

Legal conditions
limiting the possibility
of acquiring financing
by local government entities.

Current state
and proposed changes

Sebastian Skuza

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Author's affiliation:

Sebastian Skuza, dr hab. Faculty of Management, University of Warsaw,
the Unit of Banking and Financial Markets, ORCID: 0000-0002-9357-6791

Reviewers:

Hanna Kuzińska, Associate Professor in Kozminski University,
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Introduction

In 1989, the process of building a democratic system commenced in Poland. As noted by J. Regulski, the state decentralization which began in 1990 has abolished five monopolies of the socialist state¹:

- 1) political monopoly – local government elections in 1990, the first fully free elections in Poland;
- 2) monopoly of the public authority – the rule of unitary public authority was abolished;
- 3) monopoly of public ownership – in 1990, municipalities gained legal personality and thus took over a part of the state property;
- 4) monopoly of public finance – separation of local government entities' budgets from the state budget and establishment of (local governments') own sources of income;
- 5) monopoly of public administration – separation of a new occupational group, i.e. local government employees.

In 1997, the Polish Constitution² was passed, and since 1999 Poland has continued to operate in a three-tier local government structure, which consists of municipalities, districts and provinces³.

Reactivation of the local government has undoubtedly been a just and necessary step in the process of political system transformation. The nearly 50-year period of economic life “behind the iron curtain” contributed to the creation of a civilizational gap in the area of municipal infrastructure, which local government entities have been unable to functionally fill during the nearly 28-year period of their functioning. Taking into consideration the situation in the public finance sector (structural deficit), one should expect neither a significant

¹ J. Regulski, *Samorząd a model państwa*, INFOS no. 10(80), Biuro Analiz Sejmowych, Warsaw 2010, p. 1.

² Constitution of the Republic of Poland dated 2 April 1997. (Official Journal (Dz.U.) no. 78, item 483, further amended).

³ The Municipal Government Act of 8 March 1990 (Official Journal (Dz.U.) of 2017, item 1875, further amended), the 5 June 1998 District Government Act (Official Journal (Dz.U.) of 2017, item 1868, further amended), the 5 June 1998 Provincial Government Act (Official Journal (Dz.U.) of 2017, item 2096, further amended).

increase in local government entities' income nor a dramatic change in their structure, e.g. through replacement of certain subsidies with their own income. Despite the need for financing infrastructural investments, local government entities also relatively infrequently take advantage of the institution of public-private partnership.

Closing the civilizational gap in terms of ensuring the appropriate level of municipal infrastructure will require utilization of external sources of financing, namely *de facto* increasing the indebtedness level of local government entities. Effective development of local government entities in the near future is therefore, at least in part, dependent on legal regulations regarding the possibility and level of indebtedness.

The study primarily focuses on an attempt to answer the question formulated below:

Is the currently functioning system of legal limitations applied in relation to the possibility of acquiring sources of refundable financing by local government entities justified?

The presented study is primarily an analysis of the currently applicable legal solutions from the perspective of borrowing needs of local government entities in the area of financial law as of 1 May 2018. The aim of this study is to present the barriers to the possibility of entering into financial commitments by local government entities within the national regulatory environment, their criticism and *de lege ferenda* conclusions together with proposed solutions. An attempt is made to develop a proposal of regulatory changes using the so-called V. Pareto's optimum principle within the trend of normative economic analysis of law (*Law&Economics*). A normative economic analysis of law (based on principles of economics) provides proposals for changes in order to create more beneficial regulations compared to those currently in force. In the opinion of J. Stelmach, economic effectiveness of law may be illustrated as an improvement of the economic status of at least one individual with the simultaneous non-deterioration of the status of others⁴. As observed by V. Pareto, we may say that members of society enjoy maximum satisfaction in a specific situation if it is not possible to make a slight shift away from such a position so that satisfaction experienced by members of society would increase or decrease. This means that any, even the slightest, shift from this position will invariably bring about an increase in the level of satisfaction for some individuals and a decrease of

⁴ A. Drywa, *Efficiency as the value of a compensation claim for the issue of an illegal tax decision?*, Report at the 3rd International Baltic Conference titled *The Financial Law Towards Challenges of the 21st Century*, Karlskrona, Sweden, 24–27 April 2015, p. 5.

the same for others – that is to say, pleasure for some and unpleasantness for others⁵.

This study consists of an introduction, four chapters and a conclusion.

The first chapter encompasses issues associated with the essence and notion of state public debt. I present the above subject matter from a subjective as well as objective point of view. That chapter also illustrates issues associated with the methodology of calculating state public debt.

The second chapter presents limitations to the possibility of incurring debt by local government entities under the limit approach. The largest portion of that chapter is devoted to notions associated with the individual debt service ratio, which has replaced quantitative limits of indebtedness specified in the Public Finance Act of 26 November 1998 (Official Journal (Dz.U.) no. 155, item 1014, further amended) and the Public Finance Act of 30 June 2005 (Official Journal (Dz.U.) no. 249, item 2104, further amended).

The third chapter is devoted to qualitative limitations related to incurring debt by local government entities. That chapter presents issues associated with, among other things, the impossibility of capitalizing interest, maximum discount, as well as the necessity to establish the maximum value of the incurred obligation.

The fourth chapter constitutes the conclusion section and proposed changes, in particular in the areas of:

- 1) abolition of certain legal restrictions;
- 2) improvement of the local government entities' resource management process;
- 3) liability for the insolvency of local government entities and procedural actions in such instances.

The first three chapters are based on an analysis (commentary) of legal regulations, whilst the fourth chapter presents my proposals for legislative provisions. Each chapter concludes with a synthetic summary (in points).

The study primarily uses a descriptive method for analyzing legal regulations most relevant from the perspective of limitations for local government entities in relation to incurring financial obligations. The analysis, however, is not limited only to the presentation and criticism of solutions, but also proposals for changes to applicable legal regulations are simultaneously outlined.

When developing this study, I used reference literature (primarily comments), legal acts, in particular the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended) (further "Public Finance Act") and my own observation of issues related to local government entity indebtedness.

⁵ Sz. Chrupczalski, *Ekonomiczna analiza prawa własności w ujęciu szkoły austriackiej*, Kraków 2008 <http://mises.pl/wp-content/uploads/2009/09/ekonomiczna-analiza-prawa.pdf>, accessed on 04.07.2018 and V. Pareto, *Manual of Political Economy*, Augustus M. Kelley, New York 1971 (translation of the 1927 edition).

Chapter 1

State public debt in the national legal order

1.1. Definition of state public debt

Analyzed provisions of the Public Finance Act

Article 72. 1. State public debt shall cover the liabilities of the public finance sector arising from the following:

- 1) issued securities corresponding to pecuniary liabilities;*
 - 2) credits and loans taken out;*
 - 3) accepted deposits;*
 - 4) liabilities due:*
 - a) arising from separate acts and valid decisions of courts or final administrative decisions,*
 - b) recognized as indisputable by the relevant public finance sector entity being the debtor.*
- 2. The Minister of Finance shall define, by a regulation, a detailed manner of classification of debt instruments considered as public debt, including the types of liabilities regarded as debt instruments, with account being taken of basic subjective and objective categories of debt and maturity periods.*

A traditional model of public finance defines budget balance as at least coverage of budget expenses by budget incomes – without the necessity to incur financial liabilities⁶. Such a balance is the value being subject to constitutional protection, which was reflected in the judgment of the Constitutional Tribunal of 24th February 2010 (K 6/09, Official Journal (Dz.U.) no. 36, item 204), i.e. indication that the urgent need to preserve budget balance when the condition of public finance is highly disadvantageous makes it a priority to adhere to the

⁶ P.M. Gaudemet, *Finanse publiczne*, Polskie Wydawnictwo Ekonomiczne S.A., Warsaw 2000, pp. 180–187 and B. Nawrocki [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 7*, thesis 3.

constitutional principle of the budget balance⁷. As a result, it is reasonable to state that one may adopt the indices such as the ratios of deficit and public debt to the gross domestic product in order to assess the condition of public finance⁸.

The national system of public finance still faces the most important challenge of maintaining the deficit in the public finance sector at a level that guarantees stability. Deficit has a permanent and structural nature though, which results in growth of public debt and costs of its operation⁹.

The subject matter of public debt is especially important from the point of view of law and economics, and the issues concerning public debt indicate its far-reaching interdisciplinary nature even in legal studies – they belong to the sphere of the financial, civil, administrative and even commercial law¹⁰.

Public debt consists of accumulated budget deficits¹¹. The level of deficit of the public finance sector must be included in the annual report on performing the budget act (Article 182 of the Public Finance Act). Furthermore, for the sake of openness and transparency of public finance, there is the obligation to provide the general public with collective data concerning public finance (Article 34.1.3(c) of the Public Finance Act)¹².

Membership of the European Union imposes an obligation to comply with so-called fiscal criteria of convergence which refer to the maximum level of deficit and debt of the public finance sector in relation to gross domestic product. The rule concerning the manner of implementing common actions, referred to in Article 119 of the Treaty on the Functioning of the European Union, was developed in Article 126.1 of that Treaty by requiring that member states conduct actions in order to avoid excessive budget deficits. In accordance with the criteria for the deficit of the public finance sector, the deficit should not exceed 3% of gross domestic product as established by the principles defined in the European System of National and Regional Accounts (the so-called ESA 2010), set up by Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and

⁷ P. Smoleń [in:] P. Smoleń (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 7*, thesis 19.

⁸ A. Wernik, *Stan polskich finansów publicznych*, *Ruch Prawniczy, Ekonomiczny i Socjologiczny*, LXXIII, Zeszyt 3 2011, p. 5.

⁹ W. Misiąg, *Ewaluacja wobec wyzwań stojących przed sektorem finansów publicznych*, [in:] A. Haber, M. Szałaja (ed.), *Ewaluacja wobec wyzwań stojących przed sektorem finansów publicznych*, Polska Agencja Rozwoju Przedsiębiorczości, Warsaw 2009, pp. 27–28.

¹⁰ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 1.

¹¹ B. Banaszak, *Konstytucja Rzeczypospolitej Polskiej. Komentarz*, C.H. Beck, Warsaw 2009, p. 929.

¹² E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 7*, thesis 2.

regional accounts in the European Union (EU Official Journal L 174, p. 1)¹³. The abovementioned fiscal criterion regarding the deficit of the public finance sector is not reflected in the national legal order.

Article 7 of the Public Finance Act defines the surplus and deficit of the public finance sector: a positive difference between the public incomes and public expenses established for a defined settlement period constitutes the surplus of the public finance sector. The abovementioned definitions (of deficit and surplus respectively) refer both to the category of public incomes and expenses (Articles 5.2 and 6.1.1 of the Public Finance Act) and to the subjective scope of the public finance sector (Article 9 of the Public Finance Act)¹⁴. Article 7 is extremely important within the Public Finance Act, stipulating that in order to establish the surplus or deficit of the public finance sector, the value of incomes and public expenses is established after eliminating the flows (transfers) between entities of the public finance sector (consolidation), i.e. only incomes from outside the sector and expenses exclusively made outside the public finance sector are taken into consideration¹⁵. In the area of domestic financial law, apart from the public finance sector, one may also speak of the terms of budget surplus or budget deficit in the case of the state budget or the budget of a local government entity. Additionally, one should take note of the provisions of Article 220.2 of the Polish Constitution, which states that the budget act may not provide for coverage of the budget deficit by means of incurring liabilities in the national central bank.

Reference literature contains a dominant view that Article 7 of the Public Finance Act is technical and instructional, as well as analytical, in nature¹⁶. Article 7.2 of the Public Finance Act does not specify the body responsible for preparing information on the level of surplus or deficit in the public finance sector¹⁷.

Article 216.5 of the Polish Constitution contains a fiscal rule according to which it is prohibited to take out loans or grant guarantees and financial sureties as a result of which state public debt would exceed 3/5 of the annual

¹³ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 7*, thesis 3.

¹⁴ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 7*, thesis 1.

¹⁵ P. Smoleń [in:] P. Smoleń (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 7*, theses 11 and 12.

¹⁶ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 7*, thesis 4.

¹⁷ E. Chodowska [in:] A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 7*, thesis 3 and P. Smoleń [in:] P. Smoleń (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 7*, thesis 8.

gross domestic product¹⁸. The above provision, therefore, introduces a general financial rule which specifies a legal limit of indebtedness for entities in the public finance sector; however, its full materialization takes place at the level of regulations contained in the provisions of the Public Finance Act¹⁹. Regulations specified in Part II of the Public Finance Act should therefore be combined with the fiscal rule stipulated in Article 216.5 of the Polish Constitution²⁰. The legislator's intent was to implement a stable rule into the legal order to counteract excessive debt growth, i.e. such exceeding the established limit of 3/5 of the annual gross domestic product²¹. The formulation of the above rule indicates that the prohibition specified in the Polish Constitution is absolute as it does not provide for any exceptions. T. Dębowska-Romanowska highlights that *every instance of exceeding the mathematical limit of state public debt must be treated as a breach of the Constitution and therefore results in the obligation to:*

- 1) *ascertain the breach;*
- 2) *investigate and assert the liability of persons comprising the authorities and bodies whose actions (or omissions) have resulted in the said breach*²².

Exceeding the ratio stipulated in the Polish Constitution results in the initiation of prudential and recovery procedures provided for in Article 86 of the Public Finance Act.

The maximum state public debt limit stipulated by the abovementioned constitutional fiscal rule corresponds to the standard applicable in the European Union arising from Article 126 of the Treaty on the Functioning of the European Union²³.

The use in Article 216.5 of the Polish Constitution of the adjective “state” by the legislator to define public debt may raise certain doubts as to the applicability

¹⁸ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 72*, thesis 1.

¹⁹ R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 72*, thesis 3.

²⁰ K. Marchewka-Bartkowiak, *Reguły fiskalne*, Analizy BAS no. 7 (32), 18 February 2010, p. 6, M. Mackiewicz, *Problem konstrukcji skutecznej reguły polityki fiskalnej* [in:] C. Józefiak, P. Krajewski, M. Mackiewicz, *Deficyt budżetowy. Przyczyni i metody ograniczenia*, Polskie Wydawnictwo Ekonomiczne S.A., Warsaw 2006, p. 37 and K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Part II*, thesis 2.

²¹ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Działu II*, thesis 5. Szerzej K. Szmaj, *Państwowy dług publiczny – analiza pojęcia i wnioski prawnosystemowe*, Przegląd Legislacyjny 2014, no. 4(90), pp. 25–44.

²² T. Dębowska-Romanowska, *Prawo finansowe. Część konstytucyjna wraz z częścią ogólną*, C.H. Beck, Warsaw 2010, p. 118 [as cited in:] K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Part II*, thesis 5.

²³ P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 72*, thesis 1.

of the abovementioned fiscal rule. In the opinion of certain representatives of the doctrine, it is possible to specify a more narrow understanding of the above rule, relating exclusively to debt generated by state entities, not encompassing indebtedness of local government entities²⁴. However, I believe that it is more valid to interpret the term “state” in the context of public debt generated by all entities in the public finance sector. The above appears to be confirmed by the systematics in Article 72 of the Public Finance Act.

The analysis of Chapter X of the Polish Constitution as well as the Public Finance Act indicates that, as in the case of the term “public finances”, the legislator refrained from identifying the term “public debt” in favor of specifying the semantic scope. It should be noted that the calculation contained in Article 72 of the Public Finance Act is objective and subjective in nature²⁵.

The subject matter of state public debt exceeds the framework of legal considerations. This is because state public debt is not exclusively a legal phenomenon, but also an economic and social one. Precise legal regulations are immeasurably important due to the fact that the public debt level, structure and relation to the gross domestic product are primary indicators which illustrate the condition of public finances²⁶.

As of today, it has not been possible to develop a unified definition of state public debt within the doctrine²⁷. The term “debt” itself stipulates the existence of liabilities, and is therefore in essence a legal institution. E. Chojna-Duch defines state public debt as *combined financial liabilities of entities in the public sector arising from economically and legally diverse events of a legal and financial nature, and most of all shortages generated as a result of financing a surplus of public expenses above the public income accumulated in prior periods, where such liabilities should take into account debt consolidation*²⁸. The term “public debt” appears in Article 221 of the Polish Constitution in reference to determining the exclusivity of legislative initiative of the Council of Ministers in the scope of the Act on Incurring Public Debt. It should be noted that the legislator uses the terms “state public debt” and “public debt” separately in the Polish Constitution. In the opinion of certain representatives of the doctrine, Article 221 of the Constitution brings the term “public debt” closer to the term “State Treasury

²⁴ P. Winczorek, *Prawo konstytucyjne Rzeczypospolitej Polskiej*, Liber Sp. z o.o., Warsaw 2003, p. 323.

²⁵ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 5.

²⁶ R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 72*, thesis 2.

²⁷ P. Panfil, *Prawne i finansowe uwarunkowania długu Skarbu Państwa*, Wolters Kluwer, Warsaw 2011, p. 33.

²⁸ E. Chojna-Duch, *Podstawy finansów publicznych i prawa finansowego*, LexisNexis, ed. 2, Warsaw 2012, pp. 272–274.

debt”. In the view of this group of researchers, the Act on Incurring Public Debt, stated in the abovementioned Article of the Constitution, encompasses entities in the public finance sector classified in the so-called government and insurance sector, not in the local government sector²⁹. In my assessment, assuming the legislator’s rationality, one cannot agree with such an approach, taking into consideration, among other things, the fact that in Article 218 of the Constitution the legislator clearly uses the term “State Treasury”.

Refraining from defining the term “state public debt”, the legislator, however, indicates the elements of the term which enable determination of its systemic meaning. These elements are enumerated in Article 72 of the Public Finance Act, which specifies the liabilities that constitute state public debt, and in Article 73 of the Public Finance Act, which presents the method of its calculation. Taking the above regulations into account, it should therefore be concluded that the term “state public debt” corresponds to the consolidated nominal value of indebtedness of public finance sector entities determined according to the state for a given reporting period, where the indebtedness comprises financial obligations arising from debt instruments³⁰.

A detailed classification of debt instruments considered as state public debt has been established in the Minister of Finance Regulation of 28 December 2011 regarding the detailed classification method of debt instruments considered as state public debt (Official Journal (Dz.U.) no. 298, item 1767). The provisions of that regulation break down state public debt. The criteria used to establish this breakdown are as follows³¹:

- 1) object;
- 2) period of maturity;
- 3) type of creditor.

In light of § 3 of the abovementioned regulation, debt instruments considered as state public debt, classified in accordance with § 2.1 of that regulation, are divided into³²:

- 1) securities, other than shares, excluding derived rights, admitted for organized trade, taking into consideration the division into:

²⁹ R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 72*, thesis 4.

³⁰ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Part II*, thesis 4.

³¹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 8.

³² R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 72*, thesis 13.

- a) short-term securities – with an original redemption date of no more than one year (treasury bills, bonds, other securities),
 - b) long-term securities – with an original redemption date of more than one year;
- 2) credits and loans, where this category also includes public-private partnerships which affect the level of state public debt, securities whose transferability is limited, sales contracts in which the price is paid in installments, lease contracts concluded with the manufacturer or financing entity in which the risks and benefits arising from ownership are transferred onto the user, as well as unnamed contracts with a payment term of more than one year, associated with the financing of services, deliveries, construction works, with economic effects akin to a loan or credit agreement, taking into consideration the division into:
- a) short-term – with an original payment term of no more than one year or subject to payment on demand,
 - b) long-term – with an original payment term of more than one year;
- 3) deposits received, understood as liabilities arising from deposits received by a public finance sector entity, which are a means of financing a given entity's needs, in particular repayment of previously incurred liabilities or shortage of a given entity's funds, taking into consideration the division into:
- a) transferrable deposits (on demand) – immediately exchangeable for cash or payable on the creditor's demand,
 - b) other deposits, which cannot be immediately exchanged for cash or cannot be at any time used to make payments by the creditor, in particular in the form of fixed-term deposits;
- 4) liabilities due, as specified in Article 71.1.4 of the Public Finance Act, understood as indisputable liabilities, whose payment term has expired, and which have not been time-barred or cancelled.

In accordance with § 4 of the abovementioned regulation, debt instruments considered as state public debt and classified on the basis of § 2.2 of that regulation are divided into³³:

- 1) domestic debt – encompassing debt generated in relation to residents in accordance with the Foreign Exchange Law of 27 July 2002 (Official Journal (Dz.U.) of 2012, item 826, further amended), in particular towards entities of the public finance sector, the central bank, banks and other domestic financial institutions;
- 2) foreign debt – encompassing the debt generated in relation to non-residents in accordance with the Foreign Exchange Law, in particular towards entities

³³ R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 72*, thesis 14.

with their registered office in a European Union member state, where the applicable means of payment is the euro currency.

Domestic debt encompasses the indebtedness towards residents who, according to Articles 2.1.1 and 2.1.2 of the Foreign Exchange Law, are³⁴:

- 1) natural persons with a place of residence within the country and legal entities with a registered office within the country, as well as other entities with registered offices within the country, with the capacity to incur liabilities and acquire rights in their own name; residents are also branches, delegations and businesses located within the country established by non-residents;
- 2) Polish diplomatic delegations, consular offices and other Polish representations and special missions, taking advantage of diplomatic or consular immunities and privileges.

Foreign debt, on the other hand, encompasses indebtedness towards non-residents, i.e.³⁵:

- 1) natural persons with a place of residence abroad and legal entities with their registered office abroad, as well as other entities with registered offices abroad, with the capacity to incur liabilities and acquire rights in their own name; non-residents also include foreign branches, delegations and businesses established by residents;
- 2) foreign diplomatic delegations, consular offices and other foreign representations and special missions, as well as international organizations taking advantage of diplomatic or consular immunities and privileges.

The structure of Article 72.1 of the Public Finance Act may suggest that the catalog of debt instruments is a closed one. However, as to the objective perspective of the state public debt, it should be concluded that Article 72 of the Public Finance Act constitutes a certain point of reference. The catalog of instruments listed in the abovementioned Article is a closed catalog, however the inclusion of the term “liabilities due”, which may arise for various reasons, leads to different conclusions³⁶.

³⁴ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 72*, thesis 8.

³⁵ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 72*, thesis 8.

³⁶ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 7.

The category “other liabilities due” is an open category, and the legislator indicates only the sources of creating such liabilities, i.e.³⁷:

- 1) separate legislation;
- 2) legally binding court rulings;
- 3) final administrative decisions;
- 4) indisputability of the liability, stated by the debtor (the corresponding public finance sector entity).

Through the provisions of the Minister of Finance Regulation of 28 December 2011 regarding the detailed classification method of debt instruments considered as state public debt (Official Journal (Dz.U.) no. 298, item 1767), the legislator has also supplemented the list of liabilities considered as state public debt, indicating that the category of loans and credits also includes³⁸:

- 1) public-private partnership contracts which impact the level of state public debt;
- 2) sales contracts in which the price is paid in installments;
- 3) lease contracts concluded with a manufacturer or financing entity in which the risks and benefits arising from ownership are transferred onto the user;
- 4) unnamed contracts with a payment term of more than one year, associated with the financing of services, deliveries, construction works, with economic effects akin to a loan or credit agreement.

From an objective perspective, qualification of debt instruments is determined by³⁹:

- 1) strict and relatively narrow legislative regulation, which specifies individual types of contracts and actions that constitute debt – unconditional in nature, which may mean that these types of liabilities constitute a substantial part of state public debt, and liabilities listed in Article 72.1.1–3 of the Public Finance Act constitute an element of such public debt from the moment of the conclusion of a credit or loan agreement, issue of securities or deposit acceptance;
- 2) maturity of other liabilities arising from other instruments and actions; thus, also guarantees and sureties granted by public finance sector entities constitute exclusively potential debt in a situation where the debtor – surety or guarantee beneficiary – pays their obligations in a timely manner;
- 3) independence in incurring liabilities by a public finance sector entity.

³⁷ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 7.

³⁸ P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities* C.H. Beck Legalis Warsaw 2017, *Commentary on Article 72*, thesis 7.

³⁹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 7.

It should be noted that controversies in the doctrine and in practical operation of public finance sector entities were raised by the provisions of § 3.2 of the Minister of Finance Regulation regarding the detailed classification method of debt instruments considered as state public debt, which classify as credits and loans also other types of contracts concluded by public finance sector entities⁴⁰. Criticism of the above solution primarily relates to⁴¹:

- 1) equalization of the categories of credits and loans – credit agreement and loan agreement are two separate types of obligations, differing not only in terms of their legal basis (the credit agreement is regulated by Articles 69–79c of the Banking Law Act of 29 August 1997, while the source of law for loans is provided by Articles 720–724 of the Civil Code Act of 23 April 1964), but also in terms of the ownership right to funds which are subject to such agreements, the objective and subjective scope of those agreements, related remuneration and form of effective conclusion;
- 2) inclusion of “other contracts” into the credits and loans category, in particular those concluded as part of public-private partnerships;
- 3) removing the maturity-of-liabilities requirement from the “other contracts” category as a premise which decides about their qualification as state public debt; the above may result in the provisions regarding the “other contracts” category going beyond the scope of delegated legislation, forming a category of debt instrument not mentioned in statutory regulations.

1.2. Methodology of calculating state public debt

Analyzed provisions of the Public Finance Act

Article 73. 1. State public debt shall be calculated as the nominal value of the liabilities of an entity in the public finance sector upon eliminating mutual liabilities between entities of that sector.

2. The nominal value of a liability shall be understood as the nominal value of:

- 1) issued securities;*
- 2) a taken out loan or credit or other liability, i.e. the primary benefit amount due and payable on the liability's maturity date.*

⁴⁰ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 10 and M. Mazurkiewicz, *Problem zgodności z Konstytucją, Article 72 ust. 1 i 2 ustawy o finansach publicznych w zw. z § 3 jej rozporządzenia wykonawczego – zagadnienia dyskusyjne*, *Finanse Komunalne* no. 4/2011, pp. 5–13.

⁴¹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 72*, thesis 10.

3. *The nominal value of indexed or capitalized liabilities shall correspond to the initial nominal value taking into consideration the capital growth arising from indexing or capitalization, accumulated at the end of the reporting period.*
4. *Paragraphs 1–3 shall apply to the calculation of amounts of non-matured liabilities arising from sureties and guarantees not classified as state public debt, as well as, respectively, to calculation of the State Treasury debt and amounts of non-matured liabilities arising from sureties and guarantees not classified as State Treasury debt.*
5. *The Minister of Finance shall, by a regulation, specify the detailed method of determining:*
 - 1) *the value of liabilities classified as:*
 - a) *state public debt,*
 - b) *State Treasury debt,*
 - 2) *the values of liabilities arising from sureties and guarantees*

– taking into consideration the classification of debt instruments regarded as state public debt and the necessity to correctly calculate the relation of public debt to the gross domestic product.

The essence of Article 73 of the Public Finance Act involves specification of the objective scope of public debt and specification of its calculation method. The amount of state public debt is the sum of the nominal value of liabilities of public finance sector entities, as mentioned in Article 9 of the Public Finance Act, under the reservation that it does not take into account mutual liabilities between such entities. Given the exclusion of mutual liabilities between public finance sector entities, state public debt takes the form of so-called external debt. Therefore, state public debt does not show, for example, State Treasury liabilities towards local government entities arising from treasury securities or loans granted to a local government entity by a special purpose fund⁴².

In an objective view, the value of state public debt comprises the nominal values of liabilities arising from issued securities, taken out loans, credits or other liabilities⁴³. Article 73 of the Public Finance Act introduces a rule according to which the determinants of the status of a public finance sector entity's liabilities are, most of all, amounts of the primary benefit, which comprise the content of debt instruments, i.e. the nominal values of those liabilities. The nominal value

⁴² A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 73*, thesis 1.

⁴³ R. Bucholski, W. Pahl [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 73*, thesis 3.

of such liabilities must be adjusted by the amounts of additional benefits due to creditors and arising from the applied indexing or capitalization⁴⁴.

The rules for determining the value of individual categories of liabilities are stated as follows⁴⁵:

- 1) securities – the nominal value of issued securities is the primary benefit amount due and payable on the liability maturity date;
- 2) credits and loans – the nominal value of taken out loans or credits is the primary benefit amount due and payable on the liability maturity date;
- 3) deposits – the nominal value of accepted deposits is the capital amount which the debtor is obliged to pay to the creditor in accordance with terms specified in the agreement if the deposit is liquidated; the nominal value of a deposit is the value on which interest is charged (if the issued securities, taken out credits and loans or accepted deposits are indexed or capitalized, the primary benefit amount arising from the above liabilities is determined taking into account the capital growth resulting from the method of indexing or capitalization of a given liability, as of the end of the reporting period). Capitalization or indexation most often occurs in the case of treasury securities, e.g. lack of up to date interest payments for 10-year State Treasury bonds;
- 4) matured liabilities – the nominal value of matured liabilities is the amount of liabilities whose payment term has expired, and which are not time-barred or cancelled, excluding interest;
- 5) sureties and guarantees – the nominal value of liabilities arising from sureties and guarantees is the amount of non-matured and matured liabilities arising from the above, excluding mutual liabilities of this type between public finance sector entities, where:
 - a) the nominal value of non-matured (potential) liabilities arising from sureties and guarantees is the estimated amount which the guarantor would be obliged to pay by the end of the surety (guarantee) validity period, assuming full expenditure of funds from the secured (guaranteed) credit, loan or issue of securities, if the debtor for whom the surety/guarantee was granted has not paid the liability itself; in the case of credits, loans and issue of securities covered by sureties/guarantees, one takes into account the amount of the primary benefit as well as ancillary benefits if they have been covered by the surety (guarantee); the calculation of the nominal value of a non-matured (potential) liability covered by a surety or

⁴⁴ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 73*, thesis 2.

⁴⁵ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 73*, thesis 2.

- guarantee, subject to interest according to variable interest rates, adopts the interest rate applicable on the final day of a given reporting period;
- b) the nominal value of matured liabilities arising from sureties (guarantees) is the amount of the guarantor's due and payable benefit also encompassing ancillary benefits.

In the provisions of the Public Finance Act, there is no definition of the term “nominal liability value”. In legal doctrine, nominal value is defined as the amount which the lender should receive upon expiry of the loan repayment term. Nominal value may be fixed or variable, e.g. the value of bonds indexed using the inflation index⁴⁶. According to Article 73.1 of the Public Finance Act, state public debt is calculated as the nominal value of liabilities of public finance sector entities upon elimination of mutual liabilities between entities in that the sector. The legislator's use within that Article of the term “nominal value of liabilities of public finance sector entities” could suggest that state public debt should be related to all financial liabilities of public finance sector entities, which in turn would expand the objective view of state public debt. The above interpretation of the aforementioned article, considering its aims, should however be considered unsubstantiated. The nominal value of liabilities should be related to the liabilities of public finance sector entities classified in the category of debt instruments according to Article 71 of the Public Finance Act. State public debt constitutes the nominal value of financial obligations of public finance sector entities considered debt instruments; however, its value is determined upon eliminating mutual liabilities between entities in that sector (taking into consideration the rules of liability consolidation)⁴⁷.

The rules for calculating nominal values of liabilities which constitute debt instruments have been established in Articles 73.2 and 73.3 of the Public Finance Act. The above regulations also apply to the calculation of non-matured (potential) amounts of liabilities arising from sureties and guarantees. A detailed method of determining the value of liabilities, taking into account the classification of debt instruments, has been established in the Minister of Finance Regulation of 30 March 2010 regarding the detailed method of determining the value of liabilities classified as state public debt, State Treasury debt, value of liabilities arising from sureties and guarantees (Official Journal (Dz.U.) no. 57, item 366)⁴⁸.

⁴⁶ W. Bień, *Rynek papierów wartościowych*, Difin, ed. 7, Warsaw 2008, p. 51.

⁴⁷ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 73*, thesis 1.

⁴⁸ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 73*, thesis 2.

1.3. Summary

1. The subject matter of state public debt is a primarily economic phenomenon, and the scope of legal regulations related to this issue encompass areas of financial, civil, administrative and commercial law.
2. Neither the Polish Constitution nor the Public Finance Act contains a legal definition of the term “state public debt”. The provisions of the Public Finance Act are limited to specifying the semantic scope through clauses (calculation) of an objective and subjective nature. In my opinion, this approach is justifiable and there is no need to undertake to define state public debt. Certain specification would be required in the provisions of the Polish Constitution regarding the use of the terms “public debt” and “state public debt”.
3. The provisions of the Public Finance Act do not contain a definition of the term “nominal liability value” either. In my opinion, similarly to the case of the definition of “state public debt”, there is no need to define this term, and the position of legal doctrine and provisions of the Public Finance Act regarding rules for determining the nominal value, as well as (adjunctively) other provisions (e.g. the Accounting Act of 29 September 1994), should be considered sufficient.
4. The construction contained in the Public Finance Act for determining matured liabilities of public finance sector entities does not regulate this issue in an exhaustive manner, introducing a reference to separate acts and judicial or administrative decisions.
5. Certain doubts in terms of doctrine are raised by provisions of the implementing act as regards a detailed method of classifying debt instruments considered to be state public debt, in particular the recognition, at the implementing act level, of liabilities arising from certain obligations due to civil-law contracts (e.g. public-private partnership contracts) as credits or loans. Considering the intent of the legislator (closing the catalog of liabilities of the public finance sector), I believe that the matter of the debt instrument catalog should be regulated exclusively in the Public Finance Act.

Chapter 2

Limitation to the possibility for local government entities to incur financial liabilities in a quantitative aspect

2.1. Limit of liabilities of a local government entity

Analyzed provisions of the Public Finance Act

Article 91. 1. The sum of taken out credits, loans and liabilities from issued securities, as specified in Articles 89.1 and 90, may not exceed the amount stipulated in the budget resolution of the local government entity.

2. In the event of a local government entity applying for a credit or loan for a purpose stipulated in Articles 89.1.2–4 and 90, as well as in case of a local government entity's intention to issue securities for a purpose stipulated in Articles 89.1.2–4 and 90, the management of such entity is obliged to seek the opinion of the regional audit office regarding the ability to repay the credit or loan or redeem the securities.

The provision expressed in Article 91.1 of the Public Finance Act implements a prudential principle which is intended to prevent the occurrence of excessive indebtedness of local government entities, simultaneously emphasizing the significance of proper budget planning⁴⁹. The sum of taken out credits and loans as well as liabilities from issued securities for purposes specified in Articles 89.1 and 90 of the Public Finance Act cannot exceed the amount specified in a local government entity's budget resolution. The above limit is determined in the budget resolution of a local government entity in accordance with Article 212.1.6

⁴⁹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 91*, thesis 1.

of the Public Finance Act⁵⁰. The budget resolution stipulates the limit of liabilities incurred by the local government entity. Determination of the aforementioned limit is obligatory if the local government entity plans to use repayable income for the purposes stipulated in Articles 89.1 and 90 of the Public Finance Act. The aforementioned limit relates to short-term as well as long-term liabilities⁵¹. The liability limit level is a derivative of the scale of demand for repayable funds necessary to finance the needs stipulated in the budget resolution and must be strictly correlated with other structural elements of the local government entity's budget, such as planned budget deficit, scale of liability refinancing (to the extent in which liabilities are financed from repayable income), or certain expenses, e.g., planned for the implementation of projects financed from European funds. This limit also applies to financing a shortage of funds which occurs during the year (where its amount at the budget planning stage is extremely difficult to estimate), liabilities associated with loans for advance financing or loans from state special purpose funds⁵². This is because the limit specified in the budget resolution may relate separately to each of the situations stipulated in Articles 89.1 and 90 of the Public Finance Act. Thus, it is possible to separately indicate, e.g., the limit of liabilities arising from taken out credits and loans or issued securities for the coverage of transitional deficit which may occur during the year and the repayment of previously incurred liabilities. The limit may, however, be of a combined nature, encompassing all liability positions enumerated in Articles 89.1 and 90 of the Public Finance Act⁵³.

In the event of a local government entity applying for a credit or loan or intending to issue securities for financing its budget deficit, repayment of previously incurred liabilities arising from the issue of securities, taken out loans and credits, and for advance financing of activities financed from European Union resources, the executive body of the local government entity is obliged to seek the opinion of the regional audit office regarding the ability to repay the credit or loan or redeem securities. The opinion of the regional audit office is a form of the so-called preventive oversight and its purpose is to ensure correct functioning of the financial management of local government entities. The obligation to seek the opinion of the regional audit office is also valid where a loan is taken out from a state special purpose fund for a purpose stipulated in Article 90 of the Public Finance Act, while it is not required in the event where

⁵⁰ A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 91*, thesis 1.

⁵¹ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 91*, thesis 1.

⁵² *Ibidem*.

⁵³ *Ibidem*.

the purpose of incurring the liability is to cover a local government entity's transitional budget deficit which occurs during the year⁵⁴.

It should simultaneously be noted that the executive body of a local government entity is obliged to seek – in the aforementioned cases – the opinion of the regional audit office as regards the ability to repay a credit or loan and redeem issued securities. The opinion, however, is not binding, thus even a negative opinion of the regional audit office does not preclude the possibility of incurring a liability. This is because an opinion is not a supervisory decision, which remains in correlation with the principle of financial independence of local governments⁵⁵. The opinion of the regional audit office is attributed primarily an informational value, which does not mean, however, that instances in which seeking an opinion is mandatory may be treated by a local government entity as only an insignificant formal requirement⁵⁶. The basis of the regional audit office's opinion is provided primarily by prognoses of indebtedness, in which a local government entity shows maintenance of an individual debt repayment ratio level, as stipulated in Article 242 of the Public Finance Act. Nonetheless, the opinion of the regional audit office cannot be equated with an assessment of a local government entity's creditworthiness⁵⁷. In practice, a negative opinion by the regional audit office as regards the possibility of repayment by a local government entity of repayable incomes stipulated in Article 91.2 of the Public Finance Act often prevents a given local government entity's effective application for credit, loan or possibility to efficiently handle the issue of debt securities⁵⁸.

Entering into a credit or loan agreement or issuing securities without seeking the opinion of the regional audit office as to the possibility of repaying liabilities arising from the above results in accountability for breaching public finance discipline in accordance with Article 15 of the Act on Accountability for Breach of Public Finance Discipline of 17 December 2004 (Official Journal (Dz.U) of 2017, item 1311, further amended) by incurring a liability in violation of regulations regarding incurring liabilities by public finance sector entities⁵⁹.

⁵⁴ A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 91*, thesis 2.

⁵⁵ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 91*, thesis 2.

⁵⁶ E. Stupienko [in:] H. Dzwonkowski, G. Gołębiowski (ed.), *The Public Finance Act. Legal and financial Commentary*, Wydawnictwo Sejmowe, Warsaw 2014, p. 239 and A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 91*, thesis 3.

⁵⁷ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 91*, thesis 5.

⁵⁸ Ibidem.

⁵⁹ Ibidem, thesis 6.

Article 91 of the Public Finance Act is supplemented by the provisions of Article 212.1.6 of the Public Finance Act, indicating that the budget resolution must specify the limit of liabilities arising from taken out credits and loans and issued securities, as stipulated in Articles 89.1 and 90 of the Public Finance Act⁶⁰. The legislator has deemed it sufficient to specify a single limit for all liabilities invoked in the aforementioned regulations. The adoption within the budget resolution of a single (collective) limit appears to be an appropriate solution, particularly in the context of establishing such a limit as independent from changes to the budget resolution in terms of elements which determine the authorization to incur a specific liability⁶¹.

2.2. Individual liability repayment indicator of a local government entity

Analyzed provisions of the Public Finance Act

Article 243. 1. The decision-making body of the local government entity may not pass a budget the performance of which would result in that, in the budget year and in every year following the budget year, the ratio of the combined amount of that budget year's:

- 1) *credit and loan installment repayments, as stipulated in Articles 89.1.2–4 and 90, together with interest on credits and loans payable in a given year as stipulated in Articles 89.1 and 90,*
- 2) *redemption of securities issued for purposes stipulated in Articles 89.1.2–4 and 90, together with interest and discounts payable on securities issued for purposes stipulated in Articles 89.1 and 90,*
- 3) *potential repayments of amounts arising from granted sureties and guarantees*

to planned budget incomes in general exceeds the arithmetic average of the ratios of its current income increased by income from the sale of property and reduced by current expenses calculated for the last three years to budget income in general, calculated according to the formula:

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

where individual symbols mean the following:

⁶⁰ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 91*, thesis 1.

⁶¹ *Ibidem*, thesis 2.

<i>R</i>	–	<i>the total amount planned for the budget year arising from repayment of credit and loan installments as stipulated in Articles 89.1.2–4 and 90 and redemption of securities issued for the purposes stipulated in Articles 89.1.2–4 and 90,</i>
<i>O</i>	–	<i>the total interest on credits and loans planned for the budget year, as stipulated in Articles 89.1 and 90, interest and discounts on securities issued for the purposes stipulated in Articles 89.1 and 90 and repayments of amounts arising from granted sureties and guarantees,</i>
<i>D</i>	–	<i>overall budget income in a given budget year,</i>
<i>Db</i>	–	<i>current income,</i>
<i>Sm</i>	–	<i>income from the sale of property,</i>
<i>Wb</i>	–	<i>current expenses,</i>
<i>n</i>	–	<i>budget year for which the ratio is determined,</i>
<i>n-1</i>	–	<i>year preceding the budget year for which the ratio is determined,</i>
<i>n-2</i>	–	<i>year preceding the budget year by two years,</i>
<i>n-3</i>	–	<i>year preceding the budget year by three years.</i>

2. *When calculating the ratios stipulated in paragraph 1, the planned values shown in the tri-quarterly budget performance report of the local government entity shall be adopted for the year preceding the budget year. Achieved values arising from annual reports shall be adopted when calculating the ratios for the preceding two years.*
3. *The limitation stipulated in paragraph 1 shall not apply to:*
 - 1) *repayments of installments of credits and loans taken out in connection with a contract concluded for the performance of a program, project or objective co-financed with funds stipulated in Article 5.1.2, including due interest,*
 - 1a) *redemption of securities issued in connection with a contract concluded for the performance of a program, project or objective co-financed with funds stipulated in Article 5.1.2, including due interest and discounts,*
 - 2) *sureties and guarantees granted to local government legal entities performing the tasks of a local government entity as part of programs co-financed with funds stipulated in Article 5.1.2*
 - *within a time period of no more than 90 days following completion of the program, project or objective and receipt of reimbursement from such funds; this time period does not apply to interest and discounts on liabilities incurred for a national contribution, as stipulated in subparagraphs 1 and 1a.*

- 3a. *The limitation stipulated in paragraph 1 also shall not apply to the redemption of securities, repayment of credit and loan installments together with due interest and discounts, respectively issued or taken out in connection with a contract concluded for the performance of a program, project or objective co-financed in at least 60% from funds stipulated in Article 5.1.2, in the part corresponding to expenses for the national contribution financed from such liabilities. In the event of a program, project or objective which generates income, the level of financing from funds stipulated in Article 5.1.2 shall be determined upon deducting the discounted income calculated according to European Union regulations regarding such programs, projects or objectives, and the amount of expenses for the national contribution shall be determined in the amount which would arise if the level of financing from funds stipulated in Article 5.1.2 were calculated without taking into consideration the discounted income.*
4. *In the event of a failure to fulfill the prerequisites stipulated in paragraph 3 or 3a, or if the funds specified in the financing agreement, as stipulated in Article 5.1.2, have not been transferred or their return has been ordered upon their transfer, the local government entity may not issue securities, take out credits and loans or issue sureties and guaranties until achieving the ratio stipulated in paragraph 1, including in this ratio the amount of liabilities associated with:*
- 1) *non-transferred funds or funds whose return has been ordered;*
 - 2) *a failure to fulfill the prerequisites stipulated in paragraph 3 or 3a.*

The first limitation of the amount of indebtedness of local government entities following the reactivation of the local government was included in Article 24 of the Municipality Financing Act of 10 December 1993 (Official Journal (Dz.U.) no. 129, item 600, further amended), according to which the total amount of credit and loan installments payable in a given year, potential repayments arising from the municipality's issue of sureties together with interest due in that year on those credits and loans, as well as the shares redeemable in a given year issued by the municipality – reduced by the amount of installment and interest payments for a given year on credits and loans incurred by the municipality for which collateral has been established in the name of the municipality – could not exceed 15% of the planned municipal budget income. This provision raised doubts as to its effective application, particularly in reference to the possibility of making deductions from the collateral established in the name of the municipality (e.g. mortgage).

New limitations were implemented with the introduction of the Constitution of the Republic of Poland of 2 April 1997 and the Public Finance Act of 26 November 1998. In both of these legal acts, the maximum limit of state public debt has been established (60% of gross domestic product). In accordance with Articles 169 and 170 of the Public Finance Act of 30 June 2005, the

combined debt amount of local government entities could not exceed 60% of that entity's income in a budget year. That act additionally maintained the previously mentioned 15% limit of repayments, while eliminating the element of deductions from collateral established on the municipality's property. According to its provisions, the quantitative indicators limiting the indebtedness of local government entities determined that the total amount of a given budget year's⁶²:

- 1) installment repayments of loans and credits taken out for the purpose of financing the deficit or refinancing a debt, together with interest payable in a given year on all credits and loans (also those taken out to cover transitional budget shortages occurring during the year),
- 2) redemptions of securities issued by a local government entity to finance the deficit or refinance a debt, together with interest and discounts payable on all issued securities (also those issued to cover transitional budget shortages occurring during the year),
- 3) potential repayments of amounts arising from sureties and guarantees granted by a local government entity
 - could not exceed 15% of the local government entity's income planned for a given budget year. This limit has been reduced to 12%, where the ratio of state public debt to gross domestic product announced by the Minister of Finance in the "Monitor Polski" Official Gazette exceeded 55% unless the burdens arose entirely from liabilities incurred prior to the ratio announcement date. The total debt amount of a local government entity at the end of the budget year could not exceed 60% of income⁶³.

The mathematical formula specified in Article 243.1 of the Public Finance Act is intended to determine the arithmetic average of the ratio of a local government entity's current income increased by income from the sale of property and reduced by current expenses to its overall budget income calculated for three recent years. In order to calculate the aforementioned average, it is necessary to *ex ante* determine the annual ratio of current income increased by income from the sale of property and reduced by current expenses to its overall budget income, separately for each of the three years preceding the budget year for which the budget resolution project is being drawn up. The above indicator is intended to provide information on what portion of income is comprised by current income and income from the sale of property, that is what portion remains after the financing of current expenses in a given year.

The totaled annual indicators are adjusted (multiplied) by a fraction of 1/3 (arithmetic average). This is because it seems more reliable to present an

⁶² E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 1.

⁶³ *Ibidem*, thesis 2.

indicator based on an arithmetic average of three years than each of the three annual indicators considered separately. The above formula leads to limiting the impact of deviations of unit parameters on their average value⁶⁴.

When calculating the ratios stipulated in Article 243.1 of the Public Finance Act for the year preceding the budget year, the planned values shown in the tri-quarter budget performance report of a local government entity are adopted, while when calculating the ratios for two prior years, the achieved values shown in annual reports are used⁶⁵. Additionally, Article 243.2 of the Public Finance Act introduces uniform rules for all local government entities for determining the amounts of their budget income overall, current income, income from the sale of property and current expenses⁶⁶.

The algorithmically determined arithmetic average is related to repayments of a local government entity's debts which may constitute the maximum financial burden for the performed budget. The catalog of debt items is formulated by the enumerative calculation of debt instruments (positive element) as well as exemptions from the statutory limitation (negative element)⁶⁷.

A positive calculation encompasses the following liability instruments⁶⁸:

- 1) credits and loans;
- 2) issue by local government entities of securities corresponding to financial liabilities (primarily bonds);
- 3) sureties and guarantees.

It should be noted, however, that the above items are not uniform in terms of methodology of determining the liability amount. In the case of guarantees and sureties, potential payments are taken into consideration, not matured liabilities. Repayments of credits and loans as well as expenses to redeem issued debt securities are, on the other hand, determined on the basis of the cash accounting method, i.e. charges upon the expiry of the liability repayment term⁶⁹.

The negative element which shapes the catalog of budget payments related to the arithmetic average determined on the basis of the legislative formula and exemptions from the prohibition imposed on the decision-making body of a local government entity in accordance with Article 243.1 of the Public Finance Act is applicable to liabilities incurred for the performance of objectives, programs and projects covered by financing from European funds (Articles 243.3, 243.3a

⁶⁴ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 243*, thesis 3.

⁶⁵ M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 243*, thesis 3.

⁶⁶ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 243*, thesis 3.

⁶⁷ Ibidem.

⁶⁸ Ibidem.

⁶⁹ Ibidem.

and 5.1.2 of the Public Finance Act). The benefits of the above exemption are, however, limited by the 90-day term commencing on the day following completion of such an objective, project or program. The second condition which makes it possible to apply the exemption is a local government entity's receipt of reimbursement of budget funds disbursed for the above purposes. In such a case, repayments of credits, loans, guarantees, sureties and redemption of debt securities do not constitute a burden for a local government entity due to the inclusion of an individual debt indicator in the formula⁷⁰.

Repayments of liabilities incurred by a local government entity relate to its primary indebtedness as well accessory considerations. Credit and loan liabilities generate accessory considerations arising from interest, while the issue of securities – from interest and discounts (Articles 243.1.1 and 243.1.2 of the Public Finance Act)⁷¹.

In the formula specified in Article 243.1 of the Public Finance Act, the amount of indebtedness planned for financing in a given year is the sum of the “R” and “O” components. The “R” parameter relates to repayment of primary debts arising from taken out credits, loans and issue of local government debt securities, i.e. budget expenses stipulated in Articles 6.1.2, 6.2.1 and 6.2.2 of the Public Finance Act. It can, therefore, be assumed that the name of the component includes the first letter of the repayable instrument for the allocation of budget funds. Alternatively, in my view, it can be assumed that component “R” stands for a capital installment. The “O” parameter relates to repayment of installments or discounts and repayment of debts from sureties and guarantees, i.e. budget expenses stipulated in Article 6.1.1 of the Public Finance Act⁷².

The principle expressed in Article 243 of the Public Finance Act is a mandatory norm. It should be noted, however, that the individual indicator for every local government entity does not limit the amount of maximum debt, but the maximum amount of payable installments of credits and loans and redemptions of securities attributable to a given year, together with debt servicing costs⁷³.

Article 243.4 of the Public Finance Act introduces a prohibition for a local government entity that has exceeded the individual debt repayment ratio to incur new liabilities from credits, guarantees, loans, sureties and issue of securities corresponding to financial receivables. The above limitation applies until the local government entity recovers the ability to finance repayment of liabilities with the amount of summed up current income and income from the sale of

⁷⁰ Ibidem.

⁷¹ Ibidem.

⁷² Ibidem.

⁷³ Resolution of the Regional Audit Office in Kraków dated 4 May 2015, KI-412/150/15, Legalis and M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 243*, thesis 1.

property, reduced by current expenses. The above regulation is, therefore, penal in nature as it lowers the arithmetic average established on the basis of the formula specified in Article 243.1 of the Public Finance Act. It can thus be concluded that the individual debt repayment ratio formula is indirectly a disciplinary factor in terms of limiting growth of the state public debt⁷⁴.

In accordance with the rule expressed in Article 243.1 of the Public Finance Act, adherence to the individual debt repayment ratio formula is mandatory for the decision-making body during the budget procedure which encompasses passing the budget and during the long-term budget procedure. In case of a local government entity's inability to pass a long-term financial prognosis or budget due to the requirements of the formula stipulated in Article 243.1 of the Public Finance Act, such plans – in accordance with Article 240b.1 of the Public Finance Act – are established by the regional audit office irrespective of the relation arising from the individual debt repayment ratio required by legislation. On the other hand, the decision-making body of a local government entity is obliged to pass a corrective procedure program. If such a program receives a positive opinion of the regional audit office, the decision-making body could – in accordance with Article 240a.4 of the Public Finance Act – pass a long-term financial prognosis and budget in subsequent years in which it would be allowed to not maintain the required relation, where not maintaining such a relation would apply only to repayments of liabilities existing on the date of passing the corrective program⁷⁵.

The decisions of regional audit offices have established a range of theses related to the obligation of maintaining the ratios of repayments of credit and loan installments, redemption of securities and potential repayments of amounts arising from granted sureties and guarantees to planned income. The above postulates have been formulated as follows⁷⁶:

- 1) *a local government entity's failure to maintain the ratio specified in Article 243 of the Public Finance Act means that such entity cannot pass a long term budget and financial prognosis in the budget year and in every year following the budget year in which this ratio has not been maintained*⁷⁷;
- 2) *the burden of local government entity budgets with repayments of liabilities from long-term credits and loans, and issued securities together with the applicable*

⁷⁴ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 243*, thesis 6.

⁷⁵ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 12.

⁷⁶ M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 243*, thesis 4.

⁷⁷ Resolution of the Regional Audit Office in Kraków dated 22 October 2014, KI-412/294/14, Legalis.

*interest cannot exceed the ratio stipulated in Article 243 of the Public Finance Act*⁷⁸;

- 3) *when calculating the ratio stipulated in Article 243 of the Public Finance Act, there is no basis to apply exemptions related to the repayment of credit, with interest, taken out to finance an own contribution for an objective whose implementation involves funds stipulated in Article 5.1.2 of the Public Finance Act*⁷⁹.

Reference literature draws attention to reservations regarding the structure of an individual debt repayment ratio, i.e.⁸⁰:

- 1) methodology of calculating the operating surplus;
- 2) basing calculations on historical data which do not reflect the current financial status of local government entities;
- 3) no consideration for the variability of the economic condition (on a macro as well as micro scale);
- 4) forcing the shift of expenses associated with debt servicing to subsequent years, which increases the costs of debt and results in accumulation of related expenses in subsequent years;
- 5) inability to utilize so-called free funds to repay installments of incurred liabilities;
- 6) interim opportunities to improve the financial situation by sale of property.

The essence of Article 243 of the Public Finance Act involves making the level of debt dependent on the achieved operating surplus during the recent three years. Doubts associated with this methodology of calculating the indicator relate to, among other things, the fact that a more beneficial individual debt repayment ratio is exhibited by local government entities that can achieve higher income from the sale of property⁸¹.

Basing the methodological structure of an individual debt repayment ratio on historical data from the recent three years makes it dependent on the economic condition (data from years of economic boom overstate financial capabilities, while data from downturn years understate them). Additionally,

⁷⁸ Resolution of the Regional Audit Office in Rzeszów dated 28 January 2014, III/607/14, www.rzeszow.rio.gov.pl accessed on 10.07.2018.

⁷⁹ Resolution of the Regional Audit Office in Rzeszów dated 17 December 2013, XXVII/6504/13, www.rzeszow.rio.gov.pl accessed on 10.07.2018.

⁸⁰ M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 243*, thesis 5 and E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 10.

⁸¹ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 10.

it is also impossible to rule out that singular events may disrupt the indicator's reliability⁸².

A certain disadvantage of the individual debt repayment ratio is also the inclusion in the formula of overall income, i.e. current income, as well as income from property. Income from property is characterized by high variability resulting from one-off inflows arising, e.g., from acquisition of EU funds or investment subsidies.

The structure of the individual debt repayment ratio also constitutes an incentive to extend the liability repayment period (which may adversely impact the cost of debt servicing) and the investment completion period. Limited indirectly by the above indicator, the debt level of local government entities may, in consequence, provoke debt transfer to local government companies which, in accordance with Article 9.14 of the Public Finance Act, are not part of the public finance sector and are not subject to the regulations of Article 243.1 of the Public Finance Act. The abovementioned circumstance may lead to a situation in which excessive indebtedness of local government companies may result in their financial difficulties or even bankruptcy. Such entities are separate legal persons, yet given that they implement objectives (e.g. waterworks, sewage, public transport) attributed to the statutory tasks of a local government entity, their financial issues will be transferred to the level of the local government entity⁸³.

The debt repayment ratio established individually for every local government entity when assessing its financial situation to a large extent takes into consideration the individual position of a given entity. The above ratio also results in the increased significance of rational financial planning. Limiting the level of a given entity's debt is also important from the perspective of serving the state's interests as it constitutes an indirect element of limiting state public debt. The individual debt repayment ratio, however, raises much criticism from representatives of academia as well as representatives of local governments. The dependence of the possibility for a local government entity to incur debt on its ability to generate a current surplus and achieve income from the sale of property has not been combined with appropriate transfer of the decision-making freedom onto the local government level. It should also be noted that local government entities can influence the amount of achieved own income only to a limited extent. The sale of a local government entity's property is not always justifiable in a given budget year (or is not possible in general), while the expenses of local government entities are to a large extent fixed expenses arising from objectives specified by legislative regulations for such entities⁸⁴.

⁸² E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 5.

⁸³ *Ibidem*, thesis 6.

⁸⁴ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 243*, thesis 10.

2.3. Balancing the current part of a local government entity's budget

Analyzed provisions of the Public Finance Act

Article 242. 1. The decision-making body of a local government entity may not pass a budget in which planned current expenses are higher than planned current income increased by the budget surplus from prior years and free funds, as specified in Article 217.2.6.

- 2. At the end of the budget year, the incurred current expenses may not be higher than the generated current income increased by the budget surplus from prior years and free funds, subject to paragraph 3.*
- 3. The incurred current expenses may be higher than the generated current income increased by the budget surplus from prior years and free funds only by the amount associated with actual current expenses which include funds stipulated in Article 5.3 if such funds have not been transferred in a given budget year.*

Article 242.1 of the Public Finance Act contains a formulated budget balancing principle of a local government entity in the section relating to current income and expenses. The correct level of deficit as one of the primary elements of a local government entity's budget structure, having significant impact on the level of income planned in the budget resolution (including repayable income), should be ensured through correctly determining the income and expenses planned in the budget⁸⁵.

The breakdown of a local government entity's budget into the current and property part is a consequence of the breakdown of income and expenses adopted in Articles 235 and 236 of the Public Finance Act, i.e. into current and property-based. This principle is termed the "golden rule of finance"⁸⁶.

Article 242 of the Public Finance Act formulates three principles related to constructing the budget of a local government entity⁸⁷:

⁸⁵ Resolution of the Regional Audit Office in Rzeszów dated 28 January 2014, III/598/14, www.rzeszow.rio.gov.pl accessed on 10.07.2018, Resolution of the Regional Audit Office in Łódź dated 3 December 2014, 36/193/14, OwSS of 2015. No. 1, pos. 105, p. 105-109, www.lodz.rio.gov.pl accessed on 10.07.2018 and M. Szyrski [in:] A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 242*, thesis 2.

⁸⁶ M. Bitner, *Reguła deficytowa jako zasadniczy element „złotej zasady finansów publicznych” w jednostkach władzy terytorialnej – próba syntezy*, "Samorząd Terytorialny" no. 11/2012, pp. 24–61 and E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 242*, thesis 1.

⁸⁷ M. Szyrski [in:] A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 242*, thesis 1.

- 1) the inability to pass a budget in which planned current expenses are higher than planned current income increased by the budget surplus from prior years and free funds, as specified in Article 217.2.6 of the Public Finance Act;
- 2) actual current expenses cannot be higher than actual current income increased by the budget surplus from prior years and free funds (subject to Article 242.3 of the Public Finance Act);
- 3) actual current expenses may be higher than actual current income increased by the budget surplus from prior years and free funds only by the amount associated with incurred current expenses which include funds stipulated in Article 5.3 of the Public Finance Act if such funds have not been transferred in a given budget year.

The solutions contained in Article 242 of the Public Finance Act, therefore, enable the occurrence of a budget deficit within a local government entity only in the property section. Current expenses must be financed in full from current income, which means an inability to finance current expenses from repayable budget income. The above solution to a certain degree constitutes a reference to the principles stipulated in Article 9.8 of the European Charter of Local Self-Government drawn up in Strasbourg on 15 October 1985 (Official Journal (Dz.U.) of 1994, no. 124, item 607, amended in Official Journal (Dz.U.) of 2006, no. 154, item 1107), which indicate the necessity to provide local government entities with access to the domestic capital market for the purpose of financing investment expenses⁸⁸.

The provision contained in Article 242 of the Public Finance Act is intended to limit the indebtedness capacity of a local government entity in connection with financing current expenses and constitutes an incentive for local government entities to maintain operating surpluses as the higher the amount of such surplus, the greater the possibilities of a local government entity to attain its investment objectives. It should be noted that the term “operating surplus” is not a statutory term; however, it can be assumed that the legislator understands such surplus as a positive difference between current income and current expenses⁸⁹.

The principle expressed in Article 242 of the Public Finance Act applies not only at the moment of passing the budget, but also at every moment of the budget year. During the budget year, changes made by local government

⁸⁸ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 242*, thesis 1. More on limitations to liabilities that may be incurred by local government entities in OECD in: M. Bitner, *Reguły fiskalne ograniczające zaciąganie długu przez jednostki samorządu terytorialnego – analiza prawno-porównawcza*, “Samorząd Terytorialny” no. 1–2/2013, pp. 9–40.

⁸⁹ M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 242*, thesis 3.

bodies to the budget resolution cannot, therefore, result in the violation of the requirement arising from Article 242.1 of the Public Finance Act⁹⁰.

The subject of the limitation expressed in Article 242.1 of the Public Finance Act is directly the decision-making body of a local government entity. That limitation is applicable in the legislative procedure in development of the budget resolution and in the phase of passing the local government entity's budget. The managing body is, in fact, not stated in the content of the aforementioned provision, yet it should be assumed that during development of the budget resolution draft such a body should adhere to the statutory limit of current expenditure planning, even despite a lack of clear legal indication of such an obligation⁹¹.

As regards current expenses, the Public Finance Act provides for certain exceptions, stating that some expenses may be higher than the generated current income increased by the budget surplus from prior years and free funds by an amount related to the incurred current expenses with the inclusion of the following resources⁹²:

- 1) from structural funds, Cohesion Fund, the European Fisheries Fund and the European Maritime and Fisheries Fund (excluding funds specified in Article 5.5(a) and (b) of the Public Finance Act);
- 2) non-returnable funds from aid granted by member states of the European Free Trade Agreement (excluding funds specified in Articles 5.5(c) and 5.5(d) of the Public Finance Act);
- 3) intended for pre-accession programs and the Transition Facility Program;
- 4) for the implementation of Common Agricultural Policy;
- 5) intended for programs within the objective of European Territorial Cooperation; programs stipulated in Regulation (EC) No 1638/2006 of the European Parliament and of the Council of 24 October 2006 laying down general provisions establishing a European Neighbourhood and Partnership Instrument (EU Official Journal L 310, 9.11.2006, p. 1) and programs of the European Neighbourhood Instrument, Norwegian Financial Mechanism 2004–2009 and the European Economic Area Financial Mechanism 2004–2009;
- 6) intended for the implementation of the Youth Employment Initiative;
- 7) Fund for European Aid for the Most Deprived;
- 8) originating from the “Connecting Europe” Facility, as mentioned in Regulation (EU) No 1316/2013 of the European Parliament and of the

⁹⁰ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 242*, thesis 1.

⁹¹ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2. Warsaw 2014, *Commentary on Article 242*, thesis 2.

⁹² M. Szyrski [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 242*, thesis 4.

Council of 11 December 2013 establishing the Connecting Europe Facility, amending Regulation (EU) No 913/2010 and repealing Regulations (EC) No 680/2007 and (EC) No 67/2010 (EU Official Journal L 348, 20.12.2013, p. 129, further amended).

A certain deviation from the budget balancing principle is the possibility of increasing the expenditure limit by the budget surplus from the prior year and so-called free funds remaining on the current account as a result of settlements arising from issued securities, credits or loans from prior years. It should be noted, however, that the statement in Article 242.1 of the Public Finance Act that balancing the current budget is possible exclusively through the use of a budget surplus and so-called free funds is to a certain extent contrary to Article 89.1.2 of the Public Finance Act, where potential available sources of financing a local government entity's budget deficit (understood as a negative difference between income and expenses overall, and not only in the context of property income and expenses) are specified much more broadly – also through credits and loans and the issue of securities. It should be noted, therefore, that current budget deficit is a part of budget deficit and, as such, could be financed from such sources in accordance with Article 89 of the Public Finance Act⁹³.

In the Public Finance Act, while the legislator allows for the possibility of financing the current part of a local government entity's budget with the surplus from prior years and free funds understood as the surplus of financial resources on the current budget account of a local government entity arising from settlements of issued securities, credits and loans from prior years (thus, *de facto*, remaining expendable surplus returnable income), such a solution could prove unsatisfactory to local government entities. Taking into consideration the structure of the ratio specified in Article 243.1 of the Public Finance Act, current income, income from the sale of property and current expenses occur in the numerator of the right side of the formula, while the surplus from prior years and free funds are not taken into account. Thus, in case of marginal income from the sale of property, it may turn out that current expenses are higher than the sum of current income and income from the sale of property. In light of the above, a negative amount on the right side of the formula may hinder or even prevent a local government entity from using "surplus" repayable income, i.e. free funds⁹⁴.

⁹³ E. Kornberger-Sokołowska [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 242*, thesis 3.

⁹⁴ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 242*, thesis 5 and J. Salachna (ed.), *Budżet i wieloletnia prognoza finansowa jednostek samorządu terytorialnego – od projektu do sprawozdania*, Ośrodek Doradztwa i Doskonalenia Kadr, Gdańsk 2010, p. 171.

Budget surpluses of local government entities from prior years and their free funds constitute, unlike planned current income, actual (real) financial resources accumulated by local government entities on bank accounts. A common element of all budget revenues used to cover the current budget deficit of a local government entity is the fact that they constitute surpluses of financial resources generated in prior years, which is indicated by the name “budget surpluses of a local government entity from prior years”. On the other hand, according to the statutory definition, “free funds” are the surplus financial resources on the current budget account of a local government entity, arising from settlements of issued securities, credits and loans from prior years. Budget surpluses are, therefore, associated with actual budget incomes and expenses of a local government entity, while free funds arise from the settlement of repayable income from the issue of debt securities, credits and loans taken out by the local government entity⁹⁵.

In the decisions of regional audit offices, theses have been formulated relating to the effects of Article 242 of the Public Finance Act on the methods of financing budget deficits of local government entities, i.e.⁹⁶:

- 1) *The budget deficit of a local government entity “covered” with repayable income, e.g., arising from the issue of municipal bonds or a long-term credit may apply exclusively to property expenses⁹⁷;*
- 2) *In the currently applicable legal system, there is no possibility to use repayable income –credits – to finance current budget expenses of a local government entity. This is determined by the legal norm specified in Article 242 of the Public Finance Act of 2009. Considering this definition of balance of current income and expenses, the budget deficit of a local government entity “covered” by repayable income, e.g. from taken out long-term credits, may apply exclusively to property expenses⁹⁸;*
- 3) *There is no possibility to use repayable incomes – municipal bonds – to finance current budget expenses of a local government entity. This is determined by the legal norm specified in Article 242 of the Public Finance Act of 2009⁹⁹.*

⁹⁵ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 242*, thesis 2.

⁹⁶ *Ibidem*.

⁹⁷ Resolution of the College of the Regional Audit Office in Zielona Góra no. 99/2011 dated 16 February 2011, unpublished. [as cited in:] A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 242*, thesis 3.

⁹⁸ Resolution of the College of the Regional Audit Office in Zielona Góra no. 102/2011 dated 16 February 2011 unpublished. [as cited in:] A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 242*, thesis 3.

⁹⁹ Resolution of the College of the Regional Audit Office in Zielona Góra no. 101/2011 dated 16 February 2011, OSS 2011, No. 3, p. 94 [as cited in:] A. Gorgol [in:] P. Smoleń, *The Public*

It should be emphasized that the Public Finance Act sets limits on actually incurred current budget expenses, and not on their ongoing execution, which means that these provisions apply to the state of budget performance of a local government entity, but not during the entire process of the budget execution. Therefore, only upon performance of a local government entity's budget, and in practice – upon drawing up the annual report on that budget performance, is it possible to explicitly state that on 31 December of a given year the statutory limitations on current expenses have been maintained¹⁰⁰.

Article 242 of the Public Finance Act is viewed as a provision that implements a limitation on budget deficit, which is a constant element of financial management of local government. The above provision is applied in a continuous manner – regardless of other prudential and corrective measures provided for in the Public Finance Act, which seemingly assumes a higher level of restrictiveness as regards the planning and execution of the budget deficit of a local government entity compared to the state budget deficit¹⁰¹.

2.4. Summary

1. The individual debt repayment ratio is adjusted to the capabilities of specific local government entities. In my assessment, despite the drawbacks indicated in this chapter, its introduction in itself constitutes significant progress compared to previously applicable general percentage debt limits. It should be noted that the individual debt repayment ratio does not directly determine the maximum amount of debt for a given local government entity, but rather the maximum amount to be repaid.
2. The solution contained in the Public Finance Act, as a general rule, provides for the possibility of a budget deficit occurring within a local government entity only in the property portion. The above solution is justified from the perspective of local government entities' debt structure – repayable liabilities related to the local government entity's budget deficit serve only to finance pro-development expenses. Relevant provisions of the Public Finance Act are in line with the European Charter of Local Self-Government regarding the necessity to provide local government entities with access to the domestic

Finance Act. Commentary, C.H. Beck Legalis, ed. 2. Warsaw 2014, *Commentary on Article 242*, thesis 3.

¹⁰⁰ A. Gorgol [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2. Warsaw 2014, *Commentary on Article 242*, thesis 3.

¹⁰¹ *Ibidem*, thesis 4 and A. Niezgodą, *Podział zasobów publicznych Podział zasobów publicznych między administrację rządową i samorządową*, Wolters Kluwer, Warsaw 2012, pp. 102–107.

capital market in order to ensure the possibility of financing investment expenses.

3. In my opinion, it is still necessary to consider abolishing the (indirect) breakdown of the budget into the current and property portion. This issue should be the object of decisions exclusively at the level of budget classification, without affecting the systemic budget structure of the local government entity. In my assessment, it should be considered sufficient to implement provisions which state that liabilities associated with financing a local government entity's budget deficit may be incurred only for property expenses. Property incomes, clearly separated at the level of the Public Finance Act in a local government entity's budget (with no such separation in the state budget), are characterized by a significant level of fluctuation and unpredictability as well as limited possibility of their generation by certain local government entities.

Chapter 3

Limitations to the possibility for local government entities to incur financial liabilities in a qualitative aspect

3.1. Purpose of incurring financial liabilities by a local government entity

Analyzed provisions of the Public Finance Act

Article 89. 1. Local government entities may take out credits and debts and issue securities to:

- 1) cover the transitional budget deficit of the local government entity which occurs during the year;*
 - 2) finance the planned budget deficit of the local government entity;*
 - 3) repay previously incurred liabilities arising from issued securities and taken out loans and credits;*
 - 4) provide advance financing of operations financed from European Union funds.*
- 2. Taken out credits and loans as well as issued securities intended for the purpose stipulated in paragraph 1.1 shall be subject to repayment or redemption in the same year in which they were taken out or issued.*

The provisions contained in Article 89 of the Public Finance Act specify the conditions of incurring financial obligations by entities in the public finance sector other than the National Treasury. In practice, however, their scope, to the largest extent, applies to the operation of local government entities and, to a lesser extent, to other public finance sector entities¹⁰².

¹⁰² K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 1.

It appears that in adopting the norms of Article 89 of the Public Finance Act, the legislator intended to establish debt limits for local government entities in order to create the possibility of indebtedness only for the purpose of financing pro-development operations (so-called “engine of local development”)¹⁰³.

The guaranteed possibility for local government entities to raise repayable funds enables the performance of their own objectives. The possibility of acquiring such funds should be equated with the constitutionally guaranteed principle of local government entities’ independence. Also significant are the provisions of the European Charter of Local Self-Government mentioned in Chapter 2 of this study. It should be noted that the possibility of incurring liabilities in order to acquire repayable sources of financing is inseparably connected with the necessity of proper debt management¹⁰⁴.

Art. 89.1 of the Public Finance Act authorizes local government entities to take out credits and loans and issue securities, i.e. repayable financial instruments. The legal actions associated with taking out credits and loans or issuing securities are carried out by the decision-making bodies of the local government entity, but within the authorizations granted in the budget resolution (Article 212.2.1 of the Public Finance Act). The validity of legal actions associated with taking out credits and loans and issuing securities also requires the countersignature of the local government entity’s signature¹⁰⁵.

Considering budget methodology and the principles of budget classification, taken out credits and loans and issued securities should be, in accordance with Article 5.1.4 of the Public Finance Act, qualified as income. In accordance with Article 5.1.4 of the Public Finance Act, public funds comprise income of the state budget and budgets of local government entities as well as other public finance sector entities originating from¹⁰⁶:

- 1) the sale of securities;
- 2) privatization of State Treasury property and the property of local government entities;
- 3) repayment of loans and credits granted from public funds;
- 4) received loans and credits;
- 5) other financial operations.

¹⁰³ R. Arendarski, *Propozycja konstrukcji ograniczeń w zakresie zaciągania zobowiązań przez jednostki samorządu terytorialnego*, “Samorząd Terytorialny”, no. 1–2/2009 <http://www.lex.pl/akt/-/akt/propozycja-konstrukcji-ograniczen-w-zakresie-zaciagania-zobowiazan-przez-jednostki-samorza-du-terytorialnego> accessed on 04.07.2018.

¹⁰⁴ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 2.

¹⁰⁵ *Ibidem*, thesis 2.

¹⁰⁶ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 89*, thesis 2.

The budget incomes of a local government entity generated by the issue of securities and from taken out credits and loans are considered repayable income. The repayment, i.e. payment of capital installments of credits or loans as well as redemption of securities, is effected through expenditures. In accordance with Articles 6.2.1 and 6.2.2 of the Public Finance Act, public expenditures include¹⁰⁷:

- 1) repayments of obtained loans and credits;
- 2) redemption of securities.

The difference between expenses and expenditures is determined based on the economic criterion. Expenses are associated with definitive redistribution (e.g. payment for goods or services, payment of salaries), while expenditures – with a temporary transfer of funds. Public expenditures arise from the need to meet liabilities incurred previously by public finance sector entities (e.g. redemption of securities, repayment of capital credit installments) or perform contractual obligations involving the provision of public financial resources to other entities, e.g. granting a loan to the Social Security Fund¹⁰⁸.

Expenditures, similarly to expenses, are essentially a directive. In accordance with Article 52.1.2 of the Public Finance Act, expenses and total expenditures expressed in the state budget, budgets of local government entities and financial plans of budget entities constitute a limit which cannot be exceeded¹⁰⁹.

Article 89 of the Public Finance Act in an enumerative manner specifies the purposes for which local government entities may take out credits and loans and incur liabilities from the issue of securities, i.e.¹¹⁰:

- 1) coverage of the local government entity's transitional budget deficit – based on Article 89.1.1 of the Public Finance Act;
- 2) financing of the planned budget deficit of the local government entity – based on Article 89.1.2 of the Public Finance Act;
- 3) repayment of previously incurred liabilities from the issue of securities and taken out loans and credits – based on Article 89.1.3 of the Public Finance Act;
- 4) advance financing of operations financed from European Union funds – based on Article 89.1.4 of the Public Finance Act.

The term “transitional deficit” has not been defined in the Public Finance Act. It occurs in a local government entity's budget (listed in Article 89.1.1 of the

¹⁰⁷ Ibidem.

¹⁰⁸ L. Lipiec-Warzecha, *The Public Finance Act*, Wolters Kluwer sp. z o.o., Warsaw 2011, p. 67.

¹⁰⁹ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 89*, thesis 2.

¹¹⁰ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 4.

Public Finance Act) in the event of the local government entity's loss of current financial liquidity, preventing the timely performance of budget objectives or timely settlement of obligations¹¹¹. It should be noted, however, that according to Article 89.2 of the Public Finance Act, taking out a credit or loan or issuing securities for the abovementioned purpose requires repayment or redemption in the same year in which such liabilities are incurred. Liabilities incurred for such a purpose do not, therefore, result in an increase of the local government entity's indebtedness at the end of the budget year. Acquisition of repayable sources of financing will, however, always be associated with additional costs of debt servicing, in particular due to interest¹¹².

The body authorized to incur liabilities intended to finance transitional deficit is the managing body of a local government entity, which is substantiated by its exclusive competence in the area of budget performance. The local government entity management's use of the above authorization is subject to the determination of a limit of liabilities in the objective scope by the local government entity's decision-making body in the budget resolution. The decision-making body of the local government entity may specify the aforementioned limit irrespective of the limits for other liabilities specified in Articles 89.1 and 90 of the Public Finance Act, or in combination. In the event of combined determination of a limit for all liabilities, the decision-making body of the local government entity is obliged to explicitly state in the budget resolution that such a limit also encompasses the discussed category of liabilities (securities, credits and loans for financing the transitional budget deficit). By setting the limit of liabilities to finance the transitional budget deficit, the decision-making body of the local government entity decides to authorize the executive body to incur such liabilities in the budget resolution (Article 212.2.1 of the Public Finance Act)¹¹³.

Taken out credits and loans and issued securities intended to cover transitional budget deficit of a local government entity enable balancing the budget during its ongoing execution, in the circumstances of transitional shortage of funds (temporary loss of financial liquidity) for the coverage of expenses which must be incurred by the local government entity. For that reason, income and expenditures in this area are not planned in the local government entity's budget.

¹¹¹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 89*, thesis 3.

¹¹² K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 5.

¹¹³ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 89*, thesis 6.

The expense plan (and simultaneously limit) applies, however, to expenses associated with debt servicing (interest, commissions)¹¹⁴.

Taken out credits and loans or issued securities may be allocated to finance the planned budget deficit of a local government entity. As a general rule, taking into consideration Article 242 of the Public Finance Act, such liabilities should serve the purpose of financing property expenses of a local government entity. The planned deficit amount together with sources of its financing must be specified in the budget resolution. The possibility of financing the planned budget deficit of a local government entity on the basis of Article 246.1 of the Public Finance Act is subject to the opinion of the regional audit office. Such an opinion should be published by a local government entity within 7 days from the date of its receipt – according to terms specified in the Act on Access to Public Information of 6 September 2001 (Official Journal (Dz.U.) of 2016, item 1764, further amended)¹¹⁵.

Financing of the planned deficit constitutes a legally regulated situation in which a local government entity has the right to incur a liability which generates state public debt. In accordance with Articles 217.1 and 217.2 of the Public Finance Act, the difference between budget income and expenses of a local government entity constitutes – respectively – its budget surplus or deficit. The local government entity's budget deficit may be financed using income from¹¹⁶:

- 1) the sale of securities issued by the local government entity;
- 2) credits;
- 3) loans;
- 4) privatization of the local government entity's property;
- 5) budget surplus of the local government entity from prior years;
- 6) free funds, as a surplus of financial resources on the current budget account of the local government entity, arising from settlement of issued securities, credits and loans from prior years.

At this point, it is worth drawing attention to the correlation between income from issued securities, taken out loans or credits and free funds. Resources from the above debt instruments unused by the local government entity, while remaining budget incomes, obtain the "status" of free funds. Their inclusion

¹¹⁴ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 89*, thesis 4.

¹¹⁵ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 6.

¹¹⁶ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 89*, thesis 6.

in the subsequent year's budget is not subject to limitations established in regulations for their original debt instruments¹¹⁷.

Taking out credits and loans and issuing securities may also be associated with the refinancing of previously incurred financial liabilities from similar instruments, i.e. in the event of repayment or redemption of liabilities related to previously taken out credits, loans or issued securities. Debt rolling is beneficial to a local government entity if “new” debt is incurred on more beneficial conditions (with lower service costs). The prerequisite of incurring a liability in order to repay previously incurred liabilities from the issue of securities as well as loans and credits is the inclusion in a given year's budget resolution of a specified limit on incurring such types of liabilities. In the context of the debt rolling instrument, the term “consolidation” is also worth mentioning. In the broadest terms, consolidation constitutes a change in the debt structure, conditions and schedule of repayment. In the case of local government entities, the primary goal of consolidation is to adjust the debt repayment deadlines to legally specified liability repayment limits. The effect of consolidation should, therefore, be the replacement of several debt instruments with one, taking into consideration the repayment schedule based on rules stipulated in Article 243 of the Public Finance Act¹¹⁸.

Incomes acquired by advance financing of operations financed from the European Union budget are associated with contracts concluded by a local government entity with institutions managing operating programs. The amount of liabilities for advanced financing is limited by the amount of funds granted to the local government entity on performance of a project; in a given budget year – by the amount of expenses allocated to that project as shown in the local government entity's budget. It should also be indicated that the amount of incurred liabilities in its entirety must be subject to a limit of liabilities determined at the budget resolution level (Article 212.1.6 of the Public Finance Act)¹¹⁹.

The term “advance financing” mentioned in Article 89.4.4 of the Public Finance Act should be related to loans granted by the Polish Bank Gospodarstwa Krajowego from state budget funds for the financing of projects carried out as part of the Rural Area Development Program¹²⁰. The basis of such loans is the Act on the Financing of the Common Agricultural Policy of 27 May 2015 (Official Journal (Dz.U.) of 2015, item 1130, further amended). In

¹¹⁷ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis, Warsaw 2017, *Commentary on Article 89*, thesis 8.

¹¹⁸ *Ibidem*, thesis 13, 14 i 20.

¹¹⁹ *Ibidem*, thesis 15.

¹²⁰ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 8.

accordance with Article 13 of the aforementioned act, entities can take out loans for advance financing of qualified costs incurred for operations involving the European Agricultural Fund for Rural Development as part of selected objectives encompassed by the Rural Area Development Program for the years 2014–2020. Similar solutions are provided in the Act on the Activation of Funds from the European Union Budget Intended for Financing the Common Agricultural Policy of 22 September 2006 (Official Journal (Dz.U.) of 2012, item 1065, further amended). The conditions, procedure and timeframes of granting loans from the state budget for advance financing of qualified costs incurred for the performance of the abovementioned objectives, as well as settlements and repayment of loans, are laid down in the Regulation of the Council of Ministers dated 14 September 2015 on loans from the state budget for advance financing within the Rural Area Development Program for the years 2014–2020 (Official Journal (Dz.U.) of 2015, item 1558)¹²¹. In the case of local government entities in the area of advance financing, it is possible to, in particular, point to the following catalog of entities and their objectives¹²²:

- 1) provincial governments pursuing objectives in the area of technical aid;
- 2) local government entities pursuing objectives in the area of improving and developing infrastructure associated with development and adaptation of agriculture and forestry by merging land and managing agricultural water resources;
- 3) local government entities pursuing objectives in the area of services for rural economy and community, rural renewal and development and implementation of local development strategies.

It should be pointed out that incurring a liability for advance financing of objectives financed from European Union funds is also possible in a situation where there is a lack of budget deficit planned by the local government entity. A liability for this purpose is then incurred on the basis of Article 89.1.4 of the Public Finance Act, i.e. according to a clearly indicated, separate legal basis. Simultaneously, it is justified to draw attention to a certain inconsistency of regulations as in accordance with Article 127.2.6 of the Public Finance Act, funds intended for advance financing of the Common Agricultural Policy, in the part subject to reimbursement, constitute special purpose subsidies, not loans for advance financing¹²³.

¹²¹ Ibidem, thesis 8.

¹²² A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 89*, thesis 4.

¹²³ K. Szmań [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 89*, thesis 8.

3.2. Loans from a state special purpose fund for local government entities

Analyzed provisions of the Public Finance Act

Article 90. For the financing of expenses for investments and investment purchases included as part of undertakings stipulated in Article 226.3, local government entities may incur loans from state special purpose funds if so allowed by the act establishing the fund.

Article 90 of the Public Finance Act constitutes a continuation of notions regulated in Article 89 of the Public Finance Act. This regulation makes it possible for local government entities to take out loans from state special purpose funds. This Article specifies the purpose for which a local government entity may take out a loan, i.e. the financing of expenses for investments and investment purchases included as part of undertakings stipulated in Article 226.3 of the Public Finance Act¹²⁴. A state special purpose fund may be the lender for local government entities exclusively in cases where the act establishing the fund provides for a possibility of granting such loans. Such a basis is stipulated by Article 47.1a.2 of the Act on Occupational and Social Rehabilitation and Employment of the Disabled of 27 August 1997 (Official Journal (Dz.U.) of 2018, item 51, further amended), according to which the State Fund for Rehabilitation of the Disabled, in order to carry out programs supported from European Union aid funds for the disabled intended for implementation in a given year, may grant subsidies, loans and finance interest on credits given to project proponents for the execution of such programs¹²⁵.

To summarize, the regulation of Article 90 of the Public Finance Act refers to the possibility of obtaining additional sources of revenue for the purpose of financing objectives pursued by local government entities. The limitation contained in Article 90 of the Public Finance Act has been constructed in a three-step manner¹²⁶:

- 1) granting of loans by the state special purpose fund is admissible if so stated in the legislative act establishing such a special purpose fund;
- 2) loans may be granted exclusively for the purpose of financing investment expenses;

¹²⁴ A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.) *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 90*, thesis 1.

¹²⁵ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 90*, thesis 1.

¹²⁶ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 90*, thesis 1 i 2.

- 3) loans may be taken out only as part of undertakings stipulated in Article 236.3 of the Public Finance Act, i.e.:
 - a) guarantees and sureties granted by local government entities,
 - b) contracts whose performance during the budget year and in subsequent years is necessary in order to ensure continued operation of the entity and the payments from which extend beyond the budget year;
 - c) projects and objectives related to public-private partnership contracts,
 - d) financial programs involving foreign funds, including from the European Union budget.

Taking out a loan by a local government entity from the state special purpose fund requires the statement of revenues in the budget plan and inclusion in the budget resolution of a limit of liabilities arising from the above. The first limit may not exceed the amount of planned expenses for the performance of a given undertaking¹²⁷.

It should also be noted that Article 90 of the Public Finance Act cannot constitute a legal basis which entitles local government entities to take out loans in environment protection and water management funds. The above limitation is associated with the legal status of the National Fund for Environmental Protection and Water Management and provincial environment protection and water management funds, which since 1 January 2010 have been granted the status of state legal entity and local government legal entities (Article 9.14 of the Public Finance Act), and not state special purpose funds. Local government entities may therefore take out loans in the National Fund for Environmental Protection and Water Management and provincial environment protection and water management funds upon meeting conditions stipulated in Article 89.1 of the Public Finance Act¹²⁸.

¹²⁷ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 90*, thesis 1.

¹²⁸ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 90*, thesis 2.

3.3. Structure of financial instruments in relation to liability service costs of a local government entity

Analyzed provisions of the Public Finance Act

Article 92. 1. Local government entities may only incur such financial liabilities intended for a purpose stipulated in Articles 89.1.2–4 and 90 whose service costs are incurred at least once per year, where:

- 1) the discount on securities issued by local government entities cannot exceed 5% of the nominal value;*
 - 2) capitalization of interest is inadmissible.*
- 2. The limitation stipulated in paragraph 1 shall apply correspondingly to public finance sector entities other than the State Treasury.*

The aim of Article 92.1 of the Public Finance Act is the implementation of solutions (limitations) with the purpose of lowering the financial risk of a local government entity incurring costs of debt servicing which could impact the performance of its budget. The above provision introduces limitations which must be taken into consideration when establishing the method of planning debt servicing costs in a structural sense¹²⁹.

Local government entities may only incur financial obligations intended for financing the planned budget deficit of a local government entity, repayment of previously incurred liabilities arising from the issue of securities, loans and credits, and advance financing of objectives financed from European Union funds whose servicing costs are incurred at least once per year, where the discount on securities issued by local government entities cannot exceed 5% of the nominal value and capitalization of interest is inadmissible. It should be noted, however, that the above limitations do not apply to instances where the purpose of incurring a liability is the coverage of the transitional budget deficit of a local government entity which occurs during the year¹³⁰.

The debt servicing costs as a general rule are comprised of commissions and interest. Capitalization of interest (inadmissible according to Article 92.1.2 of the Public Finance Act) would result in the addition of interest charged for a specific (capitalization) period to the primary amount payable, and further interest would be charged on an amount increased in this manner in the subsequent

¹²⁹ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 92*, thesis 1.

¹³⁰ A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 92*, thesis 1 and R. Trykozko, *The Public Finance Act. Commentary for local government entities*, Wydawnictwo Taxpress, Warsaw 2010, p. 240–241.

interest period (so-called “interest upon interest”). The above limitation does not apply to debt instruments used in order to finance the transitional deficit (Article 89.1.1 of the Public Finance Act)¹³¹.

Incurring a liability exceeding the limitations stipulated in Article 92 (e.g. issue of bonds with a discount exceeding 5%) constitutes a violation of public finance discipline, according to Article 15 of the Act on Accountability for Violation of Public Finance Discipline of 17 December 2004, understood as incurring a liability in violation of regulations on the commitment of liabilities by public finance sector entities¹³².

3.4. Limitations in terms of the nominal value of liabilities of local government entities

Analyzed provisions of the Public Finance Act

Article 93. 1. Local government entities, with the exception of the State Treasury, may not take out loans or credits, issue securities and grant sureties or guarantees whose nominal value payable on their maturity date, expressed in Polish zlotys, has not been determined on the conclusion date of the transaction.

2. The Council of Ministers shall determine, by a resolution, instances in which the limitations stated in paragraph 1 shall not be applied, taking into consideration in particular the specific nature of credits and loans from international institutions or government lenders, as well as considering the possibility of meeting the incurred liabilities and the limitation of the state public debt growth rate.

The limitations contained in Article 93.1 of the Public Finance Act are intended to mitigate the risks associated with the lack of a specified nominal value of financial liabilities incurred by public finance sector entities. According to the aforementioned regulation, such entities (with the exception of the State Treasury) cannot incur financial liabilities in the form of loans or credits, issue securities and grant sureties or guarantees whose nominal value payable on their maturity date, expressed in Polish zlotys, has not been determined on the conclusion date of the transaction¹³³. The structure of each liability requires specification of its key elements, including the amount of the payable amount. The

¹³¹ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 92*, thesis 2.

¹³² Ibidem, thesis 3.

¹³³ A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 93*, thesis 1.

above limitation certainly increases the reliability of the obligation relationship entered into between the public finance sector entity and the creditor¹³⁴.

Liabilities arising from the instruments specified in Article 93.1 of the Public Finance Act incurred by local government entities, as a general rule, should therefore be expressed in Polish zlotys. In practice, they cannot be expressed in a foreign currency as these types of liabilities are associated with a currency risk, which may result in a change to their nominal value unless the method of determining the nominal value of the liability payable on the maturity date, expressed in Polish zlotys, has been specified at the time of concluding the transaction. Article 93.1 of the Public Finance Act is not, however, limited only to liabilities expressed in foreign currencies. The nominal value of the liability payable on the maturity date should be established on the transaction conclusion date. The local government entity, when incurring a liability arising from loans, credits, securities or granting of sureties or guarantees, should have a specified nominal value of such liabilities. It is necessary to emphasize the fact that – regardless of the liability’s currency – when constructing a debt instrument (e.g. local government bonds) or granting sureties or guarantees, it is necessary to consider the limitations specified in Article 93.1 of the Public Finance Act, which can *de facto* mean a lack of possibility to incur indexed or capitalized liabilities¹³⁵.

Financial liabilities which are not subject to the limitations arising from Article 93.1 of the Public Finance Act may be incurred only for specific purposes. Apart from financing investment expenses not covered by the local government entity’s planned income, the provision introduces the option to incur liabilities for the repayment of previously incurred liabilities in foreign currencies arising from the issue of securities and taken out loans and credits.

Article 93.1 of the Public Finance Act in practice prevents commitment of liabilities in foreign currencies and constitutes a special rule in relation to Article 358 § 1 and 2 of the Civil Code Act of 23 April 1964. In accordance with the aforementioned article, if the object of a liability is a monetary sum expressed in a foreign currency, the debtor may pay the liability in the Polish currency unless legislation or a court ruling which gives rise to the liability or a legal action requires the satisfaction of the liability in a foreign currency. In such a case, the value of the foreign currency is determined according to the average exchange rate announced by the National Bank of Poland as of the

¹³⁴ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 93*, thesis 1.

¹³⁵ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 93*, thesis 1.

maturity date of the claim unless the legislation, court ruling or legal action state otherwise¹³⁶.

Exceptions to the application of the discussed limitations are determined by the Council of Ministers by way of a regulation. According to § 2.1 of the Regulation of the Council of Ministers of 17 December 2010 concerning instances in which limitations regarding certain financial liabilities incurred by local government entities, with the exception of the State Treasury, do not apply (Official Journal (Dz.U.) no. 250, item 1678), the limitations stipulated in Article 93.1 of the Public Finance Act are not applied to credits or loans denominated in foreign currencies, which are taken out¹³⁷:

- 1) at international financial institutions which the Republic of Poland is a member of or has signed a cooperation agreement with;
- 2) at banks, from funds originating from credit lines made available by international financial institutions;
- 3) from legal entities established by way of legislation, from funds originating from credit lines made available by international financial institutions;
- 4) from governments or government institutions of foreign countries in accordance with agreements concluded by the Council of Ministers with the respective government or government institution.

Regardless of their currency, these limitations also do not apply to the following credits and loans which¹³⁸:

- 1) are covered by a surety or guarantee of the State Treasury, governments, government institutions of foreign states, or international financial institutions;
- 2) have been incurred in order to co-finance an undertaking for which one of the sources of financing are funds acquired as a result of incurring a liability covered by a surety or guarantee of the State Treasury or the aforementioned foreign entities;
- 3) are intended to cover liabilities arising as a result of the obligation to repay funds in connection with a failure to fulfill conditions contained in a contract based on which the entity has received funds from the State Treasury, governments, government institutions of foreign states, or international financial institutions and institutions established by the European Union, in particular funds originating from the European Union budget.

¹³⁶ P. Walczak [in:] P. Walczak (ed.), *The Public Finance Act. Commentary for local government entities*, C.H. Beck Legalis Warsaw 2017, *Commentary on Article 93*, thesis 1 and R. Trykozko, *The Public Finance Act. Commentary...*, op. cit., p. 190.

¹³⁷ A. Mikos-Sitek [in:] A. Mikos-Sitek (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 7, Warsaw 2018, *Commentary on Article 93*, thesis 2.

¹³⁸ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 93*, thesis 2.

The statutory limitations also do not apply in the case of issue of securities denominated in foreign currencies, where this applies to two specific types¹³⁹:

- 1) securities issued in foreign capital markets in the form of bonds with a redemption time of over a year;
- 2) securities issued or written in order to establish a collateral to the benefit of the State Treasury in connection with sureties or guarantees granted by the State Treasury.

Additionally, the condition for an exemption from statutory limitations on the operating activity of public finance sector entities is¹⁴⁰:

- 1) receipt by the issuer of securities of a creditworthiness rating at an investment level, awarded by a rating agency recognized in the capital market where such securities are to be issued. Such a rating should be awarded by a rating agency recognized in the capital market where the issue of securities is to take place, e.g.: Fitch Ratings Ltd., Moody's Investors Service Inc., Standard and Poor's Co. The requirement to obtain a rating specified in the regulation should be considered as confirmation of the existing market practice¹⁴¹;
- 2) an indication in the abovementioned regulation of a closed catalog of allocations of funds acquired from credits, loans and securities denominated in a foreign currency, which may only be intended to finance investment expenses which are not covered by the planned income or revenue of a public finance sector entity or to repay previously incurred liabilities in foreign currencies arising from the issue of securities and taken out credits and loans.

Financial liabilities stipulated in § 2.1 and § 3.1 of the aforementioned regulation (foreign market bonds) may be incurred only for the purpose of:

- 1) financing investment expenses which are not covered by the planned income or revenue of a public finance sector entity, or
- 2) repayment of previously incurred liabilities in foreign currencies arising from the issue of securities and taken out credits and loans.

To summarize, financial liabilities for which the limitations arising from Article 93.1 of the Public Finance Act are not applied may be incurred only for specific purposes. Apart from financing investment expenses which are not covered by the planned income or revenue of a local government entity, the regulation also introduces the option to incur liabilities for the repayment of previously incurred liabilities in foreign currencies arising from the issue of

¹³⁹ A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2014, *Commentary on Article 93*, thesis 2.

¹⁴⁰ Ibidem.

¹⁴¹ K. Szmaj [in:] W. Misiąg (ed.), *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2, Warsaw 2017, *Commentary on Article 93*, thesis 2.

securities and taken out credits and loans. It should be noted that the provisions of the abovementioned regulation do not provide for an option to incur financial liabilities in foreign currencies in order to cover a budget shortage occurring during the year¹⁴².

3.5. Summary

1. The qualitative limitations to the possibility for a local government entity to incur financial liabilities adopted by the legislator at the level of the Public Finance Act are significantly more restrictive than limitations related to liabilities incurred by the State Treasury. These limitations constitute exclusively norms of a legislative rank and do not arise directly from European Union or Polish Constitution regulations.
2. Limitations as regards determining the nominal value of liabilities of local government entities in practice make it impossible for local government entities to incur debts in foreign currencies. Restrictive provisions in this regard are intended to limit the market risk primarily arising from currency risk. However, it is necessary to draw attention to a certain inconsistency of the legislator, who on the one hand imposes restrictive legislative limitations, while on the other hand – introduces a list of exemptions at a regulation level. The above exemptions are targeted and instrumental in nature, without any limit restrictions, therefore the currency risk would burden the local government entity depending on the amount of the currency liability. The purpose and type of instrument, in my assessment, in no way limit the risks arising from the above. Considering current general limitations as to the purpose of incurring liabilities (balanced current budget), maintaining the aforementioned limitation appears unsubstantiated.
3. In my opinion, most doubts are raised by the limitation to the possibility of issuing local government bonds with a discount exceeding 5%. The amount of discount (similarly to the interest rate) is determined primarily on the basis of the established financial reliability of the issuer; the lower the reliability, the higher the discount should be, as a method of attracting potential investors interested in purchasing treasury securities. The statutory maximum limit, therefore, does not take into consideration local government entities in a medium or poor financial condition, for which the issue of bonds becomes additionally difficult due to the statutory limitation¹⁴³.

¹⁴² Ibidem, thesis 1.

¹⁴³ W. Gonet, *Zakres swobody zawierania umów przez jednostki samorządu terytorialnego*, Wolters Kluwer, Warsaw 2011, p. 110 and A. Mierzwa [in:] P. Smoleń, *The Public Finance Act. Commentary*, C.H. Beck Legalis, ed. 2. Warsaw 2014, *Commentary on Article 92*, thesis 1.

Chapter 4

Proposed changes in the area of limitations to liabilities incurred by local government entities

4.1. Introduction

The Polish finance system for local government entities in the current economic and social environment cannot function without any limitations on incurred liabilities. Such limitations were not applied during the interwar period, which nearly resulted in the bankruptcy of the then local government entities, especially those of larger cities¹⁴⁴. In my opinion, in the current legal system of public finance, one should, however, strive to abolish certain restrictions, particularly those most inappropriate from the perspective of blocking development. The current indebtedness of local government entities constitutes an insignificant part of state public debt (approx. PLN 64.4 bn out of PLN 989.2 bn as of 31 March 2018)¹⁴⁵. I believe that closing the civilizational gap in the area of municipal infrastructure will require an increase in the level of debt of local government entities. Effective development of local government entities will, therefore, at least in part be dependent on changes to legal regulations related to the possibility of incurring financial liabilities.

As concerns actions that I propose, activities related to changes aimed at minimizing differences between limitations on liabilities incurred by the State Treasury and local government entities come to the forefront. I would primarily suggest amending the Polish Constitution and significantly limiting the currently applicable wording of Part II Chapter IV of the Public Finance Act.

¹⁴⁴ More on the topic of local government entity debt in the II Republic *Reduction of the Debt of the Local Government. Report of the Central Savings and Debt Reduction Commission for the Local Government* State Printing Works 1937.

¹⁴⁵ *Debt of the public finance sector following consolidation*, Ministry of Finance, <https://www.finance.mf.gov.pl/szeregi-czasowe> accessed on 04.07.2018.

4.2. A draft revision of the Polish Constitution

An analysis of legal solutions has resulted in a reflection on the revision of the Polish Constitution. Chapter X of the Public Finance Act relates primarily to rules associated with state public debt, the National Bank of Poland and the budget act. This chapter, however, does not include the local government or issues associated with it. In my opinion, certain regulations in the Polish Constitution should contain appropriate references to local government finance.

In accordance with Article 220.2 of the Polish Constitution, the budget act cannot provide for coverage of the budget deficit by liabilities incurred in the state central bank. The literal wording of the aforementioned Article in the Polish Constitution refers exclusively to the state budget; therefore, in theory, the National Bank of Poland could finance the deficit of local government entities. This, however, would not be advisable from an economic perspective, i.e. in consideration of a direct impact of monetary policy on budget policy. Additionally, the wording of Article 220.2 of the Polish Constitution suggests the impossibility to finance the state budget deficit, contrary to the borrowing needs of the state, which is a broader term. Thus, theoretically, the National Bank of Poland could finance operations associated with rolling the debt of the State Treasury. In my opinion, a prohibition of financing by the National Bank of Poland should be more restrictive and precise, also referencing the inability of the central bank to finance the borrowing needs of the state in terms of entities (prohibition to finance any public finance sector entities by the National Bank of Poland) as well as in terms of financing (not only of the budget deficit). A clause encompassing the above regulations should be a general clause constructed similarly to the provisions of Article 216.5 of the Polish Constitution.

Additionally, I consider it justifiable to “extend” the applicability of certain regulations of the Polish Constitution regarding budget procedure and rules. Article 219.1–4 of the Polish Constitution regarding budget rules such as the provisional budget, execution of the state budget in the event of a failure to pass a state budget by the end of the preceding budget year or limited influence of the Polish Parliament (*Sejm*) on the deficit amount should be applied correspondingly to acts of local law in the area of the budget of a local government entity. Also the rule concerning the possibility of increasing expenses on condition of indicating sources of income established in Article 220.1 of the Polish Constitution should refer to local government entities. The premises of the above restriction for the *Sejm*, in my opinion, seem justifiable also in reference to the decision-making body of a local government entity. It is also necessary to specify, at the level of the Polish Constitution, the issue of utilizing the term “public debt”.

Below I present my proposal for a revision of the Polish Constitution:

*Legislative act
of ... 2019
on amendment to the Constitution of the Republic of Poland*

Article 1. The following amendments are introduced to the Constitution of the Republic of Poland dated 2 April 1997 (Official Journal (Dz.U.) no. 78, item 483, further amended):

1) *paragraph 6 is added to Article 216, worded as follows:*

“6. It is prohibited to incur loans at the state central bank in order to cover the borrowing needs of the state.”;

2) *paragraph 5 is added to Article 219, worded as follows:*

“5. As regards local law acts concerning the budget of local government entities, paragraphs 2–4 shall apply accordingly.”;

3) *Article 220.2 is amended as follows:*

“2. As regards local law acts concerning the budget of local government entities, paragraph 1 shall apply accordingly.”;

4) *Article 221 is amended as follows:*

“Article 221. The legislative initiative for the budget act, provisional budget act, act on incurring state public debt and act on the granting of financial guarantees by the state shall be attributable only to the Council of Ministers.”.

4.3. Proposed revisions of the Public Finance Act

Abolition of certain qualitative limitations restricting the possibility for local government entities to incur liabilities

As for the limitations on incurred municipal liabilities, it should be noted that the Public Finance Act of 26 November 1998, apart from “quantitative” limits, also introduces “qualitative” limits which have been implemented into the Public Finance Act in a practically unaltered form. The above solutions limit the maximum discount on securities issued by local government entities to 5% of the nominal value (Article 92 of the Public Finance Act). This provision has most certainly been implemented in order to limit the possible accumulation of payments. A similar *ratio legis* was applicable when introducing the regulation regarding the inability to capitalize interest in the case of local government liabilities. In my opinion, it is unclear, and even unjustified, why local government entities should not be allowed to issue securities based solely on the financial capabilities and profitability of the undertaking as compared to other forms of indebtedness. I represent the view that practically all forms of local government entity debt should be regulated exclusively by legislative acts

corresponding to individual securities (e.g. the Bonds Act of 15 January 2015, or the Bills of Exchange Act of 28 April 1936 – especially in the context of determining financial benefits to the investor).

Additionally, local government entities, in accordance with Article 93 of the Public Finance Act, cannot take out loans or credits, issue securities or grant sureties and guarantees whose nominal value payable on the maturity date, expressed in zlotys, has not been determined on the transaction conclusion date. In practice, this is tantamount to the inability to incur currency liabilities. I believe it to be justifiable to revise the Public Finance Act in order to adjust the legislative provisions which prevent local government entities from incurring liabilities in foreign currencies. It should be noted that the zloty exchange rate was made flexible as of 12 April 2000, and limitations to the accumulation of foreign currencies on accounts and to the possibility of incurring liabilities in such currencies do not even apply to natural persons (consumers). In the current economic system environment, I find no justification for the significant limitation to the possibility for local government entities to incur currency liabilities. Currency risk is an integral part of economic processes and cannot be entirely avoided, yet may be reduced by certain actions.

Below I present my proposed provisions of Articles 92 and 93 of the Public Finance Act:

*Legislative act
of ... 2019
on amending the Public Finance Act*

In the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended), Articles 92 and 93 are amended as follows:

“Article 92. 1. Local government entities may incur only such financial liabilities, intended for a purpose stipulated in Articles 89.1.2–4 and 90, whose servicing costs are incurred at least once per year.

2. The limitation stipulated paragraph 1 above shall apply accordingly to public finance sector entities other than the State Treasury.

Article 93. 1. Public finance sector entities, with the exception of the State Treasury and local government entities, may not incur loans or credits, issue securities and grant sureties and guarantees whose nominal value payable on the maturity date, expressed in Polish zlotys, has not been determined on the transaction conclusion date.

2. The Council of Ministers, by a regulation, shall determine circumstances in which the limitations stipulated in paragraph 1 do not apply, taking into consideration the specific nature of credits and loans from international institutions or from government lenders, as well as considering the possibility of repayment of incurred liabilities and the limitation of the state public debt growth.”.

Possibility of using derivative instruments in a local government entity's debt management

Apart from the inability to incur liabilities in foreign currencies and other indexed liabilities, local government entities also are unable to become involved in transactions related to the purchase of options and futures contracts. In accordance with Article 3.28a) of the Act on Trading in Financial Instruments 29 July 2005 (Official Journal (Dz.U.) of 2017, item 1768, further amended), derivative instruments are understood as options, futures contracts, swaps, forward agreements and other property rights whose price or value depends directly or indirectly on the price or value of financial instruments, currencies, interest rates, profitability, financial indexes, financial indicators, goods, climate changes, freight rates, emission levels, inflation rates or other official statistical data, as well as other assets, rights, liabilities, indexes or indicators, and derivative instruments related to the transfer of credit risk. The primary aim of using derivative instruments is to secure the investor against price changes of the base instrument, e.g. currency exchange rates or interest rates.

In the assessment of the Ministry of Finance, local government entities cannot carry out the transactions in question, which was stated in the letter by the Ministry of Finance No. ST1-4834-15/WWRI/08/418 dated 14 May 2008. In response to letter no. RIO-I-0717/218 regarding the possibility of concluding transactions securing currency risk in the case of liabilities incurred in foreign currencies, the Ministry of Finance informed that the Public Finance Act of 30 June 2005 did not contain provisions which would allow a local government entity to conduct the transactions in question. Article 9.3 of the aforementioned act defines the term "borrowing needs" of a local government entity's budget as the requirement for financial resources necessary to, i.a., conduct other financial operations associated with the local government entity's debt. This provision is general in nature, which was evidenced by its inclusion in Part I Chapter I 'Basic definitions' of the Public Finance Act of 30 June 2005, and does not specify the types of financial operations associated with the debt of a local government entity. Thus, there has been no determination of a set of instruments through which entities could carry out futures transactions. On the other hand, Article 168.1 of the aforementioned act enumerates sources of deficit financing, among which there are no specifications of transactions that could be the source of its financing, e.g. interest swaps. Further, Part II of that act contains a specification of what types of financial operations may be carried out by the Minister of Finance representing the State Treasury. Article 71.3 of the aforementioned act authorizes the Minister of Finance to conduct operations associated with derivative financial instruments which include: currency swaps as well as interest swaps. The provisions of the currently applicable Public Finance Act have not been altered in this respect, and

equivalents of the provisions specified above in the 2005 act have been reflected in Articles 77.3 and 166 of the Public Finance Act¹⁴⁶.

In the case of derivative instruments, it appears justified to implement a certain limitation which narrows the purpose of local government entities' involvement in such types of instruments. The primary objective of local government entities is to satisfy the needs of their inhabitants, especially in terms of municipal services, while the scope of local government entities' investment in derivative instruments should be limited only to the conclusion of transactions with the purpose of securing against risk (e.g. currency or interest rate risk). In reference to public sector entities, derivative instruments associated with currency and interest rate risk should be considered most significant. However, the current provisions of the Public Finance Act prevent even using derivative financial instruments allowed, based on a regulation of the Council of Ministers, to secure currency exposure for local government entities. Additionally, a broader issue is the removal of the possibility of using collateral in order to manage interest rate risk which is associated with nearly every debt instrument. In my assessment, there is no justification for prohibiting local government entities from managing public debt through means including derivative instruments.

Below I present a proposed revision of the Public Finance Act:

*Legislative act
of ... 2019
regarding revision of the Public Finance Act*

In the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended), Article 264 is followed by Article 264a worded as follows: "Article 264a. The managing body of the local government entity, in connection with managing that entity's debt, shall be authorized to conduct other financial operations associated with debt management, including operations related to derivative financial instruments. Article 166 shall apply accordingly."

Consolidation of local government entity funds in the Bank Gospodarstwa Krajowego

In accordance with Article 6.1 of the Act on the Bank Gospodarstwa Krajowego of 14 March 2003 (Official Journal (Dz.U.) of 2017, item 1843, further amended), the scope of the Bank Gospodarstwa Krajowego operations may encompass:

- 1) bank servicing of state budget accounts;
- 2) servicing the budgets of local government entities;
- 3) servicing state or local government accounts of legal entities established based on separate contracts in order to pursue public objectives;

¹⁴⁶ Ministry of Finance Letter no. ST1-4834-15/WWRI/08/418 dated 14 May 2008.

- 4) other activities determined by separate legislation;
- 5) other activities carried out with the use of public funds, determined by contracts concluded with state administration bodies.

The above provisions clearly state that the role of the Bank Gospodarstwa Krajowego may also be to fulfill functions of a public finance bank.

On the basis of Article 6.2 of the Act on the Bank Gospodarstwa Krajowego of 14 March 2003, the detailed scope of the aforementioned activities is specified by separate regulations and contracts concluded on their basis.

A revision of the Public Finance Act, i.e. the Act on the Amendment of the Public Finance Act and Certain Other Acts of 16 December 2010 (Official Journal (Dz.U.) no. 257, item 1726) introduced the principle of financial resource consolidation of selected public finance sector entities (primarily government administration entities) based on the institution and infrastructure of the Bank Gospodarstwa Krajowego¹⁴⁷.

In accordance with Article 78 of the Public Finance Act, the Minister of Finance acting on behalf of the State Treasury has been authorized to accept and deposit free funds and manage them in order to finance the borrowing needs of the state budget, also in connection with managing the State Treasury's debt. Free funds are accepted into a deposit by the Minister of Finance for an undetermined period. The obligation of transferring free funds into the disposition of the Minister of Finance as part of civil-law operations applies to, among others, executive agencies, the National Healthcare Fund, institutes of the Polish Academy of Sciences and other state legal entities established based on separate legislation. The above Article also provides for the possibility of voluntary participation in the system for other entities in the public finance sector, including local government entities.

One of the prerequisites for including the above entities into the liquidity management system (in a mandatory or voluntary manner) is opening of a given entity's account at the Bank Gospodarstwa Krajowego. Accepted and managed deposits of public finance sector entities are subject to interest. The interest rate has been determined depending on the deposit period, i.e. for a period of up to 3 days, from 3 to 6 days and over 7 days. The interest rate is primarily dependent on the deposit rate of the National Bank of Poland, the WIBID rate and the multiplier whose value cannot be lower than 0.9¹⁴⁸.

¹⁴⁷ S. Skuza, *Bank Gospodarstwa Krajowego as an institution running bank accounts for public finance sector entities. The current situation and self-designed proposals for change*, [in:] J. Gliniecka, E. Juchniewicz, T. Sowiński, M. Wróblewska (ed.), *System prawnofinansowy. Prawo finansowe wobec wyzwań XXI wieku*, CeDeWu sp. z o.o., pp. 381–384.

¹⁴⁸ K. Marchewka-Bartkowiak, *Technical opinion regarding the government legislative draft on revising the public finance act and selected other acts (Parliamentary Document 3576)*, Parliamentary Analysis Office and Articles 78e.1 and 78e.2 of the Public Finance Act.

Based on the provisions of the Public Finance Act and the Regulation of the Minister of Finance of 15 April 2011 regarding free funds of certain public finance sector entities deposited or managed by the Minister of Finance (Official Journal (Dz.U.) no. 81, item 443), since 1 May 2011 the Bank Gospodarstwa Krajowego has begun performing activities associated with acceptance and repayment of free funds transferred for deposit or management to the Minister of Finance by certain public finance sector entities¹⁴⁹.

In my assessment, a similar solution should be also applied to local government entities where the dispersion of public funds – due to the number of entities and their separation – is significant.

The changes proposed here would involve a revision of Article 264 of the Public Finance Act, assuming that bank servicing of the budgets of local government entities could be performed only by the Bank Gospodarstwa Krajowego, but with the possibility to entrust servicing of ancillary accounts to banks other than the Bank Gospodarstwa Krajowego, selected under the public procurement procedure. The above solution would be intended to ensure flexibility in the operations associated with the servicing of budgets of local government entities.

The proposed mechanism would involve obligatory concentration of the primary accounts of local government entities in the Bank Gospodarstwa Krajowego, which would facilitate, e.g., monitoring and could bring benefits in the area of public finance sector debt and sources of financing. Apart from operations related to budget management of local government entities, the Bank Gospodarstwa Krajowego could thus also serve as an intermediary (agent) in the organization of so-called short-term financing of individual local government entities from the funds of other local government entities with available budget surpluses. Such operations would limit the generation of state public debt at a local government level. Transitional surpluses of local government entities could be utilized also to finance the borrowing needs of the state.

Additionally, in the event of placing all funds of local government entities (accounts and deposits) in the Bank Gospodarstwa Krajowego, the Bank could offer each local government entity an individual, flexible credit line, thus such entities would be able to repay credits taken out discretionarily from the held deposits¹⁵⁰.

¹⁴⁹ Since 1 January 2015, the Regulation of the Minister of Finance of 11 December 2014 regarding free funds of selected public finance sector entities accepted for deposit or management by the Minister of Finance (Official Journal (Dz.U.), item 1864) has been in effect.

¹⁵⁰ S. Skuza, *Legal conditions limiting fundraising capabilities of local self-government units. Status and original propositions concerning introduction of changes together with Bank Gospodarstwa Krajowego*, [in:] J. Gliniecka, E. Juchniewicz, T. Sowiński (ed.), *Finanse publiczne jednostek samorządu terytorialnego. Źródła finansowania samorządu terytorialnego we współczesnych regulacjach*, CeDeWu sp. z o.o., Warsaw 2014, p. 253.

Public procurement in relation to credits taken out by a local government entity

At this point, I believe that it is reasonable to draw attention to the national and EU regulations as regards the possibility for local government entities to take out credits in the context of the need to apply the public procurement procedure. In accordance with Article 10(f) of the Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (EU Official Journal L 94, 28.3.2014., p. 65, further amended), the provisions of this legal act do not apply to loans, regardless of whether they are associated with the issue, sale, purchase or disposal of securities or other financial instruments. The state legislator in the aforementioned regard has, however, strengthened the regulations in relation to local government entities. In accordance with Article 4.3(ja) of the Public Procurement Law of 29 January 2004 (Official Journal (Dz.U.) of 2017, item 1579, further amended), regulations of this act should apply to loans or credits, regardless of whether they are associated with the issue, sale, purchase or disposal of securities or other financial instruments, with the exception of credits taken out by the managing body of a local government entity within the boundaries of authorizations contained in the budget resolution.

Additionally, Article 264 of the Public Finance Act and Article 4.3(ja) of the Public Procurement Law refer only to credits according to the definition in Article 69 of the Banking Law, ignoring the financial instrument of a loan (listed separately by name in the Public Finance Act as well as the Public Procurement Law).

Below I present proposed provisions of Article 264.1–4 of the Public Finance Act:

*Legislative act
of ... 2019
regarding amendment the Public Finance Act*

In the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended), Article 264 is amended as follows:

- “Article 264. 1. Bank servicing of a local government entity’s budget shall be performed by the Bank Gospodarstwa Krajowego – independently or on the basis of concluded cooperation contracts with other domestic banks.*
- 2. The provision of servicing stipulated in paragraph 1 shall be free of charge.*
 - 3. The conditions of bank servicing shall be specified by a contract concluded between the managing body of a local government entity and the Bank Gospodarstwa Krajowego.*
 - 4. The decision-making body of the local government entity may authorize the management of a local government entity to deposit free budget funds on*

- accounts in banks other than the Bank Gospodarstwa Krajowego, in the form of a deposit with the Minister of Finance, or to conduct operations with the Bank Gospodarstwa Krajowego intended to lower the borrowing needs of local government entities or their costs.*
- 5. The managing body of a local government entity may, within its authorizations contained in the budget resolution, take out credits or loans according to the procedure stipulated in paragraphs 7–10.*
 - 6. In order to secure a credit or loan, it is not allowed to grant power of attorney to dispose of the bank account of a local government entity.*
 - 7. In the event of credits or loans stipulated in paragraph 5, a local government entity shall award such a contract in a transparent, objective and non-discriminatory manner.*
 - 8. On the Public Information Bulletin website, the local government entity shall publish an announcement of the contract stipulated in paragraph 3 containing information necessary given the circumstances of awarding such a contract, in particular:
 - 1) the deadline for submitting offers, taking into consideration the time needed to prepare and submit the offer;*
 - 2) description of the object and specification of the magnitude or scope of the contract;*
 - 3) offer assessment criteria.**
 - 9. Immediately upon awarding the contract stipulated in paragraph 7, the local government entity shall publish on the Public Information Bulletin website an announcement regarding the contract award, stating the name (company) or name and surname of the entity/person with whom it has concluded the contract in question.*
 - 10. In the event of not awarding a public contract, the local government entity shall immediately publish an announcement on the Public Information Bulletin website informing that the contract has not been awarded.”.*

Below (as a supplement) I present a proposal of Article 4.3(ja) of the Public Procurement Law:

*Legislative act
of ... 2019
regarding amendment of the Public Procurement Law*

*In Article 4.3 of the Public Procurement Law of 29 January 2004 (Official Journal (DzU.) of 2017, item 1579, further amended), point (ja) is amended as follows:
“ja) loans or credits, regardless of whether they are associated with the issue, sale, purchase or disposal of securities or other financial instruments in accordance with the definition of the Act on Trading in Financial Instruments of 29 July 2005”.*

Qualification principles for expenses arising from public-private partnership contracts concluded by local government entities

In the United Kingdom, France, Germany or Italy, the public-private partnership is a primary mechanism of financing investments in key infrastructure, including municipal infrastructure. In those countries, the performance of a large number of public-private partnership projects has become possible thanks to targeted decisions of governments, which consider this form of partnership as the most effective mechanism in the execution of significant infrastructural projects. Public-private partnership programs adopted at a government level are characterized by precise and transparent rules concerning risk allocation amongst partners, which enables the involvement of strategic and financial investors in the development of infrastructure.¹⁵¹

In Poland, despite a functioning legal framework of public-private partnership, the performance of local government infrastructural projects in the majority of instances utilizes the traditional system of investment financing. Without pointing to public-private partnership as the only method of making domestic infrastructural investments, I consider it reasonable to undertake actions in order to find solutions which would enable development of public-private partnerships within local government entities.

As presented in Chapter 2 of this study, Article 243 of the Public Finance Act specifies the method of calculating the individual debt repayment ratio of local government entities. The value of this ratio is significantly impacted by the qualification method for budget expenses of local government entities arising from public-private partnership undertakings (current or property expenses). In reference to the ratio of property expenses to current expenses, the Public Finance Act has implemented two principles important in the context of public-private partnership undertakings¹⁵²:

- 1) balancing the current budget of the local government entity (Article 242 of the Public Finance Act);
- 2) requirement to adhere to the individual debt repayment ratio (Article 243 of the Public Finance Act).

The individual debt repayment ratio is calculated in consideration of the arithmetic average of the ratio between current income increased by the income from property sales and reduced by current expenses to budget income overall. Therefore, the liabilities of the local government entity arising from public-

¹⁵¹ *Report – comparison of PPP support systems in selected countries*, Ministry of Economy, December 2013, pp. 3–5.

¹⁵² S. Skuza, *Legal conditions limiting fundraising capabilities...*, op. cit., p. 254.

private partnership contracts, which are included in the state public debt, have an impact on the individual debt repayment ratio.

In my opinion, the above provisions reduce the attractiveness of a public-private partnership undertaking from the perspective of local government entities. Due to the above, Article 236.4 of the Public Finance Act should be revised by adding a fourth point stating that property expenses also include expenses arising from the compensation of a private partner in connection with the performance of public-private partnership objectives¹⁵³.

Below I present proposed provisions of Article 236.4 of the Public Finance Act:

*Legislative act
of ... 2019
regarding amendment of the Public Finance Act*

In the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended), Article 264.4 is amended as follows:

“Article 236. 4. The property expenses plan shall distinguish, within the structure of sections and chapters, planned amounts of property expenses, which include expenses for:

- 1) investments and investment purchases, including financial programs involving funds stipulated in Articles 5.1.2 and 5.1.3, in the portion related to the performance of the objectives of a local government entity;*
- 2) purchase and acquisition of stocks and shares;*
- 3) contributions to commercial law companies;*
- 4) expenses associated with the compensation of a private partner in connection with the performance of public-private partnership contracts.”*

4.4. A self-developed draft act on solutions regarding liquidation of a municipality

What also appears important is the State Treasury’s responsibility for local government entities. Such entities have a legal personality and, similarly to, e.g., entities operating according to the Commercial Companies’ Code, may experience financial difficulties. It should be noted that the Public Finance Act does not regulate matters associated with the possible insolvency of local government entities. The omission of the aforementioned issue appears to be a result of the legislator assuming that a local government, similarly to the state,

¹⁵³ Ibidem, p. 255.

cannot become bankrupt as both of these public law relationships are state authorities¹⁵⁴. The above is confirmed by the provisions of Articles 6.1 and 6.2 of the Act on Bankruptcy Law of 28 February 2003 (Official Journal (Dz.U.) of 2017, item 2344, further amended). One may envision a circumstance in which a local government entity maintains an individual debt ratio at the statutory level, and despite this fact experiences insolvency issues (e.g. as a result of lower than expected inflow from local taxes or lack of liquidity). In my assessment, the state legal system should be supplemented with provisions concerning the State's liability for the possible insolvency of local government entities and special procedures in situations of local government entity insolvency¹⁵⁵.

The validity of these conclusions appears to be confirmed by the legislative initiative of the Council of Ministers regarding a draft act on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province¹⁵⁶.

The Ostrowice Municipality is one of the most indebted municipalities in Poland. Due to its financial condition, the Prime Minister, through a supervisory order dated 20 January 2016, established compulsory administration in the Ostrowice Municipality. According to the information from the Regional Audit Office in Szczecin, indebtedness of the Ostrowice Municipality at the end of 2016 was approx. PLN 38.5 mn, which constituted 360.8% of the planned income, while at the end of 2017 the municipality's debt was approx. PLN 46.9 mn, which is 437.3% of its income. The level of liabilities matured at the end of 2017 was approx. PLN 10.2 mn. According to the opinion by the Regional Audit Office in Szczecin, the Ostrowice Municipality has no prospects for improving its financial standing and, as a result, no capability of economic and social development. Due to the above, it is necessary to liquidate the municipality and incorporate its area into a neighboring municipality or municipalities. The proponent has, however, observed that current legal regulations are insufficient in this respect¹⁵⁷.

In 2017, a merger of the Ostrowice and Drawsko Pomorskie municipalities was considered, which – according to the currently applicable regulations – would result in the takeover of the liabilities of Ostrowice. However, concerns associated with taking over the debt by the Drawsko Pomorskie Municipality were reflected in a negative result of public consultation. It should be noted

¹⁵⁴ S. Skuza, *Bariery w zaciąganiu kredytów i pożyczek przez jednostki samorządu terytorialnego. Część II*, Bank i Kredyt nr 3/2003, p. 67.

¹⁵⁵ *Ibidem*, p. 67.

¹⁵⁶ Parliamentary Document no. 2650. The author originally intended to only draw attention to a lack of regulations governing local government entity insolvency. While writing this study, work commenced on a government draft of an act on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province. The above served as inspiration to draw up a draft of a general nature.

¹⁵⁷ Justification of the draft act on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province, p. 1.

that currently applicable provisions of the Public Finance Act do not, in essence, provide for the possibility of effective financial support from the state budget for a municipality taking over the debts of a liquidated one.

In accordance with Article 224.1 of the Public Finance Act, a local government entity may be granted a loan from the state budget if¹⁵⁸:

- 1) it is conducting or commencing recovery proceedings, and
- 2) an analysis of the recovery proceedings program shows that it is highly likely that:
 - a) the entity's financial situation will improve,
 - b) the performance of its statutory tasks will improve,
 - c) at the end of the year in which the loan is to be repaid, the rules specified in Articles 242–244 of the Public Finance Act are adhered to,
 - d) the entity repays its loan including interest.

Article 240a of the Public Finance Act indicates that a local government entity develops and passes a recovery proceedings program only based on a notice by the regional audit office. The said notice is directed to the local government entity in the event of the regional audit office concluding that simultaneously the entity is unable to pass a long-term financial prognosis or its budget, and is at risk of failing to pursue its public objectives¹⁵⁹.

The collateral for repayment of a loan granted by the State Treasury consists of *blank* promissory notes or a notary deed regarding submission for enforcement. The collateral covers at least 100% of the amount of liabilities arising from the loan agreement (capital and interest). It should be noted that in accordance with Article 224.2 of the Public Finance Act, the loan and interest are not subject to cancellation. Additionally, in the event of failure to repay the loan within the time specified in the loan agreement, the Minister of Finance may deduct the unpaid loan amount including interest from the general subsidy established for a given local government entity. The interest rate of the loan is ½ of the promissory note rediscount at the National Bank of Poland, however no less than 3% per year¹⁶⁰.

Legally available instruments such as the aforementioned loan from the state budget turned out to be insufficient and ineffective due to the budget situation of the Ostrowice Municipality. The proposed legislative solutions are intended to enable state institutions to effectively regulate the financial situation upon liquidation of the Ostrowice Municipality. The aim of the draft, therefore, is to¹⁶¹:

¹⁵⁸ *Information guide regarding loans from the state budget granted to local government entities as part of recovery and prudential proceedings*, Ministry of Finance, www.mf.gov.pl accessed on 06.07.2018.

¹⁵⁹ *Ibidem*.

¹⁶⁰ *Ibidem*.

¹⁶¹ Justification of the draft act on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province.

- 1) establish the legal basis for liquidation of the Ostrowice Municipality and incorporation of its territory into the neighboring municipality/municipalities without transferring the burden associated with servicing and payment of the Ostrowice Municipality's liabilities;
- 2) establish a catalog of the Ostrowice Municipality's liabilities and determine the procedures to satisfy the recognized debts.

Liquidation of the Ostrowice Municipality and its incorporation into neighboring municipality/municipalities would take place by way of a regulation by the Council of Ministers issued upon consultation with the inhabitants. In accordance with Article 5 of the European Charter of Local Self-Government, only the obligation of consulting inhabitants is provided for. Changes in the division of territory associated with liquidation of the Ostrowice Municipality would take place on 1 January 2019¹⁶².

The drafted legislative act explicitly indicates that the liabilities of the Ostrowice Municipality would not become the responsibility of municipalities which would take over the territory and property of the Ostrowice Municipality. The right to demand repayment of liabilities would be applicable only to creditors who bring their claims forward within the laid down 3-month period. After that time, liabilities which are not brought forward would expire by operation of law. No interest or other non-interest costs would accrue on the amounts arising from the municipality's liabilities following the its liquidation date. On the effective date of the act, court proceedings in progress related to liabilities towards the Ostrowice Municipality and enforcement proceedings regarding the municipality's property would be subject to cancellation by law; there would also be no possibility to initiate such proceedings. Responsibility for the liabilities of the Ostrowice Municipality generated prior to its liquidation would be taken over by the State Treasury, while the body representing the State Treasury regarding these liabilities would be the Governor of the Zachodniopomorskie Province (with support of the State Treasury Solicitors' Office of the Republic of Poland). The receivables of the Ostrowice Municipality would become receivables of the municipality which takes over the area where the municipal office of Ostrowice is located¹⁶³.

In the event of incorporation of the Ostrowice Municipality in more than one other municipality, the division of the calculated compensatory and balancing part of the general subsidy and income from its share of personal income tax would be proportional to the number of inhabitants of the given part of the incorporated area. On the other hand, the educational part of the general subsidy for the

¹⁶² Ibidem, p. 2.

¹⁶³ Ibidem.

municipality or municipalities into which the Ostrowice Municipality's area is incorporated would be calculated proportionally to educational objectives¹⁶⁴.

In my opinion, it is necessary to prepare an abstract (general) legislative draft act, not a specific draft relating to the legislatively specified municipality. Due to the above, based on the legislative draft on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province, I present such a draft act.

*Legislative act
of ... 2019
on solutions concerning liquidation of a municipality*

Article 1. 1. If, in the opinion of the regional audit office, a municipality has permanently lost its ability to meet its financial obligations, the Council of Ministers, by a regulation, shall liquidate the municipality (liquidated municipality).

2. The Council of Ministers in the regulation stipulated in paragraph 1 shall establish the boundaries of the municipality or municipalities in which the area of the liquidated municipality is incorporated, taking into consideration the settlement and spatial system, social, economic and cultural bonds and the ability to pursue public objectives in the said municipality or municipalities.

3. Liquidation of a municipality and determination of the boundaries of the municipality or municipalities stipulated in paragraph 2 shall take place on the 1st of January of the year following the issue of the Council of Ministers' regulation stipulated in paragraph 1, hereinafter referred to as the "liquidation decision year".

4. The issue of the regulation stipulated in paragraph 1 requires consultation with inhabitants of the municipality or municipalities mentioned in paragraph 2. Such consultation shall be conducted by the appropriate municipal body.

5. The appropriate municipal body shall provide the minister in charge of matters of public administration with information regarding the results of the consultation mentioned in paragraph 4.

6. Article 4a.4 of the Municipal Self-Government Act of 8 March 1990 (Official Journal (Dz.U.) of 2018, item 994, further amended) shall apply accordingly.

Article 2. 1. The property of the liquidated municipality shall be by law acquired by the municipality or municipalities stipulated in Article 1.2 on the 1st of January of the year following the liquidation decision year.

2. The provincial governor having jurisdiction over the liquidated municipality, hereinafter referred to as the "governor", shall issue a ruling on the acquisition

¹⁶⁴ Ibidem p. 5.

- of real estate which comprises the property mentioned in paragraph 1, by an administrative decision.*
- 3. The body of higher instance regarding the decision stipulated in paragraph 2 shall be the minister in charge of matters of public administration.*
 - 4. The district governor having jurisdiction over the liquidated municipality shall provide the governor, free of charge, with the documentation necessary to issue the administrative decision stipulated in paragraph 2.*
 - 5. Transfer of movable property to the municipality or municipalities whose boundaries have been established in connection with the liquidation of the municipality shall take place on the 1st of January of the year following the liquidation decision year, based on acceptance protocols drawn up no later than until the 31st of December of the liquidation decision year by the person specified in Article 16.2 hereof.*

Article 3. 1. The municipality or municipalities which have acquired the liquidated municipality's property shall not be responsible for its liabilities.

- 2. Liabilities of the liquidated municipality generated prior to its liquidation shall be the responsibility of the State Treasury, represented by the governor.*
- 3. Liabilities of the liquidated municipality existing on the 31st of December of the liquidation decision year are satisfied from state budget funds, in the part at the disposal of the governor.*
- 4. Receivables of the liquidated municipality shall become receivables of the municipality stipulated in Article 1.2 into which the area of the liquidated municipality's office is incorporated.*
- 5. Monetary funds accumulated on bank accounts of the liquidated municipality, according to the state as of the 31st of December of the liquidation decision year, shall become the funds of the municipality stipulated in Article 1.2 into which the area of the liquidated municipality's office is incorporated.*
- 6. Monetary funds accumulated on bank accounts of organizational units of the liquidated municipality, according to the state as of the 31st of December of the liquidation decision year, shall become funds of corresponding organizational units of municipalities into which the area of the office of the specific organizational unit is incorporated.*

Article 4. 1. Amounts of unpaid taxes including interest due to delays, payable to the liquidated municipality, arising from property tax, agricultural tax and forestry tax shall become the income of the municipality or municipalities stipulated in Article 1.2 into which the area of a specific taxed property is incorporated.

- 2. Amounts of unpaid taxes including interest due to delays, payable to the liquidated municipality, arising from taxes on means of transport shall become the income of the municipality or municipalities stipulated in Article 1.2 into which the*

place of residence or registered office of the specific taxpayer is incorporated, and in the case of an enterprise consisting of several establishments or an entity consisting of separate organizational units, the said taxes shall become the income of the municipality or municipalities stipulated in Article 1.2 into which the location of the establishment or organizational unit owning the taxed means of transport is incorporated.

3. The rules stipulated in paragraphs 1 and 2 shall apply to the obligations associated with return of overpayments including interest.
4. Receivables of the liquidated municipality due to unpaid stamp duty and license fees including interest, as well as the obligation to return excess payments or return the aforementioned payments, shall be taken over by the municipality into which the area of the liquidated municipality's office is incorporated.
5. Amounts arising from unpaid inheritance tax and tax on civil law transactions including interest attributable to the liquidated municipality shall not be transferred to the municipalities stipulated in Article 1.2, and shall constitute income of the state budget. The State Treasury shall take over liabilities of the liquidated municipality arising from overpayments and obligation to return tax on civil law transactions as well as inheritance tax not repaid.

Article 5. Matters concerning property tax, forestry tax and agricultural tax on properties located in the area of the liquidated municipality:

- 1) initiated, but not reviewed by the 31st of December of the liquidation decision year by the head of the liquidated municipality,
- 2) resolved by the head of the liquidated municipality by a final decision,
- 3) in the area of verification activities and tax inspection, initiation of proceedings
 - shall be taken over and pursued by tax authorities of the municipality or municipalities stipulated in Article 1.2 into which the area of the taxed property is incorporated.

Article 6. Matters regarding tax on means of transport payable to the liquidated municipality:

- 1) initiated, but not reviewed by the 31st of December of the liquidation decision year,
- 2) resolved by a final decision,
- 3) in the area of verification activities and tax inspection, initiation of proceedings
 - shall be taken over and pursued by tax authorities of the municipality or municipalities stipulated in Article 1.2 into which the place of residence or registered office of the specific taxpayer is incorporated, and in the case of an enterprise consisting of several establishments or an entity consisting of separate organizational units – into which the location of the establishment or organizational unit owning the taxed means of transport is incorporated.

Article 7. 1. The provincial governor within 14 days of the municipality liquidation date shall call upon the creditors of the liquidated municipality, in the form of an announcement published on the provincial office website, to submit their claims.

2. The creditors of the liquidated municipality submit their claims to the governor within 3 months from the publication date of the notice stipulated in paragraph 1.

1. Claims not submitted within the aforementioned time shall expire.

3. The claim submission must contain:

1) the name and surname or business name of the creditor and, respectively, their place of residence or registered office, address and PESEL number or the number in the National Court Register, and in the event of unavailability of the above, other data enabling clear identification;

2) specification of the claim including additional receivables and value of non-cash claims;

3) evidence confirming the existence of the receivable;

4) collateral associated with the receivable;

5) status of the case if there is a judicial, administrative, administrative court or amicable court proceeding regarding the receivables.

Article 8. 1. The governor, no earlier than 12 months and no later than 15 months following liquidation of the municipality, in the event of recognizing the claims submitted in a timely manner, shall provide the creditor with information containing specification of the receivable and specification of the amount attributable to a given creditor.

2. The creditor may put forward objections regarding the information stipulated in paragraph 1 within 14 days from delivery of the said information to a district court having jurisdiction over the seat of the governor.

3. The said objections should fulfill the formal requirements of procedural documents and, additionally, should indicate the receivable in question and contain a petition as to the acknowledgement of or denial to acknowledge the receivable with justification and specification of supporting evidence.

4. One fifth of the court fee shall be charged in relation to objections.

5. If the objections do not fulfill the requirements specified in paragraph 3 or the applicable fee has not been paid, Article 130 of the Civil Procedure Code of 17 November 1964 (Official Journal (Dz.U.) of 2018, item 155, further amended) shall apply accordingly. The court shall reject objections brought forward after the expiry of the aforementioned deadline or inadmissible for other reasons, as well as objections whose deficiencies have not been rectified by the party, or objections for which the submitting party has not paid the applicable fee within the specified time.

6. The governor shall pay the amount attributable to the creditor immediately upon:

- 1) expiry of the objection submission deadline, in the event of non-submission of objections;
- 2) legally valid review of the objections by a court.

Article 9. 1. In reference to the financial receivables generated and not expired by the 31st of December of the liquidation decision year, due to a creditor being a body of the liquidated municipality, the new creditor shall be the corresponding body of the municipality into which the area of the liquidated municipality encompassing the place of residence or registered office of the debtor is incorporated. The body of the municipality into which the area of the liquidated municipality encompassing the place of residence or registered office of the debtor is incorporated shall assume the rights and obligations of the corresponding body of the liquidated municipality as creditor.

2. *In reference to the financial receivables generated and not expired by the 31st of December of the liquidation decision year, arising from property, forestry and agricultural tax, due to a creditor being a body of the liquidated municipality, the new creditor shall be the corresponding body of the municipality into which the area of the liquidated municipality encompassing the entirety or larger part of the taxed property is incorporated. The body of the municipality into which the area of the liquidated municipality encompassing the entirety or larger part of the taxed property is incorporated shall assume the rights and obligations of the corresponding body of the liquidated municipality as creditor.*
3. *Any sent notices, enforcement instruments, decisions containing the position of a body of the liquidated municipality and other actions of this body taken as part of an enforcement proceeding initiated in accordance with the Enforcement Proceedings Act of 17 June 1966 (Official Journal (Dz.U.) of 2017, item 1201, further amended) shall remain valid.*
4. *The proceeding regarding the position of a body of the liquidated municipality as a creditor, initiated in accordance with Article 34, 54 or 59 of the act mentioned in paragraph 3, and not concluded prior to the 31st of December of the liquidation decision year, shall continue to be conducted by the corresponding body of the municipality which receives the area of the liquidated municipality which, respectively, encompasses:*
 - 1) *the place of residence or registered office of the debtor;*
 - 2) *the entirety or larger part of the taxed property, in the case of recovery of financial receivables arising from property, forestry and agricultural tax.*

Article 10. 1. In an enforcement proceeding conducted on the basis of an enforcement instrument issued by a body of the liquidated municipality and not concluded prior to the 31st of December of the liquidation decision year, the creditor shall be the corresponding

body of the municipality into which the area of the liquidated municipality encompassing the place of residence or registered office of the debtor is incorporated.

2. 1. In an enforcement proceeding conducted on the basis of an enforcement instrument covering financial receivables arising from property, forestry and agricultural tax issued by a body of the liquidated municipality and not concluded prior to the 31st of December of the liquidation decision year, the creditor shall be the corresponding body of the municipality into which the area of the liquidated municipality encompassing the entirety or larger part of the taxed property is incorporated.

Article 11. The appropriate body of the municipality which receives the area of the liquidated municipality encompassing, respectively:

- 1) the place of residence or registered office of the debtor,
- 2) the entirety or larger part of the taxed property in the event of recovery of financial receivables arising from property, forestry and agricultural tax
 - shall represent the creditor in judicial and administrative proceedings initiated in connection with an enforcement proceeding conducted based on an enforcement instrument issued by the body of the liquidated municipality prior to the 31st of December of the liquidation decision year and concluded prior to this day.

Article 12. The enforcement body conducting the enforcement proceeding initiated on the basis of an enforcement instrument issued by the body of a liquidated municipality shall notify the debtor of the creditor change upon the first action taken towards the debtor.

Article 13. Following the municipality liquidation date, no interest on or non-interest costs of monetary amounts arising from liabilities burdening the liquidated municipality shall be charged.

Article 14. 1. In matters of liabilities and receivables of the liquidated municipality, the State Treasury Solicitors' Office of the Republic of Poland shall hold procedural substitution for the State Treasury in front of common courts, amicable courts and the Supreme Court, and shall take part in negotiations and mediations.

2. The State Treasury Solicitors' Office of the Republic of Poland and the municipality or municipalities stipulated in Article 1.2, as well as the Regional Audit Office having jurisdiction over the liquidated municipality, shall grant the governor, at their request, the necessary aid in performance of objectives specified in the legislative act, in particular – present opinions, provide information and documentation.

Article 15. On the effective date of the act:

- 1) *the court proceedings in progress in relation to liabilities towards the liquidated municipality and enforcement proceedings regarding the property of the said municipality shall be subject to cancellation by law;*
- 2) *it shall be inadmissible to initiate proceedings stipulated in subparagraph 1 above;*
- 3) *it shall be inadmissible to burden property constituents of the liquidated municipality with limited property rights.*

Article 16. 1. On the effective date of the regulation stipulated in Article 1.1, bodies of the liquidated municipality shall be subject to dissolution and the terms of office of the head and council members of the municipality shall expire.

2. *The objectives and competences of the liquidated municipality's bodies, up to its liquidation, shall be pursued and exercised by a person appointed by the Prime Minister at the request of the governor, submitted via the minister in charge of matters of public administration.*
3. *No local government elections ordered on the basis of Article 371 of the Election Code Act of 5 January 2011 (Official Journal (Dz.U.) of 2018, item 754, further amended) shall be held in the liquidated municipality.*

Article 17. 1. The existing decision-making bodies of the municipality or municipalities stipulated in Article 1.2 shall continue to hold their functions until the 31st of December of the liquidation decision year, while executive bodies of such municipality or municipalities shall continue to hold their functions until the takeover of responsibilities by a newly elected municipality head, mayor or city president.

2. *Elections to bodies of the municipality or municipalities stipulated in Article 1.2, within the new boundaries, shall be conducted together with the elections ordered on the basis of Article 371 of the Election Code Act of 5 January 2011.*
3. *In the circumstances stipulated in paragraph 2, the election commissioner shall divide the area of the municipality or municipalities the boundaries of which have been established in connection with the liquidation of a municipality into election wards or voting circuits and create separate voting circuits.*
4. *The term of the municipality head, mayor or city president, council members and councils chosen in the elections stipulated in paragraph 2 shall expire on the expiry date of the terms of councils chosen in elections ordered in accordance with Article 371 of the Election Code Act of 5 January 2011.*
5. *The first council session of the municipality or municipalities stipulated in Article 1.2 shall be convened by the election commissioner on a date within 7 days from the establishment of boundaries of the said municipality or municipalities.*

Article 18. 1. The municipality or municipalities stipulated in Article 1.2 shall assume the rights and obligations of the liquidated municipality, within the incorporated area, arising from permits, licenses and other administrative acts.

- 2. The appropriate bodies or parties to initiated and uncompleted administrative and judicial proceedings on matters concerning the liquidated municipality, excluding matters stipulated in Articles 3.2 and 3.4, following its liquidation shall be corresponding bodies of the municipality or municipalities stipulated in Article 1.2.*
- 3. In matters of local law acts established by bodies of a liquidated municipality, Article 4eb.2.1 of Municipal Self-Government Act of the 8 March 1990 shall apply accordingly.*
- 4. Local law acts passed until the 31st of December of the liquidation decision year in accordance with the Agricultural Tax Act of 15 November 1984 (Official Journal (Dz.U.) of 2017, item 1892, further amended), the Local Taxes And Fees Act of 12 January 1991 (Official Journal (Dz.U.) of 2017, item 1785, further amended) and the Forestry Tax Act of 30 October 2002 (Official Journal (Dz.U.) of 2017, item 1821, further amended) by bodies of the municipality or municipalities stipulated in Article 1.2 shall also apply in the incorporated area of the liquidated municipality.*

Article 19. 1. Employees hired at the office of the liquidated municipality as of the 1st of January of the year following the liquidation decision year shall become employees of the municipal office into which the area encompassing the liquidated municipality's office is incorporated. Article 43c of the Local Government Employees Act of 21 November 2008 (Official Journal (Dz.U.) of 2016, item 902, further amended) shall apply accordingly.

- 2. Organizational entities of the liquidated municipality, excluding the municipal office, shall become organizational entities of the municipality into which the area encompassing the office of the given entity is incorporated.*

Article 20. The municipality stipulated in Article 11.1 shall become a party to contracts and agreements concluded on the basis of Article 206 of the Public Finance Act of 27 August 2009 (Official Journal (Dz.U.) of 2017, item 2077, further amended, which the liquidated municipality has been a party to.

Article 21. 1. The decision-making body of the municipality or municipalities into which the area of the liquidated municipality is incorporated shall pass a budget resolution no later than by the 28th of February of the year following the liquidation decision year.

- 2. The deadlines associated with establishing the budget, as mentioned in Article 240.3 of the Public Finance Act of 27 August 2009 shall be postponed by 30 days.*

Article 22. The liquidated municipality does not prepare a draft of or pass a budget resolution for the year following the liquidation decision year or long-term financial prognoses for the year following the liquidation decision year and subsequent years.

Article 23. 1. The annual planned amount of the educational part of general subsidies for the year following the liquidation decision year shall be allocated to the municipality into which the area of the liquidated municipality has been incorporated, or shall be divided between municipalities into which the area of the liquidated municipality has been incorporated, proportionally to the established educational objectives.

2. In the liquidation decision year, Article 34.1.1 of the Local Government Entity Income Act of 13 November 2003 (Official Journal (Dz.U.) of 2017, item 1453, further amended) shall not apply to the liquidated municipality as regards the educational part of general subsidies for the year following the liquidation decision year.

Article 24. 1. The annual planned amount of the compensatory and balancing part of general subsidies for the year following the liquidation decision year for the liquidated municipality shall be allocated to the municipality into which the area of the liquidated municipality has been incorporated, or shall be divided between municipalities into which the area of the liquidated municipality has been incorporated, proportionally to the number of inhabitants.

Article 25. The annual planned share of revenues from personal income tax calculated for the year following the liquidation decision year for the liquidated municipality shall be allocated to the municipality into which the area of the liquidated municipality has been incorporated or shall be divided between municipalities into which the area of the liquidated municipality has been incorporated, proportionally to the number of inhabitants.

Article 26. General subsidies, the share of revenues from personal income tax, and the share of revenues from company income tax, in the scope not regulated by this legislative act, shall be governed by provisions of the Local Government Entity Income Act of 13 November 2003.

Article 27. 1. The head of the municipality or a person authorized by them shall conduct settlements, including subsidies, draw up reports and other documents required by legal regulations, concerning the liquidated municipality within the legally defined timeframes.

2. Liabilities of the liquidated municipality including interest for delayed payments and its liabilities arising from receivables stipulated in Article 60.1 of the Public Finance Act of 27 August 2009, which constitute state budget income, shall be cancelled.

Article 28. The governor or a person authorized by them shall be responsible for the performance of obligations in the area of accounting, budget and financial reporting

of the liquidated municipality, arising from accounting and budget and financial reporting regulations.

Article 29. The act shall become effective 14 days following its announcement.

Similar solutions, in my opinion, may be also applied to districts; however, it is difficult to imagine a procedure for liquidating a province.

In parallel to the above legislative changes, it would be necessary to conduct work on increasing the *ex ante* monitoring of the financial situation of local government entities. The rationale for my conclusions on the aforementioned subject matter may be confirmed by the example of French government actions. At the beginning of the 1990s, certain French municipalities were practically on the verge of bankruptcy. The central administration made the decision to design an alert system intended to inform of the financial condition of local government entities. Joint actions of the Interior Ministry and the Ministry of Finance led to an annual report on the financial condition of local government entities using a set of seven financial indicators. Four of those indicators related to the amount of debt, two – to operating costs, while one was the measure of income. The alert system is exclusively intended for internal use by the government administration – the intent of the system creators was not its broad application, specifically in a commercial manner¹⁶⁵.

In 1992, the French Interior Ministry and Ministry of Finance jointly approved the alert system in the area of local government entity finances. The components of the French alert system are¹⁶⁶:

I. Debt ratios:

F1: overall debt / overall income

F2: debt servicing / overall income

F3: [operating costs (including costs of debt servicing) and repayment of capital installments] / overall income

F4: weighted average of the F1 ratio from 3 years

II. Operating cost ratios:

F5: salaries and debt servicing costs / overall operating costs

F6: overall operating costs per 1 inhabitant

III. Income ratios:

F7: weighted average of four primary local taxes / combined taxation basis

In the material “Indebtedness of the local government and financial monitoring in Poland” of July 1999 provided to the Ministry of Finance, its authors (J. Petersen and V. Chomenowski) proposed the adoption of the French

¹⁶⁵ J. Petersen, V. Chomenowski, *Zadłużenie samorządu terytorialnego i monitoring finansowy w Polsce*, material for the Ministry of Finance, Government Finance Group under a contract with Development Alternatives Inc., July 1999, pp. 31–32.

¹⁶⁶ *Ibidem*, pp. 32–33.

alert arrangement by the Polish financial system of local governments. In my opinion, it would be justified to adopt a similar solution in relation to Polish local government entities. It seems reasonable to conclude that better *ex ante* monitoring enables a more effective reaction of supervisory bodies.

4.5. Summary

1. A revision of the Polish Constitution and the Public Finance Act in the direction presented in this chapter would, in my opinion, be an important step towards successful development of local government entities in Poland. The deliberations presented in this chapter should direct Polish legislative solutions towards a reduction of restrictions.
2. From a macroeconomic perspective, an increase in the debt of local government entities is not viewed as a positive phenomenon – debts of a local government entity contribute to an increase in the state public debt. On the other hand, from a microeconomic perspective, incurring debt may be evidence of the entity's dynamic growth.
3. The most important and urgent, and thereby relatively the simplest, action, would be to limit qualitative barriers. The aforementioned changes would make it possible to get rid of legal restrictions to the possibility for local government entities to incur debt, improve or, in certain instances, even enable a strategy of local government debt management, while simultaneously limiting an excessive debt increase. When maintained at a safe level, the debt of local government entities may result in dynamic growth of individual entities.
4. The example of the Ostrowice Municipality also confirms the need to undertake a legislative initiative in order to regulate the issue of local government entity insolvency. The above solution should be a systemic, not a special, one (as is in the case of the legislative draft on special solutions for the Ostrowice Municipality in the Zachodniopomorskie Province).
5. The currently centralized system of liquidity management of public finance sector entities (consolidation) applies primarily to government administration entities, which are obliged to temporarily provide their free funds to be managed by the Minister of Finance. The adoption of my proposed solutions regarding the location of bank accounts and consolidation of the funds of local government entities would have a positive impact on the public finance sector (borrowing needs and debt servicing costs). The Bank Gospodarstwa Krajowego in subjective and objective terms appears to be the appropriate partner for local government entities.

Conclusion

The subject matter of legal restrictions in the area of debts incurred by local government entities presented in this study, in my opinion, justifies the purposefulness and also necessity of implementing systemic changes. Presently, concerns regarding excessively high indebtedness of local government entities appear to be exaggerated and constitute only an informal element of pressure relating to increasing the state public debt. The State Treasury debt and costs of its servicing incomparably exceed those of its local government counterparts; however, there are no restrictions in this instance, in particular of a qualitative nature. A much bigger issue for the local government, nonetheless, is ensuring appropriate funds in order to meet the legislatively established objectives.

Poland's interwar experiences with excessive debt of local government entities certainly discourage the implementation of solutions based on a lack of limitations to incurring and repaying debts of local government entities. In my assessment, the most important and urgent, and simultaneously simplest, action should be to reduce the qualitative barriers concerning liabilities incurred by local government entities.

Consolidation of the funds of local government entities at the Bank Gospodarstwa Krajowego would have a positive impact on facilitating short-term liquidity of local government entities, while abolition of qualitative limitations and a change in the classification of expenses covering parts of payments within public-private partnership contracts would be significant in the case of acquisition of long-term financing related to investment project performance. I am aware of the possible criticism from advocates of restricted possibilities for local government entities to incur liabilities and, thereby, state public debt. It should be noted, however, that the validity of my conclusions may be confirmed by the example of French solutions. The financial difficulties of French local government entities at the beginning of the 1990s were not addressed by legislative and executive bodies through increased sanctions and limitations to the possibility of incurring debt. The restructuring of insolvent local government entities, however, involved primarily a renegotiation of repayment terms of individual liabilities and aid from the state through temporary increases of the local government entity's income, with simultaneously strengthened monitoring

of the financial situation of local government entities by the French central authorities. A natural partner of the government and regional audit offices as regards strengthening the monitoring of the financial situation of Polish local government entities appears to be the Bank Gospodarstwa Krajowego.

Arguments presented in this study constitute, in my opinion, sufficient material to implement the proposed changes. At this point, I should rely on the Reader's understanding and good will in assessing my intentions.

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