

The Concept of Sustainable Finance and the Issue of Financial Stability in Local Government Units

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Abstract: The purpose of this study is to approximate the essence and importance of the concept of sustainable finances and the issue of financial stability of local government. Nowadays, traditional finance is evolving towards sustainable and responsible finance, which approaches the issue of financial results and its components, risk and investments in a more comprehensive way, taking into account the social, environmental and economic aspects in the decision-making process. The following methods have been used: literature analysis and the method of a diagnostic survey using questionnaires. The study included local government units located on the territory of 5 voivodeships of the Eastern Poland macroregion: Lubelskie, Podkarpackie, Podlasie, Świętokrzyskie, and Warmińsko-Mazurskie. The population surveyed includes 210 local government units, consisting of 70% of urban-rural communes and cities with powiat rights and 20% of rural communes. The analysis of the obtained results allowed the researchers to discover the opinions of the main accountants (treasurers) in the area of financial stability of peripherally located local governments.

Keywords: sustainable finance, financial stability, fiscal solvency, accounting liquidity, local government unit

Introduction

The concept of sustainable development was created in the 1980s and is currently one of the most important concepts in terms of economic development. This concept has evolved and nowadays it is believed that it is particularly important to make the ruling classes aware that economic growth cannot only consist in the growth of GDP, production, employment or income, but that it also must maintain the current level of social, relational and

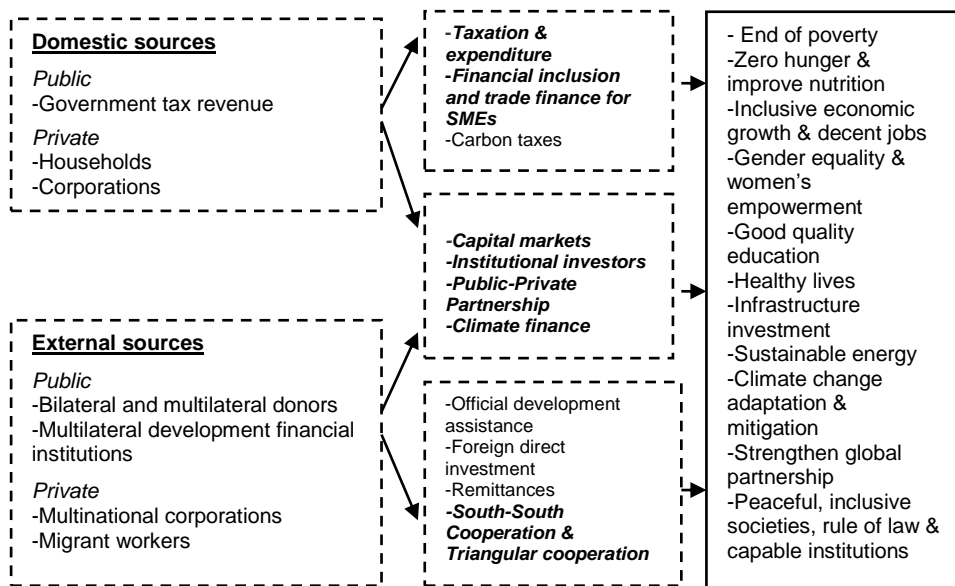
natural capital, which will ensure intergenerational justice (Latoszek, 2016, p. 26). Sustainable development signifies a certain state of relative balance between socio-cultural development, economic development and the ecosystem. One of the conditions necessary for the harmonization of development is the ability of the socio-economic system to be included, which is understood as reconciling social, economic and environmental interests, while optimizing the use of socio-economic potential (Mączyńska, 2016, p. 25). The capital base of society includes five different types of capital: financial, production, natural, human and social. The public finance system is therefore included in the financial capital component.

In the literature on the subject, the relationship between public finance and sustainable development has been repeatedly presented. Analysis of the components of the sustainable development process indicates that its implementation depends on the scope of the involvement of the financial system. This concept requires large investments, for example, in public goods, such as social services, care for the quality of water and air, and the development of other services that are the foundation of the functioning of economies and entities operating in them (Pietrzak, Dobrzańska, Kosycarz, 2016).

Currently, Europe and many other highly developed regions are moving towards the implementation of the concept of sustainable development, which is associated with the idea of sustainable finance (Figure 1). Public finance comprises processes and instruments for collecting and spending funds by public authorities. The economics of sustainable development treat public finance as a tool to achieve specific goals (Poskrobko, 2011, p. 99); (Rogall, 2010, p. 319).

The concept of sustainable finance is relatively new and less widespread, however, it is strongly becoming more and more important (Alińska, Frydrych, Klein, 2018, p. 28). The idea of sustainable public finances proclaims that they should comprehensively stimulate sustainable development by contributing to the achievement of the greatest possible number of sustainable development goals (economic, social and ecological) while maintaining neutrality in the context of other objectives. Building an internally stable public finance system is no longer the only challenge, as it is also important to skilfully apply an appropriate fiscal policy to stimulate many non-financial domains simultaneously (Cieślukowski, 2017, p. 12).

Figure 1. A schematic view of the sources of financing for sustainable development



Source: Sustainable Development Financing: Perspective from Asia and the Pacific, United Nations Economic and Social Commission for Asia and the Pacific, 2014, p. 9

In the subject literature, a general definition of financial stability is often presented, which describes it as a state in which the financial system is able to perform its functions in a continuous and effective manner, even in the event of unexpected and unfavourable disturbances on a considerable scale and a low probability of occurrence (Report on the stability of the financial system, 2018, p. 4). In a similar convention, connecting issues of stability with the functional capacity of the system, the fiscal stability of the public sector and the public finance sector is defined as the ability of the organizational units included in these sectors to provide public services, without prejudice to the possibility of providing them in the future (Navarro, Rodriquez-Bolivar et al., 2016, pp. 3961–3975). More precisely, financial stability is defined as the ability to provide services and meet current financial obligations, and in the future to maintain it without the necessity to cause a continuous increase in debt (IFAC 2012 and CICA 2009). In general, the goal of sustainable public finance, including local finance, is to avoid insolvency of public finance sector entities (Neck, Sturm, 2008). This entails a need to shift from excess economy to moderation economy - also in terms of debt. The economy of moderation

entails, in the opinion of G.W. Kolodko (G.W. Kolodko, 2014, p. 172), adjusting the size of human, natural, financial and material streams to the requirement of maintaining a dynamic balance. Public finance at every level should strive for long-term balance, which does not necessarily mean a complete lack of debt, but only bringing its amount to a safe level (Wyżnikiewicz, 2010, p. 6).

In the International Accountancy Standards Board (IASB), developed by the International Federation of Accounts (IFAC), the long-term stability of public finance sector entities (long-term fiscal stability) is considered in three dimensions: public services, public revenue and public debt (International, 2015, p. 207)

The financial situation of local governments and the stability of public services have an impact on the country's economic development, as well as the ongoing process of the political reforms aimed at promoting efficiency, balanced budgets and financial stability (Rodríguez Bolívar et al., 2016, p. 3). The assessment of financial stability of a local government unit (LGU) is an important issue because these entities are an important part of the economic processes. In Poland, local government is not only the largest service provider but it is also a serious investor. Local government investments saved the Polish economy from the severe effects of the financial crisis; however, they also significantly led to a worsening of their financial condition (Revenue of local government units 2004-2012). A financially sustainable local government unit is able to generate sufficient revenues to fulfil its basic function of providing services at an acceptable level (Financial Management, 2014, p. 10). Therefore, the financial situation of local government units affects the development of other fields of their functioning and is a source of information about their potential for economic development, and at the same time allows comprehensive assessment of the operation of these entities.

In Polish legal regulations, there is no literal and comprehensive definition of financial stability. References to individual elements facilitating the maintenance of the financial stability of LGUs are included in the Public Finance Act:

- (Article 242) - budget balance;
- (Article 217) - rules for financing the budget deficit;
- (Article 222) - establishment of a system of reserves;
- (Article 254) - managing the financial economy of LGUs;

- (Article 86, Article 260) - actions aimed at maintaining financial stability;
- (Article 243) - individual debt ratio (IDR) - limitation of indebtedness.

The issue of financial stability in the territorial government sub-sector is much less recognized in the literature than in the entire public finance sector. It is crucial to address the notion of the financial stability of local government units, which are an important entity of the financial system due to their share in the redistribution of public money, participation in the redistribution of EU funds, and the volume of purchases of goods and services made as part of the tasks implemented.

After the political system was transformed, local governments gained financial independence, which influenced their development in the area of finance management. Financial, systemic and administrative decentralization has introduced the freedom to make financial and economic decisions. A visible disadvantage of the functioning of the public sphere financial system is financial decentralization, which is not keeping up with the decentralization of tasks. The relationship between the level of financial resources and the degree of implementation of public tasks and the quality of life of the local community is widely known. However, delegating tasks to the level of local government is not always accompanied by transfer of adequate financial resources. It should be emphasized that one of the most important requirements of stability is a well-structured financing system for LGUs.

Although there is no uniform definition in the literature on the subject, there have been attempts to determine the financial stability of local government units as a state enabling the implementation of functions assigned to LGUs, and enabling the execution of transactions related to LGU tasks, with a guarantee that they will not have a negative impact on the budget. This stability is often defined as a state of the effective allocation of financial and material resources; as well as effective risk identification and management (Filipiak, 2016, p. 14-15). Pressure on the ever-constant local development; and providing high-quality public services with simultaneous multidirectional operation of a local government unit, means that financial resources are far from sufficient (Hok, 2016, p. 112). It can therefore be concluded that, on the one hand, a source of weakness for local government finance is the shortage of financial resources; and on the other hand, the lack of a rational system of managing them in accordance with the idea of sustainable finances.

The financial stability of LGUs is often combined with the issue of financial security manifested in the ability to meet obligations (Article 44 section 3 of the Public Finance Act), as well as income efficiency and the effectiveness of tasks implementation while maintaining the ability to implement development policy (Filipiak, 2016, p. 13-33). The practice of local government bodies verifies a theoretical approach through the need to make decisions that take into account the existence of various factors destabilizing financial security. In the aforementioned context of financial security, the state of financial stability of LGUs is identified with the situation in which any distortions from the market will not cause the loss of potential, and thus the ability to meet the obligations, and the implementation of tasks will be ensured at the current quality and quantity level.

Material and methodology

The literature of the subject was reviewed and it was determined that the financial stability of LGUs can be analysed on the basis of solvency defined as the accumulation of budgetary surpluses guaranteeing debt repayment, the ability to service liabilities conditioned by the level of budget liquidity, the stability of debt, the ability to generate a surplus of the original budget, and the ability to control and manage debt-related risks. In addition, the Canadian Institute of Chartered Accountants (CICA), one of the oldest organizations stating the directions of accounting development and financial analysis, noticed the need for standardization of practices and methodologies for measuring financial stability and issued documents recommending practices of financial situation analysis. In order to establish a common financial stability framework, it proposed basing it on three dimensions: sustainability, vulnerability and flexibility (CICA 1997, 2009).

The purposeful selection of 5 voivodeships was dictated by their peripherality, both in terms of spatial dimension (defined by the distance from the development centres of Poland and the European Union), as well as in socio-economic terms. The level of economic development of these areas is one of the lowest in the European Union. A low level of innovativeness, competitiveness and investment attractiveness is also characteristic for this area. Developmental delays of the macroregion have deep historical roots and are examples of long-term processes (Kukliński, 2010). Eastern Poland is also distinguished on the national scale by the quality of the natural environment

due to the greater percentage, compared to the national average, of area covered by various forms of legal environmental protection (39.4%, while the national average is 32.5%) (Kozak, 2011, p. 90).

As a result of a diagnostic survey carried out in 2018 among local government units located on the territory of voivodeships of the Eastern Poland macroregion: Lubelskie, Podkarpackie, Podlaskie, Świętokrzyskie, and Warmińsko-Mazurskie, opinions on the factors determining the financial stability of LGUs were obtained. The answers given by the financial management staff of the local government units surveyed, i.e. the treasurers of 10 cities with powiat rights, 100 urban and rural communes and 100 rural communes, allowed for analysis in terms of elements decisive for the financial stability of the units represented. The primary data obtained in the qualitative study were analysed and are her presented graphically.

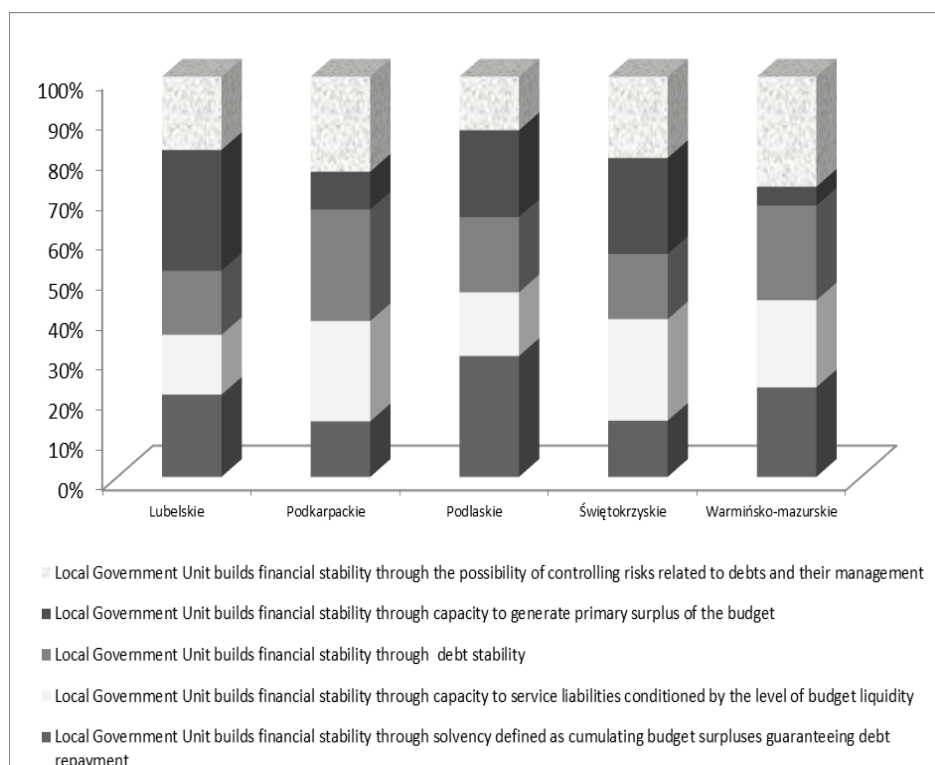
Results and discussion

In the literature, financial stability is understood as the ability to settle financial obligations while ensuring continuity in the provision of local government services. This continuity is a consequence of balancing the budget, financial independence, independence from transfers, financial liquidity and long-term solvency as well as the rational spending of public funds in communes (Stanny, Strzelczyk, 2018, p. 64). Financial stability is also characterized by a structure that strives to ensure budget balance while at the same time shaping the conditions for the increase of the degree of financial independence and security in the field of short and long-term solvency.

The study analysed the significance of solvency defined as the accumulation of budgetary surpluses guaranteeing debt repayment, ability to service liabilities conditioned by the level of budget liquidity, debt stability, ability to generate surplus of the original budget, and the ability to control and manage debt risks in building financial stability of local government units. The distribution of answers provided by the examined voivodeships is presented in Chart 1. The obtained data show that opinions on those key factors determining financial stability differ in the voivodeships examined. In the case of the Lubelskie Voivodeship, 32% of the surveyed entities considered the ability to generate surplus of the original budget to be a key factor in building financial stability. Units from the Podkarpackie Voivodeship considered debt stability as being the most important (27% of surveyed units), while in the

Podlasie Voivodship 32% of the management board members of surveyed units believe that solvency as a cumulative budget surplus guaranteeing the repayment of debt is the main factor in terms of building financial stability. The capacity to service liabilities, conditioned by the level of budget liquidity, was indicated as the main factor determining financial stability in 24% of the surveyed units from the Świętokrzyskie Voivodeship. In the Warmińsko-Mazurskie Voivodeship, 25% of treasurers mentioned the possibilities of controlling and managing debt-related risks as the main building block of financial stability of local government units.

Chart 1. Factors building financial stability of territorial government units by voivodeships of Eastern Poland macroregion (%)

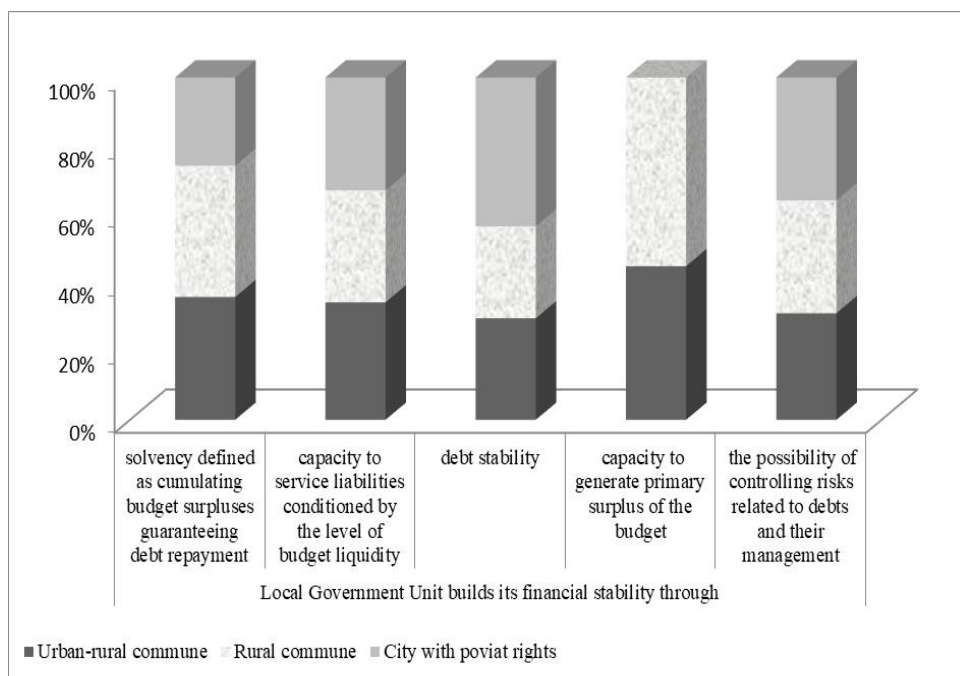


Source: own elaboration (questionnaire for the staff of finance management of the local government unit).

In the next stage of the research, the main factors determining financial stability in individual types of units were analysed (Chart 2). The distribution of the obtained answers indicates that the examined types of units as being the most important element for creating financial stability; usually

considered the same factor in the form of the ability to service liabilities conditioned by the level of budget liquidity: 35% urban and rural communes, 33% rural communes, and in the case of cities with poviats rights - 33% of respondents. Another important element was the stability of debt, which was recognized as an important factor by 33% of cities with poviats rights, 23% of urban and rural communes, and 21% of rural communes. In the case of cities with poviats rights, no unit indicated a surplus of the original budget as being a creator of financial stability of LGUs.

Chart 2. Factors building financial stability of territorial government units by the types of units of Eastern Poland macroregion (%)

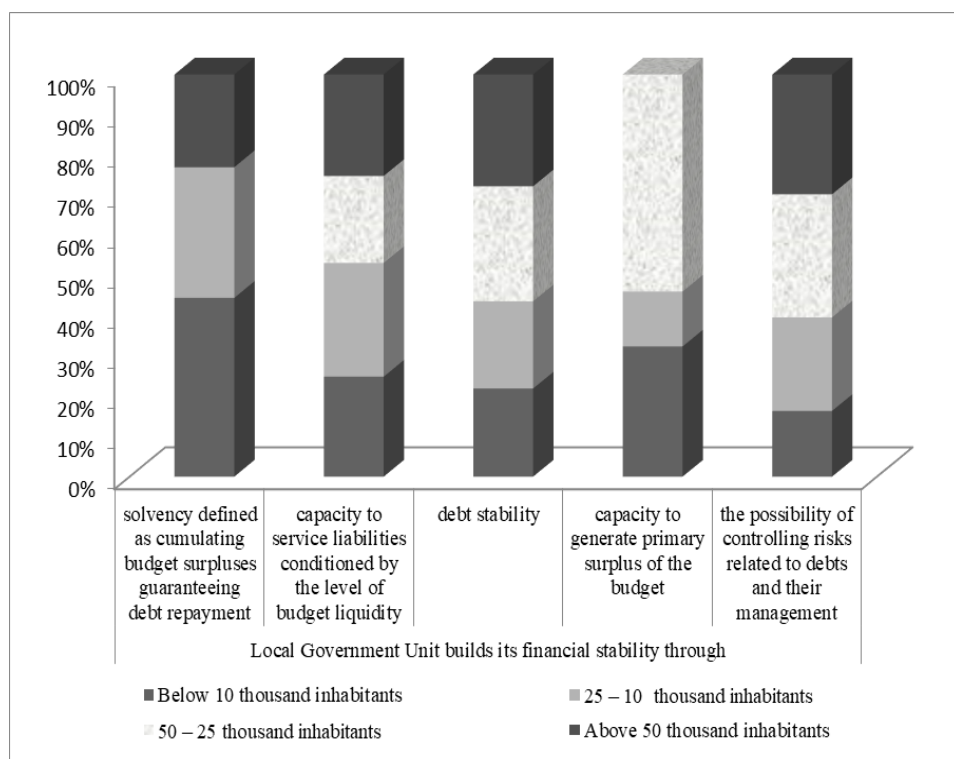


Source: own elaboration (questionnaire for the staff of finance management of the local government unit).

The answers given were also analysed depending on the number of inhabitants of selected local government units, as shown in Chart 3. In local government units, where the number of inhabitants did not exceed 10,000 residents, or ranged from 10,000 to 25,000 inhabitants, the ability to service liabilities conditioned by the level of budget liquidity was considered the most important determinant of financial stability (33% and 37% of the respondents respectively). In the case of units with more than 25,000 inhabitants, it can be

noted that equal factors were recognized as crucial, i.e. the ability to service liabilities conditioned by the level of budget liquidity, stability of debt and controllability of debt-related risks and risk management (29% in case of LGUs inhabited by 25,000-50,000 residents and 33%, 28% and 28% in the case of LGUs inhabited by more than 50,000 residents).

Chart 3. Factors building financial stability of territorial government entities by the number of inhabitants of Eastern Poland macroregion (%)



Source: own elaboration (questionnaire for the staff of finance management of the local government unit).

Conclusions

Sustainable public finance and the problem of stability of public sector units is extremely important due to the role they play in the financial system. Financial stability at the level of local government units is still a current issue, which results from the need to move from the financial administration of these units towards the real management of their finances.

The obtained and analysed views on the financial stability of local governments evoke some reflections. It should be emphasized that at the level of voivodeships of the macroregion of Eastern Poland there are very diverse opinions regarding the main factor building the financial stability of LGUs. In turn, the analysis of responses provided by the representatives of the types of local government units under review indicates that similar views regarding the key factor creating stability were recorded in all types tested. The capability to service liabilities conditioned by the level of budget liquidity and debt stability was considered to be the most important factor.

Another element that classified the analysis of the opinions was the number of inhabitants. In this respect, a certain division into units with a small population of up to 25,000 has been noted, in the case of which one of the components of financial stability is important, i.e. the capability to service liabilities, conditioned by the level of budget liquidity. In the second group of units where the population exceeded 25,000, the multifaceted nature of the problem of building financial stability was observed, and therefore the distribution of responses indicated the recognition of three equally important variables determining the studied phenomenon.