MUNICIPAL BORROWING

MACROECONOMIC AND MICROECONOMIC RISKS

Ing. Dušan Tichý, Slovak and World Economics Institute of the Slovak Academy of Sciences in Bratislava
doc. Ing. Elena Žárska, CSc., University of Economics in Bratislava

Municipality local government was constituted[1] with its own asset and financial base. This requires the use of certain elements in their activity and the creation of an asset and financial policy. A problematic field for municipalities' operation is the disproportion between the scope of codified competences and the financial capacity for covering them. This disproportion has been a dominant feature throughout the time of the municipality local government. The essence of the problem lies primarily in the state budget's relation to municipalities' budgets, as well as in the need for investing in local public infrastructure that is either unsuitable or lacking, as well as in creating the conditions for achieving the territories' development on the basis of local potential, or external capital.

The policy employed to date in financing local governments has been based on a system that was although functioning and was from a certain aspect a stabilising factor for social development, nevertheless contained numerous inherent systemic problems. These relied more on ad hoc solutions than systematic steps. This caused local bodies to become unable to react flexibly to the real development of their incomes and expenditures without there occurring an increase in their borrowing or without selling off their own assets (particularly since 1998, when local governments lost a significant share of their own assets via such disposals). The relatively small room for independent decision-making by municipality representatives on the side of repetitive incomes led to an excessive use of debt, which destabilised the fiscal balance of territorial units. In this way the growing debt burden and subsequent insolvency of several municipalities became a serious problem, since municipalities were forced to use part of their borrowed funds also for essential current expenditures. This fact was caused mainly by a restrictive approach from the Government in the field of financial policy towards municipalities.

A serious problem in the previous system of financing local governments was their financing via transfers (ie tax revenues in the state administration and via subsidies), which should have partially balanced out differences at the socio-economic level of local governments. The fact was that the previous system of allocating public funds from the state budget did not take account of the individual needs of the socially and economically less-developed local governments. The objections held by local government representatives were due mainly to the instability of the system caused in particular by the yearly change in the share of taxes (with the exception of road tax) and unobjective criteria in allocating proportional taxes (the single criterion being the number of inhabitants). Only corporate income tax revenue was redistributed according to more general criteria (the number of inhabitants and the taxpayer's seat), although even here the principle of allocating according to the firm's seat was criticised, since a firm's registered offices are often different from the location of its production facilities. Since the creation of tax revenues is locally and regionally more differentiated than population density, the system of allocating tax revenues in the state administration to local government budgets fulfilled to a certain degree also a function of balancing out finances. Practice to date however has not confirmed the existence of any integrated long-lasting system of redistributing centrally collected taxes, which was the main cause of the growing insolvency of towns and municipalities. Besides this, the system lacked any motivating mechanisms that could work to dynamise development particularly in problematic municipalities and regions. The structure of subsidies contained no systemic subsidies that would balance out the tax strength of individual municipalities and towns, and thereby mitigate vertical fiscal imbalances and contribute to the neutralisation of externalities. A certain balancing out function was fulfilled only by subsidies for local government functions performed by municipalities of up to 3000 inhabitants, where the primary aim of these subsidies was to support the provision of basic administrative tasks in small municipalities. Besides this, the system of subsidies was deformed by the administrative burden of the redistribution process.

Table 1 shows that subsidies as well as the shares of tax revenues from the state budget play an indispensab-

[1] Act of the Slovak National Council No 369/1990 Coll. on municipal establishment as later amended.

Table 1 Municipality budget incomes in relation to subsidies and proportional taxes from the state budget for 1991 – 2004

(million SKK)

Year	Total municipality incomes (mill. SKK)	Municipality incomes in relation to the state budget (mill. SKK)		Total municipality incomes in relation to the state budget (mill. SKK)	Share of incomes from state budget in total municipality incomes (%)		Total shares of incomes from state budget in total municipality incomes (%)
		Subsidies	Proportional taxes		Subsidies	Proportional taxes	
1991	16 175	7 980	2 157	10 137	49.3	13.3	62.7
1992	20 627	6 582	4 197	10 779	31.9	20.3	52.3
1993	20 966	2 227	5 648	7 875	10.6	26.9	37.6
1994	20 073	1 441	5 583	7 024	7.2	27.8	35.0
1995	22 236	1 490	5 089	6 579	6.7	22.9	29.6
1996	25 424	1 570	5 848	7 418	6.2	23.0	29.2
1997	28 786	1 745	6 068	7 813	6.1	21.1	27.1
1998	28 823	1 801	6 815	8 616	6.2	23.6	29.9
1999	27 344	1 786	6 855	8 641	6.5	25.1	31.6
2000	33 657	2 000	7 667	9 667	5.9	22.8	28.7
2001	32 718	4 774	9 363	14 137	14.6	28.6	43.2
2002	57 490	22 929	10 152	33 081	39.9	17.7	57.5
2003	70 323	34 046	10 425	44 471	48.4	14.8	63.2
2004	76 221	33 985	11 785	45 770	44.6	15.5	60.0

Source: State Accounts 1991 – 2004

Table 2 Development of municipal revenues from subsidies and taxes in state administration in comparison with annual inflation

Indicator	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Municipality incomes from proportional taxes (mill. SKK)	5 647	5 972	5 502	6 280	6 529	7 266	7 370	8 297	9 363	10 155	10 426	11 785
2. Year-on-year development (%)	34.6	5.8	-7.9	14.2	4.0	11.3	1.4	12.6	12.8	8.5	2.7	13.0
3. Subsidies (mill. SKK)	2 227	1 441	1 490	1 570	1 745	1 801	1 786	2 000	4 774	22 929	34 046	33 985
4. Year-on-year development (%)	-66.2	-35.3	3.4	5.3	11.1	3.2	-0.9	12	238	480	48	-0.2
5. Annual inflation (%)	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5
Difference 2-5	11.4	-7.6	-17.8	8.4	-2.1	4.6	-9.2	0.6	5.7	5.2	-5.8	4.9
Difference 4-5	-89.4	-48.7	-6.5	-0.5	5.0	-3.5	-11.5	0	230.9	476.7	39.5	-7.7

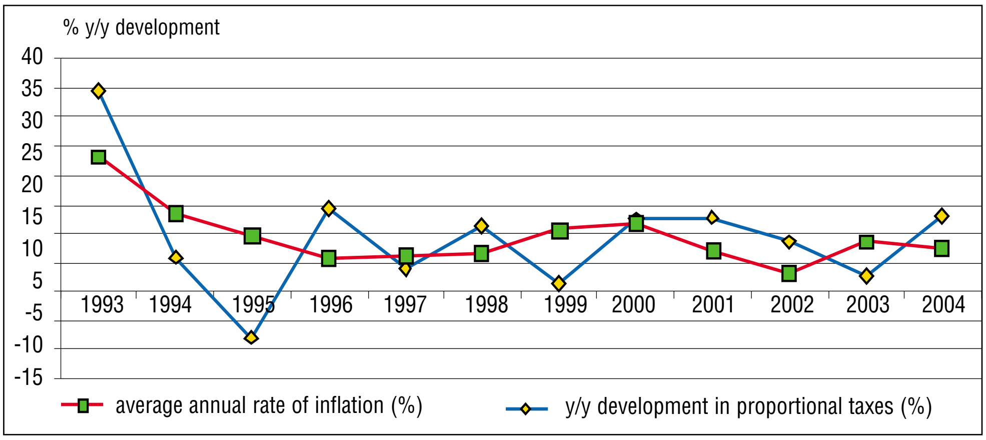
Source: State Accounts 1993 – 2004, own calculations

le role in our budgetary practice and are of great importance. The extent of subsidies and proportional taxes represents at the same time coverage of a significant percentage of local government expenditures, where one of several reasons for this state is not only to provide local governments autonomy in their income source, but also that local governments become more cautious about raising their own income sources, given taxpayers' negative reactions to higher local taxes. From Table 1 it can also clearly be seen that in absolute terms subsidies to local government budgets have declined significantly on a year-on-year basis, while this has not been sufficiently compensated for by shares in central tax revenues.

The table confirms the fact that over the years 1993 to 2001 incomes from the state budget to the local government budgets of municipalities declined, meaning that municipalities had to create their financial base largely from own funds (local taxes and charges, revenues from assets) and outside sources (borrowing and loans). Furthermore in individual years these incomes did not develop in line with inflation, whereby their real value fell. A special situation has been seen since 2002, when decentralization of general government was begun and new competences that were passed to municipalities were in the years 2002 to 2004 financed by a so-called decentralization subsidy[2].

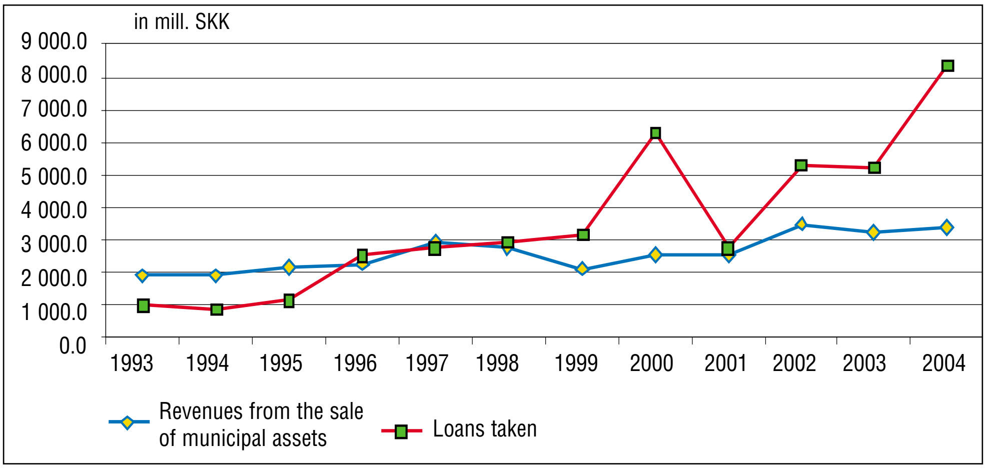
[2] Since 1 January 2005 a new model of local government financing has applied, so-called fiscal decentralization financing, which has strengthened local authorities' own incomes – mainly through corporate income tax revenue, 70.3% of which goes to municipalities' budgets. These forms of financing are governed by Act No. 564/2004 Coll. on budgetary assignment of tax revenue from territorial local government incomes and Act No. 582/2004 Coll. on local taxes and local charges for communal waste and minor building waste.

Graph 1 Comparison of development of proportional taxes (%) with average annual rate of inflation for 1993 – 2004



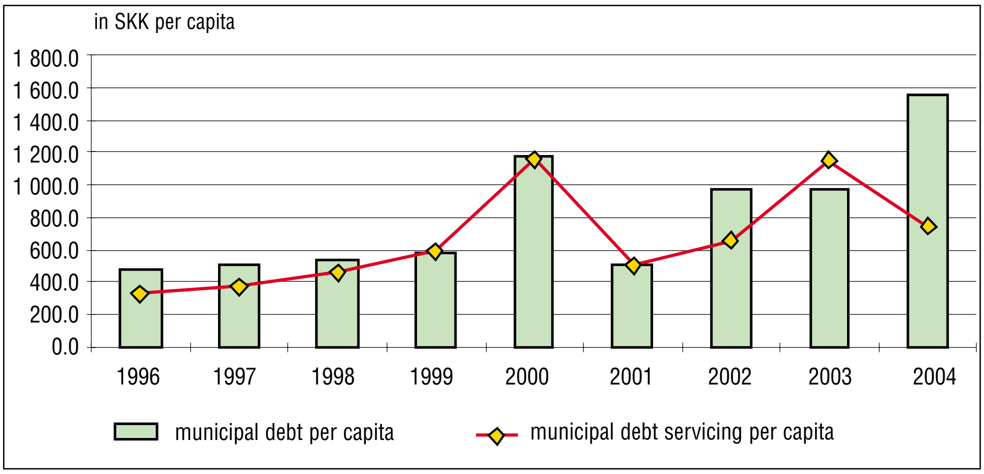
Source: based on Table 2

Graph 2 Revenues from the sale of municipal assets and loans taken in 1993 – 2004



Source: State Accounts 1993 – 2004

Graph 3 Municipal debt and debt servicing expenditures per capita for 1996 – 2004



Source: State Accounts 1996 – 2004

Central power thus got local governments permanently into problems, which was negatively reflected in the overall indebtedness of local governments. Besides this, municipalities had to obtain finance from sources which are one-off or practically irreproducible. It was in these circumstances that municipalities were selling off assets under pressure, ie under disadvantageous conditions[3]. Local governments thus had to provide many public services for citizens from the very funds they had gained from the sale, leasing of assets, from loans and bonds, because tax sources and incomes from local charges were not sufficient for this. This situation was negatively influenced also by the fact that municipalities settled the costs also for services that should have been provided for by central government on the basis of the distribution of competences. The trend in the development of revenues from the sale of municipal assets and loans taken on is depicted in Graph 2.

In graph 2 we see that since 1996 local government has been unable to help itself through selling assets, and income from loans in the following years up until 2004 several times greater than the inco-

[3] A role here was played also by the fact that the price of a significant volume of local authorities' assets was regulated through price regulations controlled by a central power (for example, the apartment fund, or upper limits on property tax and local charges).

Table 3 Municipal debt and shares in selected indicators for 1996 – 2004

in mill. SKK

Indicator	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total loans taken	2 565.7	2 733.2	2 942.7	3 162.9	6 302.8	2 730.5	5 301.4	5 254.2	8 343.8
Total cumulative debt	5 350.0	7 006.0	8 451.0	10 589.0	12 261.0	12 725.0	14 608.0	14 265.0	13 598.1
Debt servicing expenditures	1 795.2	2 015.8	2 515.3	3 195.6	6 258.4	2 717.6	3 555.9	6 207.9	4 043.2
Municipalities' capital deficit	-3 889.7	-4 086.5	-5 175.1	-3 404.7	-2 976.0	-3 601.1	-3 115.6	-3 523.8	-4 429.3
Share of municipal debt in GDP (%)	0.9	1.0	1.1	1.3	1.3	1.3	1.4	1.2	1.0
Share of municipal debt in public debt (%)	2.7	3.0	3.2	2.7	2.6	2.6	3.1	2.8	2.3
Share of public debt in GDP (%)	32.2	34.4	35.4	48.9	51.3	49.8	44.3	42.8	44.0

Source: State Accounts 1996 – 2003, Balances from DataCentre – municipality budgets for 2004 and own calculations.

Table 4 Calculations of local government borrowing limits in 1996 – 2004

Year	Municipalities' debt as at 31.12. (mill. SKK)	Actual current incomes1) in the preceding budgetary year	Debt repayment in the given year (principal + interest)	Total debt as % of current incomes	Debt servicing as % of current incomes
				limit = 60%	limit = 25%
1996	5 350.0	12 967.0	1 795.2	41.3 %	13.8 %
1997	7 006.0	18 267.3	2 015.8	38.4 %	11.0 %
1998	8 451.0	17 398.8	2 515.3	48.6 %	14.5 %
1999	10 589.0	17 710.8	3 195.6	59.8 %	18.0 %
2000	12 261.0	17 625.6	6 258.4	69.6 %	35.5 %
2001	12 725.0	20 219.6	2 717.6	62.9 %	13.4 %
2002	14 608.0	22 073.0	3 555.9	66.2 %	16.1 %
2003	14 265.0	36 517.5	6 207.9	39.1 %	17.0 %
2004	13 598.02)	51 411.3	4 043.2	26.4 %	7.9 %

Source: Návratné zdroje financovania a miestna samospráva: riziká a prínosy. Správa o Strednej a východnej Európe. M.E.S.A.10, Bratislava 2004, in [6], State Accounts 1995 – 2004

1) Current incomes = tax incomes + non-tax incomes (less capital incomes and transfers from municipalities' other money funds) + current grants and transfers.

2) Preliminary estimate.

me from the sale of municipal assets. Overall we can assess this development as clear evidence of the state's restrictive measures towards local governments. A real overview of the growing indebtedness is given by the per capita recalculation shown in Graph 3.

Municipal debt increases total public debt and, since public debt influences the overall stability of the country's financial system, it is reasonable to examine these relations in respect of GDP and at the same time also as a component of the Maastricht criteria.

From the analysis of Slovak municipality borrowing for the years 1996 to 2004 it can be seen that even if municipal debt may be considered too small to directly threaten macroeconomic stability it is worrying that this borrowing grew very quickly in this period (with the exception of 2001) to more than double. It may however be said that municipalities' overall debt does not infringe upon macroeconomic stability indicators, and thereby nor upon gradual approximation to the Maastricht criteria, which is documented by the share of municipality total debt in GDP and in the consolidated public debt.

For the stability of the local financial system it is important that the excessive borrowing and subsequent insolvency to repay liabilities does not threaten the performance of a municipality's basic functions in the field of providing public services. These facts have led to the introduction of regulated borrowing levels[4] in the Slovak

[4] Act of the National Council of the SR No 583/2004 Coll. on the budgetary rules of a territorial local government, Article 17.

system of local government financing. Under the Municipalities Act, total municipality debt may not exceed 60% of actual current incomes for the preceding budgetary year and the sum of annual repayments of returnable financing funds, including bond repayments may not exceed 25% of actual current incomes for the preceding budgetary year. This law was codified in 2001 in the Act on Budgetary Rules, though with legal effect as of 1 January 2005.

From the aspect of these conditions, recalculations were made in a study by the MESA 10 group [6], to which we have added the years 2003 and 2004.

The results show that municipalities would have exceeded that borrowing limit in the years 2000 to 2002 and the debt servicing limit in 2000. It may be presumed that a table calculated for the individual size groups of municipalities would have given different results, because in 2002 three towns – Bratislava, Košice and Banská Bystrica – formed approximately 68% of total municipality debt. Experience has shown that the microeconomic risks to the stability of the financial system are a more serious problem for large towns than other towns and municipalities.

Several problems remain open in examining and assessing the borrowing of Slovak municipalities, which will have to receive attention in the near future:

1. The regulation of borrowing has been legally effective only since 1 January 2005 and it is difficult to foresee how mainly large towns, or municipalities, will come to terms with it, since they have already had problems with their insolvency.

2. Fiscal decentralization, effective since the start of 2005, gives municipalities greater financial capacity, whereby also their capacity for debt is increased, which may lead to a growth in taking on loans.

3. The decentralization of general government has significantly strengthened the standing of municipalities in the development of their territory, something which can induce an effort to utilise their territories' potential through creating a business environment, also on the basis of borrowing.

4. A risk of increased borrowing is contained also in the high modernization debt in facilities that were passed, along with competences, in 2002 (school, social, healthcare and cultural facilities), and municipalities will be forced to solve the situation also through taking on loans.

5. The use of financial resources from European Union funds is also a potential source of increased borrowing, since municipalities can gain the necessary part of funds for co-financing also from loans.

A municipality is and will remain a relatively safe client for creditors. Debt will continue to remain a rational source for financing mainly municipalities' infrastructure or amenities. These facts nevertheless represent a risk of further indebtedness. To eliminate this risk to an acceptable degree may be achieved through compliance with the statutory set limits and their thorough control by the Ministry of Finance, as well as a prudent borrowing policy by local government bodies for which some towns have had, or will have a credit rating issued by domestic and foreign rating agencies (so far 35 Slovak towns have used only domestic agencies). The rating assesses not only the town's creditworthiness, but also its trustworthiness for entrepreneurs – potential investors and are also important information for citizens – voters on the responsibility of the local government representatives for the town's financial management and development.

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