a local government to adopt effective credit cost as the only criterion for assessing bids in a tender procedure.

- The incurring of credit by a local government is subject to the Public Procurement Act, if the estimated value of the credit exceeds the statutory threshold. To ensure competition between potential bidders, the most important item on the list of major credit contract terms, is the correct bid assessment criteria. It seems most rational to adopt the single criterion of effective credit servicing cost, on the assumption that awarding credit is providing a service on a competitive market. From this point of view, it is wrong to adopt other, frequently simplified, notions of debt servicing costs, or adopting many criteria for assessing bids. It must be stressed, however, that this approach requires a local government to specify all other material credit elements:
  - the credit structure or the dates of credit drawdowns and deadlines for repaying capital and interest, which, in turn, depend on the quality of long-term financial planning,
  - reference rate,
  - credit security, if any.

Making bidders accept a reference rate and - to a greater degree - security, is only possible if the issuer keeps track of current market trends and the preferences of banks willing to offer credit to local governments. Interestingly enough, the longer presence of local governments on the market increases the likelihood of a complete waiver of the security. The provisions of the Banking Act admittedly require a credit agreement to provide for security, but in conjunction with other provisions; in particular, those giving banks the right to demand security, which are provided for in the Civil Code and in the provisions on bills of exchange, and the prevailing practice in both domestic and foreign deals, they should not be construed as imposing a duty on banks. One has, therefore, to agree with the opinion of supervisory organs (the letter of the President of the National Bank of Poland, dated 5 March 1998, DP ZRP 20-22-148/98) that, to be valid, a credit agreement does not have to stipulate the manner by which the credit is secured.

The use of the criterion effective debt servicing cost for assessing bids implies the conducting of a tender procedure in which participants
make bids to provide a service (a tender or other form of competitive bidding). If ‘private sale’ procedure is used, this standard cannot be met.

Possible values for the standard:
(a) The only selection criterion is effective cost.
(b) The only selection criterion is nominal cost; or the selection of a lender is based on many criteria, or in some other manner than competitive bidding.

The greatest advantages of ensuring the liquidity of securities issued by local governments include:
- a potentially lower yield from issued bonds and, thus, lower effective debt servicing costs,
- facilitation of a market appraisal of issued stock,
- greater availability of loan funds – making it possible for not only passive investors, but also active ones, to buy liquid stocks;
- a crucial role is played here by legal regulations, which treat liquid bonds in a privileged manner: regulations on investments by insurance companies, pension funds and unit trusts allow such institutional investors to invest much larger sums in listed municipal bonds on a regulated market, than in those issued on the nonpublic market,
- dissemination of information and promotion of the local government.

Public trading in municipal bonds on the regulated market may bring substantial profits to a local government; it could also bring no profits at all and only take up large sums of money. As most of the advantages of public trading follow from increased liquidity, there cannot be any advantages where there is no substantial trading. In addition, in order to launch bonds on a regulated market, the right degree of investor dispersion is necessary. A local government that issues 100 bonds with face value of PLN 100,000 each, cannot expect any dispersion of investors or any substantial volume of trade. It can be claimed that the issue size is crucial for selecting the best form of trading; however, it is very difficult to determine the ‘critical mass’ - i.e., an issue size that would justify giving serious consideration to entering the public market.

A public issuing of bonds means the carrying out of an issue under Sec. 3 (1) of the Act on Public Offerings, and the Conditions Governing the Introduction of Financial Instruments to Organized Trading, and Public Companies.
It must be stressed that Standard 11 in both versions does not have universal application, i.e., it cannot be recommended to all local governments at all times. It is, therefore, radically different from the other standards discussed in this report. The inclusion of a public issue of bonds in the standards relating to technical management tools follows from a desire to stress the importance of innovation on a domestic municipal capital market that is rather less innovative.

Possible values for the standard:
(a) the local government has issued bonds by public subscription in 2004-2007.
(b) the local government has not issued bonds by public subscription in 2004-2007.

Standard 11b: It is desirable for local governments to broaden the scope of available financial instruments, by incurring debts denominated in foreign currencies.

With regard to the banking credit market, the standard for broadening the scope of the market consists of local governments incurring debts denominated in foreign currencies. In conformity with the legal provisions in force, the following types of debt can be contemplated:

- credit incurred in international financial institutions of which Poland is member, or with which, Poland has signed a cooperation agreement;
- credit incurred in banks (or loans from ‘legal persons’ created by legislation) from funds obtained under credit facilities made available by international financial institutions;
- loans from foreign governments or foreign government institutions extended under agreements made by the Council of Ministers with a government or a government institution.

Similar to a public issue, which is supposed to help local government reach out to as many investors as possible and enable the truly market pricing of bonds, incurring a debt denominated in a foreign currency is a broadening of the scope of financial instruments used and the beginning of cooperation with a new type of lender. Of course, even incurring debt in Euro, a strategic currency from the domestic point of view, entails an exchange risk. For this reason, the optimum use of the diversification possibilities of debt instruments depends on the debt policy’s provisions on debt management, and their practical use.

It must be stressed that Standard 11 in both versions has no universal application, i.e., it cannot be recommended to all local governments.
at all times. Including the incurring of credit denominated in a foreign currency in standards concerned with technical management tools, follows from a desire to stress the importance of innovation on a rather less innovative domestic municipal capital market. On the other hand, it is worth mentioning that in Poland, incurring credit in a foreign currency usually entails the awarding of a public contract through a single-source procurement procedure (pursuant to Art. 67 (1) (1) of the Public Procurement Act). Local governments that meet Standard 11b, therefore, do not usually meet Standard 10b. On a wellfunctioning market, however, there should be no contradiction between incurring credit in a foreign currency and the use of a specific procedure for selecting an offer, which allows for competition.

Possible values for the standard:
(b) The local government did not incur credit denominated in a foreign currency in 2004-2007.

Standard 12: It desirable for local governments to limit their exposure to financial risks related to incurring debts, by taking advantage of derivative financial instruments.

Derivative instruments have been used in managing State Treasury debt for many years. In the Strategy for Managing Public Finance Sector Debt for 2007-2013, approved by the Cabinet, a provision is made for the use of derivative instruments to manage exchange risk and interest rate risk (interest and currency swaps).

In developed financial markets, it is standard procedure for local governments to use derivatives to limit the risk inherent in incurring debt. Swaps are used most often to raise (a change from a fixed to a variable rate) or to lower (a change from a variable to a fixed rate) exposure to interest rate fluctuation risk. Commentaries stress that the use of derivatives is positive, provided that it follows from a cohesive policy set out in a municipal debt management strategy and is used to hedge against expected risk. Such a policy should specify, in particular, the derivatives that can be used, the long and short-term interest rate fluctuation forecasts, the persons responsible for decisions on debt structuring, and the sources of funds to cover any payments due to early termination of swap contracts. Increased exposure to interest rate risk is allowed in the case of local governments that enjoy high ratings, stable and predictable income and revenue, and high liquidity, which permits the absorption of any rate fluctuations.
The use of derivative instruments should follow from a debt policy (debt management strategy) and be based on the broad knowledge possessed by those persons who are making the deals. First, principles should be developed for measuring, monitoring, assessing and managing the risks inherent in the use of derivatives. In particular, these should include the base risk (resulting from the difference between the debt reference rate and the reference rate that determines the swap payments), the legal risk (concerning the other contracting party), early termination risk, and amortization (risk of maladjustment of debt maturity to swap maturity, or a mismatch of debt amortization periods and swap amortization periods). Moreover, a risk arises from the manner in which derivatives are selected and bought, in the principles for informing constitutive bodies, rating agencies and investors about instruments used, and in operational risk management (calculating and effecting payments, budgeting and accountancy).

The rating agency standard & poor’s relies in assessing the quality of local governments’ use of derivatives by using the following criteria: risk of the early termination of a deal, contracting party credibility, quality of derivative portfolio held, and the policy on derivative use and the procedures for using them (standard & poor’s, public finance criteria: municipal swaps, 2004). The current study discusses the use of swaps to hedge against exposure to interest rate risk, and – in the case of local governments that incur debts denominated in foreign currencies – the use of futures to hedge against exposure to exchange risk.

For the purpose of this study, hedging against financial risks is held to mean the use of derivative instruments to limit the exposure of a local government to interest rate and exchange rate risks (the latter in the case of local governments that incur debt denominated in a foreign currency).

Possible values for the standard:
(A) the local government took advantage of derivative instruments to limit interest rate risk or exchange rate risk in 2004-2007.
(B) the local government did not take advantage of derivative instruments to limit interest rate risk or exchange rate risk in 2004-2007.
Analysis of selected local governments in Poland

Description of the sample and the source of data

The study was made on 92 local governments that used long-term debt to cover their investment expenditure, co-financed with structural funds or the Cohesion Fund. The percentage shares of individual local government types, in the total group of 92 units, are shown in Fig. 2.

Figure 2. Percentage shares of local government types in the sample of 92 units included in the study

<table>
<thead>
<tr>
<th>Rural Communes</th>
<th>Towns</th>
<th>Cities with poviats rights</th>
<th>Poviats (small regions)</th>
<th>Voivodeships (regions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>10%</td>
<td>3%</td>
<td>44%</td>
<td>23%</td>
</tr>
</tbody>
</table>

Source: Own.

A detailed analysis was carried out on a group of 92 local governments that incurred credit or loans (excluding loans for prefinancing) exceeding PLN 2 million in 2004-2006, or issued bonds to raise finance for investment projects and at the same time cofinanced tasks using structural funds or the Cohesion Fund. The choice of local governments that implement EU projects was based on the assumption that communes, poviats and voivodeships using EU funds should be better prepared than others to take advantage of debt (e.g., in accordance with the procedures of the Integrated Regional Operational Programme, they had to develop plans for local development, of which long-term investment plans were an integral part).

To select a sample, budget reports (RB 27S, RB 28S, RB NDS, RB Z) from all local governments were analysed. Those that met the above conditions were selected. In particular, those local governments were selected, which in report RB-NDS, in item D111w (‘credits and loans for the implementation of programmes and projects carried out with funds coming from structural funds and the EU Cohesion Fund – completion) reported revenues greater than the revenues reported in item D1111w (‘loans for prefinancing’ – completion) or reported revenues in item D141w (securities for the implementation of programmes and projects carried out with funds coming from structural funds and the EU Cohesion Fund – completion) or item D151 (‘local government and municipal union bonds for the implementation of programmes...
and projects carried out with funds coming from structural funds and the EU Cohesion Fund - completion’). In autumn 2006, 93 such local governments were chosen; however, one local government did not provide a complete set of necessary data (it made access to such data conditional on our being subjected to a complicated formal procedure).

The results are based on questionnaires returned by local governments to the present authors, and telephone interviews and data from a database operated by the Ministry of Finance, which contains the above-mentioned financial reports that local governments have a duty to send to the Ministry. The authors drew up and sent out two detailed questionnaires to over 150 local governments. The questionnaires focused on managing finances and debt, and raising finance for investment tasks. Furthermore, over 100 telephone conversations were held with the treasurers of those local governments that were studied. Where data in the Ministry of Finance’s database raised doubts, the correct figures were arrived at in telephone conversations with local government representatives.

Results of analysis

All the local governments studied were subjected to assessment using the same criteria as defined in chapter 2, i.e. by applying the standards for long-term financial and investment planning, institutional and organizational management methods and technical tools that aid effective management of outside funds for financing local government investment projects.

In the area of long-term financial and investment planning the following four standards were distinguished: (1) whether the local government has a long-term financial plan (LFP) and a long-term investment plan (CIP) for at least seven years; (2) whether the local government has an LFP/CIP adopted by a constitutive body (local government council); (3) whether the local government has an LFP/CIP in several versions; and (4) whether there is a forecast of existing and future debt for a period of more than seven years.

The results show that only 26 per cent of the local governments have long-term financial and investment plans covering more than seven years. In turn, 18 per cent of the local governments have such plans for periods shorter than seven years, but longer than three years. In the remaining 55 per cent of cases, financial plans cover less than three years (see Fig. 3). As far as the form of a long-term plan is concerned (Standard 2), as many as 98 per cent of the local governments have had their long-term financial and investment plans approved by the
Council (constitutive body). Only in 2 per cent of cases, is a plan adopted by a resolution of a committee, or functions without a resolution altogether.

**Figure 3. Research results in the area of investment and financial planning**

The results concerning Standard 3 (having several plan versions) bear out the fact that the majority of local governments (77%) develop single-version plans. The other 23 per cent develop long-term plans in at least two versions. In 57 per cent of cases, debt forecasts for existing and future debt cover more than seven years. In 10 per cent of local governments, debt forecasts cover less than seven years. The remaining 34 per cent of local governments develop debt forecasts only for existing debt. What is interesting is the significant difference between the results obtained for Standard 1 and those for Standard 4.

An interesting picture is obtained when the results are arranged by local government type. The meeting of Standard 1 – having investment and financial plans for more than seven years – is far more common in cities with poviat rights, in poviat and in urban communes, while in rural communes and voivodeships, it is rather infrequent. As regards Standard 4, i.e., having a debt forecast for more than seven years, a high degree of conformity was demonstrated by cities with poviat rights and by poviat, while urban communes conformed the least. This means that quite a large group of urban communes incur credit for less than four years, and do not forecast planned debt (only existing debt). In this case, however, the lowest mark means a mean mark that testifies to the rather high quality of debt forecasting in the local governments.
In turn, the results obtained by the local governments with respect to Standard 2 and Standard 3 are quite similar: as regards Standard 2, all the local governments were given a very good mark; by contrast, in the case of Standard 3, the mark is very poor. It transpires that only large cities (cities with poviat rights) draw up contingency plans. In the other local government types, of which rural communes demonstrate best practices, practically no contingency plans are made, and management is on a ‘day-to-day basis,’ without anticipating any possible changes or taking into account unforeseeable circumstances.

In the area of institutional and organizational management methods, the following categories were distinguished: (5) permanent presence on the capital market, (6) development of a debt management policy (strategy), (7) designation of a unit (person) for debt management, (8) possession of a rating, and (9) an investor relations programme. Figure 4 shows the results of the local governments, arranged by categories in this area.

Figure 4. Research results in the area of institutional and organizational management methods

Legend: 5. Permanent presence on the market: revenues from debt occur: (a) in each of the last three years, (b) in two years, (c) in one year, (d) do not occur at all. 6. Debt management policy: (a) in place in the form a Council resolution, (b) is an informal document, (c) no debt management strategy. 7. Dedicated unit: a unit or person responsible for debt management: (a) exists, (b) does not exist. 8. LG rating: (a) international, (b) domestic, (c) no rating. 9. Investor relations programme: (a) a formal investor relations programme is in place, (b) a formal investor relations programme does not exist; however, all official financial documents are available through a web page, (c) a formal investor relations programme does not exist and the availability of official financial documents is restricted.

The results in this area show that it is a field in which local governments can improve many institutional aspects that are conducive to managing outside funds more effectively. Only Standard 5 – a permanent presence on the capital market – is met to the greatest degree by 70 per cent of the local governments. This is evidence of the fact that the vast majority of the local governments treat debt, to an ever increasing degree, as an ordinary – and not extraordinary – temporary source of raising funds to finance investment projects. It must be stressed,
however, that the meeting of this standard was to a high degree predetermined, in a rather obvious manner, by the choice of sample (only those local governments were studied which incurred a debt or a loan in the first place).

In no case is a debt management policy adopted by the Council. Only in 34 per cent of cases is such a document drawn up at all; and even then, it has an informal character. The other local governments do not draw up debt management strategies. Standard 7, which requires a dedicated unit or position for debt management, shows that in the majority of cases, such units or positions have not been designated after all in local government structures. Only in 9 per cent of the cases studied, is there a dedicated unit or person responsible for debt management, which means that only five cities, with poviat rights, and two urban communes, have a dedicated unit or person responsible for debt management. Most local governments have no ratings, either. This standard has not been met in as many as 91 per cent of cases. In this category, cities with poviat rights stand out dramatically; although only 39 per cent have a rating.

As regards relations with investors (Standard 9), it must be observed that only five of the local governments studied have a formal programme. The vast majority of local governments (92%) have no such programme; however, all official financial documents are accessible through their web pages. Access to official documents was restricted in only two cases; however, in individual cases, potential investors can obtain information going beyond that which local governments are required to disclose under statute.

When arranged by local government type, the research results indicate that cities, with poviat rights, and voivodeships, are quite well prepared institutionally to raise loan funds on the capital market. The difference between these two local government types and the rest is dramatic, in terms of standards referring to a debt policy, a dedicated unit or person for debt management, and having a rating.
In the area of technical management tools, the following standards have been developed: (10) cooperation with the issuing house (lender), (11) broadening of the market by the local government, (12) management of financial risks inherent in raising outside funds. Standards 10 and 11 have two complementary sub-standards for local governments that issue bonds (10a - underwriter selection criteria, 11a - character of issue) and for local governments that incur credit (10b - lender selection criteria, 11b - credit currency).

What attracts attention to this group of standards is the fact that the local governments (with the exception of a city with poviat rights) do not take advantage of any derivative instruments to limit their exposure to financial risks inherent in incurring debt. To some extent, this might be a result of the law being unclear on this point. No legal provision unambiguously authorizes local governments to use derivatives for debt management. No distinction is made either between the use of derivatives for debt management and use for other purposes (especially investment purposes). Another observation concerns the incurring of debt denominated in foreign currencies or the public issuing of bonds. With a few exceptions, these activities are pursued basically by cities with poviat rights.

The results for Standard 10 (character of debt issue) may initially appear surprising: Cities with poviat rights, while clearly being in the...
forefront in other areas, received the poorest mark in this area. The low mark is mainly due to the fact that a significant number of citypoviats take out foreign exchange credit offered by the European Investment Bank. This credit is incurred with the use of a single source procurement procedure, i.e., without any competitive bidding.

**Figure 6. Research results arranged by local government type**

<table>
<thead>
<tr>
<th>Local Government Type</th>
<th>Answer A</th>
<th>Answer B</th>
<th>Answer C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cities with poviat rights</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Towns</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural communes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poviats (small regions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voivodeships (regions)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Legend: Percentage share of answers A, B & C in the total number of answers, arranged by cities with poviat rights (mp), urban communes (gm), rural communes (gw), poviats (pw) and voivodeships (ww).

The aggregate results, i.e., the results for all the standards, in all the three areas and for individual local government types, clearly show that the standards are met to the highest degree by cities with poviat rights. In turn, the poorest results were obtained by rural communes: The share of Answer A was lowest for all local government types; while the share of Answer C was the highest. The average results obtained by the other local government types - urban communes, poviats and voivodeships - are similar. From the aggregate results and the results for individual standards, it transpires that cities with poviat rights are currently best-prepared to systematically finance their investment projects by incurring long-term debt.

**Discussion of results**

A major observation, following from the analysis of 92 budget reports, questionnaires and telephone interviews, concerns local governments, who demonstrate a relatively low degree of meeting the standards of effective management as defined in this report. The highest degree of conformity is observed in the case of standards concerning long-term financial planning and investment planning (standards included in our analysis in the first category). In contrast, local governments make only infrequent use of management tools and institutional and organizational mechanisms for financial management, which could aid the effective and efficient raising of outside funds.
In addition, legal regulations in force and the municipal loan funds market structure are not conducive to either using the tools defined in the report or increasing the presence of local governments on the capital market. The results point to the crucial role of legal regulation in making debt management good practice more popular with local governments. This applies above all to institutionally weaker governments. Local governments do best with respect to those standards that are enforced by law, or are suggested in guidelines accompanying operational programmes (the form of an CIP, debt forecasting). Most issues that relate to the standards are not, however, legally regulated.

Some regulations, nevertheless, make it harder for certain standards to be widely observed. This is particularly the case with regulations that treat local governments as a homogeneous group of entities of similar financial credibility, which is a consequence of several widely-held observations, which are only partially true. Above all, local governments cannot go bankrupt (they do not have the legal capacity to do so), and if it is unlikely that they will satisfy their obligations, they can count on being ‘bailed out’ by the State. To some extent, the situation is exacerbated by opinions on the likelihood of a debt being repaid, which were reported by regional audit chambers, pursuant to the Public Finance Act. Unlike their name suggests, these opinions are based on an analysis of statutory indices, known as ‘cautionary’ indices (referring to debt and the cost of debt servicing in relation to revenue), and cannot replace a professional assessment of LG creditworthiness. The favourable opinions issued by the State agencies responsible for supervising the financial management of local governments may suggest that the State takes over (at least) the moral responsibility for the safety of creditors’ claims.

As well as the legal environment, the existing market structure is also not conducive to the use of the tools we suggest. This is caused by the continuing excess liquidity in the banking sector, concentrated in a single bank that sets standards for financing communes, poviats and voivodeships. When servicing its local government clients, it sets up a model that other banks follow. The model significantly departs from the effectiveness model discussed in this report.

Today, local governments are not motivated to use the tools we suggested or to meet the standards we recommend. Central government should encourage local governments to increase their presence on the capital market. Meanwhile, the Cabinet’s efforts have concentrated on creating new instruments for soft, and very soft, financing (e.g., subsidies from the earmarked reserve of the Minister
of Economy, subsidies for complementing the costs of investments commissioned by other entities that are allowed to appropriate funds from the State budget; in particular, the Minister for National Education, the Minister for Sport, and the Municipal Investment Development Fund. The growth of such instruments prevents the municipal capital market from developing, which, in turn, may contribute to the lowering of the capacity of local governments to absorb EU funds in the long run. As a result, local governments may not be well-prepared to operate on the competitive capital market.

The current situation concerning local governments’ use of outside funds to finance their investment projects will certainly change in 2008-2013. The municipal capital market may soon be more competitive for local governments, and interest rates may soon be much higher than they are now. These developments will be consequences of, first, significant growth in local government demand for loan funds to meet the co-financing requirements of much greater funds coming from the EU budget; and second, the lowering of excess liquidity in the banking sector.

In the near future, those local governments that have not developed good practices relating to debt management and to their presence on the capital market will reap the consequences of their negligence. In some cases, the use of loan funds may prove completely impossible; while in others, of which there will be more, it will be possible, but at a much greater cost for servicing bonds issued or credit incurred. The consequences of the increase in debt servicing costs may include not only the general straining of local government budgets, but also, a greater dislike – or even distrust – for investments on the capital market, on the part of local government constitutive bodies in particular, and a reduction in the role of debt as a source of finance for investments. This, in turn, may make local governments lobby central government to introduce ‘soft’ financing instruments subsidized by the State budget. Such developments, while making the financial engineering of EU projects less effective, may substantially reduce local government absorption of EU funds.
Recommendations

The barriers to local government access to the capital market, identified in the report, may be removed by comprehensive and coordinated efforts on the part of central and local government, which would be aimed at improving the effectiveness of raising outside funds for financing local government investment projects. The removal of some negative aspects could considerably improve the openness and transparency of local government finances. The legal and financial institutions, and central government efforts, may undeniably play a significant role in raising the effectiveness and efficiency of local government use of outside funds; nevertheless, a decisive role in this respect will be played by the efforts of local governments in the promotion of good practices. We have outlined, below, eleven recommendations, which if implemented, could improve the effectiveness of local government management of outside funds.

A. The first eight recommendations are addressed to the central authorities: the Cabinet and legislator.

1. It is necessary for the legislator to intervene in order to promote the standards and principles underlying the drawing up of long-term financial plans (LFPs) and long-term investment plans (CIPs). Efforts should be undertaken to regulate the manner in which local government investment projects are planned and long-term financial plans drafted. A very important step forward would be to adopt the proposals included in the Cabinet’s Public Finance Bill, which provide for making it mandatory to draft long-term plans (Sec. 150(1)), to give up short term planning (for three years) (Sect. 150(2)(4)), and make the approval of expenditure appropriations for long-term programmes binding (Sec. 150(5)).

2. It is important to phase out subsidies from domestic funds for local investment projects financed with EU funds. From the wording of the Public Finance Act, it may be claimed that it is not right to combine support for projects in the form of development subsidies and earmarked subsidies to complement the financing of project costs. The experience of 2004-2006 shows that anything that makes it easier to financially engineer EU projects by creating instruments of soft financing, are not only unnecessary, but in the long run also make it harder for local governments to finance their investment projects. For this reason, budget subsidies that cofinance local government projects, and which are implemented using EU funds (except of course for
development subsidies) are an example of the ineffective appropriation of public resources.

3. The issuing of bonds should be subject to the Public Procurement Act. The existing regulations considerably obscure the transparency of this method of financing local governments, and they do not make the lowest effective debt cost the dominant guideline in the issuing of bonds. This is why we can observe many bond issues, of low value, being carried out by local governments, without a bidding procedure. Meanwhile, in all likelihood, they could have incurred credit at a lower effective cost.

4. It would be irrational for the regulator to adopt any principles that would result in cities with poviat rights restricting their capacity to incur debt. It has to be said that the Cabinet’s Public Finance Bill, which limits local government debt in proportion to the operating surplus to current income ratio, eventually intends to do just that. The operating surplus to income ratio in cities with poviat rights, which are best prepared institutionally to operate on the capital market, is on average much lower than the same ratio for small towns and rural communes. This solution means an actual restriction on financing investment projects with debt by the best - in terms of debt management - local governments.

5. It is necessary to institutionally promote the use of a rating as a tool to facilitate access to the capital market and to independently assess, among other things, some aspects of management effectiveness. A problem lies in the fact that it is difficult to make local governments acquire ratings especially when they do not enjoy any form of central government support. It would appear reasonable to stop using, or limit the use of, the cautionary indices stipulated in the Public Finance Act (debt limits, limits on debt servicing cost) with respect to those local governments that have an investment-level rating conferred by a rating agency designated by the Minister of Finance. A similar mechanism is used today in respect of authorization to issue bonds denominated in foreign currencies.

6. Some standards suggested in this report, and concerning the organization of debt management, could be promoted not only by making them a statutory duty, but also by granting certain privileges to those local governments that are the most advanced in a given respect.
For instance, local government statutory debt limits (including the limits suggested now in the Public Finance Act), which are criticised as artificial, could be applied only to those local governments that do not have a debt policy (strategy) adopted by their constitutive bodies and approved by a regional audit chamber. If such a policy were adopted, the local government would have to observe the limit stipulated in the debt management strategy, which will be reviewed periodically.

7. What should be considered is the introduction of a duty to publish, in the Public Information Bulletin, data on material clauses of contracts made by local governments, and data on other documents that embody obligations that encumber future budgets. This would make for a more objective assessment of the practical results of managing local government debt, and could, in the long run, have a significant impact on popularising good practice in debt management.

8. It is necessary to improve the monitoring and verifying of data sent by local governments to the Ministry of Finance, through the agency of regional audit chambers, as part of their mandatory financial reporting. The structure of the Ministry’s database is not sufficiently clear, and in a number of cases, the data and the values included raise doubts as to their veracity.

B. The following recommendations are addressed to local governments.

9. An issue of fundamental importance is the coordination of debt management (in particular, the choice of the form and manner of the debt, as well as its size and structure), with long-term financial planning and long-term investment planning. A rule should be introduced, which would require every local government to draw up a long-term debt management strategy that takes the form of a document and discusses such questions as the presence of the local government on the capital market, and specifies, in particular, those circumstances that justify the incurring of debt, the desired level of debt, the form of debt, the period and structure of repayment, the possibility of incurring a debt denominated in a foreign currency, the reference rate, and the manner of the bond issue. Furthermore, a debt management strategy should analyze the conditions underlying the local government’s presence on the market, the need for and functions of the rating, and the issue of exchange rate risk. The strategy should follow from an attitude to debt in which debt is treated as a stable source of finance for investments, i.e., from the permanent presence of the

<table>
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<tr>
<th>Recommendations</th>
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<tbody>
<tr>
<td>Increasing openness and transparency of debt management</td>
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<tr>
<td>Improving the quality of financial reporting data</td>
</tr>
<tr>
<td>Coordination of debt management with long-term planning</td>
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</table>
local government on the capital market. A debt management strategy should define the framework and limits for satisfying the loan needs of the local government; whereas, a long-term financial plan should allow local governments to estimate the surplus of income over current expenditure (operating surplus). Both these figures, in turn, allow one to determine the amount of investment expenditure the local government can afford to finance. It follows, therefore, that a debt management strategy that is not coordinated with a long-term financial plan and a long-term investment plan, will not fulfil its function; and conversely, the value of long-term investment planning without a strategic decision on how to incur debt will also be rather small.

10. Long-term financial and investment planning, together with a debt management strategy, should be the basis for managing local government finances. The local governments, for which the capital market is an important source of finance, should designate organizational units for managing debt, and outsource fewer tasks related to raising loan funds. Such units would be responsible for identifying and analyzing the actual possibilities of incurring debt in accordance with the standards established for a given market. They should play a major role in drawing up a debt management strategy, they should participate in the drafting of a long-term financial plan, and they should suggest the terms and manner of incurring debt and draft the necessary resolutions. In small local governments the same function would be fulfilled by a dedicated single official, who would have the appropriately defined responsibilities. Concentrating skill and experience in professional debt management departments (units), would, in turn, be the best guarantee that good practice related to the raising of outside funds (also of a ‘technical’ nature) will catch on. Local governments should be convinced of the legitimacy of assessing the ‘advantageousness’ of a particular credit by using the effective cost related to the date on which the debt is issued, interest rate, and the date of repaying the debt, consistently with a long-term financial plan, and guaranteeing the current management of liquidity. Debt management units should work out a strategic approach to bond issues, which would be based on issue programmes, and collaboration with underwriters, which in turn would guarantee to buy the bonds that are not bought by third parties. An important responsibility of such units would be to control the building of a portfolio of subscriptions and adjusting the size and structure of issues to investors’ needs.

11. In the case of very small local governments, specially small rural communes and towns where setting up dedicated debt units, if only...
in the form of a single position, seem highly unlikely, a significant role in facilitating local government access to the capital market could be played by local issuing houses, which would be set up and would operate like American bond banks. Such institutions could take advantage of pooled financing, which would be based on the sufficient creditworthiness of the group members. In this case, specifying the detailed terms and structure of an issue would be entrusted to professionals. While local government pooled financing would be the responsibility of public institutions that are set up by the public administration (e.g., regional authorities) and act as brokers between the regional authorities and investors, the fundamental difference between municipal issuing houses and other institutions that take advantage of pooled financing, lies in the form of the State aid. Municipal issuing houses should not, in principle, use financing from public funds; whereas, a significant share in the liabilities or revenues of revolving funds or leveraged lending programmes is made up of capital, reserves and subsidies from the State budget. In the case of municipal issuing houses, the role of the State should largely be limited to the financing of the process of setting up the municipal issuing houses.

An improvement in the quality of local government debt management will contribute to strengthening the competitive position of local governments as capital market players. It may also result in reducing the effective costs of debt servicing (or relieving the market pressure on increasing costs) and taking greater advantage of leverage in financing investments in the public sector. It must be stressed, however, that drawing on reserves to finance local governments, following from the increased effectiveness of debt management, should be preceded by a search for, and promotion of, alternative ways of financing investment projects (e.g., public-private partnership or other forms of structural financing). Financial innovations should be used in the first place by those local governments that already take advantage of all the possibilities offered by the more traditional forms of financing. Implementing the recommendations does not call for any significant financial outlays or changes in the local government’s financial system. Most of the recommendations could be put in place in a relatively short time.
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Annex 1.

Potential values for the criteria used for measuring the degree to which local governments meet individual standards

<table>
<thead>
<tr>
<th>Major areas of debt management</th>
<th>Management standards</th>
<th>Criteria and potential values management standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>I) Long-term financial and investment planning</td>
<td>1. Possession of a long-term financial plan (LFP) and long-term investment plan (CIP) covering more than 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Possession of LFP/CIP approved by the Council (constitutive body)</td>
<td></td>
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<tr>
<td></td>
<td>3. Possession of several versions of LFP/CIP</td>
<td></td>
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<tr>
<td></td>
<td>4. Forecast of existing and future debt covering more than 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. Existence and period of long-term investment (financial) plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a) LFP/CIP covers ≥ 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) LFP/CIP covers &gt; 3, but &lt; 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c) LFP/CIP covers ≤ 3 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>d) No LFP/CIP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Form of long-term financial (investment) plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a) LFP/CIP approved by Council resolution</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) LFP/CIP is an approved document (by committee resolution or other document)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c) LFP/CIP functions without a Council or a committee resolution.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Versions of LFP/CIP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a) LFP/CIP drawn up in at least three versions.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) LFP/CIP drawn up in two versions.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c) LFP/CIP drawn up in one version.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. Character of debt forecast</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debt forecast concerns:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a) existing and future debt, and covers ≥ 7 year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) existing and future debt, and covers &lt; 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c) existing debt only.</td>
<td></td>
</tr>
<tr>
<td>Major areas of debt management</td>
<td>Management standards</td>
<td>Criteria and potential values of management standards</td>
</tr>
<tr>
<td>--------------------------------</td>
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<td>--------------------------------------------------</td>
</tr>
</tbody>
</table>
| l) Institutional and organizational management methods | 5. Permanent presence on the capital market | 5. Debt revenues occur in:  
   a) each of the last 3 years  
   b) two years;  
   c) one year  
   d) do not occur at all. |
| | 6. Development of debt management policy (strategy) | 6. Debt management policy  
   a) exists in the form of a Council resolution  
   b) is an informal document;  
   c) no debt management strategy. |
| | 7. Designation of unit (person) for debt management | 7. Unit or person designated for debt management  
   a) exists;  
   b) does not exist. |
| | 8. Possession of a rating | 8. LG rating  
   a) international;  
   b) domestic  
   c) no rating. |
| | 9. Investor relations programme | 9. Investor relations programme  
   a) a formal investor relations programme exists  
   b) a formal investor relations programme does not exist; however, all official financial documents are accessible through a webpage  
   c) a formal investor relations programme does not exist, and access to official financial documents is restricted. |
<table>
<thead>
<tr>
<th>Major areas of debt management</th>
<th>Management standards</th>
<th>Criteria and potential values management standards</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10.a) Bonds: negotiated terms or underwriting</td>
<td>a) the underwriter is obliged to buy those bonds that are left unsold by other investors, with a local government official participating in all operations related to structuring the issue, fixing the issue price and monitoring the sale; or the issuing house is obliged to buy the entire new issue.</td>
</tr>
<tr>
<td></td>
<td>10.b) Credit: assessment of bids - effective cost or other criteria</td>
<td>b) the undertaking of the underwriter does not cover a).</td>
</tr>
<tr>
<td></td>
<td>11. Broadening of LGs presence on the market</td>
<td>10.b) Lender selection criteria</td>
</tr>
<tr>
<td></td>
<td>11.a) Bonds: public or non-public issue</td>
<td>a) bid acceptance criterion based on effective cost;</td>
</tr>
<tr>
<td></td>
<td>11.b) Credit: denominated in local or in foreign currency</td>
<td>b) other selection criteria, or selection of lender without any competitive bidding</td>
</tr>
<tr>
<td></td>
<td>12. Management of financial risks inherent in raising outside funds</td>
<td>11.a) Character of bond issue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a) public issue;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b) non-public issue.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>11.b) Credit currency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a) LG incurred credit denominated in a foreign currency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b) LG did not incur credit denominated in a foreign currency.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>12. Management of risks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a) LG uses derivative instruments to hedge against interest rate risk or exchange rate risk;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b) LG does not use derivative instruments to hedge against interest rate risk or exchange rate risk.</td>
</tr>
</tbody>
</table>
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