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## **ASSESSMENT OF GMINA'S CAPACITY TO CO-FINANCE A PROJECT WITH CONTRIBUTION OF EU FUNDS**

### **Introduction**

The funding provided by the European Union for projects executed by gminas (basic units of local government in Poland) translates directly into higher quality of provided public services and, consequently, higher standard of living of the residents. Another extremely important goal motivating gminas to obtain funds from the European Union is that they increase their investment potential<sup>1</sup>. The EU requires the beneficiaries to part-finance and pre-finance projects from their own resources therefore the ability to absorb EU funds is closely related to gmina's creditworthiness. This creditworthiness should be considered both with regard to the limits imposed by legal regulations and creditworthiness in the economic sense. The aim of this paper is to evaluate the legal regulations establishing statutory debt limits for gminas in the context of the absorption of EU funds. The literature on the subject proposes analyses which focus mainly on the modification of the very structure of the individual debt ratio (IDR) specified in article 243 of the Public Finance Act of August 27, 2009 (Journal of Laws 2017, item 2077, with later amendments)<sup>2</sup>, but make no reference to the absorption of EU funds by gminas. This paper attempts to fill this gap, the more so as the regulations included in the acts listed below specify that the objectives of Operational Programme are achieved through projects delivered with contribution of EU funds:

- 1) Act of 11 July 2014 on the principles of implementing programs in the field of cohesion policy financed under the 2014-2020 financial perspective (Journal of Laws 2016, item 217);

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<sup>1</sup> M. Nowicki, *Jak integracja z Unią Europejską wpłynie na polskie regiony*, Instytut Badań nad Gospodarką Rynkową, Gdańsk 2003, pp. 36 – 38.

<sup>2</sup> M. Tartanus-Oryszczak. *Indywidualny wskaźnik zadłużenia wymaga korekty*, Wolters Kluwer 2014.  
<http://www.samorzad.lex.pl/czytaj/-/artykul/indywidualny-wskaznik-zadluzenia-wymaga-korekty>, p. 2.

- 2) Act of 6 December 2006 on the principles of conducting development policy (Journal of Laws 2017, item 1376).

In the first year of the programming period 2014-2020 article 243 of the quoted Public Finance Act came into force. Compliance with regulations provided by this article determines gminas' capacity to carry out many crucial projects executed under Operational Programmes, such as Infrastructure and Environment or Regional Operational Programmes.

The evaluation of legal regulations involved the method of analyzing documents of a legislative nature, i.e. the Public Finance Act as well as the Regulation of the Minister of Finance on the Multiannual Financial Forecast of Local Self-Government of January 10, 2013 (Journal of Laws 2015 item 92). The analyses conducted in this study cover the period from 2011 (the rule providing that current expenditure should be covered from current revenues under article 242 of the Public Finance Act), with particular emphasis on the period from 2014 (the individual debt ratio from article 243 of the aforementioned act)<sup>3</sup>. The evaluation of the functioning of these regulations covers the period from the date when the laws came into force until 2017.

## **1. Incurring debt in order to carry out tasks**

As it was mentioned in the introduction, two rules introduced by the provisions of the Public Finance Act (Ustawa o Finansach Publicznych) are crucial to the investigation undertaken in this study.

The first of the rules is the expenditure rule, contained in article 242 of the aforementioned act, which requires compliance with the principle of financing current expenditures from current revenues. This rule applies both at the stage of budget planning and its implementation. Therefore, if despite careful budget planning adhering this rule, at the stage of budget implementation, it turns out that current income is lower than planned - the executive body must limit its current expenditure so that it does not exceed the actual current income. With such regulation, incurred debt may only be used to finance investment projects and in the case of tasks financed from current expenditure debt financing may only be used for pre-financing purpose (in accordance with art. 89, sec. 1 item 4 of the Public Finance Act: "Self-government entities may take out loans and credits and issue securities to pre-finance activities financed from funds from the European Union budget."

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<sup>3</sup> Art. 121 items 1 and 2 of the Act: Provisions introducing the Public Finance Act ( Przepisy wprowadzające ustawę o finansach publicznych) of 27 August 2009 (Journal of Laws No. 157, item 1241)

The provision of article 242 of the Public Finance Act introduced the basic rule for local self-government finances. On the one hand, it made it impossible to incur debt for expenses other than capital expenses and, on the other hand, separated the operating and investment part of the budgets of local self-governments - which guarantees control over the budget balance, especially in the case of financing public tasks from loan funds<sup>4</sup>.

Article 242 of the Public Finance Act inspired the usage of the term ‘operating surplus’ understood as the difference between current income and current expenditure. This term, which has nothing to do with the operating surplus of entities conducting business activity, has been frequently used in discussions by people dealing with public finance. Interestingly, despite the widespread colloquial use of this term, it does not appear in the Public Finance Act itself. The operating surplus can be utilized to finance investment expenses or debt repayment.

The legislator introduced three exceptions to the rule set by the provision of article 242 of the Public Finance Act:

- 1) when current expenditure in the amount exceeding current income is financed from budget surplus from previous years,
- 2) when the aforementioned budget gap is financed from ‘free reserves’ referred to in art. 217 sec. 2 item 6 of the Public Finance Act,
- 3) when the budget gap results from current expenditure incurred on projects executed with contribution of funds referred to in article 5 sec. 3 of the Public Finance Act (EU funds), if these funds have not been transferred in a given fiscal year.

The first and third exceptions do not raise any doubts. However, the consent to financing current expenditure with free reserves from previous years definitely raises objections. Balancing the operating part of the budget with free reserves is a dubious solution as de facto this means financing current expenses with securities, loans and credits (from previous years)<sup>5</sup>.

As for the impact these exceptions have on creditworthiness assessment, it will be addressed later in the paper when the provisions of article 243 of the Public Finance Act are discussed in detail.

Table 1 presents the income, expenses and balance of gminas in 2012-2016, broken down into operating and non-operating income and expenses<sup>6</sup>.

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<sup>4</sup> S. Owsiak, *Finanse publiczne, teoria i praktyka*, Warszawa 2005, p. 331.

<sup>5</sup> P. Walczak (Ed.). *Ustawa o finansach publicznych. Komentarz dla jednostek samorządowych*, C.H. Beck, Warszawa 2017, p. 726.

<sup>6</sup> Ministerstwo finansów. *Nadwyżka operacyjna w jednostkach samorządu terytorialnego w latach 2012 – 2014. Nadwyżka operacyjna w jednostkach samorządu terytorialnego w latach 2014 – 2016.*  
<http://www.finanse.mf.gov.pl>

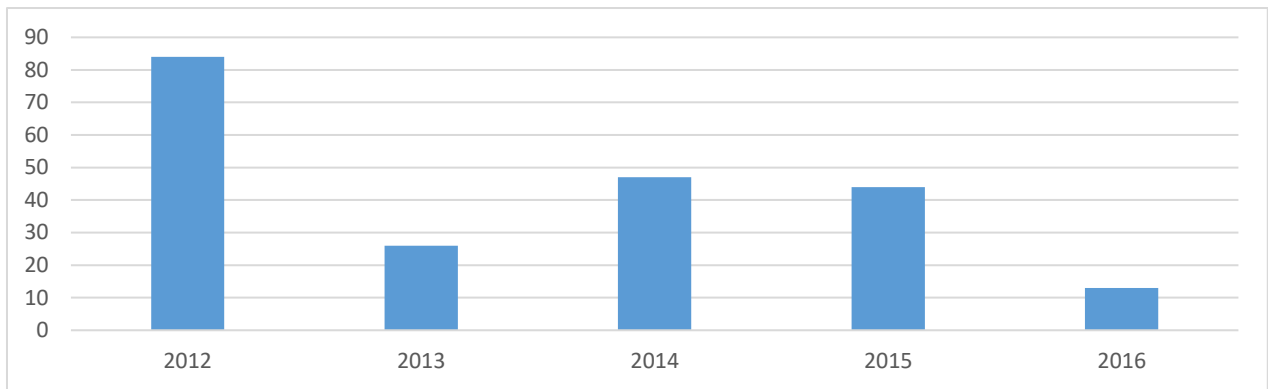
**Tabela nr 1. Operating surplus in gminas in years 2012 – 2016.**

Specification	Implementation				
	2012	2013	2014	2015	2016
	mln PLN				
1	2	3	4	5	6
<b>I. TOTAL INCOME, including:</b>	78 407	80 043	84 549	<b>87.667</b>	<b>101.795</b>
I.1 Operating income	70 547	73 611	77 712	80.186	97.583
I.2 Non-operating income	7 861	6 433	6 837	7.482	4.212
<b>II. TOTAL EXPENSES, including:</b>	78 491	79 443	85 070	<b>85.944</b>	<b>98.175</b>
II.1 Operating expenses	64 306	66 270	69 615	71.455	87.222
II.2 Non-operating expenses	14 185	13 172	15 455	14.489	10.954
<b>III. TOTAL BALANCE (I–II)</b>	- 84	601	-521	<b>1.723</b>	<b>3.620</b>
OPERATING BALANCE (I.1–II.1)	6 241	7 340	8 097	8.731	10.361
NON-OPERATING BALANCE (I.2–II.2)	- 6 325	- 6 740	- 8 618	-7.008	-6.742

Source: Reports on the implementation of the gminas' budgets for the years 2012-2016 (Ministry of Finance)

As demonstrated in Table 1 in 5 years the operating surplus (operating balance) not only increased in nominal terms but also its value, calculated as a percentage of total income, rose. From 2012 to 2016, it was respectively 7.96%, 9.17, %, 9.58%, 9.96% and 10.18%. This means that gminas are able to spend an average of 1/10 of their income on debt repayment. It is also significant that the number of gminas which are not generating any operating surplus is decreasing – as demonstrated in Figure 1.

**Figure 1. Number of gminas which did not generate an operating surplus in the years 2012 – 2016**



Source: Author's own elaboration based on reports on the implementation of gminas' budgets.

Thus, it can be concluded that after initial difficulties, gminas have complied with the requirements of article 242 of the Public Finance Act and they are able to generate increasingly higher operating surpluses, which will boost their capacity to incur debt and, consequently absorb EU funds.

## 2. Restrictions on incurring debt by gminas

The second crucial regulation affecting the gminas' capacity to absorb EU funds is the rule contained in article 243 of the Public Finance Act establishing a limit on burdening future budgets with repayment of debt and interest on debt.

In the currently binding Public Finance Act, the debt upper limit (60%) has been abandoned, while the former limit for the permissible debt repayment (15% of planned revenues) has been replaced with an individually calculated debt ratio (IDR) provided for in article 243 of the Public Finance Act. The IDR is calculated for each year according to the following formula:

$$\left(\frac{R+O}{D}\right)_n \leq \frac{1}{3} * \left( \frac{Db_{n-1} + Sm_{n-1} - Wb_{n-1}}{D_{n-1}} + \frac{Db_{n-2} + Sm_{n-2} - Wb_{n-2}}{D_{n-2}} + \frac{Db_{n-3} + Sm_{n-3} - Wb_{n-3}}{D_{n-3}} \right)$$

where:

- R - Planned for the fiscal year total amount due for the repayment of loan and credit installments and redemption of securities - payments to debt incurred to maintain liquidity and repaid by the end of the fiscal year are not included in the expenditure on this account;

- O - Planned for the fiscal year interest on loans and interest and discount on issued securities as well as repayment resulting from the granted sureties and guarantees;
- D - Total budget income in the fiscal year;
- Db - Current income;
- Sm - Asset sale gains;
- Wb - Current expenditures;
- n - Fiscal year for which the relationship is determined;
- n-1 - Year prior to the fiscal year for which the relation is determined;
- n-2 - Year two years prior to the fiscal year;
- n-3 - Year three years prior to the fiscal year.

The premise for the introduction of this regulation was the idea of linking creditworthiness in legal terms with creditworthiness in economic terms. It was assumed that economic capacity is determined by the ‘operating surplus’ i.e. the difference between current income and current expenditure. In the author's opinion, the introduction of this concept into law was not fully successful and will be further discussed below.

The left side of the formula is nothing more than the calculation of the proportion (expressed in percentage) of the expenses related to debt repayment and interest on the debt to the planned income in a given fiscal year. The liabilities also include the interest on debt incurred to maintain liquidity and repaid by the end of the fiscal year (art. 89 sec. 1 item 1 of the Public Finance Act) and potential payments due to granted sureties and guarantees. If we entered ‘15%’ on the right side of the formula we would get the same regulation as the one binding until 2013. However, the legislator's intention was to determine an individual debt ratio for each local self-government. The right side of the formula is therefore used to calculate the debt service limit, based on data from the three years preceding the year for which the calculation is made. For each year, the difference between current income and current expenditure is calculated, it is then increased by income gained from the sale of assets and finally it is divided by the total income earned in a given fiscal year. The operating surpluses calculated in this way, after averaging for the previous three years, constitute the limit of budgetary burden. Unfortunately, this concept adopted by the legislator contains errors, which include:

- 1) calculating gmina's creditworthiness on the basis of historical data,
- 2) increasing the operating surplus by the asset sale gains,

- 3) not taking into account one-off income growth related to received EU subsidies or funds for investments - which decreases the individual debt ratio by increasing the denominator on the right side of the formula, while in fact it has no impact on the actual ability to repay debt,
- 4) allowing negative value of the debt service limit.

Relying on historical data, i.e. calculating the operating surplus based on data from previous years is a significant methodological error. How relevant is the income obtained two or three years earlier to debt repayments in a given year? Even if the financial situation of the gmina was excellent, (e.g. as a result of a big sale of assets), these resources were consumed in the year of sale in order to meet the requirement of a balanced budget.

As mentioned in the discussion concerning provisions of article 242 of the Public Finance Act, the notion of operating surplus was defined as the difference between current income and current expenditure, which in budgets can be allocated to investments or debt repayment. Article 243 of the aforementioned act provides that current income can include income from the sale of assets. The result is notorious falsification of performance indicators by including in budgets and long-term financial forecasts projected income from the sale of assets, which in fact is unrealistic to earn.

The legislator provided for three exceptions to the principle expressed in article 242 of the Public Finance Act. However, it has not been noticed that in a situation when current expenses are incurred in a given year in an amount higher than the current income (and covered, for example, from the surplus from previous years) the figures substituted into the right side of the formula from article 243 will give a negative value. In individual cases, it happened that the entire right side of the formula was negative even after averaging, which made it impossible to repay not only the capital, but also interest on debt. While the repayment of the capital can be postponed in accordance with the provisions of article 92 of the Public Finance Act, interest must be repaid annually and its capitalization is unacceptable. Consequently, it was necessary to introduce new regulations providing for a rehabilitation program. Articles 240a and 240b of the act grant Regional Chambers of Audit (Regionalne Izby Obrachunkowe – RIOs) the right to draw up a budget for local self-governments without adhering to statutory regulations.

These considerations lead to the conclusion that the individual debt ratio, calculated in accordance with article 243 of the act, does not correspond to the actual creditworthiness of gminas. What is more, article 243 sec. 3 of the aforementioned act provides for a number of exceptions when the debt repayment is not included in the debt limit from article 243 of this act. This solution was intended to facilitate the absorption of EU funds even if the limit

calculated in accordance with article 243 did not allow it. However, it does not change the fact that the debt, although not included in the limit, still needs to be repaid and should be taken into account when in the creditworthiness of a gmina is assessed. The exceptions provided for in the law concern:

- 1) repayment of loan and credit installments and redemption of bonds contracted in connection with the agreement concluded for the implementation of a programme, project or task financed with the contribution of funds from the European Union budget, including due interest and, if applicable, the discount on bonds;
- 2) expenses due to sureties and guarantees granted to local self-government legal persons carrying out tasks of the local self-government within the framework of programmes financed with the contribution of funds from the European Union budget.

However, the regulations specify that the exemption from including these liabilities in the individual debt ratio was limited to the period of 90 days counted from the date the programme was completed and refunds transferred. This limitation does not apply to interest and discount on liabilities incurred for beneficiary's own contribution.

Despite the provision for the aforementioned exceptions, problems with the absorption of EU funds were still probable. That is why another regulation was introduced. Article 243 sec. 3a of the Public Finance Act provides that in the case of a programme, project or task financed with at least 60% contribution of EU funds, the restrictions under article 243 sec. 1 shall not apply to the repayment of debt and interest on debt incurred for the beneficiary's own contribution.

The regulations of the Public Finance Act discussed above are crucial for the assessment of gminas' capacity to co-finance a project. Above all, the legal capacity, i.e. compliance with the condition stipulated in article 243 of the act, is hardly relevant to the actual creditworthiness of a gmina. What is more, the necessity to comply with requirements of article 243 when a basic planning document - the Multiannual Financial Forecast – is drawn up, results in frequent data misrepresentations.

Regardless of the above reservations, the Multiannual Financial Forecast is the document on which the gminas' creditworthiness assessment is based.

### **3. Multiannual Financial Forecast as a legal regulator for the absorption of EU funds by gminas**



From January 1, 2011, the long-term planning instrument in local self-governments is the Multiannual Financial Forecast, referred to in the articles: 226 - 232 of the Public Finance Act. This document in lines 12.1 to 12.8.1 lists the EU funds which are intended to be obtained. The data provided there must be correlated with the amount of incurred debt. On the other hand, debt and its repayments (lines from 5.1 to 5.1.1.3 of the forecast) must fall within the limits calculated in accordance with the provisions of articles 242 and 243 of the Public Finance Act (lines from 9.1 to 9.7.1 of the forecast). Due to the discussed flaws of article 243, the forecasts created in gminas very often contain unreliable data, only provided to meet the individual debt ratio criteria from article 243. The resolution regarding the Multiannual Financial Forecast provides for clarifications which, duly prepared, ensure that the forecast meets the statutory requirement of feasibility. This role of the clarifications is not fully reflected in the provisions of the Public Finance Act, which allows for the data to be falsified<sup>7</sup>. Considering the provisions of the Multiannual Financial Forecast, the entity assessing the gmina's capacity to co-finance a project and, as a result, its creditworthiness must take into account the following issues:

- 1) the forecasted sale of assets is often wishful and serves only the purpose to meet the individual debt ratio criteria (as provided in article 243),
- 2) the independence of Polish local self-governments regarding their income is limited, which results from the binding catalog of revenue sources<sup>8</sup>,
- 3) most gminas forecast steady increase in income from the share in personal income tax and the general subsidy. These two types of income are directly related to the number of gmina's residents. Therefore, the feasibility analysis regarding forecasted income from these two titles should take into account the population changes,
- 4) there is no plan to increase current expenditures on remuneration, while in-depth analysis indicates that this is not possible without giving up realizing mandatory statutory tasks,
- 5) increase in current expenditure on infrastructure maintenance does not take into account new facilities funded under EU co-financed projects,
- 6) the fact that municipal investments are continuous in character and systematically burden the budget<sup>9</sup>.is not taken into account.

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<sup>7</sup> *Ibidem*, p. 646.

<sup>8</sup> Piotrowska-Marczak K., *Umiejscowienie długu w systemie finansowym jednostek samorządu terytorialnego*. In Denek E, Dylewski M. (Eds.) *Szacowanie poziomu zadłużenia jednostek samorządu terytorialnego w warunkach zwiększonego ryzyka utraty płynności finansowej*, Difin, Warszawa 2013, p. 25.

<sup>9</sup> W. Misterek *Zewnętrzne źródła finansowania działalności inwestycyjnej jednostek samorządu terytorialnego*, Difin, Warszawa 2008, p. 35.

## Conclusions

The aim of the study was to evaluate legal regulations concerning restrictions on debt incurring by gminas and their impact on the absorption of financial resources from the European Union. The conducted analysis confirms the validity of the concept of making the creditworthiness of gminas dependent on the amount of generated operating surpluses. The data presented in the paper show that fewer and fewer gminas have a problem with complying with the statutory requirement in this respect, and the amount of surpluses generated in relation to total revenues is growing.

However, the idea of financing debt repayment from operational surpluses, in the form of an individual debt ratio stipulated in article 243 of the Public Finance Act, qualifies for significant changes. The necessity to comply with the debt repayment limit based on historical data and corrected by the asset sale gains has led to unrealistic data being provided in Multi-annual Financial Forecasts, which prevents reliable assessment of gmina's creditworthiness.

In order to enable gminas to obtain EU funds, article 243 sec. 3 and sec. 3a of the act provide that the repayment of debts, incurred in connection with the implementation of contracts financed with contribution of EU funds, is not included in the debt limit. In the author's opinion, this is an ad hoc solution that creates a discrepancy between legally binding limits and an economic assessment of gminas' creditworthiness. The visible increase in the amount of operating surplus generated by gminas should prompt the legislator to abandon the exceptions provided for in article 243 of the Public Finance Act. However, this will be possible only when the financial independence of gminas is no longer limited, e.g. through underfunding assigned tasks.

## Literature:

- 1) Misterek W., *Zewnętrzne źródła finansowania działalności inwestycyjnej jednostek samorządu terytorialnego*, Difin, Warszawa 2008.
- 2) *Nadwyżka operacyjna w jednostkach samorządu terytorialnego w latach 2012 – 2014*, Ministerstwo Finansów, [www.finanse.mf.gov.pl](http://www.finanse.mf.gov.pl).
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- 4) Nowicki M., *Jak integracja z Unią Europejską wpłynie na polskie regiony*, Instytut Badań nad Gospodarką Rynkowa, Gdańsk 2003.

- 5) Owsiak S., *Finanse publiczne, teoria i praktyka*, Warszawa 2005.
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- 7) Tartanus-Oryszczak M., *Indywidualny wskaźnik zadłużenia wymaga korekty*. Wolters Kluwer 2014, [www.samorzad.lex.pl](http://www.samorzad.lex.pl).
- 8) Walczak P. (Ed.), *Ustawa o finansach publicznych. Komentarz dla jednostek samorządowych*, C.H. Beck, Warszawa 2017.

### **Abstract:**

The aim of this study is to evaluate legal regulations limiting the amount of debt incurred by gminas (basic units of local government in Poland) and the impact these regulations have on local governments' capacity to absorb financial resources from the European Union.

The method used to evaluate the legal regulations involved analyses of documents of legislative nature, i.e. the Public Finance Act as well as the Regulation of the Minister of Finance on the Multiannual Financial Forecast of Local Self-Government of January 10, 2013 (Journal of Laws 2015 item 92). The analyses conducted in this study cover the period from 2011 (the rule providing that current expenditure should be covered from current revenues under article 242 of the Public Finance Act), with particular emphasis on the period from 2014 (the individual debt ratio from article 243 of the aforementioned act). The evaluation of the functioning of these regulations covers the period from the date when the laws came into force until 2017.

The presented data and regulations confirm the validity of the concept of making the creditworthiness of gminas dependent on the amount of generated operating surpluses. The data presented in the article show that fewer and fewer gminas have a problem with complying with the statutory requirement in this respect, and the amount of surpluses generated in relation to total revenues is growing.