

ESG FUNDS AS A TOOL FOR FINANCING MUNICIPALITIES

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Abstract

In this article, the author pointing out the concept of ESG as a generally applicable concept, not only in the business sector, but even in the public sector. Applying the ESG concept in municipalities would increase the environmental and social perception of municipalities, and the quality of life of the residents would increase too. The creation of an ESG fund, which would be under the management of the business sector, would ensure the missing financial resources for municipalities who are largely dependent on the state budget and therefore cannot devote themselves more to ESG transformations. The paper represents a further continuation of author's research in this area.

Purpose of the article

We would like to point out the basic problem of the financing municipalities in the condition of the Slovak Republic. This municipalities are dependent on financing by state and our paper brings out the opportunity how to change it.

Methodology/methods

In this paper we use methods like deduction and synthesis because we are trying to make a co-operation between business sector and municipalities, and our work points out ideas how to do it.

Scientific aim

This paper points out the possibility how to use ESG funds for supporting the municipalities.

Findings

ESG funds brings more efficient redistribution of finances from income taxes.

Conclusions (limits, implications etc.)

We pointed out the positive impact for both sides, especially in increasing the ESG ratings for the municipalities and for business sector too. ESG funds brings the opportunity to support municipalities with their effort to improve living of their residents, who are often the workers in the business sector.

Keywords: *sustainability, municipalities, ESG concept, local management.*

JEL Classification: *G30, M14, O44, Q01*

INTRODUCTION

Nowadays, in addition to profit, the concept of sustainability is mentioned more and more often in the business world. Every entrepreneur would like to ensure the functioning of his company in the future and be sure that the company will prosper. Sustainability offers this possibility, as it discusses the basic problem, such as the question "How to maintain a business as long as possible and ensure its growth?". In the literature, we first encounter the term sustainable management, which tries to answer this question. Simply put, sustainability is such an action that the market perceives as appropriate and prosperous in the future, and because of this it is willing to support this type of business.

In recent years, awareness of the environmental and social challenges facing the world has increased, making these issues central concerns of individuals and communities (Dhar et al., 2022). Those companies that have decided to implement these challenges in their strategies and plans and subsequently implement them are sustainable in the long term. At the same time, if global consumers are willing to pay more for sustainable and ecological products, the competitive advantage of given companies on the market also increases (Aus et al., 2021). In the framework of sustainability, the concept of CSR - corporate social responsibility - was first formed, which later gave rise to the concept of ESG - environmental, social and governance. CSR represents the extent to which companies' actions contribute to social, environmental, and ethical considerations (Carroll, 1991).

The ESG concept modified CSR in that it also emphasizes the business side, which is the basis of the entire business and cannot be overlooked. There is also an effort to objectively measure the degree of sustainability of the company, thanks to which activities in the areas of the environment and society were added to the reporting of the company's performance (Ogden et al., 2017). The environmental pillar of the ESG concept addresses environmental concerns including carbon footprint, efficient use of resources, waste management and reduction of toxic emissions (Jasch, 2006). The social pillar addresses community issues, workforce management, human rights, responsibility for products and services, and government deals with the original idea of business, i.e. business ethics, planning and management (Ogden et al., 2017).

ESG idea existed for decades but has been seriously considered by enterprises and institutions only since the 2010s and takes a big attention nowadays, especially after pandemic COVID-19 (from 2019 to 2022). This concept is still a very new tool, but there is a big chance to develop its advantages and makes its implementation more practical. There is a positive correlation between disclosure of a company's ESG information and better performance. Lots of business and industries have acknowledge that aggressive climate mitigation and carbon dioxide reduction policies can positively impact their financial profile and lead to sustainable management (Cormack et al., 2020). Also, the social score is a more prominent driver of lower stock volatility (Engelhardt et al., 2021). So, the more ESG is the business, the more sustainable income and performance will it bring in the future.

The main idea of the ESG concept is greater prudence and an active approach in protection and assistance to the environment and in the social area. Although this approach is implemented mainly in the business sphere, some states are trying to implement it at the level of public sector as well, and nowadays thanks to that we can talk about ESG ratings of the states around the world. Based on this fact, the idea is to create an ESG concept at the level of municipalities, as the main units of the public sector, which rebuild as it were the lowest form of management. Thanks to this, their governing power and possibility will be the most effective, because it is not reliant to any further divisions, approvals, or the consent of the majority in the parliament.

Literature review shows that there is a small number of articles, which considering ESG in content with municipalities. Basic research problem consists of EU legislative implementation into the municipalities' management - problems of public transport, activities for energy transformation or dealing with the smog. This brings out important realization that except for business sector, exist even the public sector and it has even the same problems with adaptation to the new rules as the business has (Ziolo, Wojtowicz, 2022). The second issue what can be find in the available literature is the recommendation of implementing ESG into fiscal policy and in conjunction with this appears tendency to look at the ESG concept as a complex thing. There is first endeavor of starting to move beyond the level of corporations (Bruno, Henisz, 2024). Both studies have the same exact conclusions. Municipalities do not have enough money to implement or to reach ESG concept.

The new paradigm of ESG-oriented municipal bonds can be the new way how to get finances for infrastructure projects. The potential is to get investors, who like impact investing, some types of curious investors or that ones who likes new challenges. These bonds are like normal municipals bonds, but they need certificates to prove the ESG aspect and investors need to be careful, because of the greenwashing (Municipal Securities Rulemaking Board, 2024). A TIAA Company Nuveen creates own scoring methodology of the municipal bonds, which helps evaluate issuers for positive environmental and social outcomes (Nuveen, 2023). This type of financing is possible in the conditions of USA, so it is still developing.

1 GOAL AND METHODOLOGY

With this contribution above, we would like to point out basic problem of the financial burden on municipalities, especially in the conditions of the Slovak Republic, and propose a possible solution to this problem. The contribution is a continuation of the author's previous work on the implementation of ESG assessment at the level of Slovak and Czech municipalities (Matviaková, 2023; Matviaková, 2024).

In this paper we will use methods like deduction and synthesis.

2 RESULTS AND DISCUSSION

This application of the ESG concept to municipalities brought a new perspective on the ESG concept as well, where it was mainly pointed out that ESG is more than just a business idea of increasing its competitiveness on the market. It is such a complex concept that it can be used also in areas other than business. The creation of ESG criteria at the level of municipalities demonstrated the flexibility of municipalities to adapt to new trends and improve the lives of residents. It is also possible to evaluate individual municipalities based on given criteria and assign them an ESG rating, which will increase their attractiveness for potential new residents and tourists, as well as the quality of life of current residents (Matviaková, 2023).

Although ESG would also be applicable to municipalities, the basic problem remains the fact that in some country's municipalities rely primarily on financial resources from the state budget, an example is the Slovak Republic (Matviaková, 2024).

This fact was confirmed by a short financial analysis of the municipalities in the selected cross-border region of Beskydy, developed in detail in the author's dissertation. For the purposes of the analysis, we chose a total of 14 municipalities, 7 from the Czech side and 7 from the Slovak side. Based on their financial statements, we selected data such as actual income, actual expenses, net profit and asset status, data available for the years 2021, 2022 and 2023. Through this data, we calculated 3 indicators - degree of self-financing, total indebtedness

and return on equity. Table 1 shows these indicators for Czech municipalities and Table 2 for Slovak municipalities.

Table 1 Financial indicators of individual Czech municipalities

	Velké Karlovice			Staré Hamry			Bílá			Karolinka		
Year	2021	2022	2023	2021	2022	2023	2021	2022	2023	2021	2022	2023
Self-financing ratio	95,70 %	96,26 %	95,46 %	97,91 %	97,44 %	97,82 %	98,66 %	97,80 %	97,50 %	94,00 %	95,61 %	96,72 %
Total indebtedness	4,30 %	3,74 %	4,54 %	2,09 %	2,56 %	2,18 %	1,34 %	2,20 %	2,50 %	6,00 %	4,39 %	3,28 %
Return on equity ratio	0,10 %	5,12 %	1,28 %	2,3 %	2,04 %	2,70 %	0,22 %	3,22 %	1,53 %	4,13 %	1,81 %	5,60 %

	Halenkov			Huslenky			Hovězí		
Year	2021	2022	2023	2021	2022	2023	2021	2022	2023
Self-financing ratio	99,21 %	97,99 %	98,43 %	95,44 %	99,90 %	97,13 %	95,05 %	98,57 %	98,08 %
Total indebtedness	0,79 %	2,01 %	1,57 %	4,56 %	0,10 %	2,87 %	4,95 %	1,43 %	1,92 %
Return on equity ratio	3,60 %	3,64 %	0,33 %	5,78 %	6,94 %	6,02 %	-2,22 %	9,23 %	2,50 %

Source: Matviaková, 2024.

Czech municipalities demonstrate a high degree of self-financing, low overall indebtedness and adequate profitability of their own chapter. It demonstrates that Czech municipalities are not very dependent on the state and can largely finance themselves from their own activities. Their eventual transformation of goals and redistribution of financial resources for a greater positive impact on the environment and residents should therefore not be a problem.

Slovak municipalities, on the other hand, are not in a very acceptable position. Based on their indicators, we can see that their degree of self-financing is low, the highest value in the table does not even reach 75% of the self-financing rate. Total indebtedness is predominantly high, with only one municipality having a rate of total indebtedness above 1%. The return on equity is even negative in one case (-0.39%). We need to point out that high return on equity means that these municipalities have low net profit and low equity, which can be seen at self-financing ratio (equity/capital).

Table 2 Financial indicators of individual Slovak municipalities

	Makov			Vysoká nad Kysucou			Horná Mariková			Turzovka		
Year	2021	2022	2023	2021	2022	2023	2021	2022	2023	2021	2022	2023
Self-financing ratio	71,58 %	74,32 %	71,53 %	34,34 %	32,44 %	.	56,73 %	65,61 %	67,40 %	65,04 %	63,86 %	65,90 %
Total indebtedness	28,42 %	8,26 %	28,47 %	65,66 %	17,20 %	.	43,27 %	1,52 %	32,60 %	34,96 %	7,79 %	34,10 %
Return on equity ratio	1,10 %	-0,39 %	10,86 %	5,65 %	1,09 %	.	6,58 %	8,84 %	5,28 %	9,70 %	4,36 %	3,91 %

	Korňa			Dlhá nad Kysucou			Klokočov		
Year	2021	2022	2023	2021	2022	2023	2021	2022	2023
Self-financing ratio	66,70 %	49,73 %	48,86 %	8,47 %	10,91 %	15,05	33,19 %	31,72 %	31,27 %
Total indebtedness	33,30 %	21,91 %	51,14 %	91,53 %	58,16 %	84,95 %	66,81 %	24,88 %	68,73 %
Return on equity ratio	2,05 %	0,84 %	3,43 %	144,60 %	0,46 %	72,43 %	9,34 %	3,18 %	7,86 %

Source: Matviaková, 2024.

Such a high difference in financial indicators between the selected municipalities is caused primarily by political and economic differences between the Czech Republic and the Slovak Republic. Mainly the area of fiscal decentralization and the overall system of functioning and financing of self-governing regions is more efficient under the conditions of the Czech Republic, and thus brings less dependence on the state. Also, the division of power itself is defined differently in the Czech constitution. While Czech mayors and mayors are selected from the ranks of the municipal, or of the municipal council, Slovak mayors and mayors are elected by the citizens of the municipality, while they do not need to be in the municipal council, which can potentially cause their reduced abilities (Palúš, 2021). In simple terms, membership in the municipal council means already acquired abilities and competences in decision-making within a higher position in the management of the municipality, and also brings a greater degree of cooperation with other governing bodies of the municipality, respectively within the self-government, in contrast to elected representatives from the ranks of citizens, when it is not at all certain whether the person in question is qualified to perform this function.

Since the Slovak Republic currently shows a public finance deficit of over 6% (of GDP) in 2023 (ŠÚ SR), local governments also have reduced finances, which means that they only have funds for the basic functioning and running of the public administration, i.e. and municipalities. Even if additional financing from the state budget is insufficient, there is still a lack of funds for greater development of the public sector (Samosprávne kraje Slovenska, 2023).

Despite the small sample of municipalities and only one region, with the support of other sources mentioned in this chapter, we can claim that municipalities in the Slovak Republic are not sufficiently financed, neither from the state budget nor from their own resources. Therefore, based on this analysis in the author's dissertation, we propose a new method and possibility of financing municipalities in the territory of the Slovak Republic.

In the conditions of the Slovak Republic, the financing of municipalities mainly consists of these types of income:

- revenue from local taxes and fees,
- non-tax revenue from property ownership,
- interest and other financial revenue,
- sanctions,
- donations and revenue from voluntary collections,
- remittances from taxes in the state administration,
- subsidies from the state budget,
- special-purpose subsidies from the budget of a higher territorial unit,
- funds from the European Union or from abroad,
- other incomes, which include:
 - funds from extra-budgetary monetary funds,
 - funds from the difference between revenues and costs after tax,
 - returnable sources of financing or pooled funds (Zákon č. 583/2004 Z. z.).

The results of financial analysis above found out that Slovak municipalities do not have enough own resources in the form of taxes and proceeds from the sale of property and are dependent on subsidies from the state budget (Matviaková, 2024). Maybe it seems like these municipalities have lots of income, but they do not have enough money for their economy.

This paper proposes the creation of an ESG fund as a private monetary fund (a fund – a collection of funds serving a certain goal), which is between the listed types of income presented above. The basic task of which would be the pooling of funds from private companies doing business in the territory of the Slovak Republic, and the subsequent redistribution of these finances between municipalities.

This ESG fund would be created precisely by these private companies, when these companies would put into the fund a selected % of the amount of their corporate income tax (currently for 2023 it is in the amount of 21%). These few % would be exempt from taxation (since taxes are to be used for the citizens of the state and this aid to municipalities is indirect aid to citizens) (Zákon č. 595/2003 Z. z.), which would subsequently be documented to the tax office, and would provide businesses with the opportunity to contribute to the transformation of municipalities into more ESG functioning municipalities. Municipalities could apply to the fund based on submitted projects, where they would characterize an environmental or social problem for which they need a financial support, and with the help of this project they would gain for financial resources from the ESG fund. The mayor of the village would be responsible for submitted projects, who would also present these projects.

Private companies in the ESG fund would elect a fund director and a board of directors, made up of one representative from each company. Subsequently, according to the amount of the contribution, they would also receive a share in the vote, which project should receive their funds for implementation. The projects would have a certain structure created in a formal form, where the basis would be who submits the project (which municipality and who represents it - the mayor), what the given project is intended for, how much the financial support would be, how long the project would last and what are the expected benefits from the given project. The projects would be submitted within the set period (once every six months until the given date) to the created system of the given fund, and then a 60-day period would be determined for a decision on the project.

If the project is accepted, the municipality would have to document all the expenses associated with the implementation of the project and publish the results of the implementation

after this project. All formalities of submitting projects would be held publicly, both projects and acceptance/rejection decisions would be publicly accessible on the ESG fund's website.

The advantage for companies for the creating this form of ESG fund would be these:

- the remission of part of the income tax,
- the better living conditions for their employees,
- their increase of competition in the market,
- cooperation between business sector and public sector.

By this step, for companies to consciously increase the ESG level of the municipalities, they would automatically increase their ESG ratings, as they would appear more attractive on the market for potential customers and investors. They would also increase the quality of life of the residents in these municipalities, and since it is assumed that some of the employees come from these municipalities, they would practically increase the satisfaction of their employees. Also, these companies could themselves create project proposals for individual municipalities and offer these proposals to the mayors. This step would also support cooperation between the business sector and municipalities, which is very welcome and beneficial (Hamalová, Belajová, Kováčsová, 2012).

The advantage for public sector for the using this form of ESG fund would be these:

- less conscientiousness and work from the state,
- more effective allocation of the tax money,
- less job positions in state positions, less noneffective costs in state budget,
- more job opportunities directly in ESG funds or job in mayor's office – more effective jobs and less bureaucracy,
- cooperation between business sector and public sector,
- increase the environment and social level in public sector,
- increase of attractiveness for residents and for tourists (also high ESG rating for municipalities).

A significant advantage of this financing is the reduction of the amount of redistributed money from the state budget for municipalities, which would reduce the workload of the state, some jobs could be canceled (these people could go to work in the institution of the ESG fund or in municipalities with mayors to create ESG projects), and most importantly, this money would go directly to the municipalities, they would not have to pass through the decision-making powers of the state, which would decide whether to allocate funds to the given municipalities or not (Sabayová, Presperínová, 2018). This will also reduce the level of bureaucracy, which makes decision-making even slower.

To begin with, we would propose one ESG fund for businesses and municipalities within the entire state, and later, if this method of financing municipalities would catch on and be effective, several ESG funds could be created, processing finances and projects within counties and regions (on the example of Slovakia creation of three ESG funds – for western, central, and eastern Slovakia). In the event of non-compliance with any conditions, fines and sanctions would be imposed, which the ESG fund would set based on laws and rules within the state, as well as by the municipalities.

CONCLUSION

In conclusion, the ESG concept should be used in other sectors than business sector too. This concept consist of more than only environmental and social label. It brings out the main point, and that is people and nature are important, because they are the main keys to business and its success. Also, everything around us matters, business can not be only the numbers and indicators, behind them exists qualitative indicators, which can sometimes have higher impact than quantitative indicators.

In this paper author outlined one method how the ESG can be implemented into the municipality management system, and author also outlined a new model of financing the municipalities. Slovak municipalities are lack of money, they can not reach a needed level of self-financing and even they do not have enough money from state. So, we presented the opportunity for business sector to help them through the ESG fund, and redistribute some percentage of income tax into municipalities, who need this money.

This paper provided a proposal and planned continuation of the author's investigation of ESG issues to apply it in the public sector and increase the level of municipalities and the quality of life of residents. The author's contribution pointed to the possible connection and creation of cooperation between municipalities and the business sector, emphasizing the advantages for both parties. The next step in this issue could be discussion with municipalities and big corporations in the Slovak republic about the possibility of their cooperation, and modeling real conditions of how this could work in reality.

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