

# The Fall of Ostrowice Local Authority – Reasons and Conclusions



*Ostrowice. We went to a community so in debt that it has to disappear from the map.*



MARIAN SADKOWSKI/REPORTER





*Ostrowice community with the highest debt Marcin Bielecki /PAP*

## Introduction

In 2016 Ostrowice's debt became front-page news. It was the most indebted local authority in Poland.

Ostrowice local authority (LA) became insolvent and on 1 January 2019 disappeared from the map of Poland.

The aim of this talk is to firstly present the reasons for such an unprecedented and dramatic LA demise. Secondly, to try to reach conclusions on how to avoid this situation in the future.



## Therefore this will include the following:

1. General terms and conditions of Polish local authority financial activity,
2. Ostrowice LA profile,
3. Ostrowice budget,
4. Ostrowice debt development,
5. Violations of the law found during the audit,
6. State activity – appointed administrator, LA liquidation,
7. Finally, a discussion on the National Council of the Regional Chambers of Audit's suggestions to avoid the above mentioned situation in the future and previous legislative work on these proposals.



## 1. General terms and conditions of Polish local authority financial activity

- high level of local authority self-reliance,
- according to article 171 of the Polish Constitution, the legality of actions by a local government shall be subject to review,
- lack of hierarchical supervision in the relationship between local authorities, counties and regions,
- the self-governing nature of local government units shall be protected by the courts,
- external audit institutions – regional chambers of audit, handle financial management audits for LA responsibilities according to legal criterion; they have no competence to carry out such audits based on economic targets, due diligence and care (value for money),
- local authorities conduct their financial activity based on budget and long-term financial forecast passed for the budgetary year and at least three consecutive years; the forecast includes the debt amount forecast covering the period in which the local authority will be paying liabilities



## Statutory debt limits

According to the Public Finance Act of August 27, 2009 the budget can not be passed if:

art. 242 – current expenses are not financed from current revenues,

art. 243 – repayment index for credit, loans and maturity of bonds exceeded the individual LA debt repayment capacity ratio, according to legal formula.

Regional chambers of audit supervise budgetary and long-term financial forecast resolutions according to legal criterion, taking into account compliance with debt limits. They give opinions on the possibility of paying back long-term obligations.

In 2017, 37 local authorities had a problem to comply with art. 243 of the Public Finance Act.



## 2. Ostrowice LA profile



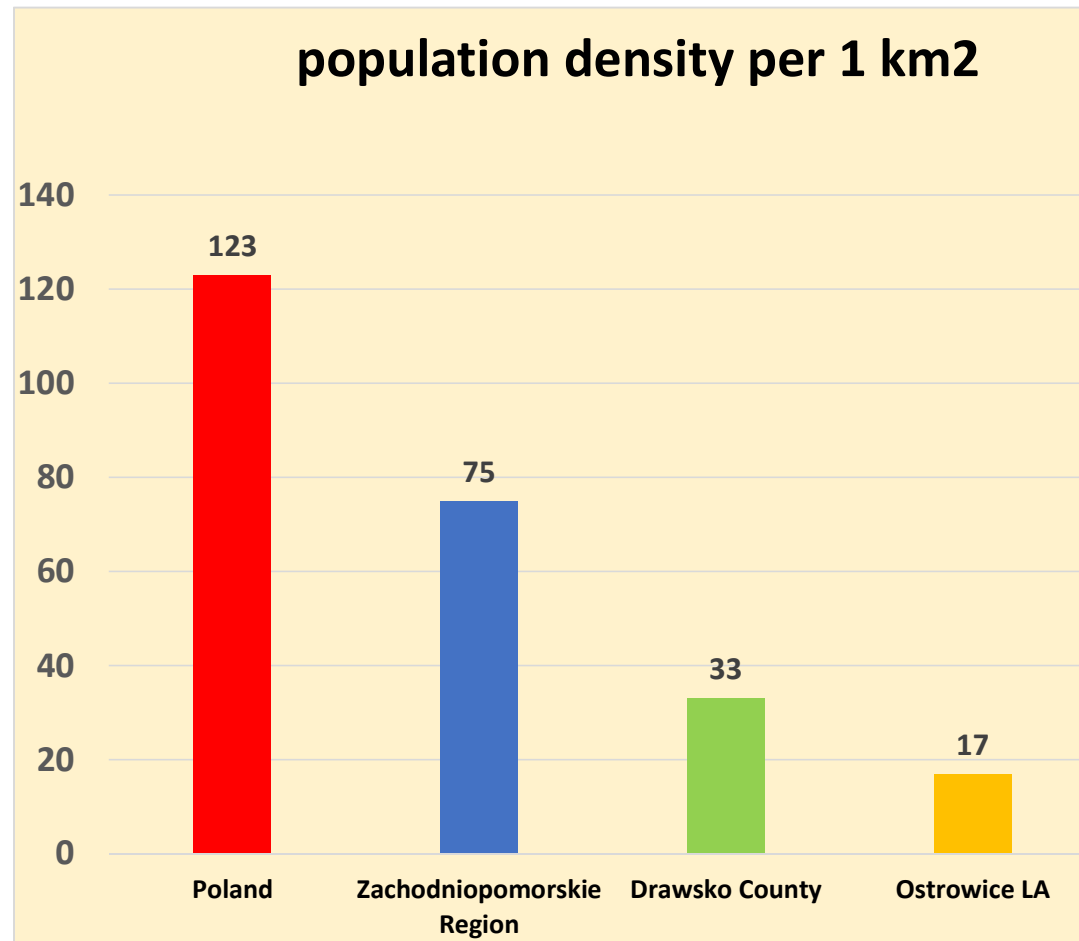


number of inhabitants – 2,589

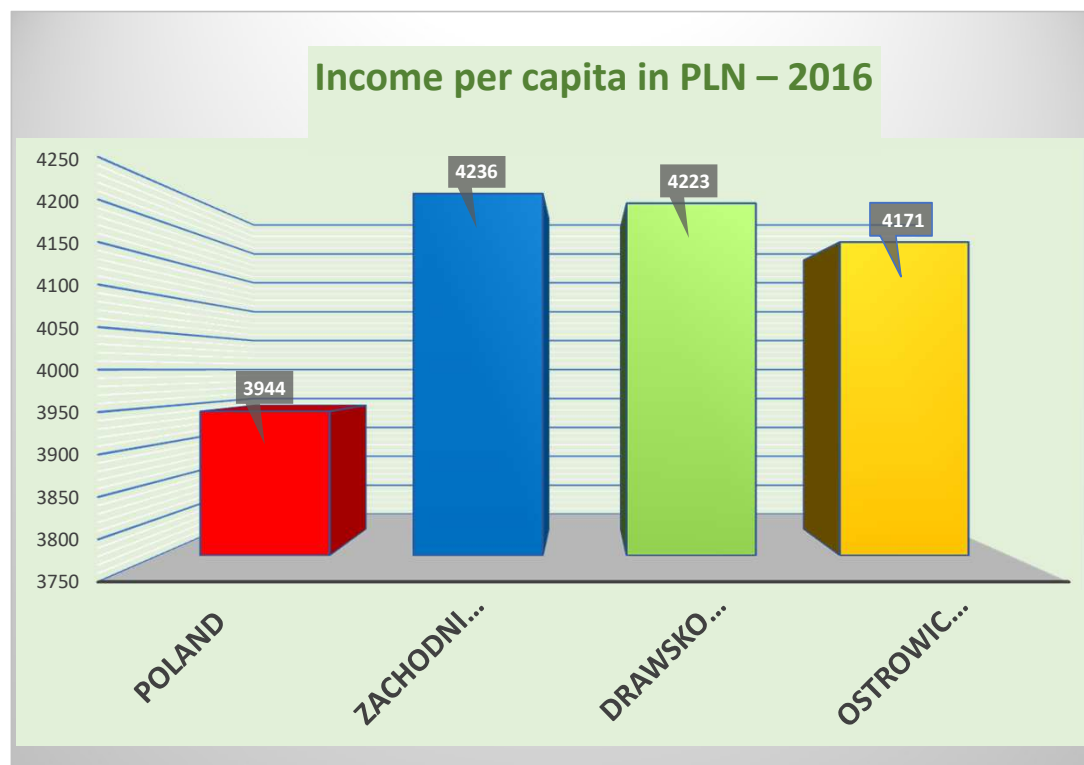
low population density – 18 persons/km<sup>2</sup>

unemployment rate – 14.1%

local authority area is covered by countryside and nature environment protection – Natura 2000 Program

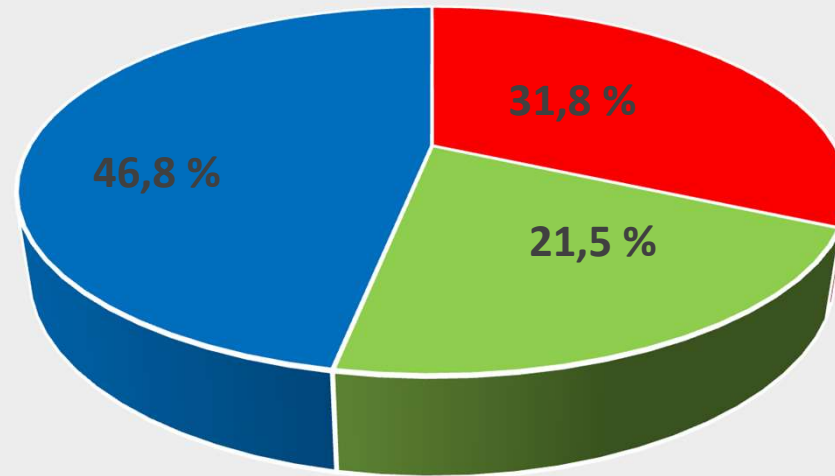


### 3. Ostrowice budget



The income per capita in Ostrowice LA was higher than the national average (approx. 950 EUR). It remained relative to the low population density. In reality Ostrowice LA was economically and financially disadvantaged.

## Ostrowice LA income structure in 2012



■ subsidies, ■ grants ■ LA income

The LA income to subsidies and grants ratio differs slightly from the national average.

The period 2011-2013 was financially decisive for Ostrowice LA.

During this period:

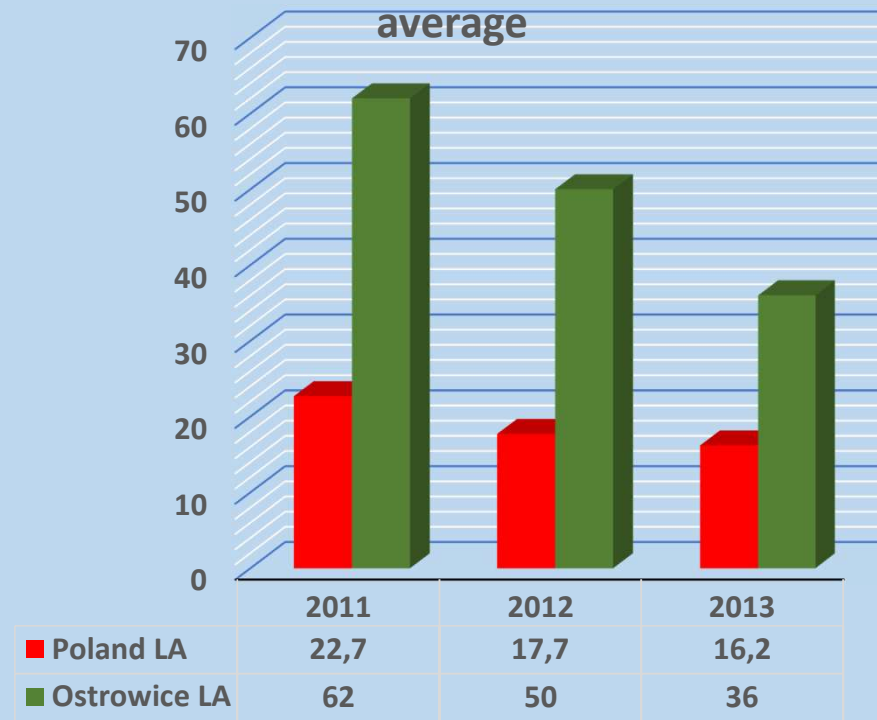
incomes (in PLN) were: 16.2m, 11m, 20.5m (EU funds represented a significant share of these incomes: 7,7 m, 1 m, and 3,8 m).

expenses (in PLN) were: 22.3m, 19.4m, 17.2m

result (in PLN) was: - 6.1m, - 8.4m, + 3.3m

accumulated deficit (in PLN) – 11.2m.

### Capital investment share in total expenditure compared to the national average



Big capital investment share in total expenditure ( 62%, 50%, 36% respectively) - the national average approx. 20 % ).

**Excessive investment !!!**



## 4. Ostrowice debt development

Reports on Ostrowice LA's financial situation started alarm bells ringing

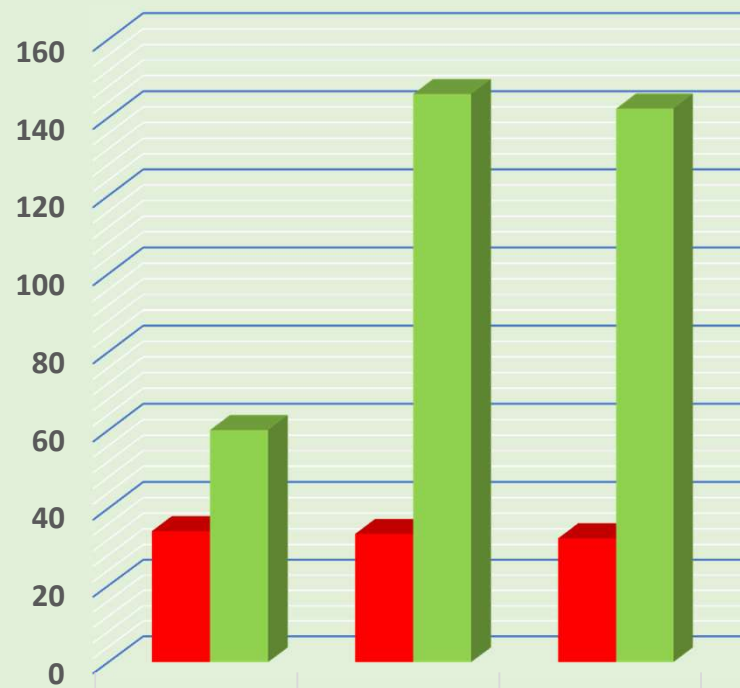
- budget deficit many times higher than planned,
- unpaid short-term liabilities,
- property income level fell to just 7%.

Problems in passing a resolution on long-term financial forecast in 2014 to comply with art. 243 of the Public Finance Act.

Adjudication held that this resolution was invalid – court proceedings.



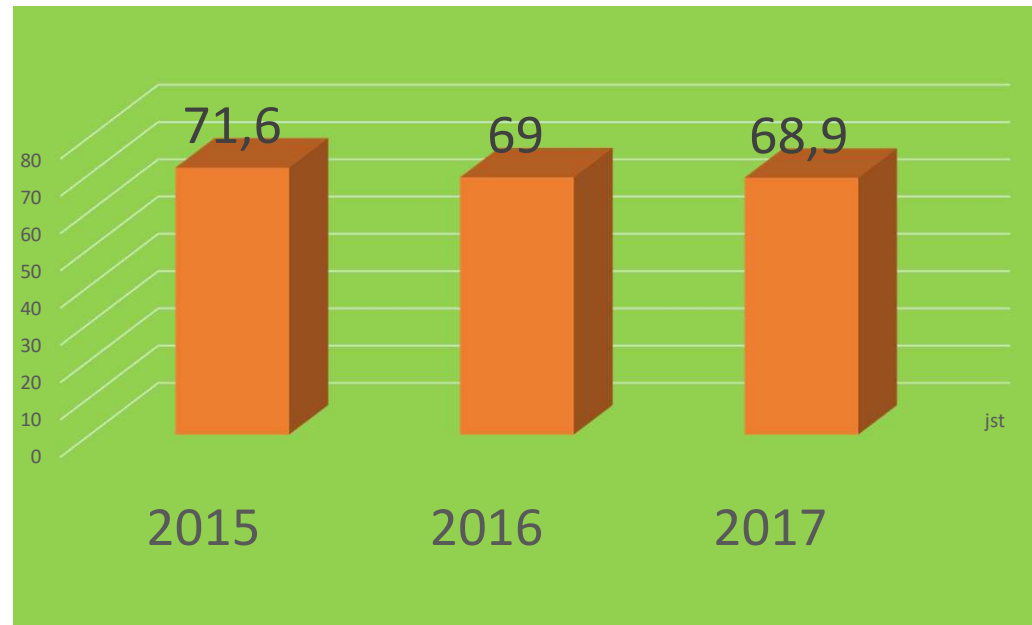
### Local authorities and Ostrowice LA indebtedness in relation to incomes (2011-2013)



	2011	2012	2013
Local authorities	34,15	33,4	32,3
Ostrowice LA	60	146	142,3



## Local authorities indebtedness (in billion PLN) for the period 2015-2017



Local authorities indebtedness retains on level of approx. 70 mld. PLN, approx. 30 % of total incomes

## 5. Violations of the law found during the audits

- Entering into unspecified contracts to bypass the restrictions of art. 243 of the Public Finance Act, e.g. sale of water and sewage facilities to another party with the obligation to pay a high rent to them with the option to buy it back at a given date (sale and lease-back – hidden loan agreements for a total amount of 5.4m PLN, cost ( in form of monthly rent ) of these instruments from nonbanking financial institutions (NBFI) was extremely high- 89,2 % of sale price! ;
- unreliable reports, underestimated debt, which after correction reached 27m PLN;
- liabilities contracts violated law from the beginning (breaching debt limits, lack of required legislative resolutions, accountant countersignature, Regional Chamber of Audit opinion).





**Corrective program**, which attempts to improve LA's financial situation in these circumstances (art. 240a of the Public Finance Act), LA may apply for loans from the state budget

negative opinion was given on the corrective program – It was assumed, that Ostrowice LA would regain the ability to repay its obligations and would finally comply with the legal level of repayment in 2031.

Regional Chamber of Audit report on the state of Ostrowice LA financial management prepared, June 4, 2014.

the report pointed out in its conclusion that Ostrowice LA had used very expensive NBF financial instruments, had very limited possibilities to develop current revenues, had no funds for financing its own tasks, its existence was threatened



## 6. State activity – administrator appointed, LA liquidation.

Ostrowice LA became insolvent. The debt reached almost 40m PLN (15.2k PLN – 3.5k EUR per capita).

The administrator was appointed and directed by the Prime Minister – his duty was to balance debts and find solution to Ostrowice LA financial burdens.

Polish law does not allow for local authority bankruptcy.





Act of July 5, 2018 on special solutions for the Ostrowice LA in the Zachodniopomorskie Region

Ostrowice LA was dissolved, its area was divided between neighbouring local authorities and on January 1, 2019 disappeared from the Polish local authority map.

The state took over Ostrowice LA liabilities up to 50m PLN

### **Conclusions**

The fall of Ostrowice LA was caused by the Mayor's irresponsible and illegal activity which has resulted in pending criminal proceedings.

As a result of irregularities found during an audit of Ostrowice LA and other LAs, the National Council of Regional Chambers of Audit recommended carrying out coordinated audits within the scope of incurring liabilities, in particular non-standard liabilities and loan-like obligations.



Conclusions drawn from the coordinated audits highlight the need for:

- changes to the statutory list of debts; this list should include, among others, unspecified agreements which have similar economic effects to loan agreements,
- set up systems to continuously monitor liabilities resulting from non-standard financial instruments,
- substantially increase audit and training courses to raise awareness of potential threats related to these sources of funding.

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Implementation of the National Council of Regional Chambers of Audit proposals - legislative changes taking into account local authority reports.

It is the specific responsibility of regional chambers of audit to not allow the example of Ostrowice to happen again.

Shouldn't we also discuss limited insolvency proceedings for local authorities?

**Thank you for your attention!**

