

# **The System of Funding Operational Programmes in Poland: Implications for Public Finance**

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## **Abstract**

*The paper explores the issue of funding the operational programmes effectuated in Poland based on the financial frameworks of the European Union for 2000–2006 and 2007–2013. The membership of Poland in the European Union provides an opportunity to receive additional funds, however the funds absorption also brings about costs. The author's aim is to evaluate the influence of the Polish systems of funding the operational programmes co-financed by the EU structural funds on the public finance. The systemic solutions implemented in Poland affect two basic macroeconomic parameters: public debt and budget deficit.*

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## Introduction

In the times of economic crisis the implementation of structural and cohesion policies of the EU becomes more and more challenging. Both the European Union institutions preparing the EU budget drafts under growing financial needs, but also the member states with high level of public debt and budget deficit are facing the problem of funding the regional development. According to the author, the issue of funding the regional development deserves special attention within the contemporary economic thought and within a practical aspect of functioning of the fund system of operational programmes carried out based on public funds, also the EU structural funds. The issue is particularly relevant in regards to both: alarming level of public debt and budget deficit and attempts to balance public finance in Poland and beginning of the negotiations about the shape of regional policy of the EU and its funding in the forthcoming preparatory period 2014–2020. The implementation of new methods and instruments of the public finance management in order to overcome the growing public debt and budget deficit remains a crucial issue in the current debate in Poland and at the international level. All actions for improvement public finance are one of the strategic goals of public governance. According to the author, the issue becomes even more relevant as Poland (a candidate country to the euro zone) must complete the convergence criteria: maintain public debt level no higher than 60% of GDP and budget deficit level no higher than 3% of GDP.

Some issues examined by studies on the socio-economic development are analyses of types and scope of use of the EU structural funds and evaluation of quantified indexes of this funds, such as social value of implemented projects, independent studies of unemployment level and employment growth, number of roads and expressways built, number of new schools and educational pre-schools, which confirm the economic potential growth of particular regions. These valuable analyses serve the purpose to corroborate a practical connection between absorption of the EU structural funds, economic growth and higher competitiveness of regions. However, analyses that prove the connection between expenditure on the regional policy and its impact on macroeconomic parameters of public finance (public debt and budget deficit) are missing in the conclusions in regards to influence of expenditure on a level of the regional development indexes. Similarly, research on the influence of expenditure on the implementation of operational programmes financed by the EU public funds on the public finance indexes is missing in the public finance studies. Nevertheless, the issue deserve special attention in regards to the fact that

since the Polish accession to the EU, the European Union budget funds and structural funds have become an integral part of public finance system and the national budget.

The author's aim is to present an evaluation of the funding system of operational programmes carried out in Poland based on the EU financial frameworks for the years 2002–2006 and 2007–2013 on a level of indexes of public finance, such as public debt and national budget deficit.

## 1. Review of Selected Theories of Public Debt and Budget Deficit

The theories of the public finance presented below have been selected in respect to their practical application. The theories have determined state policy in regards to imposing fiscal burdens and scope of public expenditure. The public debt issue in the theoretical meaning is a part of general economic theory, the public finance theory in particular.

The theoretical framework for economic liberalism has been created by Adam Smith in the eighteenth century. The last, fifth book of Adam Smith's 'An Inquiry into the Nature and Causes of *the Wealth of Nations*' is dedicated to the *public finance issue* (Smith 1954; Buchanan 1999). Adam Smith supported the *laissez-faire* theory opposed to government intervention in economic activity of citizens. The book 'The Wealth of Nations' of Adam Smith contains the principal assumptions of liberal economic thought. The role of state in national economy, public expenditure in particular, should be reduced to its basic functions, such as exterior defence, protection of personal property rights, system of justice, organization of public works. He also argued that the national budget should be reduced to the minimum (Fedorowicz 1965: 161). According to Adam Smith's thought, public expenditures should be limited. He did not believe the public debt itself was destructive, however he argued that the generated public debt had detrimental effect on capital. The Adam Smith's theory was developed by D. Ricardo. He stated that the capitalized value of future tax payments by citizens living at the times of debt creation transformed the interest payments on the debt into a regular transfer. In his opinion, this transfer is not shifted to future generations. In this situation, public debt does not transfer the real cost of public expenditure to the future (Poniatowicz 2005: 42).

Both Adam Smith and David Ricardo claim that financing the expenditure through public debt offering shifts the burden of expenditure, until the time of **maturity of outstanding** public debt. The debt service and payments bring about a growing tax burden, which costs are shifted from generation to generation. The authors note that future generation may benefit from the debt, dependently on type of a governmental expenditure. However, the risk of creation of an excessive debt by present tax-payers must be also considered (Jajko 2008: 10–11).

J. S. Mill, classic of English liberal thought, stated that public debt brings about a double burden. The first burden refers to the costs beared by present generation. The possible expenditure on the support of labour market are taken away from employers. The second burden is shifted to the future, as the debt service brings about new taxes (Poniatowicz 2005: 42; Adams 1975).

The classic theories can be seen as containing contradictory elements. Some of the classic authors opt for balanced budget and minimal tax burden. However, they indicate the more and more active role of the state, what requires a growth of public expenditure. J. Tucker argues that a liberal government policy does not relieve the government of an active role in economic growth, high employment ratio and protection of national production. D. Ricardo indicates an additional role of the state: repeal of the international trade restrictions. Still, an extreme liberal J.M. Mill stated that the number of government initiative's are as broad as societies initiatives (Moździerz 2009:15–19).

According to M. Poniatowicz, Paul Leroy-Beaulieu, a French economist from the eighteen century, was one of the scientists that contributed to the development of public debt theory. He strongly opposed to the statements of Jean Francois Melon and Francois Arouet Voltaire concerning the public debt issue. He defines the statements as 'sophismata', apparently true and difficult to refute by non-economists. The most relevant sophismata that he mentions are following:

- Internally held debt does not make a state poorer,
- Internally held debt is like a debt of the left hand owed to the right hand; from the perspective of the nation, if the amount is held by lender or a loaner the wealth of nation is the same.
- Public debt is detrimental if it brings about an interest payment on externally held debt.

Paul Leroy-Beaulieu argues that interest on the capital lent to state is an advantage taken by renters only, at the loaners (tax-payers)' expense. In that case, lack of loans let the loaners keep the amount of money which would be paid through taxes for the purpose of loan service. Additionally, renters who don't lend to state don't lose

their interests. However, he states that a loan brings about a loss for one of the parties. If a loan is not taken, both parties dispose of money; in the opposite case the whole amount is owned by one of them. He also argues that a loan can be beneficial or detrimental for the society. The effect of loans depends on the effectiveness of the public debt use. J. P. Beaulieu also distinguishes consequences of public debt creation from the consequences of financing the public expenditure (Poniatowicz 2005: 43–44).

The public expenditure growth (in regard to revenues possible to achieve) can lead to creation of a revenue gap. Then the deficiency of revenue must be reduced by undertaking particular actions, i.e. internal or external debts. The economic and legal dimensions of a debt incurred by governments can be explained by comparing a debt to a tax. According to one theory, cost of a debt is bigger than cost of a tax in regards to the interests paid. Tax reduces the purchasing power of tax payers, however it brings about smaller liabilities for a state. Another theory is opposed to the statement concerning voluntariness and conventionality of a loan. The conditions of a loan are imposed by state. Loaners are not authorised to negotiate the loan conditions nor to put psychological and material pressure on the state.

However, according to the assimilation theory, there are identical consequences of both loan and tax:

- consumption of economic subjects is reduced in both cases,
- both forms of financing are not a burden for economy nor society in the long term.

Debt service brings about a transfer of revenues from tax-payers to the owners of government bonds. In this situation the domestic product is not reduced.

A realistic theory draws attention to a particular character of a public debt. According to this theory, a possibility of psychological pressure of the loaners on a state is not excluded completely. However, the pressure cannot be compared to the legal obligation of paying taxes (Gradoń 2004: 26–28; see also Krawczyk 2007: 14–16).

The orthodox approach to theory of public finance is based on an assumption that the national budget (public expenditure and tax revenues) need to be balanced (Zajda 1958: 165–166). J.B. Say is a founder of this theory. He argues that the amount of public expenditure determines the size of capitalization. An excessive growth of public expenditure causes growth of interest rates and reduction of wages and other revenues. In regards to the fact, the public expenditure should cover only the necessary governmental activities. A national budget should be balanced permanently, as a budget deficit can lead to bankruptcy and it constitutes a burden for future generations.

A postulate of the strict balance of a national budget was formulated i.e. during the International Financial Conference, organized in Brussels in the year 1920. Participants stated that governments using budget deficit will economically destroy their countries (Poniatowicz 2005: 45). According to the Nobel Prize winner, P.A. Samuelson, public finance is interpreted analogically to a household finance in the orthodox theory. Public debt is considered as a burden for future generations. As such, it should not be applied by governments (Samuelson, Nordhaus 2000: 525). In the situations of an inevitable public debt, the orthodox fiscalism supporters recommended an use of loans and credits for the investment purpose. The loans and credits should be used in long-term operations. Also, they should be paid as soon as possible to not to grow the costs of debt service (Poniatowicz 2005: 46; Hyman 2002; King 1992).

A relevant statement of public finance theory says that a government should determine a clear source and destination of the taken loans. Supporters of this theory claimed that budget deficit (if inevitable) must serve the purpose to finance expenditures stimulating economic growth. If there is a need for a loan, it should have a long-term character to not to reduce current capitals necessary to private entities. The orthodox fiscalism accepts an opportunity to use the collected taxes for the fiscal purposes only (pays for the fiscal, customs and other administration service) (Gaudemet, Molinier 2000: 166).

The attempts to develop a protectionist state policy were undertaken also by German scientists. A. Wagner postulated a stronger state intervention into the market mechanism. He is an author of a growing public expenditure rule (a Wagner's rule). This concept was applied in an economic doctrine of several Western countries. It was also one of foundations of welfare state. A. Wagner's concept of state became a basis for development of social security and for growth of social expenditure. The theory of A. Wagner is based on an assumption of the market failure. Market mechanism rewards factors of production (land and capital). However, it cannot satisfy growing social needs. In regards to the fact, state interventions are required to resolve social problems (Ziółkowska 2005: 32).

The contribution of A. Wagner to the interventionism stream had an impact on the theory of J.M. Keynes, created in the twelfth century. After the crisis of the years 1929–1933, the normative postulates of economic were revised. A budget policy was supposed to become a crucial instrument of anti-cyclical policy. The virtue of maintaining a balanced budget were not that appealing anymore (Bugaj 1998). According to his statements, the capitalist economy is not balanced. The productive potential is not fully used and the phenomenon is accompanied by unemployment.

The main source of disturbances is a limited capacity of private entities to invest. This factor brings about a need for interventionism. State can regulate a demand using the instruments of revenues and expenditure. J. M. Keynes accepts a budget deficit in the times of economic crisis. Then a budget deficit can help the economy to enter to the growth path (Ziółkowska 2005: 33).

J.M. Keynes created a concept of an unbalanced budget. It was due to a significant growth of public expenditure during economic depression, when budget revenues were lower. He opposed to the financing based on a growth of fiscal burden. In his opinion, if the fiscal burden grows, the purchasing parity 'is shifted from one hand to another'. In consequence, the effective demand is growing but the individual demand is limited. Public debt should be financed by emission of national bonds in the banking or individual sector. According to J.M. Keynes, public debt can be an effective instrument to create aggregate demand (Poniatowicz 2005: 49).

Theories of J.M. Keynes were applied for the first time by a New Deal Policy in the 1930's in the USA. New Deal was a programme of social and economic reforms introduced by president Roosevelt in the years 1935–1939. The aim of the programme was to counteract to detrimental effects of the economic crisis. Instability of market mechanism was interpreted as a reason of the economic depression. A state intervention was needed to stabilize the economy and make it more effective. The programme counted several instruments: unemployment benefits, public works, actions to reduce the unemployment level. Some legal instruments were also applied to stabilize industry, agriculture and banking sector. After the second world war, this conception became a leading macroeconomic theory (Bartkowiak 2003: 41; Fischer, Dornbusch 1983: 607).

The ideas of J. M. Keynes were developed in twentieth century by A. H. Hansen. He was strongly opposed to the conservative statement about the detrimental effect of public debt on the national economy. He argued that the impact of public debt depended on conditions and situational context of its creation. The most significant purpose for the economy is to limit fluctuations of conjunctural cycle (Ziółkowska 2005: 33).

In the 1940's, the fact to incur a debt was not considered anymore as a proof of a weakness of a state. It started to be interpreted as a source of funds for the public expenditure. It served the purpose to balance global demand and global supply, in particular the expenditure for investments creating a multiple effect on production. Public debt management became a basic instrument of reduction of fluctuations of conjunctural cycle (Bitner, Chojna-Duch 2007: 118). From the perspective of a national economy, the goals achieved thanks to the debt emission are the most important.

Other relevant issues are the debt level and structure. Public debt can be favourable for the economic development. However, it can be also damaging or limit further sustainable development of a country (Jajko 2008: 9).

J. Tobin mentions two threats related to public debt. The first one is a push out effect, as earnings that could be invested in productive capital what raises real wages of future generations must be used to finance a deficit connected to public debt. The second one refers to growing costs of debt service. They increase budget deficit and consequently also public debt. J. Tobin created a concept of acceptable level of growth of public debt. It assumes a constant relation of public debt to GDP (Moździerz 2009: 31; Tobin 1980).

In the contemporary economic thought a neo-Keynesian school unites the Keynesian analysis and elements of monetarism. British economist W. Beveridge developed a systematic deficit theory based on Keynesian thought. He assumes that public deficit can be beneficial for the national economy. A more significant volume of public expenditure increases global demand and stimulates economic growth. However, this concept neglects some possible negative effects of an increase in public expenditure. A constant budget deficit brings about a burden of costs of growing public debt. In this situation a state becomes less creditworthy, what leads to an increase in interest rates. There is also likely that a state will need to cover the deficit by printing money. However, the monetisation escalates inflation processes (Poniatowicz 2005: 50; Duverger 1978).

M. Poniatowicz mentions also a cyclical deficit theory and a deadlock theory. According to the cyclical deficit theory, budget deficit results from conjunctural fluctuations in the economy. Shortages in budget that appear in the times of economic crises may be covered by budget surpluses in the times of economic prosperity. However, M. Poniatowicz argues that the theory may be difficult to apply in practice. It is little likely to preview precisely duration of an economic cycle. Also, there is a possibility of political pressure to use a budget surplus to fund public expenditure. There is no guarantee that budget surpluses will cover future deficits.

As opposed to the cyclical deficit theory, the deadlock theory questions a balanced budget rule. According to the deadlock theory, the budget deficit determines a surplus of defined liabilities over defined incomes. It does not either take under consideration the differences resulted from provisional operations, i.e. loans. This theory allows a deficit under specific conditions. In the times of prosperity, an additional money creation that could cover an increase in expenditure is compensated by an increase in production. It can be concluded that the phenomenon consists in distribution of an additional purchasing power through budget operations. However, it does not bring



about inflation and depreciation of money as the increase in production balances the mass of money. According to P.M. Gaudemet, this is a safe and allowed deadlock. The deadlock is allowed only if a surplus of public expenditure is used to fund productive expenditure, at least to the level of earnings possible to collect by state to cover this additional expenditure. However, there is no guarantee that an additional money creation will be compensated by an appropriate increase in supply of goods and services. Additionally, it is difficult to preview a scope of deadlock in regards to the economic conjuncture previewed (Gaudemet, Molinier 2000: 51).

A.H. Hansen states that a recovery of economic balance should be based on the following sequences:

- Incurring credits in the times of economic depression in the commercial banks. It may stimulate economic growth and increase both in domestic product and earnings,
- Intensification of public expenditure from progressive income taxes and actions for a full employment in the times of a recovered balance of economy,
- Restraining of inflation processes in economy by applying a consumption tax. Takings from the tax would be used to fund public expenditure (Owsiak 2004: 41–42).

A.H. Hansen postulated elaboration of two budgets: an operational budget, meant for service of current public tasks, and an capital budget. The second one would constitute a long-term plan of public expenditure and a fund for an investment activity of a state. The author is opposed to a typical for the orthodox theory search for analogies between private and public economies. In his opinion, satisfaction of citizens' needs, not reaching profits, is a purpose of a state.

Abba Lerner, an American economist, supporter of Keynesian theory and author of functional finance theory is more radical in regards to application of public finance and instruments of economic policy. He recommends the application of all effective instruments of a government's financial policy, like: taxation, public debt or control of money supply. He opts for a public expenditure growth when full employment is not secured by consumer spending (Poniatowicz 2005: 52; Laffer, Miles 1982).

J.M. Buchanan, author of the theory of social choice argues that maximizing the social utility or general welfare should be reckoned a determinant for public expenditure. His concept is based on the assumption that public debt may be beneficial for society when its positive effects surpass costs of an increase in tax burden caused by debt service. However, there are doubts concerning the appropriate measures of social utility of public expenditure, especially in regards to its subjectivity (Poniatowicz 2005: 53; Buchanan 1958).

In the 70's, the effectiveness of government interventions was lower. The economies of Western developed countries were affected by stagnation: low economic growth rate, increase in unemployment and high inflation. Traditional instruments of government intervention were not effective anymore to fight the economic difficulties. There was a need for new actions for economic development. Some specialists in the domain of public finance argued that the way of government economic policy led to an increase in inflation, budget deficit and public debt (Postuła 2007: 29). Economic schools based on classic economy assumptions were becoming more popular than Keynesian school. Monetarists and their representative Milton Friedman argued that economy was stable 'by nature' and would come back to its natural state after every period of temporal instability. They reject all forms of government intervention as it counteracts the natural market forces. They accept the monetary policy only. According to monetarists, a disturbed balance of budget and increase in public debt bring about inflation, especially in a case when budget deficit is funded by creation of additional money instead of loans taken in the capital market (Poniatowicz 2005: 54; Musgarve 1984: 682, see also among many others Dumas 1985; Faeber 2002; Missale 1999). They postulate a passive role of government, as the government intervention is considered to be detrimental for the economy. They also argue that the cause of economic fluctuation is due to insufficient price elasticity. According to this theory the price elasticity grows over time and prices play more and more important role in regulation of economy. Economic policy should be limited to monetary policy. The last should be based on the control of money aggregates. However the use of interest rate should not be applied (Ziółkowska 2005: 36).

Supply-side economics appear in the late 70's. Supporters of this theory are opposed to both Keynesian and monetarist school. They state that both theories do not include the social aspect of economy. In their opinion a government intervention should be limited to guarantees of private property rights, security and cautious monetary policy. They state that reducing the tax burden is a best way to eliminate barriers to economic growth. It prompts to work, save and invest money, therefore it contributes to creation of supply. Supporters of the supply-side economics are critical of budget deficits that always limit investments and contribute to inflation growth (Poniatowicz 2005: 55).

M. Poniatowicz mentions also a theory of social choice. J.M. Buchanan, author of this theory is particularly interested in the economic theory of bureaucracy, political parties, democracy, collective and individual decisions. He aims to explain how governments make decisions in regards to economic policy. He argues that policy makers act in their own interest and not necessarily represent the interest of society.

Therefore they create a regime of constant budget deficits what favours inflation and destabilises economy. However Buchanan points that constitutionally regulated limits to the uncontrolled increase in public debt may resolve the indicated problem (Poniatowicz 2005: 55–56).

## **2. Budget of the European Union and the EU Financial Framework**

The funding of the European Union activities is being seen as a controversial issue that provokes public debate. The institutional system of funding and methods of funding the structures of European integration have been evolving through the years of development of European Communities. Present European Union system of funding is complicated as structures of European integration include organs, rules and mechanisms serving the purpose of funding both the European institutions and the European Union policies established based on the EU Treaties (Treaty 1951: art. 2, 3 and 78; Treaty 1957: art. 199; Treaty 1957: art. 174; Treaty 1965: art.1, 9 and 20; Treaty of Nice 2011).

The main core of the EU integration process has been to create a large common European market. The member states have recognized the primary role of market mechanism in the common market creation. In capitalist economy, one of the basic instruments of economic policy is budget (Soboń 2008: 7). The European Union activities are funded from the following sources: general budget, European Development Fund and credits and loans from financial markets. Additionally, the EU activity is supported by such financial institutions as European Investment Bank, European Investment Fund and European Bank for Reconstruction and Development. However the main source of funds is the EU general budget. It encloses 95% of the amount of revenues and expenditures of the EU (European Union 2002: 128).

The general budget of European Union constitutes a financial plan of the EU activities. It is elaborated and executed by the European Commission and its subordinated subjects. This plan includes revenues and expenditures of the European communities forecasted for a budgetary year. The EU general budget is also a supranational and redistributive fund. It has a redistributive character as it contains revenues collected from internal sources which are spent according

to established rules. The mechanism of redistribution is based on principles of universality and constraint. Payments to the budget are irrecoverable. Also, there is no mutual performance from the European Communities. The budget is supranational as it is in its own sources of revenues which were formerly sources of revenues to the national budgets. The EU member states have been obliged to collect and transfer revenues from tax, custom and other sources to the EU general budget. The EU general budget is supranational also in regards to the fact that expenditures are executed in all the EU member states. Revenues and expenditures of the EU budget are enacted by the Council of European Union and European Parliament. According to law, the European Commission has a right to collect revenues and execute expenditures. However it is not allowed to impose tax burden on particular tax payers. All actions of the European Commission in regards to expenditures must be based on an appropriate executive budget act (Cieślukowski 2006: 15–16). Socio-economic policy of the European Union and functions of the EU budget have been determined by principles of subsidiarity and equilibrium. The principle of subsidiarity means that public actions should be undertaken at the lowest possible level of public administration. If an undertaken action is not successful as expected it should be transferred to higher level administration (Begg, Grimwade 1998: 104). In case of the European Union the principle of subsidiarity means that the EU actions are limited by its treaties. The EU is enabled to undertake countermeasures when actions of a particular member state are not successful as expected (European Union 2002: art.2)

The European Union system of funding has evolved considerably since its creation. The evolution has been due to many reforms that have been introduced to mitigate political crises related to budget negotiations. The EU budget expenditures differ from the national budgets expenditures. Expenditure for education, health or public debt service are not built into the EU budget. The main part of expenditure is dedicated to agriculture, in particular to the EU interventions on agricultural markets. The aim of the interventions is to stabilize prices of agricultural products and *keep the EU market prices higher than world market levels*. The EU budget differs from national budgets also in regards to the fact that expenditure is divided into obligatory and non-obligatory. The obligatory expenditure are related to functioning of the European Union, enabling the EU to meet its internal and external obligations established in treaties and other related legal acts. The obligatory expenditure include spending on agriculture and external spending ensued by international agreements with third countries. The non-obligatory expenditure includes structural funds, spending on administration and internal policy. The obligatory expenditure is

established by the Council of the European Union and is enacted by the European Parliament. However, the non-obligatory spending is enacted ultimately by the European Parliament which is enabled to vote down by a 3/5 majority vote of the present deputies the draft expenditure plan proposed by the Council of the European Union (Soboń 2008: 23–25).

Taking under consideration the EU financial framework is essential when elaborating the EU budget. The EU financial framework is a seven-year framework for its spending and budgets set every year. It has been a relevant political decision of the EU member states in regards to the EU system of funding. A financial framework include all expenditure divided into categories which reflect present political priorities of the EU. A ceiling for expenditure and annual spending amount is assigned to every category (Małuszyńska, Gruchman 2005: 80–81). The EU financial framework is a general plan of revenues and expenditures of the EU in the mid-term. A basic relation between financial framework and general budget consist in a fact that an amount of revenues and spending determined in the financial framework for particular years delimits the amount of revenues and expenditure from the EU budget (Cieślukowski 2002: 146–150). Arrangements made by the EU member states in the time of creation of the EU financial framework are confirmed by the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management. The legal act is in force during 7 years. All institutions taking part in preparing annual budgets are obliged to comply with the ceilings for all categories of expenditure established in the EU financial framework. However the financial framework cannot be seen as a simple financial programming as the ceilings for expenditure (in total and for every category of spending) are binding in the process of the annual budget preparation. Also the annual budget specify expenditure in a more detailed way. Therefore the determination of expenditure in particular categories is not that restricted. However there is a need for adjustment of financial framework to the every year particular context. It is due to the following reasons:

- Inflation, that is not taken under consideration while preparing financial framework,
- Need for knowledge about a current GDP value with the purpose of estimating limit of domestic funds,
- Need for indexation of GDP for an appropriate estimation of some agricultural spending (Małuszyńska, Gruchman 2005: 80–81).

There have been enacted four financial frameworks: for the years 1988–1992, 1993–1999, 2000–2006 and 2007–2013.

The EU general budget expenditure, including the spending on structural funds, Cohesion Fund etc. is established according to the European Union law. The EU member countries must create a system of implementation the funds based on the EU regulations. The EU regulations determine mode of preparing the programming document. Based on the document, every country can precise its priorities of socio-economic policy that would be compatible to the EU directions of development and the EU socio-economic policy. According to the Council Regulation (EC) No. 1260/1999 (OJ L 99.161.1) that enacts general provisions on the structural funds and to the regulation (EC) No. 1083/2006 of the 11<sup>th</sup> July 2006 that enacts general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and that overrules the regulation (EC) No. 1290/1999 (OJ L 06.210.25), the Commission Regulation (EC) No. 1828/2006 of the 8<sup>th</sup> December 2006 that sets out rules for the implementation of Council Regulation (EC) No 1083/2006 and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund (OJ L 06.371.1), a strategic programming document must be elaborated by every EU member state willing to carry out projects funded from the structural funds (more about strategy and planning: Domański 1995: 8; Kołodziejewski, Tyszecki 1991: 126; Klasik 2002: 29; Karpiński 2002: 17; Kłosowski, Warda 2001: 16; Breński, Oleksiuk 2008: 86). This document is a base for an appropriate development policy. The aim of creating the document is to order goals, therefore to get a clear picture of goals and directions of socio-economic development, to subordinate short-term actions to long-term actions, to coordinate economic and social transformations, to maximize strengths and opportunities for development, to manage better resources and to get additional, external funds (Potoczek 2000: 79–80).

### **3. Financing Projects from the European Union's Structural Funds Based on Financial Framework for the Years 2004–2006 and the Public Debt in Poland**

Selected theories of public finance being part of a general economic theory have been presented in the first chapter. According to M. Poniatowicz, there are two contradictory doctrines about public debt. The first one assumes that growing budget deficit and consequent public debt prove the malfunction of system of public finance .

Additionally, it is opposed to the neutral role of state, it is damaging for the economy as a whole and unethical. The other extreme theory assumes that state is allowed to incur a debt and should do so. This doctrine points at the obligatory role of state in stimulation of economic growth. The budget deficit and public debt are perceived just as instruments of the intervention.

In regards to Polish membership in the European Union since the 1<sup>st</sup> May 2004 and the consequent opportunity to obtain the European Union funds for various projects, introduction of new accurate regulations to the Polish public finance system was necessary. By virtue of the amended public finance act from the 26<sup>th</sup> November 1998<sup>1</sup> the European Union funds, including the funds for implementation of pre-access programs, structural funds, European Agricultural Guarantee and Orientation Fund 'Guarantee Section' were incorporated to the public funds. These funds as being public funds could have been allocated to public expenditure or national and regional budget expenditure. According to the act, the expenditure included loans given to finance assignments carried out based on co-funding from the European Community budget – pre-funding funds, being re-funded by the European Commission. Consequently, the pre-funding of assignments carried out based on co-funding from the European Union budget was a source of loan needs of the national budget and it was classified as public debt.

According to the above definition included in the public finance act, public debt constitutes a nominal liability of the public finance sector entities after consolidation and elimination of mutual liabilities). This value in relation to GDP is one of the basic measures of the condition of public finance. Levels and dynamics of growth in the public debt in Poland in the years 2004–2008 are presented in the Table 1. The data shows that the public debt in Poland had been increasing since the year 2004. In 2004, the debt amounted to 431 431,1 mln PLN, in 2005 – 466 601,0 mln PLN, what constituted 47.5% of GDP, in 2006 – 506 263,5 mln PLN (47,8% of GDP), in 2007 r. – 527 441,8 mln PLN (44, 9% GDP) and in 2008 – 597 795,6 (47% GDP). It is worth noting that the dynamics of growth in public debt were more significant than the growth in GDP. Dynamics of growth decreased in 2007 as a result of a good situation of the national economy. However in 2008 the dynamics of public debt grew of 5.1 pp. in relation to the GDP growth.

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<sup>1</sup> Polish Journal of Laws 2003/15/148 with later amendments. The author begins the analysis of legal regulations based on the public finance act of 1998, as the regulations determined by this act were applicable during the first year of membership of Poland in the European Union, when the rules of funding the Sectoral Operational Programmes were elaborated.

**Table 1. Public debt of the state**

Position	Debt of the State Treasury	Public debt of the state	Public debt of the state with outflows related to pre-financing deducted	Gross Domestic Product (GDP)
2004	402 860.3	431 431.1	430 402.1	924 538.0
% GDP	43.6	46.7	46.6	
2005	440 167.4	466 601.0	459 965.0	982 565.0
% GDP	44.8	<b>47.5</b>	47.5	
2006	478 526.4	506 263.5	478 526.4	1 060 194.0
% GDP	45.1	<b>47.8</b>	45.1	
Dynamics		108.5	107.0	107.9
2007	414 223.2	527 441.8	516 575.8	1 175 266.3
% GDP	35.2	<b>44.9</b>	44.0	
Dynamics		104.2	104.9	110.9
2008	456 090.8	597 795.6	589 795.6	1 271 714.6
% GDP	35.9	<b>47.0</b>	46.4.9	
Dynamics		113.3	113.3	108.2
2009		669 881.4	665 513.3	1 344 037.4
% GDP		49.8	49.5	
Dynamics		112.1	112.9	105.7
2010		747 906.3	737 490.3	1 415 385.4
% GDP		52.8	52.1	
Dynamics		111.6	110.8	

Source: Author's own account based on: NIK 2007: 132; NIK 2008: 140; NIK 2009: 144–147; NIK 2010; NIK 2011: 194..

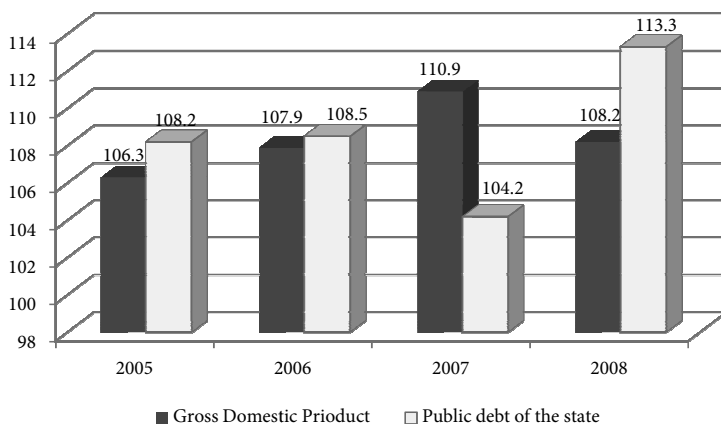
The increase in public debt in the years 2004–2006 was due to an increase in treasury and local government entities debt. The increase in public debt resulted, in particular, from funding the loan needs of the national budget and funds applied to reform the social security system. Additionally, the necessity to finance the pre-finance balance, expenditure due to structural funds and Common Agricultural Policy, and providing funds for next year's budget brought about another increase in public debt. In regards to remaining factors of the increase, conversion of liabilities of Social Insurance Institution (ZUS) to Open Pension Funds (OFE) due to not transferred insurance premium and indexation of 12-years fixed rate treasury bonds were also significant (NIK 2007: 132). Similar conclusions were also drawn in the



‘Information on the results of control of Treasury debt and liquidity of national budget’ of Supreme Audit Office (NIK). The last indicates that in regards to remaining loan needs, pre-funding of assignments financed by structural funds of the European Union contributed the most to an increase in public debt. In the years 2006–2008, It brought about a necessity to provide funds and consequently caused a total increase in Treasury debt of 7.7 billion PLN (NIK 2009: 16) what came to 86% of the national budget loan needs in relation to the total amount assigned to loans.

In 2007, the public debt growth rate began to fall in relation to previous years. It was due to lower loan needs related to funding budget deficit and relatively high nominal GDP growth (NIK 2008: 140). In 2008, public debt grew sharply of 13.3% with reference to the year 2007. Consequently, ratio of public debt to GDP increased from 44.9% in 2007 to 47.0% in 2008. The Supreme Audit Office warned that maintaining or subsequent increase in disproportion between public debt and GDP, by 2010, could lead to crossing the first threshold of public debt, per article 79, section 1, clause 1 of the public finance act (NIK 2009: 144).

**Graph 1. Dynamics of increase in public debt in the years 2005–2008**



Source: NIK 2007: 132, NIK 2008: 140, NIK 2009: 144–147.

Ratio of expenditure due to loans given to pre-finance to public debt in a budget year constitutes a proportional measure of influence of loan needs on the amount of public debt. In 2005, funds for pre-financing brought about an increase in public debt of 1.4%, in 2006 – of 2.8%, in 2007 – of 2% and in 2008 – of 1.4%. It means that ratio of public debt to GDP could have been lower of these measures and could have amounted in 2005 – 46.8%, in 2006 – 46.4%, in 2007 – 44% and in 2008 – 46.4%. The presented data should be referred to the level of risk and thresholds of public

debt determined by the public finance act. According to the act, when the public debt approaches to the level of 50–55% of public debt to GDP ratio, the Cabinet of Ministers enact a budget act that determines the ratio of deficit to budget revenues at a level no higher than in the present year. Therefore, if the same system of pre-funding the operational programmes carried out based on a new financial framework was applied (and it is worth noting that Poland could have used 11 billion EUR from the European Union budget based on financial framework for the years 2004–2006 and 59 billion EUR based on financial framework for the years 2007–2013), the ratio of public debt to GDP could be even more adverse. It is due to the anticipated increase in loan needs that could be detrimental to public finance.

In the years 2006–2008, in spite of unstable market conditions and irregular distribution of loan needs, liquidity of public finance was guaranteed. However, in 2008 funds from pre-payments of the European Union structural funds, amounted to 4 657.2 millions of PLN, were temporary used to finance the deficit and other loan needs. This solution can be perceived as economical, as it reduced costs related to the emission of treasury bonds. However it was contrary both to the article 98, section 2 of public finance act of 30<sup>th</sup> June 2005 that did not include this form of funding loan needs and to the article 202, section 1 of this act that commands use of the European Union funds according to its destination determined by international agreements, separate regulations or declaration of donor. These documents do not include this form of application of the European Union funds (NIK 2009: 8–9).

Analysis of expenditure bore by Poland based on financial framework 2004–2006 should also focus on other costs that affected the public debt, such as over-contracting, payments due to payments 5% and exchange rate differences. The mechanism of over-contracting was elaborated in order to use all funds intended for Poland for the years 2004–2006. Based on the mechanism, additional contracts were drowned up, exceeding allocated funds. The surplus was supposed to be compensated by positive exchange rate differences and savings on projects. However, the mechanism entailed a risk related to accounting projects and exchange rate differences. The following solution was implemented: in case of over-contracting exceeding the European Union structural funds allocated to carry out operational programmes, the costs of a particular operational programme will be bore by national budget. The applied mechanism was due to the fact that contracts were based on calculations in Polish zloty but calculations with the European Commission were kept in euro. Accordingly, savings related to exchange rate differences could be used to carry out additional projects.

At the introductory stage of the implementation of the structural funds, funds intended to refund expenditure were transferred from the European Commission as pre-payment<sup>2</sup>. Both pre-payment and periodic payments were transferred from the European Commission to a fund account, e.g. European Social Fund, European Regional Development Fund that was opened by Ministry of Finance in the Department of Paying Authority. Afterwards, the funds were transferred to a programme fund appropriate for every operational programme. Next, the funds were transferred to the Managing Authority of an operational programme. Based on a programme, the beneficiary received the re-payment of expenditure that had been bore. All calculations were kept in euro, except the beneficiary account.

Due to Repair Programme introduced by Ministry of Regional Development in 2005, beneficiaries received accelerated fund transfers. The payments were transferred from the accounts of Managing Authority that managed operational programmes that were lacking in funds necessary to re-pay the beneficiaries expenditure due to prolongation related to time from a certification of applications for payment to refund from the European Commission. Therefore, introduction of supporting funding the accounts from national budget was necessary. The financial support was supposed to come to an amount that guaranteed flow of funds certificated by Paying Authority to beneficiaries. However, difficulties in funding arose as the substantial and financial involvement of projects increased and the certificated amounts came to 95%. The European Commission, according to the system of fund implementation and the system of fund regulations, suspended payments of the remaining 5%, until a project was closed and motion for final payment was submitted. Consequently, Poland had to involve additional funds to close the projects that had been carried out.

In case of prior transfer of funds from programme account to the Managing Authority and subsequently to beneficiary, funds from the European Commission remained in the programme account. They were used as revolving funds. They could also been transferred as re-payment of 'loan' or to the national budget account.

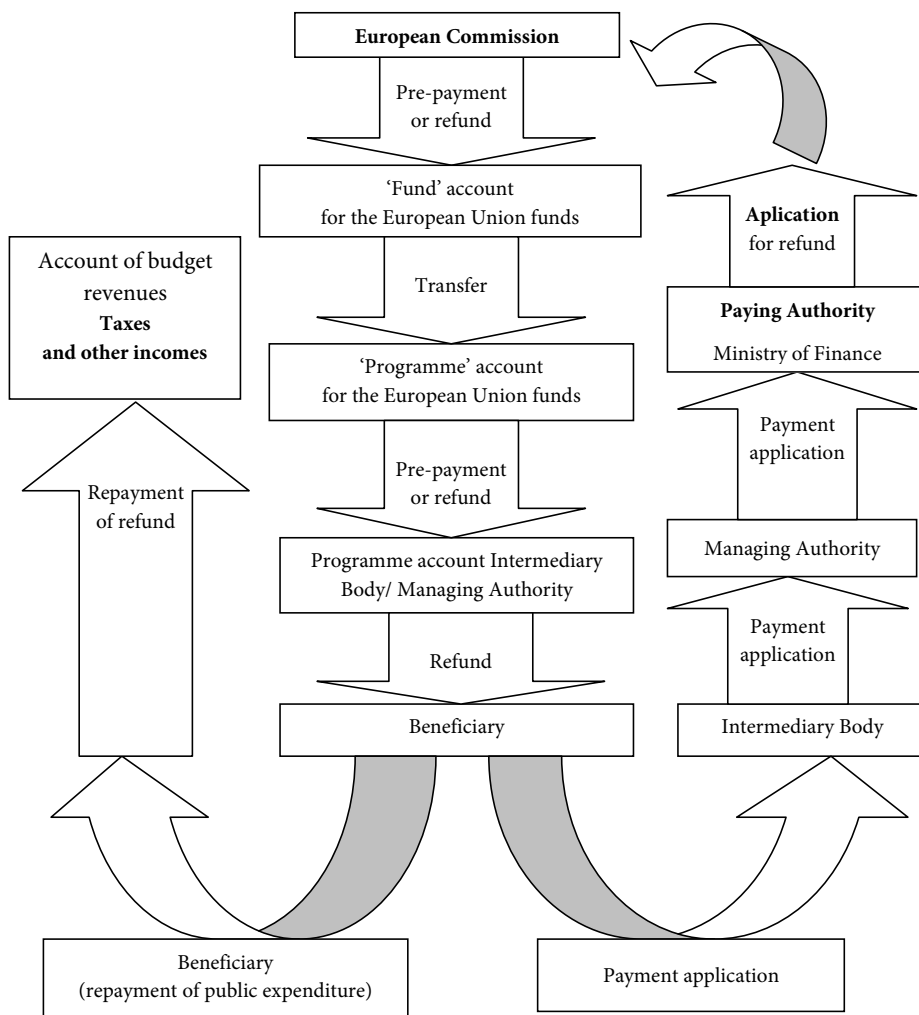
The funds transferred to programme account constitutes loan needs of national budget, therefore they influence level of public debt. Once the Paying Authority accepted payment application, the accepted amount was paid from the programme account. The payment was calculated based on average exchange buying rate announced by National Bank of Poland. The payment application to the European Commission was verified first by Paying Authority. Afterwards, it was prepared based on the EUR/PLN exchange rate set by the European Central Bank. Negative

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<sup>2</sup> A general schema of the financial flow is presented in Figure 1.

exchange rate differences related to the calculations of expenditure according to rates of National Bank of Poland and European Central Bank, if existed, were covered from national budget.

**Figure 1. General schema of financial flows from the European Commission based on NPR (National Development Plan 2004–2006)**



Source: Analysis of the author.

In regards to the analysis of impact of the system of funding projects based on financial framework 2004–2006 on public debt, the author concludes that

undoubtedly the pre-funding mechanism that was introduced and regulated by public finance act had an influence on level of public debt.

The mechanism also contributed to the increase in public debt of 7.7 billion PLN and consequently affected ratio of public debt to GDP. The costs of over-contracting, exchange rate differences and other loan needs related to closure aid could also burden the national budget. It is impossible to determine precisely the amount of additional public expenditure. It is also difficult to estimate public expenditure due to over-contracting, as they are closely connected with exchange rate variation, however it might be possible at the closure of the operational programmes. **Due to the complicated mechanics of account settlements, access to specific financial statements from the national budget is not possible.** Additionally, it is difficult to estimate amount of non-qualified expenditure included in contracts for additional funding that was necessary to bear as a part of particular projects. In case of national budget entities and local government entities the costs were bore also by the national budget.

#### 4. Expenditures Refundable by the European Commission and Its Impact on the National Budget

By virtue of the amended Act on Public Finances of 30 June 2005, from 2007 on, financial means acquired from the budget of the European Union (EU) deemed refundable, are included in the national annual budget. As a result, public expenses related to the 2004–2006 EU budget were treated as expenditures of the budget, while the financial means from the EU structural funds became seen as a part of budget revenues. Thus, completion of specific expenses and revenues of that type affected the level of national budget deficit. During the first year (2007) of using the new rules of fund transfers, the national budget was refunded by the EC a total of PLN 7.534 million as a result of public expenditures, where PLN 1.699 million came from structural funds, representing 22.8% of the planned revenue from that source of funds (Table 2).

The much lower than expected amount is attributed to the following factors:

- a. Only 41.1% of the refundable expenses were carried out as planned;

b. A fact that the actual date of carrying refundable expenses out and the term of actual refund vary have been overlooked during the planning of the budget (NIK 2008: 52).

In 2007 the higher than expected overall revenues for the national budget were registered due to a higher than forecasted GDP growth rate. A sudden good performance in execution of the budget revenues from PIT and CIT was a result of a good shape of the economy and fiscal discipline of the taxpayers.

As far as completion of the national budget revenues from the refundable expenditures by the EC is concerned, it should be noted that some 45% of the national budget deficit could be attributed to not receiving transfers from the EC, and 36.2% of the deficit should have been covered by the anticipated but not received structural funds. In 2008 the gap became even wider, as only 41.8% of the refundable expenditures were actually reclaimed by the state, and merely 18.5% of the structural funds were transferred to Poland's central budget that year. In effect, 86% of the national budget deficit emerged from not receiving transfers from the EC, and as much as 67.6% of the deficit should have been covered by the projected but eventually not received structural funds.

Those poor results may be explained by the unsatisfactory level of attainment of the targets set by the National Strategic Framework. Another factor that should be taken into account is that some of the receivables to be borne by the EC comprised the funds from the 2004–2006 EU budget. In that EU budget, there were specific measures devised to increase the efficiency of the transfers made to the beneficiaries. Furthermore, lack of proper regulations on the national level at the time had impact on the decisions by the Polish Ministry of Finance on assigning the financial means from the EC to a separate account on the revenue side of the national budget. The national auditor (the Supreme Chamber of Control) referred to those issues in their reports regarding the completion of the national budget and monetary policy targets of the state (NIK 2008: 51; NIK 2009: 56).

As late as 2009, the Ministry of Finance, in response to the national auditor's concerns raised in their reports, introduced internal procedures on how to transfer the EU funds from the accounts denominated in euro (EUR) to the national budget. According to the new procedures, transfers were to be made based on the preliminary expense statements presented by the administrators of specific parts of the budget, as well as their reports of expenses actually made submitted every half a year. There is, however, a noticeable inconsistency in such a procedure: a statement of preliminary expenses is, by definition, only a plan, and, as such, not necessarily can be fulfilled in its entirety within the timeline given, because closing

of a specific project can take longer than originally expected or savings are achieved in course of the project's completion. In 2009 the national budget revenues from the EC refundable expenditures increased, as 76% of the planned revenues were actually received. Furthermore, 74.6% of the revenues from the structural funds included in the amended national budget were effectively collected. As of the deficit of the national budget, only 41.5% of it resulted from not received paybacks for the refundable expenditures by the EC, and approximately 29% of the deficit came from unrealized structural funds payments.

The generally low level of efficiency in financing the EU-supported projects was a result of overtly optimistic assumptions about the capacity for implementation of operational programmes made at the stage of national budget planning in 2007 and 2008, as well as ineffective project management and coordination by the relevant institutions. Moreover, lack of appropriate regulations and procedures regarding classification and allocation of the financial means was an additional hindrance in effective spending, especially at the project preparation stage (before signing of the contract for co-financing). Even though the Ordinance of the Minister of Regional Development of 7 September 2007 regarding the spending related to operational programmes<sup>3</sup> dealt with the issue, the decision to actually release the funding was left to the Ministry of Finance. Such a decision, if made, would mean deliberate acceptance of the fact the financial means for the project could be not included as a revenue of the national budget, as they, as uncertified, would not be considered refundable by the EC. Thus, the national budget would have to carry additional burden.

A desire for sudden reduction of the public debt could be the reason for adopting a specific system of operational programmes financing for the 2007–2013 EU budget, based on the principle of incorporating cash flows into the national budget. The decision was taken at the times of swift economic growth, when the state recorded a high level of revenue from income and indirect taxes, which translated into a lesser than anticipated level of national budget deficit. Such a choice appears to be politically motivated, as it allowed for increasing of the revenue and decrease the budget deficit. It also indicates how short-sighted was the approach of the government towards the issue of financing operational programmes. The decision-makers simply assumed that the economic growth would continue at a relatively high pace, so national budget revenue would constantly be on the rise, and eventually revenues

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<sup>3</sup> Polish Journal of Laws 2007/175/1232 and amendments to the Ordinance of 10 February 2009, *Polish Journal of Laws* 2009/23/1140.

and expenditures would become more or less balanced. Furthermore, the issue of institutional efficiency was also apparently overlooked. The volume and pace of financial transfers from the EC depends heavily on smooth work of the entire system of institutions responsible for implementation of structural funding. Therefore, a question arises whether financing of operational programmes can be accurately planned? The public expenditure forecasts and their actual execution are summarized in the Table 3.

**Table 3. The National budget expenditure borne for the purpose of financing projects under the frame of the National Development Plan and the National Strategic Framework 2007–2010**

	Refundable spending as planned (amendments included) (in PLN thous.)	Refundable spending – completion (in PLN thous.)	%	National contribution as planned (amendments included) (in PLN thous.)	National contribution – completion (in PLN thous.)	%
2007	4 708 140	2 888 048	61.34	5 235 320	4 084 858	78.02
2008	17 948 533	4 774 807	26.60	9 881 121	3 977 563	40.25
2009	15 515 448	14 523 810	93.61	3 444 341	3 277 703	95.16
2010 <sup>a</sup>	1 447 400	335 423	23.17	6 093 021	3 868 467	63.49

<sup>a</sup> The 2010 data include spending borne for the technical assistance within the frame of operational programmes and national co-financing of operational programmes.

Source: Author's own account based on the reports on completion of the national budget in the years 2007–2009 and monthly reports by the administrators of the specific parts of the national budget.

The data presented in the Table refer to the spending actually made, that is, to spending included in the budgets of the administrators of specific parts of the national budget enhanced with financial means from the appropriated reserves of the national budget. Analysis of the data allows seeing that so called 'national share' in the projects ran within the frame of operational programmes was financed more effectively than the expenditures to be covered externally, that is, with the EC funds.

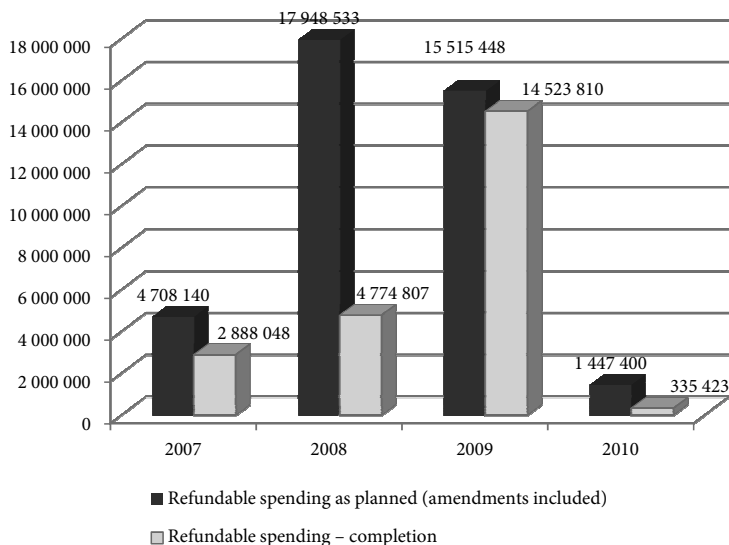
In 2007 the volume of funds allocated in the national budget to the task of co-financing of EC-funded projects exceeded the volume of refundable spending. Total of 78% of the financial means assigned to co-financing was actually spent, while the figure for refundable spending amounted to only 61% of what had been intended. At the time projects covered by the 2007–2013 EU budget were already underway, and the 'national share' required for the projects is not deemed refundable. Furthermore,



in 2007 some projects covered by the former EU budget (2004–2006) were still being implemented<sup>4</sup>.

In 2008 the volume of EC refundable spending from the EU structural funds, as planned, was nearly four times higher than in the preceding year. Nevertheless, performance of the relevant administrators of the specific parts of the national budget was poor in terms of meeting the target set by the annual budget legislation: only 27% of the refundable expenditure planned was eventually completed that year (Graphs 2 and 3), significantly less than in 2007 and 2009, respectively. On the other hand, in 2009 over 90% of the planned expenditure ('national share' and EC refundable spending) was eventually completed, yet such a good result was mainly an effect of amending the 2009 national budget legislation.

**Graph 2. Completion of the EC refundable spending in 2007–2010**



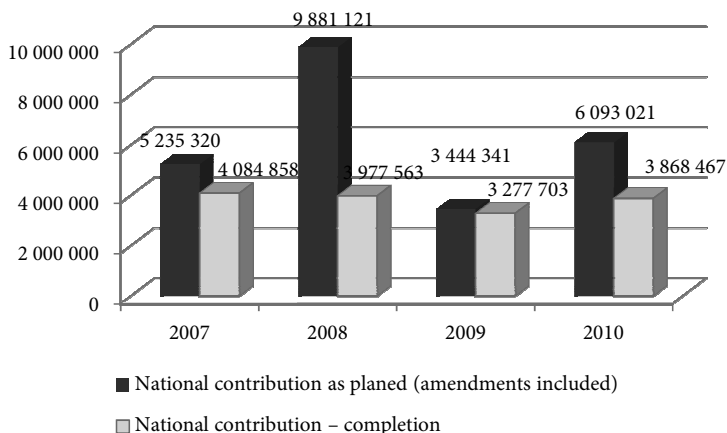
Source: Author's own account based on the reports on the national budget legislation for the years 2004–2010 and monthly reports on completion of the national budget in 2010.

In 2010 (as of 30 April) the volume of EC refundable expenditures included in the national budget amounted to only 9% of what had planned a year earlier, while the volume of 'national share' increased nearly twice. As of the end of April, only 23% of

<sup>4</sup> Financing of projects under the 2004–2006 EU budget was prolonged until June 31, 2009 by decisions of the European Commission.

planned EC refundable spending was actually executed, whereas 63% of the volume allocated to the national share were put into use.

**Graph 3. Completion of the national contribution 2007–2010**



Source: Author's own account based on the reports on the national budget legislation for the years 2004–2010 and reports on completion of the national budget in the years 2004–2010.

Considering that the EC refundable expenditure was, in a substantial part, not carried out as originally planned, no revenue from this particular source could boost the national budget. Having that in mind, one must come to a conclusion that unrealistic planning of the national budget revenue from the refundable expenditures which ultimately cannot be made blurs the picture of the state of public finances. The 2009 national budget provides a very meaningful example of the consequences of using potential proceeds from the EC to enhance the revenue side of the budget: originally, the revenue was to reach a level of PLN 20,087,937 thousand, while the spending would amount to PLN 28,778,259 thousand. However, following amendments made that year to the national budget legislation in response to the onset of the economic crisis, volume of the revenue was set at PLN 27,087,780 thousand, and the expenditure – at PLN 21,790,987 thousand. Comparison of those figures may lead to a following question: did the national deficit disappear as a result of a deliberate increase in the forecasted sum of the EC refundable expenditures? The ex post analysis of the actual efficiency in collecting the EC transfers covering the public expenditure conducted above casts shadow of a doubt over feasibility of such approach to budget-planning.

All things considered, a closer look at the shape of the system of financial transfers from the EC to the national budget of Poland being in place from 2007 on implies

that the revenue collected within the budget year cannot match expenditure actually carried out within the same budget year. Spending usually proceeds at a faster pace than receiving revenues, with the latter depending on how quickly the beneficiaries of the EU projects request payment from the EC.

The data on revenues and expenditures of the national budget over 2007–2009 period (Table 4) indicate that in 2007 58% of revenues due to be received from the EC in return for the refundable spending made were completed, yet, based on the data, it remains unclear what portion of those revenues should be attributed to the former (2004–2006) EU budget and what was the share of the current (2007–2013) EU budget. A similar question arises while analyzing the data for 2008. In 2009 the national budget actually received total of 128% of the forecasted amount of revenue. Revenue to be received from the EC in return for the refundable spending could be effectuated by requests for payment submitted to the EC. As a result, national budget could receive transfers from the EC on continuous basis. The transfer of the funds was actually conducted based on the pre-scheduled expenditures prepared by the administrators of the specific parts of the national budget. The actual amount of revenue in 2009, just like in 2008, could be achieved thanks to the down-payment made by the EC. The down-payment was in fact used to support not only the revenue side of the national budget but also to accomplish other objectives, for instance, to finance the cost of service of public-debt, free of interest. Only in 2009 total of 1,200,000 million euro was spent for that purpose.

**Table 4. Completed expenditure and completed revenue of the national budget in 2007–2009**

	EC refundable spending – completion (PLN mln.)	EC refundable revenue – completion (PLN mln.)	EC refundable revenue completed to EC refundable spending completed (%)
2007	2 947.0	1 699.4	57.7
2008	5 045.0	3 737.0	74.1
2009	14 523.0	18 554.7	127.8
2010 <sup>a</sup>	33 542.3	74 046.0	22.1

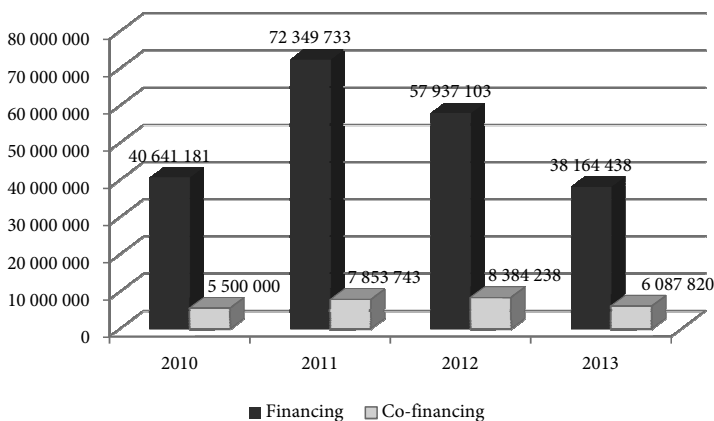
<sup>a</sup> As of the end of April 2010.

Source: Reports on the national budget completion for the years 2007–2010, Ministry of Finance

The system based on the principle of incorporating the financial streams from the EU budget (structural funds included) into the national budget was in operation for only three years. When the Polish economy began to experience a noticeable slowdown in the GDP growth, decrease in the fiscal efficiency of the state, negative impact of specific decisions taken by the government in the previous year's regarding

the field of public finances (lowering the level of a mandatory contributions to disability pensions, cutting PIT rates in 2009 and amending the VAT regulations in favour of the taxpayers), increase of the expenditures related to the 2007–2013 EU budget and volatility in the financial streams from the EC, the public finances were struggling to stay in balance. As a result, the national budget deficit rate grew from the level of 3.7% of GDP in 2008 to 7.1% in 2009. Considering a rapid deterioration of the macroeconomic conditions, sustaining that system in the years to come would certainly lead to a continuing increase in the level of the public expenditures related to the 2007–2013 EU budget, thus only add to a further swelling of the national budget deficit. In order to take full advantage of the financial streams to be channeled into the operational programmes in Poland within the 2007–2013 period, the Ministry of Regional Development assumed that the volume of EC refundable spending would have to reach its peak in 2011, when the total amount of public expenditure to be reclaimed by Poland from the EC would grow by 178% compared to the 2010 figure (see Graph 4).

**Graph 4. Completion of the national contribution 2007–2010**



Source: Author's own account based on the reports on the national budget legislation for 2011.

Nevertheless, it remains to be seen when the transfers from the EC will arrive. So the current state of the public finance in Poland is not only a result of the ongoing economic slowdown but also of the fiscal imbalance of structural nature. Refraining from introducing a major reforms in that field during the times of economic prosperity (2006–2007) had a clear negative effect on the state of public finances. During those years, when the national economy performed well, the decision to incorporate the EC transfers (structural funds included) to the national budget was taken with

a view of reducing public debt, whose level at the time was getting close the first safety threshold set by the domestic law (public debt to the GDP volume ratio at 50%). That move, however, inevitably led to worsening in the public debt/GDP ratio. Poland is by no means a country, which could afford to take such a step without considering its potential disastrous impact on public finances.

Number of EU-15 member states, more affluent than Poland, like Germany and France, either abstained from taking such a direction in their public finance policy or decided to abandon it, had it been in place. Both in Germany and France the system of financing operational programmes remains outside of the national budget frame, so that the EC refundable spending is not covered with the budgetary financial means. The revenues and expenditures incurred due to the EC transfers are only included in the annual reports on the national budget completion or, in an even more loose form, summarized in appendices to the national budget legislation. In both countries, the government puts a pressure on the beneficiaries to ensure that the requests for payment are timely submitted to the EC.

The worsening state of public finance in Poland had not gone unnoticed by the EU. On 7 July 2009 the Ecofin officially recognised there was an excessive level of the national budget deficit in Poland and issued a recommendation to reduce it in line with the EU Treaty<sup>5</sup>. Poland was called to reduce the excessive national budget deficit until 2012 in durable and credible manner. As a consequence, Poland has to curb exaggerated public spending by introduction of a 'golden rule' on expenditures. The rule applies to both expenditures to be taken by decision (non-fixed) and those which are determined by law (fixed). The 'golden rule' will remain in use until the excessive deficit vanishes, and the procedure launched by the Ecofin is terminated. In the next step, the former 'golden rule' should be replaced by a new one, which will ensure that deficit stays on acceptable level. That new rule is not likely, however, to apply to the expenditure on operational programmes within the 2007–2013 EU budget.

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<sup>5</sup> As stipulated by the Article 126, item 7 of the European Union Treaty.

## 5. Financing Operational Programmes from 2010 – en Route to Higher Public Debt?

In order to counteract the process of increasing national budget deficit (of which inclusion of the EU structural funds was one of the reasons), the amended Public Finance Act of 29 August 2009 named the state-owned Bank Gospodarstwa Krajowego (BGK) the payer of structural funds, responsible for making transfers to beneficiaries. In 2004–2006 BGK played a role of a loaner to beneficiaries carrying out EU-funded projects. The budget of the EU funds was deliberately excluded from the national budget frame. **The question should be raised whether the EU funds should become part of the national budget and how it should be financed or should it be represented separately.** There are no straightforward answers to any of those questions. According to the amended Public Finance Act of 29 August 2009, the deficit of the budget of the EU financial means is not a part of the national budget deficit, so that figure of the latter obviously becomes smaller. A portion of the expenditures to be covered by the European means budget will be reclaimed from the EC. However, being aware of the preliminary expenditure schedule for 2011–2013 period prepared by the Ministry of Regional Development, as well as of the methodology currently employed in planning the revenue from the EC refundable spending, one should be skeptical about the feasibility of collecting the whole sum as intended. In effect, a necessity to cover the gap with the means obtained directly from the national budget is likely to become unavoidable. The amended Public Finance Act of 29 August 2009 has broadened the definition of the ‘borrowing needs’ of the state by adding a new, previously unrecognised by national law, type of a deficit, that is, the ‘European means deficit’. It is likely that at least a part of that type of deficit is going to be financed with the means acquired from issues of government bonds, which will clearly be reflected in the rising level of the public debt. Naming the BGK as the payer may be seen as a new solution in a way, yet it closely resembles the role the bank already played during the 2004–2006 period (under the ‘old EU budget’), when it was responsible for granting loans to the beneficiaries of operational programmes by the ‘pre-financing’ scheme using the means transferred from the Ministry of Finance (the loans would be repaid once the respective means was transferred by the EC). Under current regulations, the Ministry of Finance still transfers the financial means to the BGK, which subsequently releases them to the beneficiaries, only not as loans (as it was previously) but as payments.

Comparing the 'prefinancing' scheme and the system of direct payments made by the BGK to beneficiaries, one should remember that while implementing the former caused the public debt to rise by PLN 7.7 billion, borrowing for the sake of having the sufficient funds for payments to beneficiaries can also easily translate to higher public debt and worse public debt/GDP ratio. Additional pool of European funds assigned to Poland for the purpose of the National Strategic Reference Framework 2007–2013 might turn out to be another factor possibly causing increase in the level of public debt. Furthermore, the process of preparing the next EU budget (2014–2020) is already underway and Poland is likely to receive as much as EUR 80 billion within its timeline. Another pivotal point will then be reached in 2014, when the current EU budget is almost over, while the new one is about to commence. In the Table 5 and Va, the data illustrating the dynamics of public debt in Poland is shown, as well as the volume of debt excluding the borrowing needs of the national budget related to the operational programmes financing. The conclusions are very much alike with those drawn upon analysis of the public debt dynamics in 2004–2008 period. The public debts has continued to rise. While in 2008 the public debt/GDP ratio amounted to 47%, in 2009 it was already as high as 49.8%, and in 2010 the public debts reached the level of 52.8% of the GDP. All those figures are calculated by the Polish Ministry of Finance, which uses different methods for that purpose than the EU, according to whom the public debt/GDP ratio was 54.9% in 2010. The Public Finance Act sets the second 'prudence level' at 55% of GDP. If the public debt exceeds 55% of GDP but remains below 60% of GDP, then the government is obliged to prepare a draft budget legislation for the next year which needs to ensure that no deficit is allowed or the gap between the revenue and spending will fall below the second 'prudence level'. In order to secure accomplishment of such goal, the public sector pay has to be frozen, old-age pensions and disability pensions may only be raised by the increase in the Consumer Price Index (CPI) for the previous year, no credits or loans from the national budget may be granted (except for continuing of the lines of credits released prior to introducing the new, restrictive budget rules), and, last but not least, level of spending cannot increase. Yet, the two methods employed for the sake of calculating the actual volume of national budget deficit vary significantly. In the author's opinion, the EU method seem more reliable than the domestic one. The volume of debt of the general government is calculated to establish whether the member state meets the Maastricht convergence criteria. If the EU method is employed, the special public funds such as the National Road Fund and the National Railways Fund operated by the BGK and used as a source of financing of the strategic infrastructure projects (also ran within the frame of the Infrastructure and Environment Operational

Programme) (NIK 2011: 193). According to NIK report, the public debt could be maintained under the 50% GDP level because of a part of the borrowing needs of the national budget could be satisfied with the funds acquired as down payments from the EU, and some of the infrastructure projects in the national road network became financed by the National Road Fund, which formally remained outside the national budget frame. Ministry of Finance's position is that the funds acquired as down payments from the EU are not treated as state debts, even though they eventually have to be returned to the national budget. It is argued that once such funds are acquired as a down payment, they are formally owned by the state, so when they are subsequently put into use, for example to cover the borrowing needs of the state, the level of public debt is not affected, as no new liability emerges in effect. However, if the amount of funds obtained as down payments from the EU and used to satisfy the borrowing needs of the state in 2009 had been acquired from the market through auctioning of the government bonds, the level of public debt at the end of the year would have amounted to 50.1% (the official figure was 49.8%) (NIK 2010: 153).

Tables 5 and 6 provide an insight into the completion of the revenues and expenditures of the EU funds budget, which figures are put next to the financial plan included in the national budget legislation for 2009–2011. Apparently, there was a tendency to increase the planned spending for the sake of operational programmes in 2007–2013, as well as revenues from EC refundable expenditures. In 2010 the revenues planned rose by 54% in comparison to the 2009 figure but the revenues from the structural funds amounted to only 94% of what was planned a year earlier. In 2011 the revenues planned increased by 94% in comparison to the 2010 figure but the revenues from the structural funds planned were nearly twice as high as the year before. As far as expenditure side is concerned, there was also a growing trend observable, only the dynamics of spending is higher than in the case of revenue, thus the burden on the national budget triggered by the spending on the regional development becomes considerably heavier. The difference between the actually completed revenue and expenses of the EU funds budget, that is, its deficit, translates to the borrowing needs of the state, as stipulated by the Public Finance Act. In 2006–2008 period the borrowing needs of the state related to the 'prefinancing' amounted to PLN 7.7 billion, in 2009 its amount was PLN 4.4 billion and in 2010 – PLN 10 billion (NIK 2011: 141; NIK 2010: 165).



**Table 5. Completion of the ‘European funds budget’ revenue 2009–2011**

Position	Financial means from the EU and other sources – non-refundable <sup>c</sup>	Common Agriculture Policy and Common Fisheries Policy <sup>b</sup>	Structural funds and other sources
Financial plan after 2009 amendemnets <sup>a</sup>	27 087 780.0	1 773 449.0	25 314 331.0
Completion	18 058 751.0	116 421.0	17 942 330.0
%	66.7	6.6	70.9
Financial plan after 2010 amendemnets	41 728 303.0	17 936 118.0	23 792 185.0
Completion	37 706 686.0	13 974 561.0	23 732 125.0
%	90.4	77.9	99.7
Financial plan after 2011 amendemnets	68 443 429.0	21 765 264.0	46 678 165.0
Completion	42 953 999.0	15 903 671.0	27 050 328.0
%	62.8	73.1	58.0
Planned revenue dynamics 2010/2009	154.0		94.0
Planned revenue dynamics 2011/2010	164.0	121.3	196.2

<sup>a</sup> 2009 data on national budget revenue to serve as benchmark in the analysis of planned revenue dynamics.

<sup>b</sup> 2009 data reflects only the revenues planned to be collected under the Rural Development Programme .

<sup>c</sup> prior to amending the 2009 national budget legislation the planned revenue amounted to PLN 20 631 937 thous.

Source: Author's own account based on operational reports on completion of the national budget in the years 2009–2011, Ministry of Finance.

**Table 6. Completion of the ‘European funds budget’ expenditure 2009–2011**

Position	Financial means from the EU and other sources – non-refundable <sup>b</sup>	Common Agriculture Policy and Common Fisheries Policy <sup>b</sup>	Structural funds and other sources
Financial plan after 2009 amendemnets <sup>a</sup>	21 253 876.0	6 792 885.0	14 460 991.0
Completion	16 466 248.0	2 993 251.0	13 472 997.0
%	77.5	44.1	93.2
Financial plan after 2010 amendemnets	56 270 072.0	17 979 781.0	38 290 291.0
Completion	48 124 677.0	14 612 625.0	33 512 052.0
%	85.5	81.3	87.5
Financial plan after 2011 amendemnets	84 004 046.0	19 172 295.0	64 831 751.0
Completion	45 925 282.0	13 964 438.0	31 960 844.0

Position	Financial means from the EU and other sources – non-refundable <sup>b</sup>	Common Agriculture Policy and Common Fisheries Policy <sup>b</sup>	Structural funds and other sources
%	54.7	72.8	49.3
Planned revenue dynamics 2010/2009	264.8	264.7	264.8
Planned revenue dynamics 2011/2010	149.3	106.6	169.3

<sup>a</sup> 2009 data on national budget expenditure to serve as benchmark in the analysis of planned expenditure dynamics.

<sup>b</sup> prior to amending the 2009 national budget legislation the planned expenditure amounted to PLN 28 778 259 thous.

Source: Author's own account based on operational reports on completion of the national budget in the years 2009–2011, Ministry of Finance.

Having in mind all those recent events, one may wonder whether the current financing system will prove viable in providing the smooth cash flow and at the same time will not have negative impact on the state of public finance.

Among other strategies for combating public debt, the public debt theory mentions imposing of the constitutional restrains which prevent the state from assuming excessive debts. Poland's system of public finance is quite unstable, as it is changed periodically following the upswings and downswings of the national economy, and whose shape depends heavily on the economic policy agenda of the government administration currently in power. The condition of public finance is far from satisfactory and its frequent changes have been driven by the desire to improve the main financial indicators, that is, the volume of public debt and national budget deficit. Nevertheless, creative accounting produces a false picture of the public finance in the long run. Considering Poland' aspirations to join the Eurozone, the fate of Greece and other countries which had adopted euro and recently experienced a full blown crisis of public finances should be seriously taken into account.

Instability of the public finance system (to which volatility of investment schemes using EU structural funding contributes), marked by frequent changes in relevant legal regulations, results in a blurred and complicated picture. The national regulations dealing with the issues of EU structural funding currently in place result in a severe financial burden borne by the national budget. On the other, Poland is not the only member state which struggles with the challenge of excessive public debt and national budget deficit. The Constitution of Poland explicitly sets the acceptable level of public debt at 60% of GDP. The national budget deficit ought not to exceed the 3% of GDP

threshold. The analysis of the available data conducted thus far in the article allows formulating a conclusion that the current regulations on EU structural funding and its impact on the state of public finance have noticeable negative implications both on the national budget deficit and the public debt.

Among other factors, efficiency of the operational programmes under the EU multi-annual budgets depends on how smoothly and uninterruptedly the financial transfers can be made. The domestic level arrangements adopted in Poland, due to their complicated nature and negative influence on the state budget, may in fact become a serious hindrance to timely and correct completion of the operational programmes. When drafting the national budget, the government should take a realistic approach to the issue of public expenditures related to the operational programmes and revenue which can be collected as a result of EC refunds. On the other hand, planning of the national budget spending is interlocked with the EU structural funds allocation in line with the N+3 and N+2 rules<sup>6</sup>. As a consequence, there is a fixed-time period during which Poland as a member state has to actually spend the financial means obtained from the EU budget, otherwise the remnants of those funds have to be returned. In the case of growing needs for public expenditures related to the operational programmes, the public finance would further deteriorate, provided no constitutional 'safety valve' in a form of 60% of GDP threshold of the public debt volume was in place.

Discussing the issue of operational programmes financing and its impact on the state of public finances, one must not forget to take into consideration the matter of efficiency of investment projects financed with the EU structural funds. Should the investment enhance the GDP growth in the future, than a temporary leap in the level of public debt could be treated as unpleasant, yet necessary sacrifice. Unfortunately, not all the spending made within the frame of operational programmes is channeled into investment projects, as there is some current expenditure involved. Furthermore, not all the spending is deemed eligible and refundable, as part of it is eligible but non-refundable, and, finally, some expenses are non-eligible and non-refundable but, nevertheless, have to be made for the sake of carrying out the EU funded projects successfully. No one can accurately predict whether the debt incurred today will be redeemed in the future thanks to the EC refunds. In addition, the debt is not interest-free, so yet another category of costs to be borne by the public finance enters the

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<sup>6</sup> N+3 and N+2 rules determine that expenses originally planned for a specific year may be actually made later, over two or three following years, for example expenses planned for 2010 may be postponed until 2012.

picture. Certainly, the EU structural funds are aimed at generating the economic growth, accelerating the economic development in a country that still is to catch up with the leading economies in the entire EU, but they trigger substantial costs which put the stability of public finance at risk.

Regular increase in the volume of the expenses on the operational programmes translates into the rise of the borrowing needs of the state on annual basis, which in the long run may drag the public finance into a downward spiral of indebtedness. There are other negative consequences of the enduring excessive public debt and national budget deficit mentioned by the literature such as current account deficit, crowding out effect or accelerated inflation (Wernik 2007: 90; Horsman 1988; Parkin 1987: 310–337; Dornbusch 1986: 184–185 Stargent, Wallace 1981: 1–17; Heilbroner, Bernstein 1989: 9–10). Those phenomena remain, however, beyond the author's focus.

In the literature, financial means from the EU structural funding are considered a type of instrument of public economic intervention (Żukrowska 2003: 122; Behrens, Smyrl 1999: 423–425; Ederveen, de Groot, Nahius 2002: 2; Taylor, Wren 1997). Such instruments, if put in to use in a relatively closed economy, may produce negative effects leading to a growing dependency on external sources of financing, which are mainly used to satisfy current consumption needs. The policy of EU structural funds implementation currently exercised in Poland leave a deep mark on the face of the public finance.

## Conclusions

European Unions makes up a system in legal, institutional and socio-economic sense. Regional policy of member states is determined by financial obligations to and involvement of the European Commission. Regional policy is arranged in the mid-term perspective, which is determined by the EU budget, where revenues and expenditures are set. The EU budget also directs the dimensions and priorities of the regional policy, as long as they are financed by the EU. Poland's membership in the EU brings an opportunity to catch up with the other member states in terms of economic development. A member state seeking to take advantage of this opportunity needs to create a viable system of allocating the EU funds. Effectiveness of such a system depends mainly on the system of public finance and its condition, which is measured by the volume of public debt and the national budget deficit. There are

two contradictory doctrines dealing with the two aforementioned issues; the first doctrine sees indebtedness of the state as unacceptable, while the other allows it. The public debt and the national budget deficit may, nevertheless, become the subject of creative accounting.

The paper aims at analyzing the impact of the system of financing of the EU-funded operational programmes on public debt and national budget deficit. The author explores *ex post* the process of structural funds implementation within the frame of the 2004–2006 National Development Plan and the 2007–2013 National Strategic Framework. Based on the available secondary sources, the point is made that the current system of financing of the EU-funded operational programmes has indeed an impact on the volume of public debt and national budget deficit.

In the 2000–2006 and 2007–2013 EU budgets structural funds made up vast parts of the liabilities<sup>7</sup>. The fact that the balance of financial flows between the EC and Poland (EC refundable spending versus the member state dues) was positive from Poland's perspective is undeniable. Nevertheless, in an attempt to assess the state of budget completion and estimate the volume of public debt and national budget deficit in a given budget year, one should take into account the planned revenue and expenditure, because the annual budget legislation is in fact a financial plan for a year to come, where such parameters as public debt and budget deficit must be included. Furthermore, the fiscal policy of the state is based on the budget legislation. The data on the state of public finance included in the annual budget legislation, especially the public finance parameters, determine the direction and pace of the economic development. For those reasons, it seems crucial to compare the plans concerning the inflow of financial means to be received from the EU (which is reflected in the national budget) with the amount actually received.

Comparative analysis reveals that since 2007 Poland has continued to plan the revenues from the EC refundable spending in an overtly optimistic way, as the volume of financial means actually received from the EU turned out to be significantly smaller than expected. As the result, even though the balance of financial flows between the EC and Poland remained positive over 2004–2009 period, it has not improved the state of Poland's public finance. In the balance sheet only the relation between the membership dues paid by Poland to the EU budget and the inflow of financial means from the EC is reflected. Membership dues, however, do not make up the total costs borne by Poland due to implementing the operational programmes. It might be

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<sup>7</sup> Under the 2004–2006 EU budget Poland received total of EUR 14,891.5 mln, and under the 2007–2013 EU budget – total of EUR 69,2 bln. The amounts given comprise both the EU and national shares.

assumed that the decision to include the revenues from the EC refundable spending in the national budget was taken primarily to indicate another important source of revenue, which would lead to a decrease in the volume of the national budget deficit.

In exploring the issue of what effect the EU structural funds had on the volume of public debt and national budget deficit, the author reached for the financial data on borrowing needs of the national budget and actual completion of the EC refundable spending compared to the revenues actually collected.

While Poland's membership in the EU opens a wide spectrum of chances for external sources of financing before the country, it also brings serious financial costs related to use of EU structural funds which need to be borne by the beneficiary. Considering growing national budget deficit and public debt, it is not an easy task to assess opportunities and threats to the public finance entailed by the current system of absorption of the EU structural funds. Public finance system in Poland is constructed in such a way that EU structural funds have to be counted either as revenues which subsequently affects the level of public debt or expenditures and, then, the national budget deficit is impacted. In an attempt to curb the national budget deficit, the special, separate 'European funds budget' was created by the Public Finance Act and the national budget legislation in 2010. Within the 'European funds budget' the refundable spending from the following sources is included: EC (means dedicated to operational programmes under the 2007–2013 National Strategic Framework), the Swiss-Polish Cooperation Programme, the 2009–2014 Norwegian Financial Mechanism, and the Common Agricultural Policy and the Common Fisheries Policy. While the deficit of the 'European funds budget' does not increase the national deficit budget, the means included in that budget still translate to borrowing needs of the state. So whatever strategy on positioning the EU structural funds within the national system of public finance is employed, the two key public finance parameters (national budget deficit and public debt) will be affected anyway.

With no solution which would allow preserving the two key parameters unaffected at hand (it is unfeasible to even try to balance the public spending related to EU structural funds and the actual inflow of those funds), the state probably might simply accept the fact. Furthermore, the two EU budgets will certainly come across each other, at least at the early stage of the 2014–2020 EU budget implementation. It will be necessary to secure means for closing the projects financed from the 'old' EU budget, and to facilitate the national contribution for the projects financed from the 'new' EU budget at the same time, so the borrowing needs of the state will inevitably grow as a result. If the national economy performed well enough, such a challenge to the public finance could probably be successfully coped with. Let us not forget that

the decision to recognize the EU structural funds as a part of the national budget was taken in 2007, when Polish economy enjoyed prosperity. However, in the times of economic stagnation (and possibly, even a recession), when the revenues of the national budget keep decreasing, gaining additional financial means for the budget can only be achieved through borrowing, which translates to a higher public debt and an increased interest to be paid on the debt. Provided the Polish government continued on that path, the country might soon find itself in a debt trap. Should the public spending dedicated to the implementation of operational programmes continuously increase, the borrowing needs of the state would grow proportionally. Whereas the EC refundable spending might be redeemed even after the next EU budget expires, there is still a considerable risk from the recipient's point of view hidden in the floating of exchange rates: most likely, the PLN/EUR exchange rate at the moment of requesting funds from the EC will differ from the exchange rate at the time of the financial means being actually transferred to the account of the national budget. Moreover, some irregularities may occur in course of implementing operational programmes, and the funds which had already been received from the EC will have to be returned in effect<sup>8</sup>.

In the paper, not only the issue of national contribution into financing the projects under the operational programmes is mentioned but also other factors which may negatively impact the national budget such as the costs of overcontracting (contracts whose amounts exceeded the volume of total allocation), exchange rates and additional borrowing needs related to the pressures of closing the operational programmes under the 2004–2006 National Development Plan are highlighted. Considering how lengthy is the process of closing the financing lines from the EU budget as it is nearing to an end, it was not possible to determine accurately the amount of extra spending. Assessing the volume of spending borne due to overcontracting is equally difficult, as it mainly depends on the exchange rates floating. As the clearing rules established for the current system are very complicated, accessing all the data relevant for this study is not doable. Difficulties encountered in the process of assessing the level of eligible costs to be borne for the sake of carrying out the projects are also noteworthy. Last but not least, in case of state budgetary agencies and local government, eligible costs were also borne by the national budget. However, due to the methodology currently employed in presenting the financial data in the annual budget reports, it is not feasible to precisely determine their amount.

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<sup>8</sup> In 2009 total of PLN 53 mln was returned to the EC, and in 2010 the amount returned was PLN 7 mln.

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