

# **PROGRAM FOR RESTRUCTURING OF PUBLIC FINANCES OF POLAND**

June 5, 2003

<a href="#"><u>Introduction</u></a> .....	5
<a href="#"><u>Chapter I</u></a> .....	7
<a href="#"><u>The basic macro proportions of economic development</u></a>	7
<a href="#"><u>Chapter II</u></a> .....	13
<a href="#"><u>Public Finance and the European Union accession</u></a> .....	13
<a href="#"><u>Chapter III</u></a> .....	18
<a href="#"><u>The state budget</u></a> .....	18
1. <a href="#"><u>The condition for implementation of the state budget</u></a> .....	18
2. <a href="#"><u>The rules of construction of the state budget in the years 2004-2007</u></a> .....	19
2.1 <a href="#"><u>Pro-development impulses</u></a> .....	20
2.2 <a href="#"><u>Decentralisation</u></a> .....	21
2.3 <a href="#"><u>Structuring the method for the expenditure calculation and the budget presentation</u></a> .....	21
3. <a href="#"><u>State budget revenues in the years 2004-2007</u></a> .....	22
4. <a href="#"><u>State budget spending in the years 2003-2007</u></a> .....	23
5. <a href="#"><u>The state budget deficit in the years 2003-2007</u></a> .....	26
<a href="#"><u>Chapter IV</u></a> .....	29
<a href="#"><u>Income of the local government units</u></a> .....	29
I <a href="#"><u>General purposes</u></a> .....	29
II <a href="#"><u>Basic systemic solutions – the final model</u></a> .....	29
III <a href="#"><u>Basic systemic solutions – transitional model</u></a> .....	30
<a href="#"><u>Chapter V</u></a> .....	40
<a href="#"><u>State-owned extra budgetary funds and State Treasury agencies</u></a> .....	40
I <a href="#"><u>State-owned extra budgetary funds</u></a> .....	40
II <a href="#"><u>State Treasury agencies</u></a> .....	42

<u>Chapter VI</u> .....	45
<u>Independent public institutions of healthcare (ZOZ)</u> .....	45
<u>Chapter VII</u> .....	46
<u>Higher education and science units</u> .....	46
I <u>Higher education</u> .....	46
II <u>Research and development institutes</u> .....	47
<u>Chapter VIII</u> .....	48
<u>Tax system and legal public levies</u> .....	48
I <u>Tax system</u> .....	48
1. <u>Income taxes</u> .....	48
1.1. <u>Personal income tax (PIT) and corporate income tax (CIT)</u> .....	49
1.2. <u>Simplified taxation methods</u> .....	52
1.3. <u>Farmers income tax</u> .....	52
1.4. <u>Capital income taxation</u> .....	54
2. <u>Indirect taxes</u> .....	56
2.1. <u>Value added tax</u> .....	56
2.2. <u>Collection system of excise tax</u> .....	56
3. <u>Real estate value tax</u> .....	57
II. <u>Public levies</u> .....	58
<u>Chapter IX</u> .....	61
<u>Long-term instruments of budget offsetting</u> .....	61
I. <u>New solutions in the scope of special purpose funds</u> .....	61
II. <u>Greater elasticity of state budget spending</u> .....	62
III. <u>Improvement of tax collection</u> .....	63
IV. <u>Other possibilities for budget reinforcement in 2004-2006</u> .....	65
V. <u>Liquidation of some institutions</u> .....	67
<u>Chapter X</u> .....	68
<u>Financial instruments</u> .....	68

<a href="#"><u>X.1.General assumptions</u></a> .....	68
<a href="#"><u>X.2. Investments funds</u></a> .....	69
<a href="#"><u>X.3. Securitization</u></a> .....	70
<a href="#"><u>Inestors</u></a> .....	72
<a href="#"><u>X.4. Sureties and guarantees</u></a> .....	74
<a href="#"><u>1. Sureties and guarantees issued by the State Treasury</u></a> .....	74
<a href="#"><u>2. Sureties for the small and medium-sized enterprises</u></a> .....	76
<a href="#"><u>X.5. Public-private partnership</u></a> .....	77
<a href="#"><u>X.6. Gaining the funds from the Open Pension Funds (OFE)</u></a> .....	78
<a href="#"><u>Chapter XI</u></a> .....	80
<a href="#"><u>Financial Discipline</u></a> .....	80
<a href="#"><u>Chapter XII</u></a> .....	84
<a href="#"><u>Methodological adjustments to international norms</u></a> .....	84
<a href="#"><u>I Own resources</u></a> .....	84
<a href="#"><u>II Incomes, revenues, expenditures and outlays</u></a> .....	84
<a href="#"><u>III Financial flows from EU’s structural funds and cohesion fund</u></a> .....	84
<a href="#"><u>IV Standardizing of budgetary accounting regulations</u></a> .....	85
<a href="#"><u>V Standardizing the rules of reporting</u></a> .....	85
<a href="#"><u>Chapter XIII</u></a> .....	87
<a href="#"><u>Abandonment of restoration of public finance – scenario of economic stagnation, financial and socio- economic crisis</u></a> .....	87

## Introduction

Poland is in a need of reform – and to an extent even a reconstruction – of the public finance system. This is a matter of a common consensus. The awareness is wide spread, that a too large portion of our common money is not used effectively and sometimes even wasted.. This must not be continued, and it is not a matter if the country can withstand it only for one more year or three.

Herewith, in the ongoing discussions the question is not IF the state of things should be changed but HOW it should be done.

Such discussions have been held since the beginning of the Polish transformation, when due to its radical approach, quite often ad hoc measures had to be taken – in order to temporarily ease the social tensions. This led inevitably to complication of the situation of the public finance sector and an escalation of the expenditures.

The presented Public Finance Reform Program – of which outlines are accepted by the government – will constitute a foundation for the development of Poland based on four pillars. These are:

- fast economic growth,
- fair division of the effects of the growth,
- maximizing the profits of the European integration,
- increasing the effectiveness of the state in everything which concerns its finance and economy.

This will require acceptance of many challenges. These are:

- construction of foundations to restart a path of fast economic growth to the levels of the time of “the Strategy for Poland” (1994-97) through facilitating such budget construction for 2004 and the coming years, which will ensure proper macroeconomic basis for a stable development. Clear signs of accelerating growth are visible, but holding on to this path will be only possible through implementation of the Program;
- increase of the independence and enhancing the position of the local governments;
- enabling absorption and best possible use of European assistance funds and hereby assuring a positive political climate for EU accession and a favorable flow of funds between Poland and the EU;
- acceleration of programs which are being implemented on unsatisfactory scale: Economic The Government Strategy for Entrepreneurship-Development-Employment, the Anti-corruption Strategy, and the National Development Plan. The full implementation of these programs is disturbed not only by bureaucratic indolence and incorrect co-ordination mechanisms, but also by tensions within the public finance system. Therefore the Public Finance Reform Program together with the other programs will have a positive effect on the development of entrepreneurship and the growth of employment.

The starting point for the construction of the Program are macroeconomic assumptions for 2004-2007, which assume the return to the path of fast GDP growth of 6% in 2006-2007. Only continuous growth pace, which exceed 5% will allow for reduction of the distance between Poland and most developed countries in Europe.

The most important factors, which will enable the growth are as follows:

- dynamic export;
- increase of investment;
- increase of consumption – through return effects of the improving living standard of the society on the economic growth.

The stimulation of the investment activities is crucial for the Polish economy, because it will simultaneously lead to an increased employment and an enhanced competitiveness of our products. The EU accession provides an extra stimulus to these activities because it opens up the chance to use about PLN 63 billion from the Structural Funds, the Cohesion Fund and the means of the Common Agricultural Policy. Never in the history has our country had a chance for such a large capital inflow. The condition for use of these funds is putting forward co-financing, preparation of projects and programs which will be accepted by the EU and creation of a system for efficient administration of the EU funds.

The program stipulates a solution which is a qualitative and substantial reduction of CIT, which is also a result of the consultations which the Program was subject to before shaping its final form. By the replacement of the current 27% rate of CIT by the low 19% rate, the entrepreneurs will stay with PLN 4.5 billion more than now. This means a substantial injection of investment means.

Furthermore, the PFRP provides a solution, which reduce the tax burden for the low income earners by PLN 1.4 billion per year, which means that this money will leave this sum in their pockets thanks to the introduction of the lowest tax rate of 17%.

However, the above demand impulses have to be compensated by the removal of tax exemptions and relieves – with just a couple of socially justified exclusions such as the relief for lone parents and a common marital taxation. A matter, which does not need further explanations is that the rights already possessed have too be preserved up till their cease.

A liquidation of the separation of the category of agricultural producers, combined with taking into account the specific nature of the sector in the agricultural tax, serves the equalization of the rights and duties of the citizens.

The Public Finance Reform Program sets out the limits for government engagement showing the necessary changes in the expenditure/revenue system and the rules for management of public funds. At the same time, the limitations have been taken into the account regarding the extensive budget deficit and fast growing public debt. It is undisputable that in the coming years the economy will need a larger pool of state guaranties and sureties (about 2% of GDP per year). Therefore the public debt must not exceed 55% of GDP, which results from the prudential procedures foreseen by the law, which prohibit the increase of the ratio of debt to GDP after exceeding that limit.

The local government entities play an important role in the efficient use of the EU funds. The Program proposes solutions which aim to increase the resources which those entities can govern independently, which creates basis for economizing the co-financing of the projects. That is thanks to an increased portion of direct taxes which will stay with the local governments.. These activities should not only strengthen the economy but also improve the efficiency of its functioning and enhance the social ties. The strengthening of the financial position of the local governments will be favorable for the institutions, the citizen society and will serve the local democracy.

The necessary steps for increasing the development chances for the economy and the return to the path of fast growth will include the removal of automatic valorization and indexation mechanisms as well as liquidation of some funds, agencies and special purpose resources.

The Public Finance Reform Program is an initiative which can become a coordinating mechanism for all ongoing initiatives aiming to realizing the targets and tasks, set out in the beginning of the term in the Election Program of the SLD-UP government and in the exposé of the Prime Minister. An effective and active realization of the PFRP will be facilitated by a proper social agreement between the employers, employees, local governments and representatives of socio-economic groups in the society. The importance of such an agreement must not be underestimated, since the realization of the program requires preparation and adoption of an over a dozen acts. Already 10 of those are in the final stage of construction.

It has to be pointed out that the final form of the Program has taken a considerable impact from the consultations with various organizations and social groups as well as from the commentaries put forward by the citizens on the Ministry of Finance web site.

The name of the Program relates to a repair of the state finances. However only part of it constitutes of repairing. This relates to the clearing of the system from old accretions such as various relieves and indexation wherever it is possible. A similar nature has the elimination of solid mechanisms of the expenditure assessment, flexible budget policy, which consider the real economic and social needs. Reform activities also consist without a doubt of sharpening of consequences of abuse of the financial discipline. The proposed tax measures and further decentralization of the public finance are of reform nature.

In general, the Public Finance Reform Program will serve the development of Poland which will be base on sound economic and financial rules, which will fully allow to use the chance which Poland stands afore.

## **Chapter I**

### **The basic macro proportions of economic development**

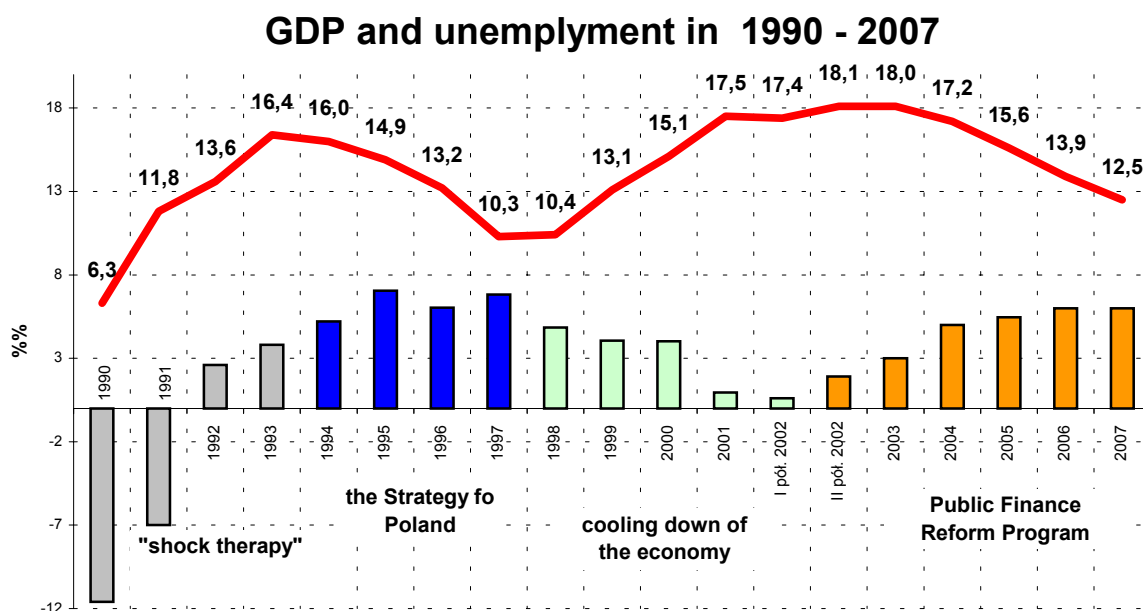
1. Despite the unfortunate cooling down of the economy during 1999-2001 – which has taken its price in the form of economic stagnation and a dramatic rise of unemployment as well weakening inclination to invest – the Polish economy still has the potential of human capital and unused production capacity. Therefore the return fast is not only desirable but also possible.

A way of achieving a sustainable and dynamic growth is to increase the investment and to stimulate the export. Both processes can seriously be intensified by the EU accession.. The European market as well as sources of capital are opening up for the Polish entrepreneurs. The role of the Government is to lead such a policy which will facilitate the use of those new chances and will give a systemic support for the pro-development activities of the entrepreneurs.

Achieving over 3% of GDP growth in the year 2003 is still possible, however difficult due to unfavorable external conditions and a monetary policy which impedes growth. The

devotion of the largest possible portion of this growth for investment will enable the acceleration of the economy in order to achieve an economic growth of around 6% in 2006 and 2007. It is worth remembering that in the years 1994-1997 – during the implementation of the “Strategy for Poland” – the average growth rate amounted to 6.4% which is comparatively illustrated by the figure 1.1.

Figure 1.1



- The experience from the years 1994-1997 shows that the fundamental factor behind the GDP growth and the reduction of the unemployment was the rate of investment increase (figure 1.2)

In the beginning of the nineties, the investment dynamics were negative. A clear acceleration of investment could be noticed first in 1994. The same year, the rate of unemployment started to fall from its rise to 16.4% during 1990-1993. Unfortunately, starting 1995 the real interest rate systematically began to rise; in 1996 the rate was 4.6% and in 1997 it was already 9.5%, which distorted the investment expansion. Starting from 1998, the investment dynamics became weaker and became negative from 2001. As a consequence of restrictive monetary policy, the CIT reductions which were consequently introduced were unable to uphold the growth of investment pace. A consequence of the reduced investment growth was the deceleration of the development of the economy which was accompanied by a quick rise of the unemployment.



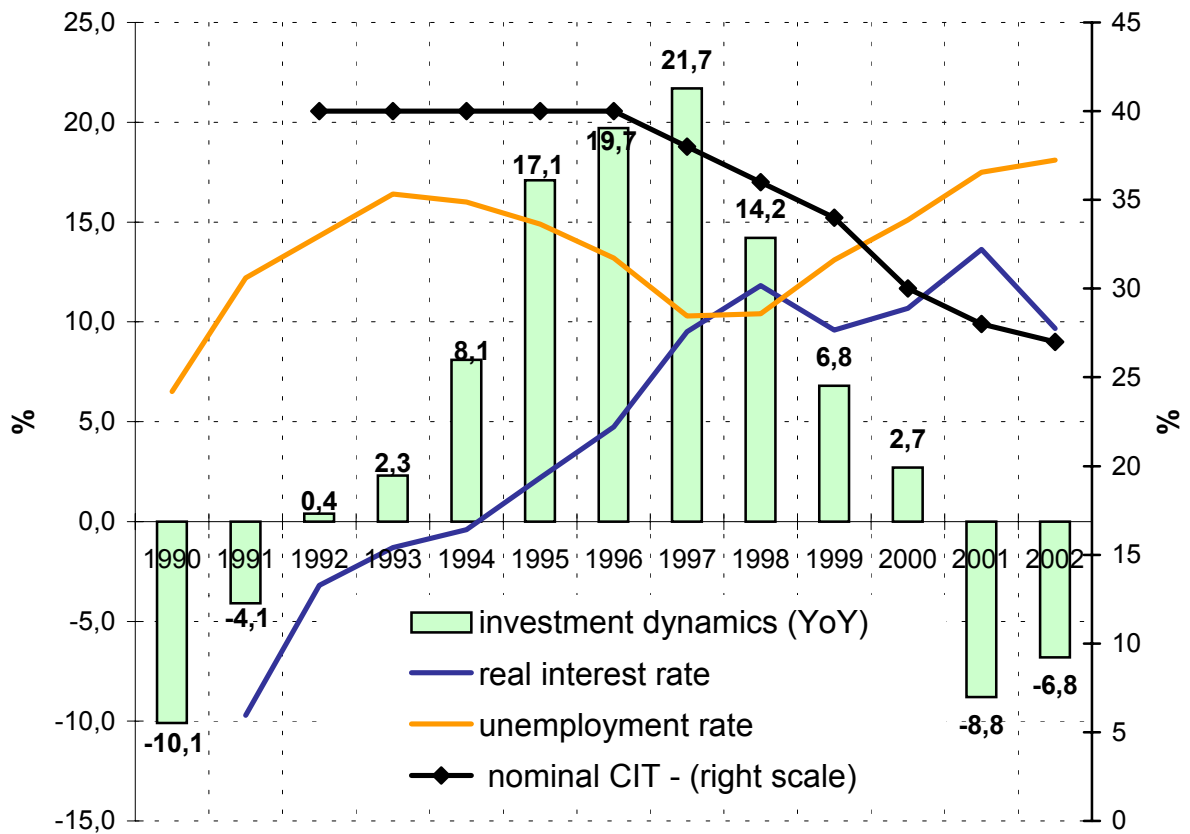


Figure 1.2 Macroeconomic indicators and the CIT

3. A sustainable return the fast economic growth is dependent on a couple of conditions:
- increase of investment after its fall in 2001-2002. The investment outlay should rise by 60% in 2007 compared to 2002. However this will be possible only through an effective use of EU funds;
  - further decrease of the interest rates by the NBP and the gradual liquidation of the valuation reserve;
  - a controlled level of the budget deficit, which will facilitate easing of the restrictive monetary policy as well as if will prepare the economy for the €o zone accession;
  - an increase of the investment and consumption

The table 1.1 presents elements of the dynamic development forecast.

Table 1.1 fundamental macroeconomic indicators in the years 2002-2007

	2002	2003	2004	2005	2006	2007	Index 2007
	Percentage growth in relation to the previous year (constant prices)						year 2002 = 100
GDP	1,4	3,0	5,0	5,4	6,0	6,0	128,0
Consumption	2,8	2,8	3,3	3,9	4,3	4,9	120,6
Investment	-6,8	2,2	12,2	12,8	13,5	10,0	161,5
Export	4,8	8,4	8,8	9,0	9,1	8,7	152,5
Import	2,6	6,9	8,4	9,6	9,7	8,7	151,3
Inflation (GDP deflator in %)	1,4	1,0	1,8	2,4	2,7	2,8	111,2
Average employment (000)	8778	8734	8828	9034	9227	9399	x
End of year unemployment rate (%)	18,1	18,0	17,2	15,6	13,9	12,5	x
GDP in current prices (PLN bn)	772	803	859	927	1009	1099	x

4. In the next couple of years, the situation on the labor market will be determined by:
- the consequences of the structural changes in the Polish economy, including the reduction of employment in uncompetitive branches of the industry and creation of new efficient branches based on new technology;
  - a fast rise of population in the productive age. In 2000, 612 out of 1000 people were in the productive age, in 2005 the number will be 642. The demographic changes are an additional issue among the labor market problems.

In the ongoing government programs “Entrepreneurship” and “First Job”, actions have been taken in order to create new jobs and to preserve the existing ones. Moreover, the government labor policy foresees various other actions aiming to improve the situation, e.g. adjustment of education to labor market needs, job consulting and voluntary work as a chance to gather first working experience and to test the qualifications. Creation of incentives to work together with the rising consumption already in 2003 will cause a reverse in the unemployment tendency. At the end of 2007 the unemployment rate should oscillate below 13%.

5. The fundamental factor of production is the level and dynamics of accumulation of fixed assets.

After the investment boom, which took place in 1994-1997, we are observing a decline of the investment growth rate, and in 2001-2002 even a decline of investment outlays. This was mainly an effect of the restrictive macroeconomic policy and a costly cooling of the economy.

The return to a double digit growth rate of the investment, which is necessary for further modernizing of the economy and a stable economic growth in the long term, must be accompanied by pro-investment activities in the Government's economic policy. These should include:

- a reduction of the CIT rate from 27% in 2003 to 19% in 2004, which if combined with the liquidation of all exemptions and relieves as well as reduction of real interest rates and a rise of effective demand will enable further increase of the investment activities by the entrepreneurs;
- gaining of additional resources for the economy in order to stimulate exports, purchasing of new technologies and financing direct investment in military and civil industry. These possibilities are being created by offset agreements following aircraft and other purchases for the Polish army, which are already signed or are in the process of negotiations;
- a full use of the EU funds, thanks to preparations of good projects and assuring of suitable co-financing from domestic resources.

If the above conditions are met, it is estimated that the declining pattern of investment outlays will break, starting from the second half of 2003. In the years 2004-2007 the average growth of fixed asset outlays could reach 12-13%. This will be mainly due to foreign direct investment inflow, especially green field investments.

The improvement in the industry sector will be combined with the growing dynamics in the branches which are crucial to technological development. This is tied to a deep reconstruction of the system of implementation of innovations, including changes in the research and development of the economy. It is planned to reduce the financing of the research entities in favor of financing the research activities together with their commercialization. The EU accession will demand adjustment to EU standards and will facilitate a free flow of capital and technology which will intensify the technological upgrade. An effective convergence to a know-how economy which is also stressed in the Lisbon Strategy is not possible in Poland without an enhancement of innovations.

6. After years of decreasing of the growth rate of the domestic demand and even its real decline in 2001, the pattern has now been reversed and it is estimated that in the years 2003-2007 this rise will continue. The assumed increased availability of credits, and especially investment credit, will cause the real rate of the growth of domestic demand to will be within the limits of 2.6-6.1% in the years 2003-2006.

The real rate of growth of gross outlays on fixed assets which according to the above conditions could be estimated to around 2-3% in 2003, 12-13% in 2004 and average 13% in the years 2005-2007, will cause a year to year rise of accumulation.

The rate of acceleration of private consumption will increase due to an improved situation on the labor market, a rising living standard of the society and greater availability of credit. According to the forecasts, the rate of growth of the private consumption (which is the main part of the consumption demand) will amount to 3.1% in 2003, and in the years 2004-2007 it will further accelerate (3.8%, 4.4%, 4.9%, 5.6% respectively).

It is forecasted that the negative value of the trade balance will gradually increase in the years 2003-2007. However, the external imbalance, because of the import input in the Polish production and the transfer of modern technologies from countries with higher rate of development should be treated in positive light. The structure of financing of the deficit of the current account balance should not create doubts because of the expected EU related capital inflow, a liberal foreign exchange regulations and an increased investment activity.

7. The average year to year inflation should not exceed 3 % in the years 2003-2007, which means that this will allow to meet the inflation criterion of convergence enabling Poland to join the EMU. This goal should be a primary determinant of the Central Bank's interest rate policy, including the short term open market interest rate which should be lowered (both in nominal and real terms) in order to ease the monetary conditions. This course of monetary processes and the direction and scale of capital flows in the years 2003-2007 indicates that after a nominal appreciation of the Polish currency in 2004 the PLN/EURO exchange rate will stabilize.
8. The return to the path of fast economic growth will partially be dependent on the expected improvement of the world economy. It seems that more favorable external conditions for the Polish economy can be first expected in 2004. However, it has to be pointed out that the delays of the large Euro zone countries in implementation of structural reforms (labor market, social security) can work in favor for the competitiveness of the Polish companies abroad.
9. The implementation of the Public Finance Reform Program is a necessary condition for fulfillment of this dynamic prognosis. In other case the problems, which our country stands afore can not be solved. These can be classified into three groups of issues:
  - fulfillment of the constitutional obligations of the state towards its citizens, which is financing military, judicial and public security expenditures;
  - the care of the state (the government and the local governments) for creation of foundations for flourishing of the entrepreneurship resulting in a long term development of the country, which requires looking after the development of the institutional frame of the market economy as well as investment in human capital, education, IT, and national heritage;
  - fulfillment of past obligations (servicing the public debt) and the new ones including obligations towards the international community.

Most of these tasks are and will be financed by public resources and therefore it is important that they are managed, gathered and spend in a proper and effective way – according to the rules of just division by the State which efficiently fulfills its obligations – at the same time radically reducing the bureaucratic waste and eliminating corruption.

Our economy can develop dynamically, if it is capable of wise use of the benefits from the coming EU membership. Because of that only, the GDP can grow by additional 1.5-2% percentage points annually. Poland can use the EU accession opportunities only if we successfully remove the existing economic barriers, including a relative technologic backwardness, insufficient availability of capital, limited human resources and lacking public funds spent on research and social affairs. Among the necessities is a reduction of the unemployment, as well as a efficient social policy, which prevents exclusion of some

social groups from taking part in the benefits of the growing efficiency of work and production.

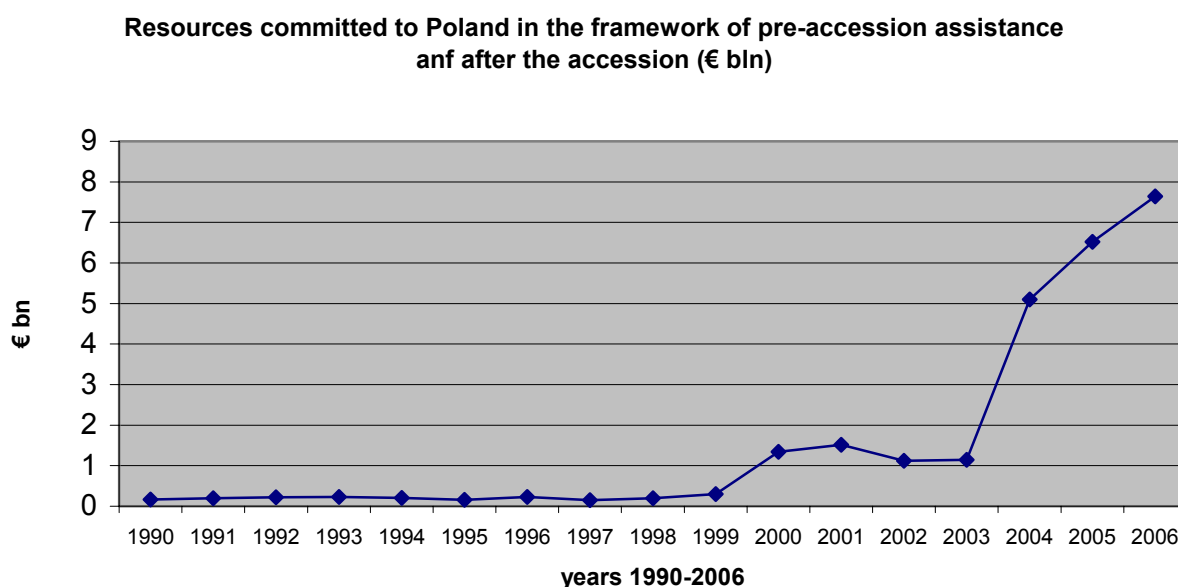
In order to make that happen the public finance system has to be reconstructed and the financial policy has to be changed in a way which facilitates a part of social transfers in favor of development matters. The Public Finance Reform Program is a complex proposition of such a change.

## Chapter II

### Public Finance and the European Union accession

1. Starting from 1990, Poland has enjoyed pre-accession assistance granted by the EU in the frames of the PHARE program, and from 2000 this assistance includes also SAPARD and ISPA. During this period, the flow of assistance funds directed to Poland has amounted to € 6 bn (commitments). After the EU accession, there is an expected substantial increase of funds for Poland's discretion among others structural and cohesion programs. The development of the size of the funds already transferred during the years 1990-2003 and the estimated funds for the years 2004-2006 is illustrated by the following figure:

Figure 2.1

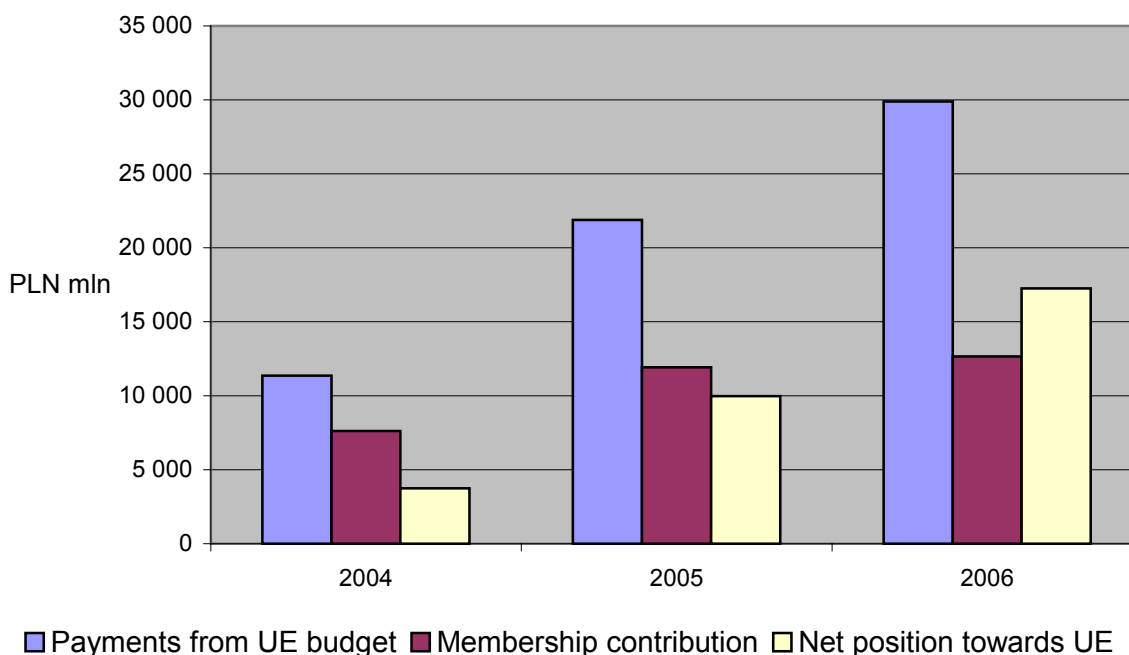


The average amount per capita of the received resources in the pre-accession period and the estimated size of the funds after the accession is respectively € 13 for the years 1990-2003 and € 166 for the years 2004-2006.

2. The potential commitments of the European Union towards the Polish economy after the accession (2004-2006) have been estimated to around PLN 90.5 bn, however these funds will be transferred up till 2009 and in the case of the Cohesion Fund even up till 2010. Taking to the account the level of payments, it is estimated that up till 2006, Poland will be able to use PLN 63.1 bn, including the PLN 6.7 bn of compensations to the Polish budget, PLN 10.7 – pre-accession assistance projects (PHARE, ISPA, SAPARD) and the PLN 45.7 bn will be assorted for financing of new pro-development programs and

assistance to the agricultural sector<sup>1</sup>. The amounts of the EU transfers to Poland and the flow from our country to the EU budgets are set in € in 1999 constant prices. In the estimates regarding the budget, those means have been calculated into PLN in current prices<sup>2</sup> in the following years.

Figure 2.2 Assessment of net budgetary position of Poland according to the accession treaty



3. The use of the EU funds requires meeting certain conditions:
  - preparation of projects suitable to the country's needs and accepted by the EU;
  - putting forward from the state budget and the local government budgets means of co-financing the particular projects. The average scale of co-financing amounts to 25%. The ability to put forward own public means for development purposes could become a barrier for gaining the EU funds. The resources from the Structural Funds and the Cohesion Fund which are set aside for Poland in the years 2004-2006 can also be used after the year 2006<sup>3</sup>;
  - upholding suitable budget discipline according to the Stability and Development Pact.
4. The issue of the flow of fund for the particular project is strictly regulated by rules according to the EU Regulation No 1260/1999 art. 32 which reads:
  - the advance payment, which constitutes around 7% for the particular assistance, can be divided among two fiscal year at the most;
  - the term payments, up till 95% (including the advance payment) of in input of the fund for the particular assistance should (if possible) take place three times per year 2 months from the date of application to the European Commission.

<sup>1</sup> The assessment of the net budget position of Poland according to the Copenhagen negotiations on December 13, 2003 as well as the level of public expenditures related to servicing of EU funds (co-financing, pre-financing, and additional budget expenditures related to the Common Agricultural Policy) are set out in the Appendix II.1)

<sup>2</sup> In order to calculate the sums in € m in 1999 constant prices, the following multipliers, which are a combination of the cumulated inflation in the € zone and the exchange rate, have been used: 2004 – 4.6065, 2005 – 46936, 2006 – 4.7725.

<sup>3</sup> That is due to the payment scheme for Poland as commitments in the particular years. The resources allocated as commitments for 2006 will be paid out up till 2009 (in case of the Cohesion Fund 2010)

- the final balance (which is minimum 5% of the fund's input in the particular assistance) is paid out if, during 6 months from the final date of payment, a declaration of actual expenditures is cleared. The judicial regulations do not directly specify the date of the final balance payment;
- from the date of the final balance transfer, there is 9 month for a correction application.

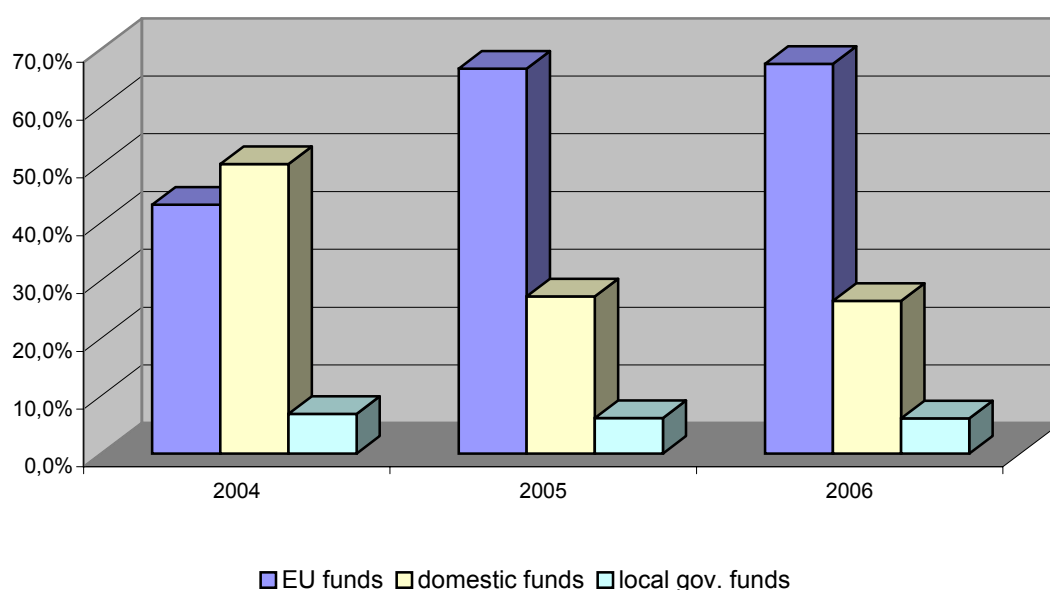
However, it has to be pointed that at the Copenhagen Summit, Poland succeeded in negotiating a more favorable advance payment schedule, which with regard to the structural funds is 10% in 2004 and 6% in 2006, and with regard to the Cohesion Fund, the advance payment will constitute 20% due after signing of the first contract.

5. The largest beneficiary of the EU transfers is the agricultural sector which will be able to use the market operation resources, direct payments and rural area development financing.

In the case of the direct agricultural payments, during 2004-2006 the farmers will receive reduced payments in relation to other EU countries. The size to the direct payments will amount to 25% in 2004, 30% in 2005 and 35% in 2006. Those payments can be raised to 40% by use of the EU funds for the development of the rural areas. Poland is entitled to fill in the direct payments from its own resources to the level of 55% in 2004, 60% in 2005 and 65% in 2006 if the financial situation allows it.

The expenditures for the development of the rural areas relates to financing by EU funds of: support areas which are especially difficult to manage, agricultural-ecological programs, forest plantation of rural areas, support to developing farms, creation of producer groups, technical assistance and early retirement.

Figure 2.3 Resources for agricultural assistance in the years 2004-2006



An important role in the support of the agriculture is played by the EU payment schedule. In 2004 the payments will be made from the domestic budget and afterwards refunded by the EU. It is estimated that 64% of the resources planned for 2004 will have to be pre-financed. The main problem in the realization of the agricultural policy will therefore be putting forward an appropriate pool of funds from the state budget and from the local government budgets, The means from the budgets will be engaged primarily in pre-financing of the ongoing pre-accession projects (PHARE, ISPA, SAPARD).

6. In the remaining programs which enjoy EU support, the input of the Polish public finance system is characterized by a larger local government engagement. The Polish input is also supplemented by extra budgetary means (extra budgetary funds and agencies). Another supplement can be constituted by credits from the European Investment Bank. This solution is however public debt creating because the credit flow would go to the state budget or other entities which are included in the public finance system.

Table 2.1 The structure of financing of programs outside the agricultural sector

	2004	2005	2006
	%		
EU funds	61.8	66.1	68.7
Domestic means including:	38.2	33.9	31.3
State budget	11.1	11.6	13.1
Local government budgets	26.1	19.9	14.7
Other	1.0	2.4	3.5
Total	100	100	100

7. Poland will provide the common budget with the following resources:

Table 2.2 Poland's contributions to the UE budget and other EU institutions 2004-2006 in PLN m

	Year		
	2004	2005	2006
Membership contribution	7 173	11 537	12 203
Payments to the European Investment Bank <sup>4</sup>	372	379	386
<b>Payments to the European Central Bank</b>	72		
Payments to the European Coal and Steel Research Fund		-	66

<sup>4</sup> The payments to the EIB include 5% of proportional share of the country in the subscription capital and the payments increasing the reserve fund and the supplementary reserve of the EIB. The size of the payments is dependent on the GDP ratio of the country to the whole UE GDP. According to the negotiation results, the payments to the EIB are made in eight installments during 2004-2009.



Total	7 617	11 916	12 655
-------	-------	--------	--------

Economizing of these amounts is a necessary condition for the membership. These resources must come from the budget and in case of the payments to the ECB they will have to come from the NBP. The yearly contribution will be paid in monthly rates.

However, it has to be pointed out, that the size of the net payment to the general EU budget will be reduced thanks to the special cash-flow facility which was negotiated in Copenhagen. This means that lump sums will be transferred from EU directly to the budget. According to the Accession Treaty in the years 2004-2006 these sums will amount to (in PLN m):

2004	2040.7
2005	2581.5
2006	2147.6

In this way the net payments to the EU budget and other EU institutions in these years will respectively sum up to 3 743.3, 9 972.7 and 17 240.4.

8. The EU entry creates ambitious challenges for the Polish economy.

First, it opens the possibility of broader market access for the entrepreneurs, but this will be under stiff competition requirements.

Second, it creates chances for gaining means for investment in: transport, environment and agriculture under the condition that the public finance sector and the domestic capital will fill in up to 25% of the investment outlays.

Third, the membership in the EU creates chances for a deep modernization of the agriculture, which however requires restructuring of the public means, which are already engaged in this sector and introduction of efficient channels of for absorption and distribution of EU funds.

Forth, the state budget and the local government budgets must economize means for pre-financing and co-financing of the programs supported by the Structural Funds, the Cohesion Fund and the pre-accession funds. The available EU resources require either economizing of sufficient amount of domestic means or they can not be fully used by the Polish economy which would mean a irreparable loss of a chance to speed up the development.

The current structure of the expenditures of the state budget will have to be more elastic in order to make it again more solid after substantial quality changes. In the new structure, it appears that the expenditures related to the accession will be solid, but this is with regard to the overcoming of the technological and civilisational backwardness, which plagues our economy.

## Chapter III

### The state budget

#### 1. The condition for implementation of the state budget

The public finance sector constitutes of entities and institutions, of which activities are financed by means coming from taxes, payments and other obligatory contributions (social insurance, fines etc.). The target for the activities of those entities is provision of services to the citizens and fulfilling of the constitutional duties of the government and local government towards the citizens. During the nineties, the public finance sector have been to a large extent transformed.

First, the revenues of the sector in the relation to the GDP have been declining – from 41.9% in 1995 to 38.4% in 2000, which was accompanied by a reduction in expenditure from 44.4% of GDP in 1995 to 41.4% in 2000. In 2003, the revenues of the public finance sector amounted to about 39.9% of GDP and the expenditures – 45.9%.

This direction of changes of the relations of revenues and expenditures to GDP is not favorable for the economy, because it is the cause of the rapid increase of the public debt. During the last years, the revenues in relation to GDP increased only by 1.7 percentage points and the expenditures rose by 4.8 percentage points.

The reasons for this development should be viewed as follows:

- a rapid decrease of the rate of economic growth in the years 2001-2002, especially from the Q4 2000 to Q2 2002;
- transgressions accompanying the realization of the systemic reforms taken up in 1999, as well as delays of the realization of structural reforms in the economy which was especially noticeable in 2000-2001;
- too harsh activities aiming to decrease the state budget deficit in the years 1998-2000, which led to an increased indebtedness of the other entities of the sector.

In 2001 the public finance sector was on the verge of a deep destabilization. The actions which were taken at the end of that year – which showed to be insufficient – in order to regain stability are a difficult long term process.

The main problems of the sector concentrate in the state budget. The budget is the entity which has the largest pool of income and at the same time being the primary source of assisting other entities in case their own incomes are not enough to finance the activities required by law. In 2003, the general expenditure quota constitutes in 53.5% of transfers to other entities, especially the extra budgetary funds (the Labor Fund, the Agricultural Social Insurance Fund, the Social Insurance Fund) and the local government entities. Still, those entities are not capable of gathering enough means to cover their expenditures, which is, e.g. in the case of the Labor and the Social Insurance funds, caused by the difficult situation on the labor market. (The income of those to funds depend on the wage bill of the economy).

The only way for a general and sustainable ease of tensions in the public finance sector and in the state budget is a return of the economy to the path of a stable, sustainable and fast long term development. In that situation, it becomes possible to reduce and organize the state budget expenditures and the expenditure of other entities of the public finance

sector. At the same time the general income quota injected to the sector rises, which enables a reduction of its deficit.

Poland is currently in a particular situation allowing for the use of the EU resources for development goals. During the years 2004-2006, our country will have discretion over both the pre-accession funds PHARE, ISPA, STRUDER as well as the structural funds, the cohesion fund and the Common Agricultural Policy.

An effective use of the EU resources, through enhancing of the investment activities can seriously accelerate the economic growth, which will have a positive effect on the labor market. The own domestic capital resources are still small in relation to the needs. The EU resources will be more and more available, but it requires adherence to strict procedures and co-financing of the projects from domestic means. A large advantage of the EU funds is that they do not have to be repaid under the condition that they are used accordingly.

There is plenty of evidence that the public expenditures are better controlled if they are realized under the surveillance of the local communities, which can benefit from the material effects of those expenditures. Decentralization of the state finance is both an instrument which brings greater efficiency to the management of public monies as well as it improves the allocation of public resources. Decentralization is also an instrument stimulating local economic activities and therefore it is necessary to continue the process of financial independence of local communities. This process was impeded in 2001 at the time of worsening of the economy. Today, the acceleration of this process should constitute one of important impulses for a quick return of the economy to the path of sustainable development. Also in this case, the EU funds will play a large role because most of them is addressed to local communities.

It has become necessary to sort out the structures of the state, to enhance the security of the citizens and accelerate the economic turnover. Most of these issues are constitutional duties of the government, and the financial side is covered by the state budget.

We are entering the period, which from one side requires large outlays directed towards long term support of the development of the economy and on the other hand – outlays on sorting and rationalizing. The public resources are relatively scarce and they are to a large extent engaged in financing of social expenditure and servicing of the debt. In this situation, the repair of the public finance becomes a difficult task, which at the same time is necessary.

## **2. The rules of construction of the state budget in the years 2004-2007**

A reconciliation of the necessity to initiate pro-development stimulus in the economy with the requirement of continuation of the process of decentralization of the public finance on one hand, and on the other – a range of actions in order to sort out the existing activities causes a need to include the following in the budget construction:

- a necessity of protection of existing pro-development impulses and introduction of new ones;
- enhancing of the independence of local government entities;
- processes of adjusting of the economy and the public finance sector to the EU requirements;
- sorting out the rules of construction and presentation of the budget;

- removal of situations, which favor or cause waste of public resources, with a control over both domestic and EU resources.

## 2.1 Pro-development impulses

The state budget and other parts of the public finance sector are a substantial factors creating both supply and demand for the economy because they provide services for the citizens. The demand role of the whole sector, and particularly the budget, is especially visible on the financial market. Though a system of taxes and payments, the budget reduces debt creation and credit for financing of the deficit, and therefore reduces the credit sources which are available for the entrepreneurs. This fact means, that the budget has a limited ability to increase its income through tax raises and because of scarce credit resources. In the Polish conditions, there is a constitutional limit of the relation of public debt to GDP of 60%<sup>5</sup>. Taking into account, that the EU financial regulations also limit the admissible level of public debt<sup>6</sup>, the size of the budget deficit and the deficit of the whole public sector have to be implicitly controlled.

Table 3.1 Central European countries and the Maastricht criteria in 2002

	Maastricht criteria	Czech Republic	Hungary	Slovak Republic	Poland
Public Debt* (% of GDP)	60.0	25.6	55.9	36.0	41.8
Budget Deficit* (% of GDP)	-3.0	-6.2	-8.7	-7.0	-4.1
Inflation (%)	2.7	1.8	5.3	3.3	1.9
Long term interest rates (%)	7.0	4.2	7.0	8.0	5.7

\* public debt and budget deficit calculated according to ESA95

A simultaneous initiation of pro-development impulses, which can contribute to a faster development of the economy, induces tax and payment reduction. This way of pro-development budget construction has found a broad support during the consultations on the assumptions of the PFRP. Tax cuts (especially income taxes) should increase the consumption and investment demand.

In the Polish economy there is currently unused potential of machinery and labor force. An increase of the consumption demand could stimulate an economic rebound, but a sustainable path of a stable development will depend on the investment demand. It is therefore necessary to simultaneously increase the demand and to create a friendly investment climate. One of the key issues in this point of view is gathering of resources enabling the use of the EU funds. Those resources should enable payments of the contributions and pre- and co-financing of projects.

<sup>5</sup> Additional procedures are initiated when the relation of the public debt to GDP exceeds 50% or 55%. In the first case, the reduction of the state budget deficit for the next fiscal year consist of the rule that the following year's deficit can not exceed the current year's deficit. In the second case (excess over 55%), both the Government and the local governments are required to decrease the relation of debt to GDP, which can include a reduction in guaranties and sureties.

<sup>6</sup> The fundamental differences between the European System of National and Regional Accounts 1995 (ESA95) and the act on public finance are: the scope of the sector (in ESA95, the second pillar of the pension system is included in the public sector and the Agency for the Agricultural Market is excluded from the sector) and the way to calculate the level of public debt. According to ESA95 the debt does not include (opposite to the Polish system) due obligations, which are overdue expenditures (expenditures on memorial basis) as well as potential payments from guaranties and sureties.

The above conditions in relation to the elements of state budget construction imply that:

- according to the potential of the economy, the individual tax dimension should be reduced; the source of inflow increase should be a more effective tax collection and broadening of the tax base;
- the level of the state budget deficit should be strictly controlled and kept on the level below 60% of GDP;
- through economizing and expenditure reduction or a better use of available means, resources should be freed for payments related to EU.

## **2.2 Decentralisation**

More efficiency in realisation of public spending means, among others, passing a growing part of the expenditure covered so far by the state budget to local authorities.

At the moment, the state budget forwards to the local authorities revenues in the form of:

1. share in the personal and corporate income tax
2. subventions
3. subsidies

Share in the income tax and subventions are the local authorities' own income and as such they can be used for any purpose that they will decide. Subsidies are the revenues that can be spent only on specific – determined by law and state administration – purposes. In the case of subsidies, the recipients have limited power as to the method and scope of the subsidies consumption.<sup>7</sup> It leads very often to malpractice and disrespect for public finance discipline.

In Public Finance Reform Program, it has been proposed to increase the participation of the local authorities in the income tax, at the same time increasing their responsibility for execution of the tasks financed so far by subsidies and along with a gradual increase of the amount available for them.<sup>8</sup>

For the state budget, such decentralisation means lower income and lower spending as compared to the current situation.

## **2.3 Structuring the method for the expenditure calculation and the budget presentation**

Activities in this field concentrate on reaching the flexibility in determination of the limits for expenditure through resignation from the method of automatic indexation and valorisation, which had been imposed by certain laws or norms. The details for that notion will be presented in Chapter IX.

In the same chapter, it has been proposed to increase the control over the spending effected by the special budget entities and eliminate those structures that either have fulfilled their mission or have not proved useful.

---

<sup>7</sup> The current law on the local authorities' revenues allows in the years 1999-2003 for the change of the allocation of maximum 15 % of the value of the subsidies.

<sup>8</sup> Details of this proposal will be elaborated in chapter IV.

Accession to EU will also require to systemise the method of how the state budget will be presented. Also, new elements will be introduced into this presentation. For example, it will be necessary to include in the budget the financing of the spending that will be co-financed by EU (pre-financing), or to highlight the spending that will be financed by the revenue from privatisation. Gradually, it will be necessary to adjust the presentation of the Polish budget so that it can be internationally compared according to the ESA '95 rules.<sup>9</sup>

### 3. State budget revenues in the years 2004-2007

1. The state budget revenues in the years 2004-2007 are forecasted based on the above-mentioned assumptions regarding macro-proportion and the effects of the proposed changes in the income and indirect taxes system. The forecast takes into account the effects of the EU accession and the results of the decentralisation. Below, it will be presented how the state budget revenues will change according to the influence of each of these factors.
2. The assumptions concerning the economic growth and the inflation rate in the years 2004-2007 allow to determine the budget revenues in the period in question, as well as the revenue and spending split between the state budget and the local governance.

Table 3.2 Presentation of the changes in the state budget revenue forecast in the years 2004-2007 (+ increase / - decrease) ( PLN bn)

	Year				
	2003	2004	2005	2006	2007
Forecast based on macro-economic assumptions	155.70	164.16	171.67	184.06	195.21
Changes in the tax system	-	-4.33	-2.93	-2.23	+0.46
Changes resulting from the decentralisation	-	-6.31	-10.36	-10.70	-10.07
Changes resulting from the EU membership	-	-3.51	+1.14	+1.44	-1.91
<b>Total – the state budget revenues forecast</b>	<b>155.70</b>	<b>150.01</b>	<b>159.52</b>	<b>172.57</b>	<b>183.69</b>

In the period in question, just by the influence of the macro-economic factors, the state budget revenues will increase on average by 5.7 % a year. In 2003, the revenues have been increased by the Parliament by PLN 820m as the result of the introduction of the regulations increasing the revenues from the custom duty and the excise tax, as well as by further PLN 380m through the transfer of special funds for the budget revenues. In reality, the revenues forecast for 2003 were by almost PLN 1bn lower than the ones found in the budgetary law. Taking into account that correction, the revenue in 2007 will be probably by 25.6 % higher than in 2003. In the same period, the GDP will increase its nominal value by 36.8 %. Therefore, the revenue forecast is constructed in a realistic way and includes a security margin.

<sup>9</sup> Details of this notion will be developed in chapter XII. It is also included the proposed new act on the public finance.

In 2003, the value of the state budget revenues agreed by the Government is at the level of ca. 19.2 % of the GDP. In 2004, this index will be at the level of 19.1 % and in the coming years will be at the level of between 18.5 % and 17.7 % of the GDP.

However, the activities leading to the improvement of the tax system will influence the presented macro-economic forecast. In the period in question, the tax system changes will go in two directions. On the one hand, the necessary adjustments in the VAT and the excise tax will bring an increase in the revenue; on the other hand, the revenue will be temporarily decreased by the changes in the income tax system. The situation will be balanced in 2007 by the revenues that will increase as the results of the faster economic growth. Thus, Public Finance Reform Program is an instrument that will structurally stimulate the socio-economic development of Poland.

More important and more permanent changes in the revenue structure will result from the increase of the local authorities' share in administration of the personal and corporate income tax. The years 2004-2005 will be a transitory period, during which the local authorities' shares in the revenues will be gradually growing. In the next years, the rules of the division of the public means between the state budget and local authorities will be stabilised.

In 2004, the accession to EU will also have its effect on the revenue of the state budget. As the consequence of this fact, despite the partial budget compensation and the means devoted to reinforcement of the external border, the balance of the state revenue will be negative. Part of the VAT and the excise tax will not be accounted in Poland, but will be paid in the common market. Also, the regulations for the payment of the custom duty and the excise tax will change. Those changes will result in the decrease of the state budget revenues by ca. PLN 3bn in 2004, of which:

- As the result of the border opening, the VAT revenues will decrease by PLN 1.9bn and the excise tax ones by PLN 0.4bn. This effect will be permanent.
- Introduction of the excise storage will decrease the revenues by PLN 0.8bn, but only with a temporary effect as in the next years it will bring an increase of the excise tax revenues.

The opening of the European market will also mean lower imports. Majority of goods will be passing the border without any custom duty, which will decrease the revenue from this source by one third as compared to 2003. The decreasing trend will continue in the next years. The influence of the above-mentioned factors on the state budget income has been presented in the relevant tables in the appendices.

As the result, the state budget will arrive at the income shown in the last row of the table 3.2.

#### **4. State budget spending in the years 2003-2007**

The spending projection is another important element in the long-term budget forecasting. The spending has been divided in the following groups: fixed, variable, accession-bound and other.

The first group comprises spending related to: subsidies to the retirement and pension system; the Labour Fund; subventions to local government; cost of the public debt service; the national defence system and the multi-purpose aircraft; construction, maintenance and

modernisation of roads; guaranteed bonuses for the owners of the “home-saving books”; as well as salaries, salary-related costs and administration costs of the budget-financed entities. In 2003, this group constitutes 85.5 % of the total spending amount.

The second group are the variable expenditures of the budget, i.e. the spending determined by the decisions of the Government. In 2003, this group constitutes 8.5 % of the total spending.

The third group is the spending related to the accession to EU. In 2003, 3.5 % of the total spending has been devoted to that purpose.

The fourth group is the spending that is determined by the decision independent of the Government, i.e. the expenditures by the highest state authorities, the tribunals, the control and supervision institutions and the court administration. This group constitutes ca. 2.5 % of the total budget spending.

For determination of the specific spending groups, the following assumptions have been taken:

- The spending on the national defence system and the multi-purpose aircraft have been estimated at the level of 2 % of the GDP from the year preceding the budget year.
- The automatic formula of spending indexation has been abandoned, however, the means for retirement and pension increase according to the current rule – previous year inflation rate increased by 20 % of the real salary increase – have been provided for. It is estimated that for 2004 the index will be 1.34 % which will effect the spending of PLN 1.3bn.
- PLN 1.0bn has been forecast for the changes in the salaries of the persons with the index system. Those means can be used to maintain the real level of the salaries in the group in question or to correct the salary structure while the standard salaries will be frozen at the nominal level.
- It has been assumed that in the period in question, the spending on construction, maintenance and modernisation of roads will increase at the rate reflecting its real value. Its relation to the revenues from the fuel excise seems to be incorrect, especially, if a new law including a special fare for the construction of motorways and express roads will be introduced.
- Other expenses (outside the fixed ones, the non-governmental entities spending, and the spending resulting from the EU membership) have been kept at the nominal level from 2003.
- The revenue from privatisation have been moved to the budget spending account.
- In this group of spending, there are: contribution for the Pension Funds, means constituting the Demographic Reserve Fund and the means coming from the privatisation that will be used for modernisation of the defence industry.
- The budget spending account includes also the means coming from the foreign loans for the restructuring of the mining industry and financing the EU programs. It is justified by the fact that those means will be further passed to the investors and enterprises managing the restructuring process.
- The budget spending account comprises also the means for direct subsidies as part of the Common Agricultural Policy, which will be refunded in the next budget year.
- The scope of the budget spending has been determined taking into account the introduction of the system set by the law on the revenue of the local authorities.



The estimation of the budget spending in the years 2003-2007 has been presented in the table 3.3.

At the same time, a more detailed information concerning next year spending has been presented in “The Assumptions For The State Budget 2004.”

Table 3.3 The forecast state budget spending in the years 2003-2007

Budget spending (PLN bn )	Year				
	2003	2004	2005	2006	2007
Total	194.4	192.1	200.3	208.6	219.0
Public debt service	27.2	27.5	28.3	31.4	32.0
Subsidies for specific funds: FUS, KRUS, Labour Fund	47.0	39.9	41.2	42.6	45.0
Subventions for local government	29.3	30.3	30.0	26.0	26.0
Spending on roads	4.4	1.9	2.0	2.1	2.5
Spending on the national defence system, including the multi-purpose aircraft	15.2	16.1	17.2	18.5	20.2
Guaranteed bonuses for the “home-saving books”	0.8	0.6	0.6	0.6	0.6
Spending on the non- governmental institutions	1.5	1.6	1.6	1.6	1.7
Spending on the courts	3.4	3.5	3.6	3.7	3.9
Salaries, salary-related costs and specific costs	41.0	40.7	41.8	43.0	44.3
EU related spending	0.9	7.5	11.5	16.3	16.7
Other	22.7	22.5	22.5	22.8	26.1

Analysing the above table, it has to be noticed that the amount for the public debt service will reflect the changes in the interest rates, exchange rates<sup>10</sup> and the nominal value of the public debt.

In the spending for subsidies to the specific funds, the means for retirement and pension indexation have been provided.

The salary spending comprises the salaries themselves, the salary-related cost and the specific costs of the budget entities. This cost rises ca. 1bn PLN a year.

The EU related spending has been set at the level providing the means for the membership contribution. The support for the EU programs has been included in the spending account.

Other budget expenditures are more disciplined than the rest of the items. It is forecasted that it will not be before the years 2006-2007 that it will be possible to substantially increase the spending in this category.

<sup>10</sup> The level of the public debt is very sensitive to the change of exchange rates. The change of the PLN/€ rate by 10 % (the change that was noticed between 1.1.2003 and 20.3.2003) caused the increase of the relation of the public debt to GDP by 1 %.

The maintenance of the level of the state budget spending that has been presented above will allow – after temporary increase in 2004 – to return on the path of the decrease of the nominal value of the budget deficit and its relation to the GDP.

### 5. The state budget deficit in the years 2003-2007

In the years 2003-2007, the state budget deficit will look in the following way:

Table 3.4 The state budget deficit in the years 2003-2007

	Year				
	2003	2004	2005	2006	2007
State budget revenues					
In PLN bn	155.7	150.0	159.5	172.6	183.7
In relation to the GDP	19.38	17.46	17.21	17.11	16.72
State budget spending					
In PLN bn	194.4	192.1	200.3	208.6	219.0
In relation to the GDP	24.20	22.36	21.61	20.68	19.93
Deficit acc. to the Polish methodology					
In PLN bn	38.7	42.1	40.8	36.0	35.3
In relation to the GDP	4.82	4.90	4.40	3.57	3.21

The budget deficit of 2003 is not comparable with the values in the next years because the year 2003 spending includes the amount coming, among others from the privatisation, that will be spent on financing the Open Pension Funds (PLN 11.5bn). If this value was introduced, in 2003 the spending would be at the level of 182.9bn PLN and the deficit would be decreased to the level of PLN 27.2bn, i.e. 3.39 % of the GDP. In other words, launching the public finance reform along with the creation of development stimuli in the economy requires in our circumstances an increase in the public debt by ca. 1.5 % of the GDP, i.e. PLN 12.1bn.

Taking into account the security measures present in the law on public finance, it has to be noticed that, in 2003, there is a high risk of passing the 50 % threshold of the relation of the public debt to the GDP. It will require the decrease of the state budget deficit in 2005.

The increased deficit in 2004, at the level of 4.9 % of the GDP, means entering the public debt level of 54 to 55 % of the GDP, which clearly marks the danger to be avoided if the state budget is to continue the employment of the state guarantee mechanism. The solution for that situation is either to limit the spending or to increase taxes – which is contrary to what the Public Finance Reform Program proposes along with the development priority.

Our method of calculating the budget deficit and the public debt – different from the ESA'95 method used in EU – causes that the values in those categories are significantly higher than with the calculation method used in EU.

Table 3.5 Public debt in Poland in the years 2003-2007

	Year				
	2003	2004	2005	2006	2007
Estimation of the public debt					
PLN bn	403.3	465.6	507.9	551.8	600.1
% of the GDP	50.2	54.2	54.8	54.7	54.6

Estimate acc. to the ESA'95					
<b>Deficit</b>					
PLN bn	32.3	39.8	33.1	29.4	31.2
% of the GDP	4.02	4.63	3.57	2.91	2.94
<b>Public debt</b>					
PLN bn	341.2	395.8	441.8	471.2	512.5
% of the GDP	42.5	46.1	47.7	46.7	46.6

It is therefore necessary to control the public debt of both the state budget and the local government. The further fast growing debt would destabilise the public finance, which would endanger the state, the society and the national economy.

It has to be also mentioned that it is necessary to determine the methods according to which it will be possible to estimate our public debt and the budget deficit of the whole public sector according to the international standards. It has to be mentioned, that it has not been internationally confirmed that the funds of the Open Pension Funds will be counted as the public sector. In case that the Open Pension Funds did not belong to the public sector, the indexes presented in the table 3.5 regarding the public debt according to the ESA'95 methodology would be worsened by ca. 2 %.

As it has been presented in the table 3.5, Poland can reach the path allowing the limitation the budget deficit do the level required by the Maastricht criteria. Thus, Public Finance Reform Program can – on condition of the successful realisation of the proposed solutions – allow Poland to enter the €o zone as early as in 2007, which would further improve the competitiveness of our economy and by this the pace of the development and the living standard of the people.

The threat of passing the level of 55 % in the relation of the public debt to the GDP makes it required to use the valuation reserve of the National Bank. Putting the means from the reserve to the state budget will decrease the level of the public debt in the relation to the GDP.

Table 3.6 The state budget deficit in the years 2004-2007 (with the means from the valuation reserve)

	Year				
	2003	2004	2005	2006	2007
State budget income					
PLN bn	155.7	159.0	164.5	172.6	183.7
relation to the GDP	19.38	18.51	17.75	17.11	16.72
State budget spending					
PLN bn	194.4	192.1	200.3	208.6	219.0
relation to the GDP	24.19	22.36	21.61	20.68	19.93
Deficit acc. to the Polish methodology					
PLN bn	38.7	33.1	35.8	36.0	35.3
relation to the GDP	4.82	3.85	3.86	3.57	3.21

Table 3.7 The public debt in Poland in the years 2003-2007 (with the means from the valuation reserve)

	Year				
	2003	2004	2005	2006	2007
Public debt estimate					
PLN bn	403.3	456.3	493.4	537.3	585.6

relation to the GDP	50.2	53.1	53.2	53.3	53.3
Estimate acc. to the ESA'95 methodology					
<b>Deficit</b>					
PLN bn	32.3	39.8	33.1	29.4	31.2
relation to the GDP	4.02	4.63	3.57	2.91	2.84
<b>Public debt</b>					
PLN bn	341.2	386.6	427.7	457.1	498.4
relation to the GDP	42.5	45.0	46.1	45.3	45.4

## Chapter IV

### Income of the local government units

#### I General purposes

1. Accession to the European Union presents new challenges not only to the state budget but also to the local government. They can actively participate in the realisation of projects financed by European Union. However, only upon meeting the condition of generating funds for preparing the projects and co-financing of agreed programmes.
2. The financial situation of every level of the local government administration is different. Besides that gminas, poviats and voivodships are very diverse.
3. The purpose of the suggested solutions so as to financing of local government units is:
  - Increasing economic responsibility of the units by increasing the share of own incomes in the total financial funds.
  - Creation of instruments enabling support of entrepreneurship and supply of human capital of high potential
  - Increasing capacity for absorption of union funds.
4. The search for solutions meeting the above criteria has been subjected to the following assumptions:
  - The inflows that currently are revenues of gmina, powiat and voivodship special purpose funds will be local governments' incomes and the funds will be liquidated.
  - The increase in local governments' own incomes will be accompanied with putting them in charge of the tasks that are currently being financed by subsidies or subventions from the state budget.
5. The proposed solutions in the public finance system tend towards further decentralisation of public tasks and increasing the role of local governments. The systemic changes in municipal public finance will strengthen the local governments by increasing the number of tasks they are entrusted with and giving them more independence in management of public funds.
6. Income from the share in PIT and CIT taxes will supplement the local governments' own incomes.
7. The reform of local government finance will be carried out starting in the year 2003 and will be held in two stages:

I stage – in the years 2004 and 2005 a transition model will be introduced. The regulations of a new, final financial system will be developed by the municipalities themselves.

II stage – starting from 2006 the final system of local government finance will be introduced.

#### II Basic systemic solutions – the final model

1. Limiting the scope of subsidies for financing and co-financing of own tasks and some tasks from the scope of central government and the loss in subventions will be compensated by increasing the inflows from PIT and CIT (information on tasks which are proposed to be directed to local government are presented in Attachment 4.1). Because of large diversification in local government units' incomes, implementation of the new

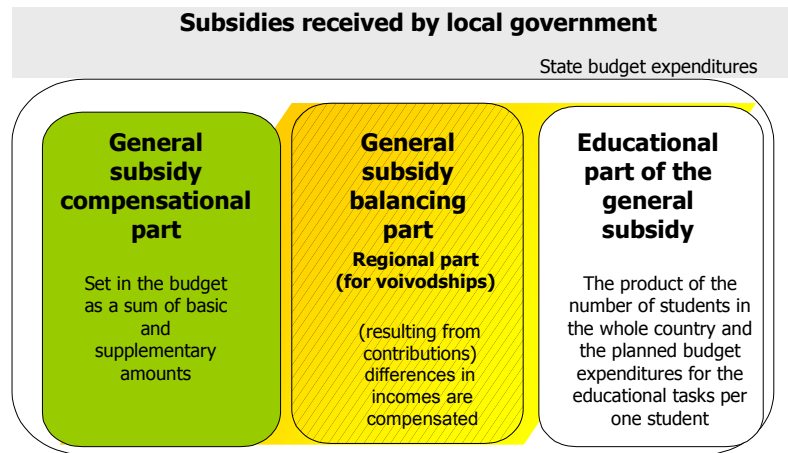
financing model would require additional transfers of funds from the state budget for the compensation mechanisms. In the conditions present in the year 2003 it would require almost PLN 5.7 bn.

2. The final model requires on one hand generating the funds required for the compensation mechanism and on the other hand creating new rules for financing of educational tasks, therefore its implementation would be possible starting from 2006 and only after liquidation of all exemptions and relieves in income taxes (PIT and CIT). Verification of the number of poviats would facilitate introduction of final financing model.
3. In the global amount of subsidies for local government units educational subsidy constitutes 77%. It is necessary to ensure the proper level of financing of educational tasks after local government units obtain increased shares in PIT and CIT instead of educational subsidy. It requires defining of educational standards.
4. Therefore introduction of the final model will be preceded by implementation of temporary regulations, which will allow for gradual increase in the public funds directly and independently managed by the local government units. A transitional period is proposed.

### **III Basic systemic solutions – transitional model**

1. The regulations proposed for the transitional period will be foundation for preparing municipalities' budgets and for financial administration from the year 2004 as well as for implementation of a new financial system.
2. The proposed transitional model for local government financing is based on general assumption that the units will be financed mainly by own incomes and subsidies and particular subsidies will be only of complementary character.
3. In the transitional period the share in PIT will be gmina's and poviat's income. The voivodships' local governments will receive income from CIT.
4. The level of general subsidy will be lowered together with increasing own incomes. There are plans to liquidate:
  - compensational part of the general subsidy
  - a part of the road general subsidy for poviats and voivodships
5. The local government units will receive general subsidy, consisting of parts:
  - compensational
  - balancing (only gminas and poviats)
  - regional (only voivodships)
  - educational

6. Because of large differences in the level of incomes in gminas, poviats and voivodships an appropriate compensational system will be put in place. It will aim at protection of units, which are economically weaker. The differences in incomes will be compensated in the form of compensational and balancing parts (gminas and poviats) or regional (voivodships) part of subsidies.



7. The compensational part of the general subsidy will be an expenditure of the state budget and will be a stable source of funding for the local government units (local government units will receive monthly instalments).

## GMINAS

Taking into account gminas' income, economic and social diversity a categorization of gminas will be introduced, which will differentiate their position in the system of compensation of the differences in their in income potential.

The compensational part of the general subsidy will consist of the basis amount and supplementary amount:

- **Basic amount** – its level will be determined based on the basic tax incomes (incomes from: share in PIT and from local taxes and fees, which are possible to be raised by the gminas using the maximum rates of these taxes regardless of the reductions and relieves).

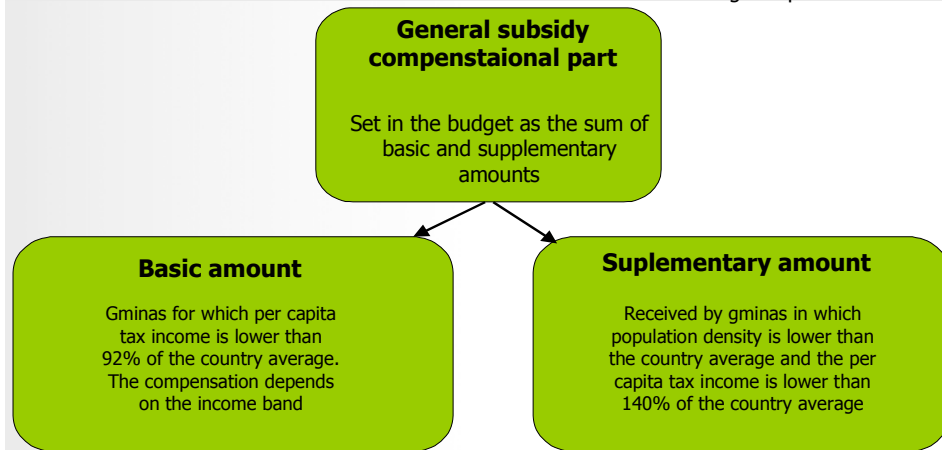
The basic amount will be directed to gminas, in which per capita income is lower than 90% of the average per capita income in the whole country.

This system assumes higher proportion of per capita compensation for gminas, in which those incomes are lower.

The equalizing of income potential will depend on the relation between per capita income in a gmina and average per capita income in the whole country.

## General subsidy compensational part

State budget expenditure



- for gminas where per capita income is lower than 40% of the average per capita income in the whole country, the income will be compensated in the three bands:
  - up to 40% of average country per capita income in 90%
  - from 40% to 75% of average country per capita income in 80%
  - from 75% to 92% of average country per capita income in 75 %
- for gminas in which average per capita income is higher than 40% and lower than 75% of the average country per capita income the income will be equalized in two bands:
  - up 75% of average country per capita income in 80%
  - from 75% to 92% of average country per capita income in 75%
- Supplementary amount – its level depends on population density in gmina and on relation of average population density to per capita income in gmina.

This amount will be directed only to gminas where population density is lower than average country population density and per capita income is not higher than 140% of average per capita income in the whole country.



## POVIATS

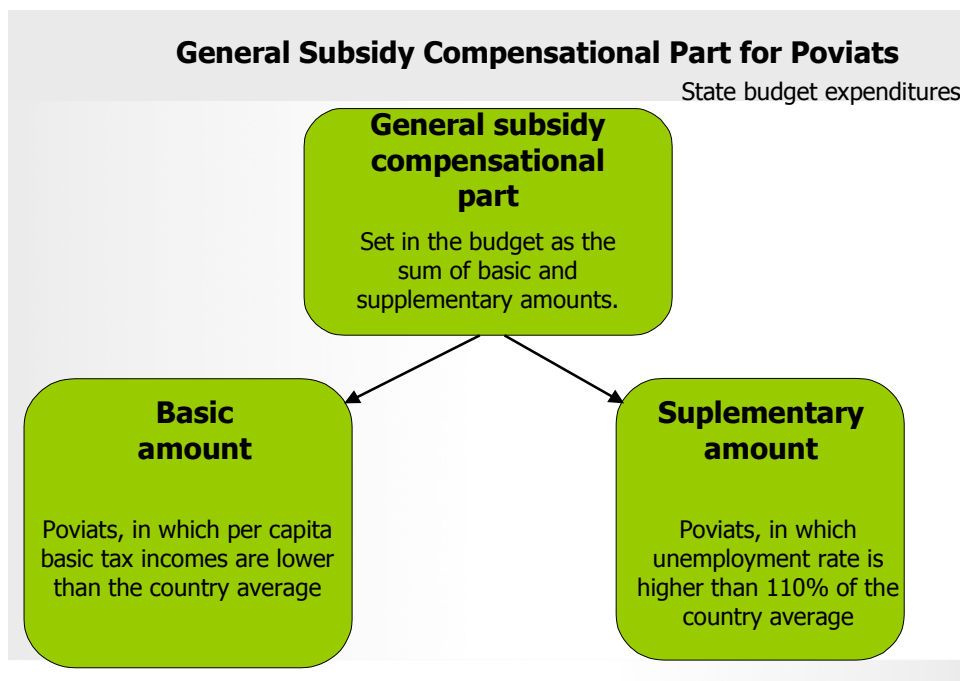
Compensational part of the general subsidy will consist of the basic amount and supplementary amount.

- Basic amount will be directed to these poviats, in which the indicator of basic tax revenues (from PIT) per capita is lower than average per capita income in the whole country.

The compensation will constitute 80% of the difference between the average country per capita income and per capita income in the poviat.

- Supplementary amount will depend on the unemployment rate in the poviat. The higher the unemployment rate in a poviat, the higher the amount will be.

Establishment of the supplementary amount, constituting a part of compensational part of the general subsidy, results from the fact that the poviats realise a big chunk of tasks so as to employment and counteracting unemployment. Moreover, the problem of unemployment is a local problem and its consequences are particularly strongly felt on the local level. Providing these municipal units with financial funds for counteracting unemployment will allow for diminishing the negative impact of unemployment and then might lead to increase in employment and development of entrepreneurship.



## VOIVODSHIPS

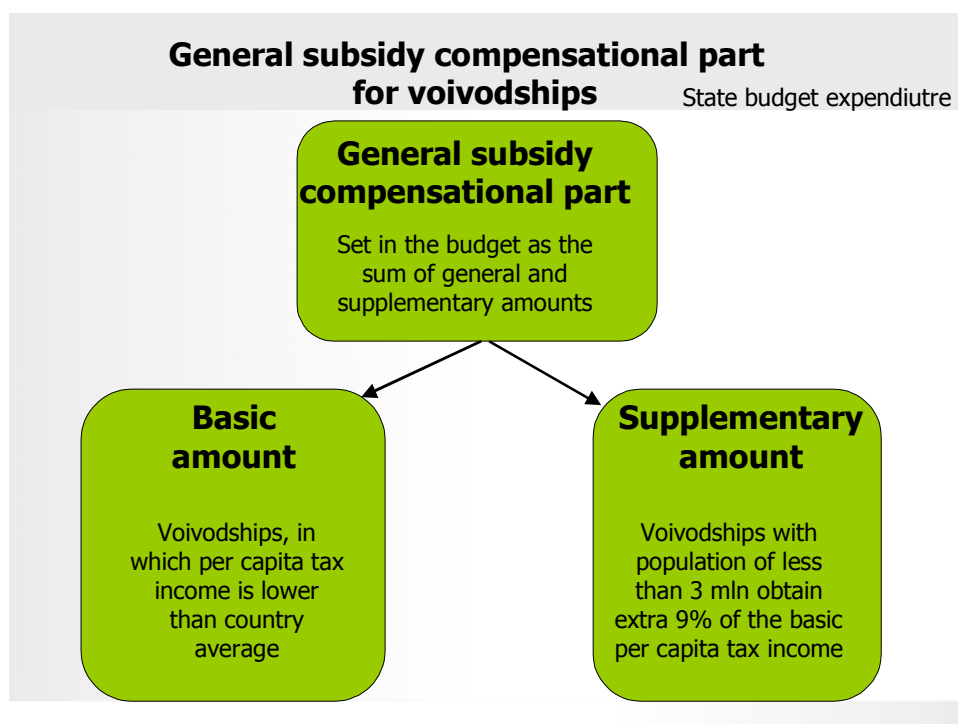
Compensational part of the general subsidy for the voivodships will consist of basic amount and supplementary amount.

- Basic amount will be directed to those voivodships, in which the basic per capita tax income is lower than average per capita tax income in the whole country.

The compensation will constitute 70% of the difference between average voivodship's per capita income in the whole country and per capita income in the voivodship.

- Supplementary amount will depend on the number of inhabitants in the voivodship.

The voivodships, in which the number of inhabitants does not exceed 3 million will receive this amount. The basis for its estimation will be the number of inhabitants in the voivodship calculated in a manner specified by an act.



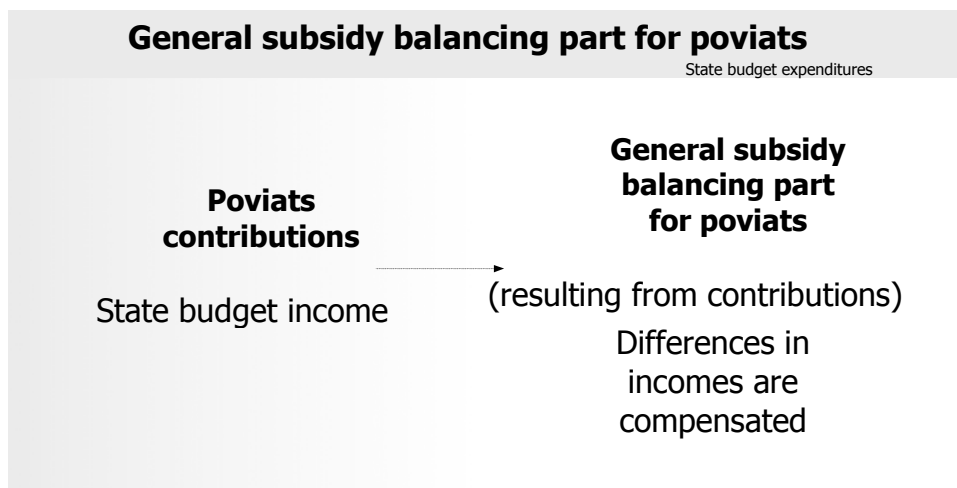
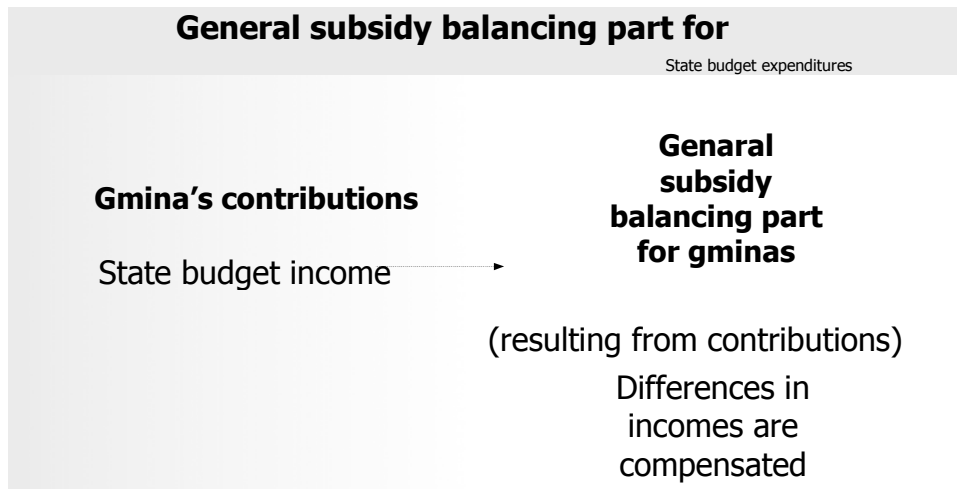
8. Simultaneously with introduction of significant changes in the local government finance system, within the transitional model, adjusting mechanism will be introduced. In the case of gminas and poviats it will be performed by balancing part of the general subsidy, voivodships will receive the regional part.

A 'solidarity' mechanism will be introduced since the funds for this part of subsidy will come from the contributions by the richest units. These contributions will be incomes of the state budget and the amounts raised in this way will be distributed among units in order to compensate for the differences caused by systemic changes.

## GMINAS AND POVIATS

Balancing part of subsidy for gminas and poviats will be distributed while taking into objective criteria specified in an ordinance.

In 2004, the balancing part of the general subsidy will be directed to gminas and poviats in which the incomes specified according to the rules given in the act will be lower than incomes obtained according to the regulations being in place at the moment.



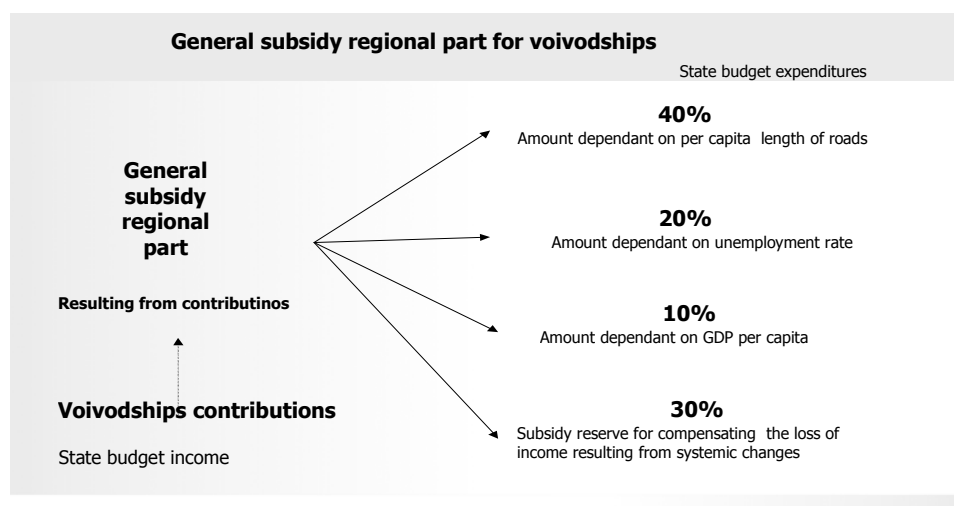
## VOIVODSHIPS

Regional part of the general subsidy will be introduced for the voivodships. It will be distributed based on macroeconomic performance, unemployment rate and GDP. Another important factor determining this subsidy will be per capita length of roads in the voivodship.

The total amount of the regional subsidy for the voivodships will be distributed as follows:

- 20% among voivodships in which the unemployment rate is higher than 110% of the rate in the whole country. The amount of this subsidy, for a voivodship meeting the criteria for obtaining it, depends on whether the number of unemployed, calculated for the age ranges, is higher than percentage share of the unemployed in that age range compared to the total number of unemployed in the country;
- 40% among voivodships, in which the per capita length of roads is higher than the average per capita road length in the whole country;
- 10% among voivodships in which per capita GDP is lower than 75% of per capita GDP in the whole country;
- the remaining 30% will be distributed among voivodships taking into account the objective criteria. The manner of distribution of this amount will be specified in an ordinance after consulting representation of local government units.

In 2004, 30% of the total amount of regional part of general subsidy for voivodships will be distributed among voivodships, in which incomes, as defined in the way specified in an ordinance, will be lower than incomes obtained based on the current regulations.



9. Educational part of the general subsidy will be maintained, respecting the method of calculating the necessary financial funds for one student. The total amount of the educational part of the general subsidy for the local government units would be set as the product of the number of students in the whole country and the planned state budget spending for the educational tasks in the base year, calculated for one student.
10. In the transitional model the contributions to the state budget will be made by gminas, poviats and voivodships.

## **GMINAS**

The contributions will be made by those gminas, in which the per capita income is higher than 140% of average per capita income in the whole country.

There will be three categories of gminas making the contributions:

- gminas, in which per capita income is higher than 140% and lower than 180% of the average per capita income in the whole country;
- gminas, in which per capita income is higher than 180% and lower than 220% of average per capita income in the whole country;
- gminas, in which per capita income is higher than 220% than the average per capita income in the whole country.

## **POVIATS**

The contributions will be made by those poviats, in which per capita income is higher than 110% of the average per capita income in the whole country.

There will be three categories of poviats making the contributions:

- poviats, in which the per capita income is higher than 110% but not higher than 120% of the average per capita income in the whole country
- poviats, in which per capita income is higher than 120% and lower than 125% of average per capita income in the whole country
- poviats, in which per capita income is higher than 125% of average per capita income in the whole country.

## **VOIVODSHIPS**

The contributions will be made by voivodships, in which the per capita income is higher than average per capita income in the whole country.

There will be two categories of voivodships making the contributions:

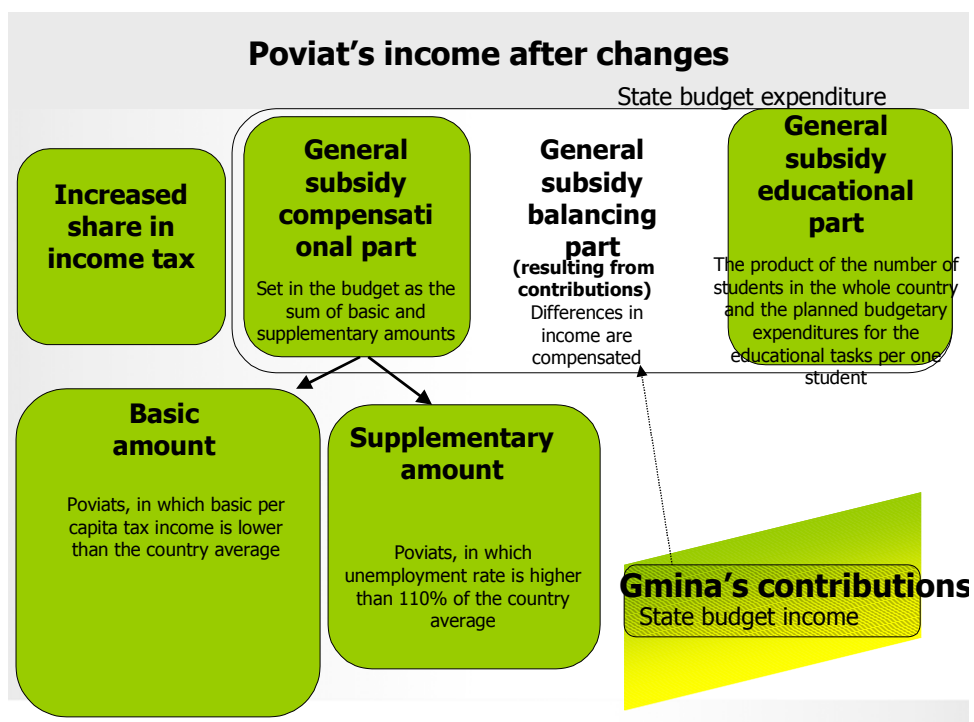
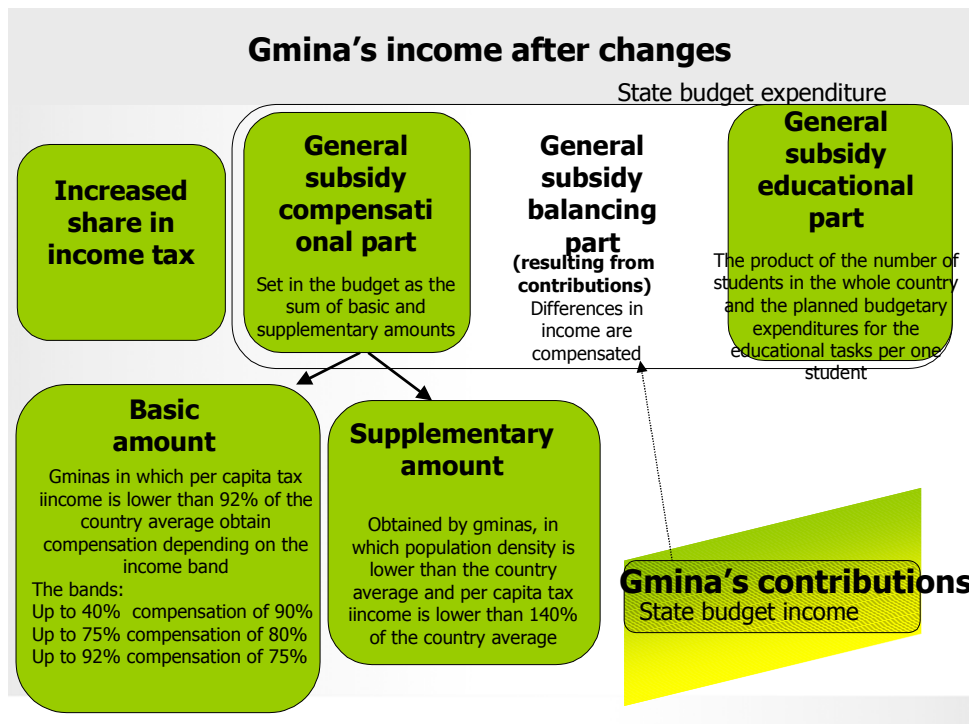
- voivodships, in which average per capita income is not higher than 170% of average per capita income in the whole country;
- voivodships, in which the per capita income is higher than 170% of the average per capita income in the whole country.

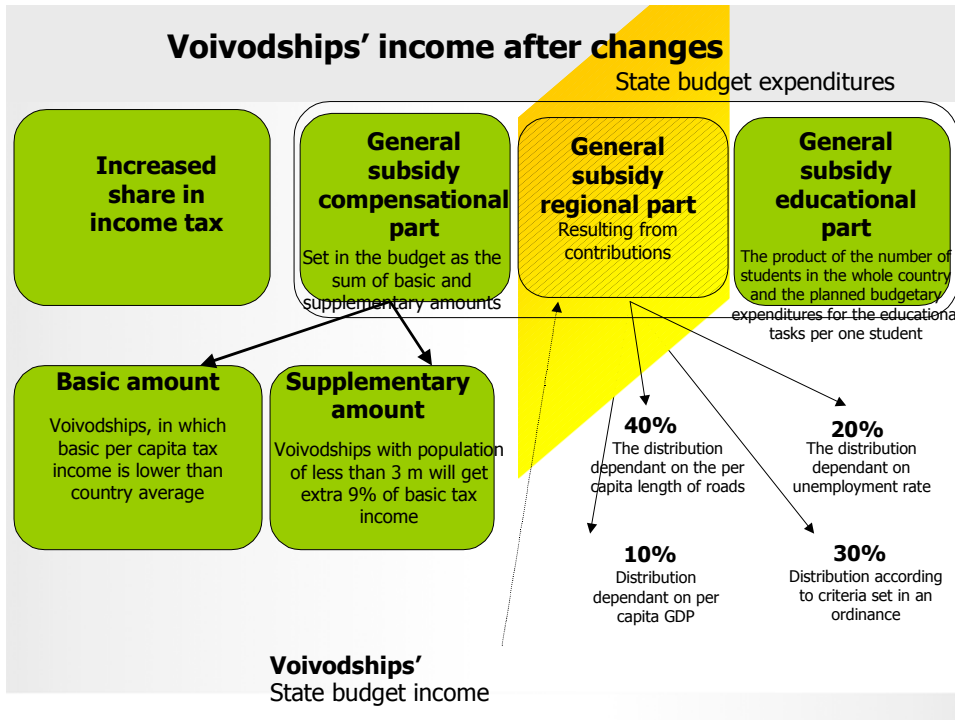
11. The poviats' share in the income from administration of State Treasury's real estate will be increased from 5% (currently) to 20%. It should translate into more rational administration of the State Treasury's real estate.

12. Taking into account the proposition by the local government units, gradual path towards final model of financing the selected tasks of social assistance is suggested:

- financing of stay of boarders in the social assistance houses in the transitional period will be financed by two sources: from own incomes (increased share in income tax) and subsidies from the state budget. It is assumed that every year the subsidies will be gradually reduced and the share in personal income tax will be increased;

- financing of tutelary-educational establishments; in 2004 they will be financed by subsidies from the state budget, from the year 2005 the subsidies will be replaced by own incomes.
13. In the transitional period monitoring will be carried out on constant basis, which will allow for evaluation of the mechanisms and making corrections during introduction of the final model.
14. The changes in the incomes of gminas, poviats and voivodships are presented in the below chart:





## Chapter V

### State-owned extra budgetary funds and State Treasury agencies

#### I State-owned extra budgetary funds

1. There are 20 extra budgetary funds in the public finance sector, of which 13 are state-owned extra budgetary funds. In the financial point of view the 14<sup>th</sup> extra budgetary fund is National Healthcare Fund, which was established 1 April 2003.
2. Extra budgetary funds present the group disposing of 16% of public sector revenues, with the expenditures reaching 16.6% of sector expenditures. As the result, these are the institutions responsible for managing significant, sixth part of public money.
3. Part of state-owned and some of local government extra budgetary funds possess legal personality. They are also granted significant independence in comparison with budgetary units in the process of taking financial decisions in order to fulfill statutory tasks.
4. Managing the public resources by the extra budgetary funds was often badly evaluated by the control institutions and Parliament. Hence the postulates for reorganization and liquidation some of these funds were risen.
5. As the main rule it is considered that the funds, of which functions may be taken over by the state budget or local government budgets without any negative consequences for realization of social and economic goals, should be liquidated. In this case the tendency to consolidate public resources within the confines of budgets of different administrative levels should be decisive.
6. Within the domain of finance of the extra budgetary funds, the following changes will be introduced:
  - The rules of financial planning, reporting and accounting will be unified;
  - The financial scrutinies conducted by relevant ministers including ex-ante control in investment decisions and causing liabilities actions will be strengthened;
  - The possibility of purchasing and shares acquisition in the companies of commercial law, investing resources in the instruments of financial market other than security bonds and bonds guaranteed by the State Treasury, will be lifted.
6. There is basis to leave in the present shape – with the current range of operation but with strengthened supervision – some of state-owned extra budgetary funds, National Healthcare Fund and 3 local government extra budgetary funds.
7. In the progress of social consultations, the current situation of resources managed by State-owned Fund of Rehabilitation of Handicapped People (PEFRON) was discussed. Resources of this fund are not only assigned to fulfill the tasks imposed by the law of 27 August 1997 on professional and social rehabilitation and employment of handicapped people, but also to maintain the funds' offices and its 16 branches functioning in the voivodship cities (planned employment for year 2003 is 701 workplaces with the average salary PLN 3,962). The operation of PEFRON gained positive opinions by the consulted institutions, so it is recommended to maintain its existence.



8. Simultaneously it is proposed to reconsider the purposefulness of existence in the current form of:
- a) Alimentary Fund; what is directly connected with the reform of family benefits provided for in the framework of draft law on family benefits introduced by Minister of Economy, Employment and Social Policy<sup>11</sup>;
  - b) Privatization Fund; resources of this fund are assigned to cover the costs of privatization and execution of the law on compensation for periodical freeze of salaries in budgetary sphere as well as loss of some augmentations or bonuses to old age pensions or disability pensions. Realization of these goals was the basic idea to set up this fund. Currently, the payments are on the verge of finish.
  - c) Central Fund of Arable Lands Protection; it has mainly the function of redistribution, which was justified at the time of 49 voivodships. Currently, there are no basis to maintain this fund. As the result it is reasonable to disburse the resources of regional Funds for the self-governments' budgets. In this case these resources could finance integrated programs of regional development in the range of rural areas development. Proposed solution would be crucial pace in the process of decentralization of public finance management;
  - d) Veteran Fund; proposal of liquidation of the Veteran Fund does not include limitation of benefits for veteran and their families including currently served with this fund, which operation is fully subsidized by the national budget. It is worth mentioning that after entering into force the amendment law on provision of disabled war veteran and military men and their families, the law on veterans and people being victims of war and post-war persecutions, the law on personal income tax and the law on family, nursing and educational benefits the directions of this fund resources spending were significantly limited<sup>12</sup>.

The tasks which are being realized concerning social aid for veterans, maintaining the base of social houses for elderly people, healthcare units, healthcare resorts and educational actions, may be carried out by the gminas (delegated tasks) or directly by the Office of Veterans and Persecuted People;

- e) Artistic Activity Promotion Fund; this fund is disposed by minister responsible for culture and national heritage protection. It is recommended to maintain this fund expanding at the same time the entitlements of Minister of Culture to execute its rules of financial management;
- f) Moreover, in the process of changes in the system of environmental protection funds Minister of Environment will draw up project of integrated management for Central and Voivodship Environmental Protection and Water Administration Funds. This integration is the pace to meet the criteria of the EU Accession Treaty, particularly to

---

<sup>11</sup> Currently, the draft of law of family benefits is the subject of parliamentary works. According to its assumptions, alimony benefit is proposed to be replaced by increased family benefit related to impossible execution of alimony orders or the impossibility to determine the commitment to alimony. Under this solution the Alimentary Fund will be liquidated and its assets will be transferred to finance the family benefits.

<sup>12</sup> Part of prior relives due to veterans, which were financed by the Fund's resources, was replaced by the compensatory bonus paid by the pension organs and financed with national budget.

improve the ability to absorb structural funds<sup>13</sup> and Cohesion Fund resources<sup>14</sup>. These goals will be carried out by:

- unified planning system of the activities essential to meet the criteria of the EU Accession Treaty;
- strengthening the role of governmental administration in funds management and supervision on the realized undertakings;
- giving priority to finance undertakings essential to meet the criteria of the EU Accession Treaty;
- unifying the rules of allocation and writing off credits and subsidies for The National and Voivodship Environmental Protection and Water Economy Funds.

g) Operating in the framework of Agricultural Social Security Treasury (KRUS), Reserve Fund and Motivation Fund:

- according to law of 20 December 1990 on agricultural social security operating in confines of KRUS Reserve Fund is aimed to cover the shortages of administrative fund as well as prevention and rehabilitation fund. Regarding to the sources of fund financing, its liquidation is to eliminate combining budget resources (allocated from budget subsidy for pension fund) with contribution resources in the fund accumulated only with fees paid by insured. At the same time proposed solution will amend the finance flows in KRUS.
- motion for liquidation of Motivation Fund, of which resources are designated to bonuses for KRUS employees, is justified with proposal to include KRUS employees in the general regulations for state office employees (it is provided for in the amendment draft law on social security for farmers);
- next important element of farmers social security system reform concerns the augmentation the insured farmers' share in system financing by combining the fee level with financial situation of insured farmers, e.g. combining the fee with the farm area.
- supervision of the KRUS activity will be taken over by the minister responsible for social security.

Detailed data concerning particular funds are presented in the appendix V.1.

## **II State Treasury agencies**

1. Currently, there are 7 State Treasury agencies. These institutions act using separated part of State Treasury in order to carry out specialized tasks. Three of them act in agriculture services and two in the area of national security. They were set up under specific acts of law.
2. In 2003 financial plans of agencies were included in budget law for the first time. In comparison with extra budgetary funds the agencies administer a slight part of expenditures and revenues of public sector. However, its management is not clean of shortcomings similar to disadvantages of extra budgetary funds. As the reason, the proposals for amendments are alike. Most of the activities were mentioned in item 5.

---

<sup>13</sup> Gminas' and Poviats' Environmental Protection and Water Administration Funds operate within the provisions of law on environmental protection of 27 April 2001, having in disposal such small amounts of money that they are not capable to start investment tasks.

<sup>14</sup> Capital investments which are thought to increase in the future the funds' revenues, holding on the other hand the risk of these expectations, limit significantly the possibilities to disburse current financial resources for environmental tasks. These financial operations do not comply with „Preliminary conception of economic-environmental instruments system modification” which is aimed to search new sources of capital for environmental goals.

In the financial management of the agencies it would be additionally recommended to:

- prohibit launching new foundations;
- allocate financial resources in one state owned bank;
- discipline salary policy.

The proposals for further existence of agencies were introduced in appendix V.2.

3. It is proposed to carry out gradual and deep changes in the Agency of Agricultural Propriety of State Treasury (AWRSP). Thanks to this project it would be possible for the Agency to free of tasks not tied with takeovers and circulation of arable lands as well as to take over these tasks by other institutions. At the same time the revenues surplus over the expenditures of the Agency should be the part of national budget.

It is necessary to shift social tasks, currently carried out by AWRSP, to local governments or according to the characteristics of the minister responsible for social security, transferring at the same time financial resources to these institutions in the confines of public sector reform.

With reference to the social tasks carried out by the Agency indirectly<sup>15</sup> or directly (aid and activating programs) – these tasks should be delegated to coordinate by the minister responsible for social security. Execution of these task may be transferred to the local government units (own tasks, in particular situations delegated tasks), NGOs, charitable organization etc.

There is no reason to maintain the social welfare subsystem financed in vague, nontransparent way by the usage of financial surpluses of AWRSP in the national social security system for the country-living citizens on the areas of former state-owned farms. However, it is suggested that the institution should be based on already functioning institutions in European Union (e.g. French Agency SAFER) on the strength of overtaken arable lands resources.

The new institution (named as Land Bank, Land Office or National Agricultural Fund) would be responsible of arable lands circulation, issues concerning individual farms area augmentation, creation new family farms or alternatively issues concerning demands of people resettled from East, which in the light of Constitutional Tribunal ruling the need of real possibilities to gain the compensation. This new institution might be also included in the issue of re-privatization. It may be needed as well to simplify the privatization of the part of real estate, which in the current conditions, cannot be permanently allocated (monumental apartments or in the structures being integrated part of household).

Under the law on amendment of law on managing agricultural real estates of State Treasury of 20 December 2002, shares in companies, founded on the base of resource property, owned by the Agency, become the property of Minister of State Treasury. However, executed by the Agency the rights of law in the companies dealing with plants and animal breeding of special priority for national economy might be executed directly by the Minister of Agriculture and Rural Development.

---

<sup>15</sup> It concerns disbursing money for Work Fund, so financing the pre-pension benefits, aid for unemployed workers of former state-owned farms and professional activation.

4. The second in the row important issue in the reference to State Treasury agencies is liquidation by the year 2005 the Military Housing Agency (WAM) by merging it with Military Property Agency (AMW). Such solution allow to save resources in the process of administrative structures simplification.

WAM existence as the separate institution will postpone rational solution of the problem of apartments for soldiers, which is lifting the responsibility for administrating these apartments by national agenda.

AWM and AMW merge should be accomplished as soon as possible, although before it is necessary to:

- solve the issue of apartments usage of people who have already exited the army, but still has been occupying the locations being at the disposition of Agency;
- reconsider the conception of new apartments construction within the confines of new forms of house building e.g. within the confines of Social Construction Societies.

However, with the reference to other State Treasury agencies it is necessary to amend the rules of financial economy and improve the supervision over exploitation of State Treasury property.

5. It is necessary to create comprehensive and stable system of State Treasury property management being under the rule of organs and units of governmental administration units. Comprehensive stocktaking of the property will be taken already in 2003, and furthermore the functional division of particular items in the aim-task arrangement will be drawn up. The property should be managed in complex, since partly solutions create the possibility to abuse. Minister responsible for administrative issues or State Treasury agency pointed by the minister will be responsible for the effective exploitation of the property.

## Chapter VI

### **Independent public institutions of healthcare (ZOZ)**

1. The system of healthcare service financing implemented in 1999 divided functions of supervision over the healthcare institutions and payment for the services. Supervision over healthcare institutions functioning is held by:
  - Local governments (gminas, poviats, voivodships);
  - Minister of Internal Affairs and Administration;
  - Minister of National Security;
  - Minister of Health (blood donation stations, Air ambulance service);
  - The authorities of higher medical school and medical universities with the reference to clinics.

Financing of ZOZ activity was due to contracts with former Healthcare Offices and the subsidies of national budget. The budget also overtook the service of almost PLN 9 bn of debt, which was burden of the healthcare units at the end of 1998. The budget is also financing the court verdicts on the faults in the art of medicine committed before 1999.

The amendment of financial management of independent public institutions of healthcare needs the assumption of the jurisdiction of law on public finance by encompassing ZOZ with procedures of internal audit.

2. In spite of disbursing rising public resources for financing the healthcare institutions network (roughly PLN 30 bn year-to-year, it means PLN 774 for a citizen) the finance problems met in this sector are still not satisfactory solved.
3. The new manner of financing by the National Healthcare Fund should simplify the solution of some problems, but to gain considerable improvement in this area possibly soon it is necessary to:
  - finalize the concept works on proper organizational form of ZOZ and implement the new model of healthcare institutions network, mainly hospitals. It will be sort of support for the foundation organs to take decision about future existence of some institutions;
  - introduce the standards of services paid with the public resources with exact price indication for services;
  - strengthen the supervision over the expenses for the medicines and subsidies to medicines, using the possibilities provided for in the law on prices.
4. The state budget under the current law system cannot conduct another general operation of debts repayment. This obligation burdens the founding organs – mainly local government units – their support may be to issue security bonds or alternatively controlled bankruptcy of ZOZ.

## Chapter VII

### Higher education and science units

#### I Higher education

1. Currently there are 360 higher schools in Poland., of which about one-third are state schools, and the rest are private ones. In 121 state schools 77% of total number of students are taught.

In the total number of students of state schools (over 1,4 m people) about 55% are students of daily studies, and the rest are the students of weekend, night or extramural studies. These courses are payable.

2. According to currently existing system of material aid students may benefit from different forms of financing from the national budget, *inter alia* social, scientific scholarships, the grants of minister assigned for the achievement in education as well as subsidies for accommodation and reinforcements or subsistence allowances.

Introduced in 1998 the system of student credits gave the possibility to apply for the preferential credits with subsidy to interests by the Credit and Loan Fund. The fund is administered by the Bank Gospodarstwa Krajowego (BGK) and subsidized by the national budget. New provisions in the range of social aid for the students should be directed to limit the different types of such aid and introduce one coherent financial benefit allowing eligible person (after meeting formal criteria) to study at the freely chosen university. The level of the benefit guaranteed by the state should be differentiated with the regard to place of residence and student's and his/her family's financial situation.

3. Appropriate financial management conducted by the schools combined with the relevant personnel policy may contribute to improvement of the educational process. In order to gain this goal it is suggested:
  - increasing the responsibility of school presidents for the financial policy;
  - introducing the rule of consent for employment of additional research worker by the school president.
4. Care of the education quality needs more strict rules on accreditation for particular faculties and for all higher schools. It seems to be worthy to create the mechanisms of systematic inspection of the educational quality in higher schools which could be connected with the financing level.
5. Recognizing higher schools as the important centers stimulating regional growth, it is necessary to work out the mechanisms tightening the cooperation of schools with the domestic regions and increasing their share in financing existing local mechanisms.

## **II Research and development institutes**

1. The financial system of science existing so far needs modification in order to increase effectiveness of research and development works as well as to bolster country economic development.
2. Transformation of Science Research Committee (central organ of governmental administration) into opinion-counselor Science Council operating under the Minister of Science and Informatization will rationalize the procedure of assignation and accounting the financial resources designated to science, in particular allow to run the active scientific and scientific-technical policy of the state:
  - Minister of Science and Informatization (MNI) will have the right to decide whether to finance specialized, preferred research programs and projects and to point out the executors of these tasks;
  - the rules concerning criteria and the modes of assignation and accounting the resources for the science in order to choose financing the best units and projects will be amended;
  - Economic and scientific verification of scientific units will be carried out, the MNI will be running the registry of these units (including research and development units as well as possessing the statute of National Research Institute). Only the units appeared in the registry would be entitled to receive the subsidies form the national budget for the statutory activities and investments;
  - In the reformed system of research financing the priority will be given to bigger projects, bringing tangible benefits for the economy, which requires stable financing. There are also assumptions that the resources for the co-financing of project approved to finance by the European Union structural funds will be saved up.
  - the possibilities to declare insolvency for the research and development unit will be created.
3. Above-mentioned allows to concentrate the resources and will give the chance to run scientific and innovative policy consistent with national economic policy. Stricter selection of research projects and their executors should increase effectiveness of public resources management.

## Chapter VIII

### Tax system and legal public levies

#### I Tax system

Existing tax system was the effect of process set up in the early nineties. Since then the conditions of economic activity has been changing systematically. As the result, the complicated, inconsistent, expensive in administrating and burdensome tax system for entrepreneurs and citizens was created. There is an urgent need to implement changes in regulations, in particular concerning personal income tax (PIT) and corporate income tax (CIT) in order to facilitate deliverance of tax duties, simplify the whole system, increase its transparency and banning the inconsistency in interpretation. It is necessary to arrange the scope of entities and objects in the tax system.

Furthermore there is a need to arrange the sphere of capital tax, so that, beside already taxed income of savings and deposits interests and dividend, the relevant, uniformed regulation encompasses as well the benefits of transactions in financial market, property rights, copyright and related rights. System of indirect taxation, consisted of value added tax (VAT) and excise, must be reformed according to European Union criteria.

The reform meets following goals:

- modernization and simplification of tax system;
- unifying the rules of taxation of the corporate income-tax;
- reduction of tax brackets;
- extending the tax base;
- harmonization of tax rules with the European Union criteria.

These changes are aimed to create stable tax system, which will offer profitable conditions of activity for enterprises, encourage the household to economize and decentralize public finance. The tax system modernization will be expanded in time till 2006. In 2004 following new regulations will be implemented:

- PIT and CIT in the part connected with arranging the list of tax relieves as well as the registry of incomes currently being not taxed, as well changes in the tax brackets;
- lump-sum income-tax for some revenues of private persons;
- value added tax for services and custodies, which will be regulated by new law;
- excise (by issuing new law as well);
- civil law actions tax (the regulations will be adopted to EU directives);
- personal income tax;
- corporate income tax, incomes of private persons from the extra-agriculture economic activity, agriculture activity, capitals and revenues of acquired timber.

Furthermore in 2006, existing real-estate tax will be replaced by the tax of real-estate value, which will bring additional revenues for the local governments.

#### 1. Income taxes

Currently, the system of income taxation consists of:

- personal income tax (PIT);
- corporate income tax (CIT);



- deposit interests tax;
- so-called simplified taxation methods.

The simplification in the scope of tax entities will concern division of all the income tax taxpayers for two basic groups:

- persons obtaining revenues from work will be PIT taxpayers;
- persons obtaining revenues from the economic activity (agricultural and extra-agricultural) and obtaining the revenues from capitals will become CIT taxpayers. Income will be established under the basis of tax book or it will be possible to profit from simplified taxation methods. For the CIT taxpayers the income will be established on the basis of the account books.

### **1.1. Personal income tax (PIT) and corporate income tax (CIT)**

The system reconstruction will be based on arranging in the scope of tax entities and tax objects of particular taxes and expansion in the scope of revenues encompassed with the system.

The system arrangement is based on several criteria:

- more precise description of revenues or the conditions of obtaining tax-relieves, which are often practically misinterpreted and inconsistent;
- maintaining existing regulations of including to the revenues which are not taxed, the revenues received by way of welfare benefits paid by public resources;
- maintaining the tax exemptions for social scholarships;
- maintaining the rule that the compensations for loss of health or material loss are not taxed;
- maintaining the relieves for joint marital taxation, lone parent taxation and handicapped persons as well;
- keeping the right for the taxpayer to deduct from the revenues the fees for the social security system as well as to diminish the tax-duty by the amount of fees for the healthcare security and 1% deduction for free support for the organization of public benefit;
- maintaining the rights vested before 2003 to the now liquidated tax-relieves.

In the perspective of year 2003 the works to arrange the object scope of income taxes should cause increase of budget revenues by about PLN 6.6 bn in comparison with current revenues of income taxes. Taking into consideration the reform of local government units, these additional revenues will supply local governments radically increasing their ability to co-finance the European Union programs supported by structural funds and Cohesion Fund.

It is also suggested that the tax rate in the corporate income tax was lowered from the level of 27% to 19%, as well as that the additional tax rate of 17% for persons whose year-long revenues are lower than PLN 6,600 was introduced.

New solutions as the proposals in the scope of income tax – PIT and CIT:

- introduction of the lowest tax rate of 17% for the persons whose year-long revenues are lower than PLN 6,600 – with maintaining the amount free of taxation at the current level of PLN 2,800 as well as the cost of revenues – what will cause that the tax burdens will be lowered by PLN 1.4 bn;

- rationalization of entity and object tax relieves and exemptions in PIT will have the effect on changing the households net revenues – with other conditions unchanged – during the years 2004-2007 adequately by PLN 0.4 bn; PLN 2.4 bn; PLN 2.8 bn and PLN 6.6 bn;
- lowering gradually tax rate by 8 percent points (from current 27% to 19%) will bring the enterprise income rise by about PLN 4.5 bn;
- unified rules of accounting for all the persons running economic activity, that is transposing the enterprises taxed currently under the personal income tax to the groups of companies taxed under the corporate income tax with maintaining the simplified taxation methods, will lower the tax burdens for these taxpayers by about PLN 2.5 bn.

The following table presents detailed accounting effects for the tax reform.

## Effects of income taxation system reform in comparison with existing system of 2003

PLN bn

		2004			2005			2006			2007	
		Public finance sector	National budget	Effect for base of local governments	Public finance sector	National budget	Effect for base of local governments	Public finance sector	National budget	Effect for base of local governments	Public finance sector	National budget
<b>Personal income tax</b>												
PIT	Introduction of 17% tax rate	-1,4	-1,0		-1,5	-1,0	-1,5	-1,5	-1,1	-1,5	-1,6	-1,1
	Tax exemptions and relieves liquidation	0,3	0,2		2,0	1,4	2,0	2,4	1,7	2,4	6,6	4,6
	Capital revenues	0,0	0,0		-1,4	-1,0	-1,4	-1,5	-1,0	-1,5	-1,6	-1,1
	Transfer of economic activity	0,0	0,0		-8,3	-5,8	-8,3	-8,7	-6,1	-8,7	-9,3	-6,5
	Dividend tax rate reduction from 15% to 19%	0,1	0,1		0,1	0,1	0,0	0,1	0,1	0,0	0,2	0,2
<b>Total PIT</b>		<b>-0,9</b>	<b>-0,6</b>		<b>-9,0</b>	<b>-6,3</b>	<b>-9,2</b>	<b>-9,1</b>	<b>-6,3</b>	<b>-9,3</b>	<b>-5,7</b>	<b>-4,0</b>
<b>Corporate income tax</b>												
CIT	Tax rate reduction to 19%	-4,5	-4,3		-4,2	-3,9	-4,2	-3,9	-3,7	-3,9	-4,2	-4,0
	Tax exemptions and relieves liquidation	0,2	0,2		0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
	Transfer of economic activity	0,0	0,0		5,7	5,4	5,7	6,0	5,7	6,0	6,5	6,2
	Dividend tax rate reduction from 15% to 19%	0,0	0,0		0,0	0,0	0,0	0,0	0,0	0,0	0,1	0,1
	Donation liquidation	0,1	0,1		0,2	0,1	0,2	0,2	0,2	0,2	0,2	0,2
	Capital revenues	0,0	0,0		1,4	1,4	0,0	1,5	1,5	0,0	1,6	1,6
<b>Total CIT</b>		<b>-4,2</b>	<b>-3,9</b>		<b>3,4</b>	<b>3,3</b>	<b>1,9</b>	<b>4,0</b>	<b>3,9</b>	<b>2,5</b>	<b>4,3</b>	<b>4,2</b>
<b>Total (Effects of PIT and CIT regulations changes)</b>		<b>-5,1</b>	<b>-4,5</b>		<b>-5,7</b>	<b>-3,0</b>	<b>-7,3</b>	<b>-5,1</b>	<b>-2,5</b>	<b>-6,8</b>	<b>-1,4</b>	<b>0,2</b>

## 1.2. Simplified taxation methods

Lump-sum forms of taxation are predicted for small companies, of which turnover is lower than € 800,000.

1. **Taxation card** – this form will be exclusively designated for taxpayers that run their business single-handedly as well as for accomplices in the civil partnerships obtaining revenues from some types of activity.

Construction of that kind of taxation will be supported on current solutions: tax-rate will depend on kind of economic activity, on number of employed people, on number of citizens in town of residence of the company;

2. **Lump-sum tax of recorded revenues** – this form will cover mentioned in the act of law particular economic activities described in the Polish Classification of Goods and Services. Taxpayers who decide to choose this form of taxation will be characterized by different tax rates depending on economic activity. These taxpayers will be obliged to evidence the revenues as well as to deposit the annual tax return.

Upper limit of tax rate for the taxpayers conducting extra-agricultural economic activity will account for 19% of revenues.

3. **Lump-sum income tax** – as opposed to both previous forms of taxation the object scope of this form will encompass all kinds of economic activity. The revenues of private persons from extra-agricultural economic activity, including activity in the form of civil partnership as well as some private commercial companies will be the subject of this form of taxation if the turnover is within the limit of € 800,000.

Tax-duty will be based on the income established on the revenues revealed in the revenue evidence diminished by flat-rate costs of revenues. The costs for particular activities described in Polish Classification of Activities will be established on average data, stemming from analyses of private persons running extra-agricultural economic activity annual tax return for years 2001 and 2002 as well as monthly tax returns for the part of year 2002 and will be characterized in the appendix to the act of law. The tax rate will account for 19%.

The rules concerning the deadline of lump-sum tax payment, revenue evidence and delivering the forms will be analogous to lump-sum tax of recorded revenues.

## 1.3. Farmers income tax

Currently individual farmers pay taxes determined by the quality and area of farm (conversion hectare) and depending on rye price announced by the President of Central Statistical Office. Consequently, farmers are excluded from income tax system. As the result it is suggested to include them into general system of taxation. Proposed solution for farmers taxation will be set within the assumption that:

- the revenues from the income tax will be at the same level as revenues obtained from agricultural tax;

- tax will be neutral for farmers and gminas' budgets.

The taxation rules for farmers will depend on farm area. In the farms where the area is lower than 15 ha<sup>16</sup> income would be the product of multiplication of flat-rate income of 1 conversion hectare and number of conversion hectares (depending on area, sorts and classes of arable lands as well as on inclusion to the taxation district), on which the agricultural activity is set up<sup>17</sup>.

Tax rate of flat-rate income of farm would account for 9%.

Farmers owning arable lands of area lower than 15 ha would have the possibility to choose the way of establishing the income from their farms: either statistic income from the 1 conversion hectare or income resulting from book keeping.

However, in the farms with the area higher than 15 ha (not regarding to the legal status of the farm owner) income would be established on the base of book keeping. The incomes stemming from special branches of agricultural production would be also established on the base of book keeping, as well as taxed under this tax rate.

Regarding to the rule of generalization in the tax system, it would be reasonable to tax with the real estate tax all real estates, including arable ones. It would be necessary to conform the real estates tax rates for arable lands as well as to lessen adequately the income tax rate, what would finally allow to maintain at the current level the tax burdens for farmers.

---

<sup>16</sup> This is the doubled area of average farm.

<sup>17</sup> Flat-rate income of 1 conversion hectare will be determined by the statistical data announced by the President of Central Statistical Office. The transformation of physical hectares to conversion ones as well as determining the taxation districts will comply with the regulations provided for in existing provisions of law on agricultural tax.

## 1.4. Capital income taxation

The main goal in this scope is to unify the rules of capital income taxation for all entities. The wide definition of this income source is proposed. It will consist of financial capital, property and property rights incomes, including *inter alia* lease, sell off the parts of property, sell off the liabilities as well as copyrights and related rights.

The assumptions were adopted to describe the capital income taxation method:

- the object of taxation is the capital income determined by the general rules (surplus of revenues over the costs of these revenues) obtained within the territory of Poland and not connected with the other income sources;
- the revenues of taxpayers, whose economic activity is to obtain the capital as well as the revenues mentioned beneath are excluded from the capital revenues:
  - the capital revenues obtained by the public benefit organizations disbursed for their statutory activities as well as for tax payments not being the costs of revenues;
  - private persons not running economic activity obtaining capital revenues from selling off goods (real states) or property rights (e.g. the right of property to housing association flat or usable premises as well as the right to perpetual usage of lands) if it happens after 5 years starting from the end of the year when the it was acquired or constructed, and in case of payed sell off of goods, if it happens after 1 year starting from the end of the month, when it was acquired.
- capital revenues is created at the moment of obtaining or putting at taxpayers disposal the financial resources, financial values, goods, services or other revenues in nature form (the cash method of accounting was adopted for the capital revenues, simultaneously determining precisely the method of determining the financial value of goods, services and other revenues in nature form);
- the cost of revenues as the expenses connected with the revenue were recognized. These expenses must be substantiated with relevant paper and in particular:
  - the act of law will provide for the detailed provisions concerning costs of revenues with the regard to particular sorts of capital revenues;
  - the categories without specified costs of revenues will be determined;
  - the percentage indicator of flat-rate costs of revenues will be lowered from the current value of 50% to 20%, *inter alia* with the usage of copyrights and related rights by the authors and artists;
- maintaining current general rule (with some exceptions) of taxation neutrality for the mergers and divisions of capital corporations (resulting from EU directives). It is suggested that current solutions concerning taxation of companies mergers and divisions were maintained;
- presenting the possibility to account for the incurred loss solely with the revenues stemming from this source during 5 subsequent tax years on the general rules, determined for the taxpayers running economic activity;
- unifying the capital income tax rate at the level of 19%;
- the capital tax will not lessen the tax burdens stemming from other sources (currently for CIT payers the dividend and other revenues of profits in legal entity taxes diminish the tax accounted at the general rule);
- the obligation to capital revenues tax collection as well as to deliver capital revenues tax return belongs to:

- taxpayer,
  - payer – in the provisions provided for by the act of law;
- 
- should the non-resident obtain capital revenues there will be in comparison with current legal situation expansion in catalogue of capital revenues encompassed by the “at the source” taxation;
  - as the accounting period for the capital revenues tax will be adopted the period of 3 full subsequent months. Declaration and payment for the last accounting period in the tax year would be the ultimate declaration of amount of the capital revenues obtained in the tax year. The tax payment resulting from the ultimate declaration form would be final tax accounting of capital revenues.

## 2. Indirect taxes

### 2.1. Value added tax

#### Reform goals

The crucial goals of the tax reform are:

- arrangement of the provisions of law on value added tax of goods and services, which was amended 32 times;
- conforming the law provisions to EU directives;
- introducing the regulations concerning taxation of goods and services delivery among the taxpayers of different EU residence country within the area of these countries;
- separating the value added tax from the excise tax in law taxation system;

#### The process of works on the reform

The works on the act of law on value added tax of goods and services have stepped into the last phase. The implementation is predicted at the very latest at the day of Polish accession to EU, it means 1 May 2004. At this phase of works – assuming that the reform program will be realized entirely – there are no changes predicted in the VAT tax rates except from the changes resulting from the necessity to conform to EU regulations.

In accordance with negotiated exemptions, the VAT tax rates will be modernized in 2003. Notwithstanding the VAT is the most important source of revenues for the national budget and the changes introduced in 2004 will not provoke increase in tax receipts.

### 2.2. Collection system of excise tax

#### The premises to implement new legal provisions:

- the necessity to conform domestic law provisions to the standards determined by the European Union acts of law (*inter alia* Directive 92/12/EEC of 25 February 1992 on the general rules concerning products being subjects of excise taxation and on storing, circulation and supervising of such products),
- the necessity to meet the obligations stemming from the Polish negotiation stance in the area of “Taxation”.

#### Main premises to the draft law:

The law on excise tax is to:

- introduce the rules of free movement of excise goods with suspended excise tax collection with accordance to EU standards;
- introduction of institution for tax storing as well as for excise guarantees;
- expand the scope of taxpayers;
- create the state supervisory systems guaranteeing the inspection over the excise tax revenues;
- allow the free movement of unmarked excise goods between tax stores;
- expand the range of entities obliged to apply the taxation marks.

The act of law will enter into force on 1 January 2004, except from the provisions regulating the tax administration potential preparation to collect and control the excise tax as well as provisions concerning registration of entities being excise tax payers, which will enter into force 14 days after the law is issued.



### 3. Real estate value tax

Current real estate taxation system differentiates the tax-duty on the type of real estate and character of exploitation as well as on the quality of taxed lands. Usually, the tax is accounted for 1 m<sup>2</sup> of the real estate. The new system will tie up the tax-duty with the property market value.

#### Reform goals

The basic goals of reform are:

- unification of the rules of real estate taxation and conforming them to the requirements of market economy by introducing value as the basis of taxation;
- increase of gminas own incomes from local tax and offset the levels of burdens depending on the particular kind of property;
- strengthening the autonomy of gminas in local tax administering;
- rationalization of tax payers' economic behavior in the scope of property management;
- conforming the rules of real estate taxation to the solutions applied in EU countries.

#### The process of works

The amendment of laws on local taxes and fees, on agriculture tax, on the civil action tax, on the legacy and donation tax as well as the new law on forest tax have brought several advantages:

- arrangement of taxation law system;
- combination of real estate taxation basis with the data from the lands and buildings registry;
- simplification of tax burdening system;
- notaries are obliged to pass on the transcripts of notarized acts concerning real estates to the tax offices;
- introduction for the offices of gminas the necessity to run the real estate tax evidence electronically from 1 January 2005;
- adoption of delegation in the law on local taxes and fees for issuing to 2004 the regulation in the scope of electronic standard of real estate tax evidence.

#### Tax rates

Having prepared the real estate evidence and valuation system it will be possible to precise the exact level of tax rates. The basic rule in the process of tax rate estimation will be the neutrality rule. The receipts of new tax system should be equal to incomes which are currently being obtained. Regarding to the current tax rates differentiation, the new tax rates, estimated on the value of real estate, should vary from 0.1% (flat buildings) to no more than 2.0% (buildings in which the economic activity is located).

#### Time limits for the reform implementation

The real estate taxation reform will be run under several conditions:

- finalization of real estate electronic evidence system around the country till the 1 January 2005;
- creation of tax reporting system allowing the Ministry of Finance quick access to tax information gathered and archived by the gminas (as the expanded form of existing gmina reporting system);

- creation of monitoring institution for the real estate prices (value registry) in the tax offices as well as preparation the software allowing automatic estimation of value brackets for the real estates on given area;
- collecting and analyzing data of 2005 concerning the real estate value and taxation data in order to determine the tax rate level as well as the financial effects of changes. Taking into consideration the above mentioned conditions, the reform might be implemented no sooner than the 1 January 2006.

## II. Public levies

1. Polish economic system contains 59 different kinds of public levies, including: 10 types of taxes, 6 types of contributions burdening costs of work, 3 types of fees connected with environment protection and 40 different types of payments (licenses, permits, certificates etc.). These rules are included in 35 acts of law and 20 regulations. The qualifications to pay these levies differentiate on branch of activity, influencing in the way difficult to describe on the financial situation of particular enterprises, causing in many cases bureaucratic mess impeding economic activity. Each administrative department till the deadline limit of end of July 2003 should make the overhaul of the all public levies being under its jurisdiction as well as analyze the possibilities to limit the number of levies e.g. by merging or mainly by unification of counting manner and simplification of discharging rules. The proposals in this scope have to be presented to the Council of Ministers till 15 August 2003.
2. Alternative decrease of public levies burdens for the enterprises in favor of local government units (about 22% of public levies is received by these units) have to be negotiated within the Government and Local Government Common Committee.

The Ministry of Finance under its jurisdiction has already stimulated changes leading to limitation of public levies. Starting on 1 January 2003 several favorable solutions were introduced for the entrepreneurs:

### In the scope of civil law action tax

1. tax exemptions for the loans given to the entrepreneurs for setting up new or continuing economic activity, not regarding to the amount or loan value (exemption excludes loans given to the company by the accomplice);
2. Excluding the contract of guarantee from the catalogue of taxed civil law actions.

### In the scope of fiscal charge

1. Excluding the consignment document from the catalogue of taxed fiscal charge. This change will have important economic and practical impact for the haulers as well as for the entities profiting from their services. Realization of the duties imposed on the payers was connected with plenty, burdensome and laborious tasks, including the necessity to count and collect the fiscal charge, run the registry of this charge, dispose the declarations as well as paying in the collected charge on the account of taxation organ.
2. Charging with the fiscal charge the documents including the guarantee's declaration of will instead of taxing the contract of guarantee with the civil law action tax. This change will have practical importance, since it derogates the obligation to depose the PCC-1 declaration. Currently the fulfillment of the commitment is carried out by stamping the marks of fiscal charge on the paper;
3. Tax rates reduction of:
  - Certificates on tax-duties reduced from PLN 19 to PLN 15;

- Permits (permissions, licenses) for running economic activities others than mentioned in the IV part of appendix to the act of law reduced from PLN 833 to PLN 600 (this change is the return to the rate binding till 31 December 2000);
  - Permits issued on the basis of construction law for the construction of water-supply, sewage, electro energetic, telecommunication, gas, heating systems as well as roads except for access roads, access to buildings and exit roads reduced from PLN 4,164 to PLN 2,000;
4. Differentiating the levels of rates for the permits for admission to circulation and usage of plant protection agent, regarding to period of this admission (for 10 years – PLN 1000, for 3 years – PLN 600) as well as rate of fiscal charge reduction from PLN 694 to PLN 400 of single permit for admission to circulation and usage of plant protection agent;
  5. Separating new tax rates for the fiscal charge for the objects, which till 31 December 2002 were encompassed with general rate of PLN 833 and as the consequence rates reduction to:
    - PLN 400 for the permits and licenses issued on the basis of law on road traffic connected with run economic activity;
    - PLN 500 for the permits to running economic activity connected with organization of tourist events as well as with mediation for clients' order in reaching the contracts on provision of tourist services, issued under the provisions of law on tourist services;
  6. Exempting from fiscal charge the permits for:
    - removing trees and bushes issued to entrepreneurs;
    - occupying road lines;
    - transport of abnormal vehicles,

In the scope of real estate taxation:

1. Introducing the possibility to differentiate by the municipal councils the levels of tax rates for the particular entities of taxation with particular regard to the real estate location, run activity type, the manner of exploitation, technical condition of building.
2. Lifting the existing limitation to lower by the municipal councils the upper limits of tax rates (to 50%), which would expand the autonomy of gminas in the range of enacting real estate tax rates accordingly to local preferences, especially being conducive for the growth of economic activity and attracting domestic as well as foreign investors;
3. Introducing the legal definition for the lands, buildings, and structures connected with running economic activity as well as adopting the rule that in case of the object of taxation cannot be used to run economic activity because of technical requirements, it is not considered as connected with running economic activity resulting from lower tax rate in the real estate tax;
4. Introducing the preferential tax rate for the real estate tax for the buildings in which medical service business is run;
5. Introduction tax exemptions for lands, which cannot be rationally exploited in the real estate economy such as wastelands, ecological lands, forested and bushed lands with exception of lands used for economic activity as well as lands under embankments, lands between embankments with regard to their special importance in case of flood. Furthermore, having analyzed other public levies, which may be lifted, it is suggested relinquishing collecting handling fees in the scope of:
  - Exercising the custom control act;
  - Confirming the origin or custom status of custody;
  - Confirming the indicator of productivity or indicating method of evaluation thereof;

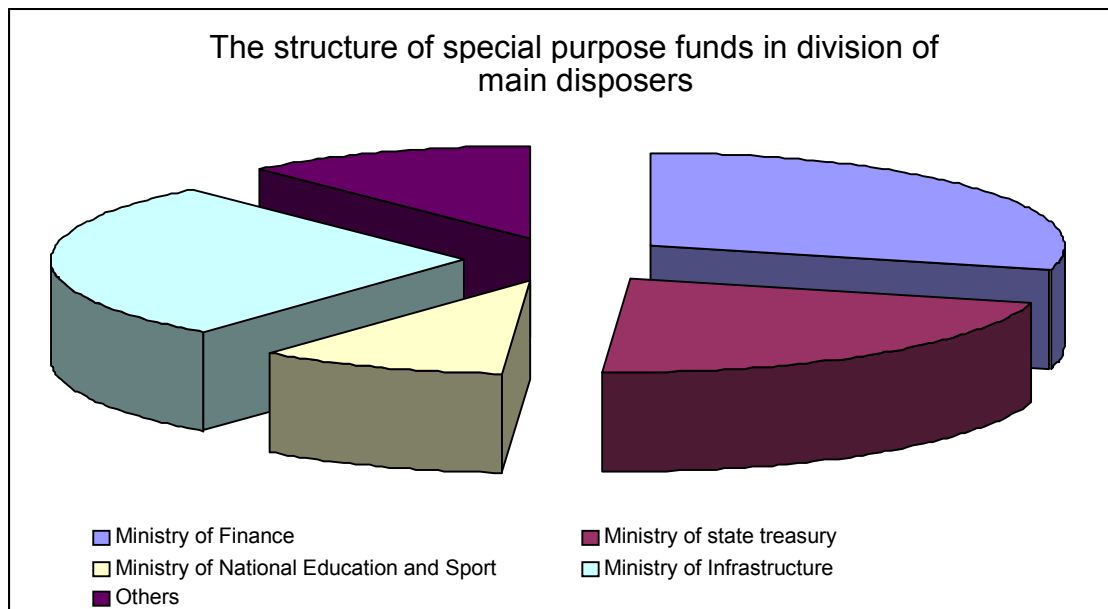
- Canceling the custom application;
- Encompassing the custody with transit procedure;
- Taking up the activity in order to cover the amount stemming from custom debt by the security;
- Exercising the act of registering in the list of customs officers.  
The only handling fee which would rest is the fee for considering the application form concerning the intellectual propriety protection.  
Additional handling fees would be also lifted:
- Failing by a person to meet the deadline of commitment or delivery of documents indispensable to give the custom destination for the custody;
- Removing custody from the custom supervision;
- Breaching by the person conditions or deadlines of the suspension procedure or the economic custom procedure;
- Breaching the conditions of custom exemptions for imported or exported products.

**Long-term instruments of budget offsetting**

Described earlier scenarios of budget constructions shows clearly, that there is a need to introduce permanent solutions in the rules of gathering the income as well as shaping the spending of the state budget.

**I. New solutions in the scope of special purpose funds**

1. Special purpose funds is the name for the separated accounts, on which budgetary units may gather the revenues stemming form tightly specified sources. State budgetary units may manage the special purpose funds under authorization of the law. Territorial units obtain relevant authorization under the resolution of appropriate organs. The spending, which may be financed by the special purpose funds, are also determined by the acts of law or resolutions. In 2003 on the accounts of special purpose funds of the state budget the overall amount of accumulated resources will account for PLN 4,626m.
2. The greatest share in this amount belongs to the revenues of ministerial special purpose funds: Ministry of Finance (29.1%), Ministry of State Treasury (27.7%), Ministry of Infrastructure (21.9%) and Ministry of National Education and Sport (9.9%). The rest of 11.4% of revenues is accumulated by more than 20 different disposers: ministries, central and voivodship offices. There are currently 58 special purpose funds.



3. The expenses from special purpose funds are designated for different goals. Taking into account the different kinds of expenses, 4 main sorts of expenditures may be separated:
  - a) as the bonuses to salaries (12 special purpose funds);
  - b) as the motivation source – bonuses and rewards for special achievements (13 special purpose funds);
  - c) as the financing source for the newly established fees (31 special purpose funds);

d) as the co-financing to the statutory activity of budgetary units (53 special purpose funds).

Some of the disposers manage with several special purpose funds and some of these funds may have several functions at the same time.

4. The special purpose funds are in reality the incomes or revenues which belong to the state budget. All the more, the expenses financed by these funds should be covered to a large degree directly with budgetary resources with complete supervision of Government and Parliament. Especially, it concerns the sources belonging to mentioned group: a), c) and d). In the disposer's point of view – as the owner of special purpose funds – these method of public resources management has several advantages:
  - greater autonomy in resources disposal;
  - motivation influence on the employees, who work out the income;
  - sources do not expire at the end of year.
5. Special purpose funds belonging to group c) will be partly liquidated as the result of verification of the fees registry. The costs of these fees are born by the economic entities and citizens (*vide* public levies). The rest of the revenues stemming from the fees should be included into budget income. Enriching the budget revenues by the resources rooting from special purpose funds of budgetary units cannot be automatic.

Every time the special purpose fund will be liquidated the benefit account will be presented.

6. The proposal of special purpose funds liquidation was criticized by the remarks submitted by some ministries. The difficulties which may occur in the every day activity of budgetary units were mentioned. Inter-ministerial Team has started arranging special purpose funds functioning. According to fixed agenda the interested ministries will submit proposals of shifting the receipts of special purpose funds to the state budget as well as relevant transferring of expenses. The necessary law amendments will be worked out.
7. The analysis of designation and sources of origin of several special purpose funds showed that their liquidation would bring severe limitation of priority Government activities, in the domain of culture support as well as sport support among children and youngsters. It is recommended to maintain the co-financing of culture and physical culture as well as sport with the subsidies to the rates in chance betting games being the national monopoly. Existing currently the special purpose fund called “post-penitentiary aid fund” will be transformed to the fund with tasks and financial supplies analogous to currently existing.

## **II. Greater elasticity of state budget spending**

1. In state budget, 100 expenses categories are shaped on the basis of valorization and indexation mechanisms. Sporadically both mechanisms are used together.

Valorization means that in precedent years the real value of expenditures is maintained e.g. unemployment benefit is valorized two times a year with the relevant price index. Similarly many of the branch benefits are valorized.

Under the indexation, we understand the connection between the particular budget expense with the other economic index or value e.g. expenses for the building,

maintenance and modernization of roads are connected with the value of forecasted excise tax income on engine petrol, expenses for the national security are connected rigidly with the GDP value as well as the value of some benefits depends on the growth of average or minimal remuneration.

All these connections prevent the Government and the Parliament from taking expenditure decisions in flexible manner as well as conforming them to the current priorities and goals of social and economic policy or to budgetary financial abilities.

The services and benefits which are valorized or indexed are presented in the appendix IX.2

The general rules in the determination of particular expenses' levels may be formulated as below:

- the automatic valorization and indexation is being given up. The Parliament under the motion of Government, according to the agreed priorities as well as to state budget financial abilities, should decide on amounts disbursed for particular task financing;
- the occasional benefits for different working groups should be limited. These benefits are valorized or indexed and what is more they fade the remuneration rules of different working groups as well as they are undermining the clarity and consistency of taxation system, since they are considered as the incomes free of tax. It is recommended to liquidate these benefits or in some cases to include them into salaries.
- old age and disability pensions are the specific group of spending, which are valorized and indexed. The valorization index is being negotiated during the works of Three-party Committee on Social-Economic Issues and as the results of these negotiations the nominal and real value of these expenses is constantly rising.
- During the years 2004-2006 the general valorization of budget sphere remuneration for all employees should be abandoned. However, there are working groups for which the salary correction is necessary. The changes in the structure of employment connected with EU accession will be indispensable. In this case the mechanism of valorization is groundless, also regarding to the record-breaking, negligible low rate of inflation, which amounted in April this year merely 0.3%

The solutions mentioned above are already taken into consideration in the expense forecast of stability and growth scenario.

### **III. Improvement of tax collection**

Last years saw the actions resulting from expansion of tax base and limitation of pathological phenomenon like reduction of the shadow economy. The improvement of tax administration operation by law amendment on executive proceedings, new electronic systems EGAPOLTAX and EGASPRAW as well as lengthening the deadline for VAT payments will have positive effects on tax collection. The improvement of companies activity will be also due to works on the law on restructuring some public receivables of companies as well as on amendment of law on employees legal claims in case of employer's insolvency.

The proceeding of amortization of loans encompassed with restructuring was conducted and new solutions introducing tax bonuses as well as provisions in the range of bank reserves were presented. As the example of decision causing smuggling limitation and expansion of tax base was the decrease of tax rate for the spirit products by 30%.

According to plan, this decision lowered the spirit products smuggling, and on the other hand it caused the sale increase for alcoholic products produced in Poland.

The Ministry of Finance is going to continue the works influencing on the shadow economy share decrease in economy, limitation the scale of smuggling as well as improving tax collection. The tax system changes and other below mentioned activities will be conducive to improve the situation:

- introduction the new method of lump-sum tax in the range of economic activity taxation, in which flat-rate costs accounted on the basis of real statistical data will allow to diminish the number of cases when the costs are overstated;
- increase of tax rates for the fuel oil to the level close to diesel oil, with ensuring the users of fuel oil the reimbursement of additional excise, which should prevent from the frauds on the fuel market.

The crucial issue influencing on decrease of smuggling proceedings will be the usage of European Union funds for the improvement of border infrastructure. Conforming the Polish east border to the standards provided for in the Schengen Treaty will improve the information system as well as increase the effectiveness of customs service.



#### **IV. Other possibilities for budget reinforcement in 2004-2006**

1. Processed analysis show that the state budget in the discussed period must economize new, additional streams of resources among others to finance member contributions to European Union budget as well as to pre-finance and co-finance the structural and cohesion programs. The second mentioned group will not have entirely the characteristics of ultimate expenses, since the resources will be refunded to a large degree with structural funds, Cohesion Fund and EU budget. Notwithstanding, temporally – probably during the period of 18 to 24 months – state budget will have to bear the expenses.
2. The local government units are in similar situation. They will also be enforced to disburse part of the resources for the new spending. In this situation the Government has taken actions in order to obtain new finance resources and different methods of financial plans creation. These instruments are described in chapter X.
3. Some of the activities proposed in the Public Finance Reform Program are aimed to economize the most possible amount of sources to co-finance structural and cohesion funds. In national finance resources exists another one, not actively executed yet, financial source namely valuation reserve accumulated by National Bank of Poland. The concerns are about position VI.I of the liabilities of NBP “The reserve to cover the risk of instability of exchange rate of Polish zloty to foreign currencies” accounting for PLN 27,415 m. on 30 November 2002, what makes 3.6% of GDP (at the current rate of exchange the index is even higher). The amount consists of accumulated profits as the time goes, which are the source of difference between current exchange rates of foreign currencies and lower exchange rates of these currencies at the moment of reserve accumulation by NBP. In the technical point of view, this amount is the separated position, which is potential profit. It may be realized only by selling off foreign currencies. To that moment the amount has the role of reserve in case of appreciation of foreign currencies. While selling off the foreign currencies reserves the relevant part of valuation reserve increases the profit of NBP (position VIII of liabilities in the NBP balance sheet). About 93% of NBP profit, also coming from dissolved part of mentioned reserve, is assigned for national budget in next year. It is the question of accounting practice whether and how much of mentioned amount should stay in the reserve for the risk of valuation of PLN cover or it should be the income. There are examples of the valuation reserve execution in the period of financial tensions (in some countries during passed years e.g. in Germany, in Sweden and Switzerland).
4. The situation in Poland is more complicated. Firstly, the law on accountancy does not apply to NBP however the international standards of accountancy do not create sufficient basis and cannot be implemented entirely. By 1 January 2004 the regulations of accountancy will have been modified by NBP according to regulations of European Central Bank and European System of Central Banks.

Secondly, albeit the basis funds of NBP are low, they are compensated in excess with huge net assets.

Thirdly, the valuation reserve is not practically need, since NBP has sufficient net assets to cover the losses resulting from alternative nominal appreciation of Polish currency. In practice, on no account the entire amount of reserve will be needed, since it would be necessary in case of PLN appreciation to the amount of about PLN 3 for USD 1, which

seems to be unreal. Even the IMF reckons the Polish valuation reserve to be exceptionally high, excessive in comparison to needs, which may appear in connection with PLN appreciation (IMF note of 11 March 2003 "Valuation reserve of NBP"). In a row, the Committee for Annual Report Examination of NBP states that in case of hypothetical situation of selling off entire valuation reserve sources of central bank, PLN 14 bn of valuation reserve would not be dissolved, what proves the shortcomings of its construction.

Fourthly, NBP keeps extraordinary foreign currency reserves amounting over USD 31 bn, excessive in comparison to security requirements both with reference to money supply and size of imports. Taking into consideration exchange goal of central banks the foreign currencies reserves protect against devaluation however in condition of floating exchange rate huge currency reserves are not needed.

5. Under these conditions it is considerably justified the execution at least of part of valuation reserve in order to cover high cost of EU accession. In this context two reservations are arisen.

Firstly, it is considered that the profits have virtual character. It is not true, since they are in fact realized in the valuation reserve and not earmarked for the state budget. It may be found as true since the profits are not realized. These profits could be easily materialized by acquiring by the Government the foreign currencies sold by NBP and then reselling them to NBP at the market exchange rate. That is the question of conventions, which may be revised.

Secondly, the arguments are arisen that the execution of valuation reserve may increase the money supply. However, it would happen in case when mentioned amount helps to increase domestic budget expenses or reduce the tax incomes. In the final effect, there will not be money supply increase when the amount is used outside the country to pay the member contribution to EU and foreign debt service (as it was marked in IMF note of 11 March). On the contrary the budget deficit would be increased. According to accountancy standards of ESA'95 such reserve execution will not change the index of budgetary execution Maastricht criterion however it would decrease the index of public debt execution criterion – what is more important – in the point of view of legal and constitutional limitations.

6. In the technical point of view valuation reserve may be executed in legal way or by harmonizing the accountancy regulations of NBP with regulations of ECB and ESCB or by – with regard to difficult situation of economy – relevant decisions of Monetary Policy Council in the range of coordination between fiscal and monetary policy. To encourage the implementation of last proposal it is recommended the partly execution of valuation reserve to support public finance reform – PLN 9 bn in 2004, and in 2005. There are exceptional circumstances for such approach to valuation reserve, but it demands constructive cooperation of the NBP part.
7. Thanks to reinforcement by valuation reserve the national budget would be capable of carrying out the tasks more effectively along with lower budget deficit or – considering different point of view – without necessity to drastic tax rises or to cut the expenses.

## **V. Liquidation of some institutions**

1. There is a need to carry out the systematic overhaul of institutions which have already fulfilled their mission or are losing the importance in constantly changing conditions. In this manner the resources for new task financing may be obtained.
2. It is necessary to liquidate the Ombudsman Office for Women Issues including its tasks to an extended Ombudsman Office.
3. There is a proposal to liquidate the Governmental Center of Strategic Studies.

## Chapter X

### Financial instruments

#### X.1. General assumptions

In order to maximize the funds intended to finance public utility undertakings, particularly providing the necessary funds co-financing the projects utilizing European Union funds' sources, it will be necessary to broaden the scope of financial instruments used in the Polish financial market. Based on the other countries experience several examples and solutions which could be adopted in Poland, particularly for financing infrastructural investments, are shown below. Other countries experience shows that these projects can be financed simultaneously from the number of public and private sources at the same time (so called - financial montage) using the whole spectrum of organizational solutions. In the process of implementation of this programme detailed investment measures will be undertaken aiming at broadening the scope of usage of the financial instruments.

In a face of state budget limitations it is essential to make the private capital more interested to co-finance public utility undertakings.

The necessary public and private funds will be provided, among the others, through:

- Usage of the traditional investment financing sources, such as the sureties and guarantees which translates also into the entire spectrum of the debt instruments. It will be aimed at the greater usage of the municipal bonds and the bonds backed by the incomes.
- Creation of the favorable conditions for the implementation and usage the new on the Polish market possibilities for investment financing, such as securitization or public-private partnership.
- Implementation of the widely used in the European Union solutions, such as creation of the Special Purpose Vehicles (SPVs) for the sake of execution of the investment projects being financed from various public and private sources.

Particularly important role in financing the investment projects, especially the big infrastructural ones, will be performed by the Bank Gospodarstwa Krajowego (BGK) acting as: the issuer of the bonds guaranteed by the State Treasury, the depository of the public funds intended for the infrastructural investments and the entity assuring the service of the accounts for the funds co-financing the infrastructural projects. The BGK will take the action in order to assure the smooth fulfillment of these functions.

Many of the financial instruments being used in the world are relatively faintly known in the Polish market. Their implementation demands undertaking appropriate organizational actions and legal solutions. Below, the development of the system of investments funds, securitization and the public-private partnership is being concentrated on. Also the assumptions for the strategy for the State Treasury guarantees and sureties are being discussed in a range of utilizing funds accumulated by the Open Pension Funds.

## X.2. Investments funds

In the proposed Act on the Investment Funds there have:

- Implemented complex solutions for the securitization
- Resigned from the mixed investment funds and specialised closed-end investment funds regulations transferring the solutions regarding these funds into the closed-end fund.
- Made the investments limits of the open-end investment fund more elastic and adjusted them in line with the UCITS Directive. The open-end investments funds are also allowed to make the money deposits on bank accounts, acquire money market instruments and to sign the contracts, subject of which are non-standardized derivative instruments.
- Implemented the new kinds of the investment funds:
  - Open-end investment fund with various participation units, which can sell to the participants the participation units of various types, even though it does lead the homogeneous investment policy
  - Primary and related funds which nature is the reflection of the ones functioning in the USA (hub & spoke) and €ope (master feeder). In this solution the investment fund corporation creates the group of funds consisted of the primary fund which sells the investment certificates and participation units issued exclusively to the related funds, which in turn, can keep in their investment portfolios participation units or investment certificates of the primary investment fund, only.
  - Funds with the separated sub-funds which is the reflection of what exists in the €ope as the *umbrella fund*. This regulation is aimed at allowing for the creation of the number of funds operating within the framework of one investment fund. Each of the sub-funds can lead its own investment policy.
  - Money market funds, which are mainly to be the tool intended to make use of the seasonal financial surpluses and to make use of the spare funds in the periods when there are no favourable conditions on the capital market discouraging from investments on the stock exchange.
  - Portfolio funds – this is the solution that allows for creating and operating in Poland exchange traded funds. Portfolio funds would operate based on the legal framework of the closed-end investment fund. This form of fund assures the continuous possibility of issuing and cancelling the certificates.
  - Securitization funds – their creation is aimed at the liabilities securitization process to be commenced on the Polish market, together with a vital role of the investment funds.
  - Non-public asset funds – their principle is to invest the funds' assets into the stocks and stakes of the non-public entities and to prepare and implement restructuring programmes of these entities in order to raise their value. These type of fund operates in the world as the private equity, the goal of which is the realization of the high risk investment policy and allowing this sort of fund for paying out the funds sourcing from the revenues from selling off its deposits.
- Introduced the possibility for the investment funds to grant the securities in a form of the loans and, in the case of the closed-end investment funds, the possibility to grant the loans of money, sureties and guarantees.

### **X.3. Securitization**

Securitization is the method of the monetization of the future and overdue assets and revenues. Assets based securitization is the form of the transfer of receivables from the originator (owner) to the Special Purpose Vehicle / Special Purpose Entity, which in turn based on these receivables issues and sells debt instruments representing these receivables.

General diagram of the securitization transaction is shown on the Chart 1. Such a transaction consists of the elements, as follows:

- Transfer of assets, for example future or overdue receivables portfolio, from the Originator to the Special Purpose Vehicle, which, in turn, issue directly or indirectly bond instrument backed by the particular assets. In the moment of setting a deal the net proceeds from the bond issue are transferred to the originator of the transaction in a form of the payment for the receivables transferred. Bonds issued by the SPV are aimed at domestic and/or foreign investors
- Receivables are being executed by the originator or specialised third party entities (Entities Executing the Receivables)
- Receivables executed are intended to cover the SPV's expenditures (including the payments for the Entities Executing the Receivables) and debt service costs deriving from the bonds issued
- Investors do not have the regress rights against the Originator. In a situation when the execution of the receivables is worse versus planned, investors claim their rights against the SPV
- In order to provide the issue's liquidity there can take part specialised entity in the transaction whose aim is to assure the liquidity of the transaction (liquidity assuring entity). This entity shall satisfy the potential claims that can be raised when the asset inflows are unsatisfactory for satisfying the obligatory payments.
- In a situation where the whole or part of the bonds issued is denominated in one currency e.g. €, and the receivables are denominated in other currency, e.g. PLN, the protection against the exchange rate risk is necessary. In this situation, in the securitization transaction there can take part credit/insurance agency which will issue the exchange rate insurance.

To limit the issuance costs both parties of the transaction can consider the possibility of getting the State Treasury guarantees for the bonds being issued. These guarantees can be put together with the European institutions rolled guarantees.

Securitization, as a new financial instrument can have the significant impact on the Polish financial sector's functioning. Firstly, it creates safe, long term financial instruments, that can be the answer for the growing investment needs of the financial institutions in Poland, particularly open pension funds. Secondly, it is conducive to make the credits more liquid and, as a consequence, to lower its costs. Moreover, commencement of the securitization will have a positive impact on the development and improvement of the banks' operating conditions, which, in turn, will have to, to the greater extent, concentrate on improvement of the banking products and getting new clients.

Traditionally, the securitization is being used in order to service the credit obligations. However, in many countries, both in the European Union and United States, there were some other ways to make use of it that were worked out. For example, the SPVs are given

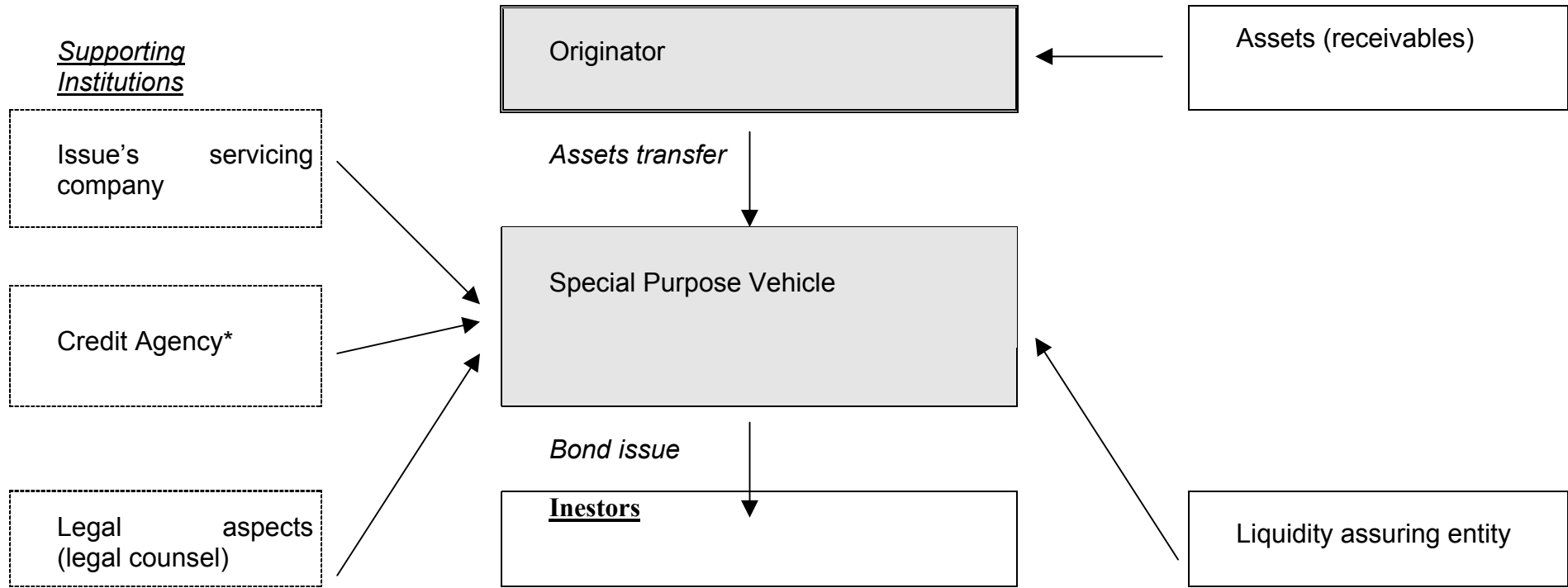
the right to the public sector assets, including the right to the future revenues (e.g. the prospective inflows from the excise tax, road fees or expected transfers from the European Union). In exchange, the public sector entities receive the money immediately, which are in turn spent on the public investments. Therefore, the usage of the securitization can be the additional impulse for the investment revival.

Several countries with a high level of public debt have used the securitization as a method of additional financial inflows and short-term budget deficit financing in the period before and in the first years of the European Union accession. Austria, Greece, Finland and Italy all they did the securitization of the receivables and assets, such as: inflows from the lottery (Greece, Italy), inflows from the EU (Greece), immovables (Greece, Austria, Italy) and not paid in contribution for the social and accidental insurance (Italy). The value of particular transaction was very diversified and varied from € 300m up to € 6,500m.

Taking into account the projected structure of the Polish budget for the years 2004-2006, the securitization is likely to be very effective tool bringing down the tension of the public finances during that period. Based on the European Union countries experience, securitization could apply to the following: expected payments from the European Union, inflows from the lotteries organized by the State Treasury (Totalizator Sporowy, PML), inflows from the excise tax, privatisation proceeds, ZUS receivables (Social Security Entity), inflows from immovables and premises leased, sale of land. The wide use of the securitization can be also used while creating the ways for infrastructural projects financing.

Particular attractiveness of the securitization as a alternative source of financing for the countries with a high level of indebtedness lies in the fact that it creates the possibilities to treat these revenues as an off-balance sheet financing. However, the Eurostat's regulations limit these possibilities to securitization of particular assets, despite the fact that there is some room for this kind of accounting procedures and they are being made use of.

**Chart 1: The securitization transaction diagram**



\* entity increases also the credit standing through the insurance, guarantees or credit accounts.



Securitization can be the mean disciplining the economic entities, since it practically makes it impossible to fall behind the payments. Within the securitization of the arrears – both the current and overdue ones have to be paid on a regular basis in a full amount, in line with a payment schedule. This improves also significantly the payments execution. Also, the very important element of this transaction can be the usage of the private entities specialised in the receivables' execution, which are motivated by the income sharing mechanism.

Finally, the securitization influences positively the budget liquidity through the monetization of long-term and illiquid assets, such as e.g. immovables.

As a new type of activity on a financial market, the securitization should be legally regulated in a form of the specific act and should be subject to the supervision. It favours the safety of investment into the securities, issued in connection with the receivables acquired. Securitization of the receivables by means of the securitization fund being supervised by the Securities and Exchange Commission shall allow for transparent and professional management of funds deposited by the investors.

Suggested measures in this respect shall allow for transparency of public finances. Legal wording shall be agreed in such a way to prevent from hiding the real public sector debt as a result of the securitization transactions, which could, in turn, endanger the long-term financial balance. It is also necessary to take into consideration the European Union's and particularly Eurostat's regulations in this respect. It is worth mentioning that the investment expenditures which are meant to be fully returned can be treated in a different way versus the non-returnable ones (in an operational sense), such as: financing of the education, security or the national defence. For example, the prospective revenues from the road fees, separated PKP's revenues and some EU transfers can be subject to securitization without any fears that there can be some disturbances in the transparency of the state budget's expenditures and incomes.

These and other questions related to the securitization are subject to draft Act on the Investment Funds. Solutions proposed are aimed at commencing the process of implementation on the Polish market the securitization of the receivables by means of the universal mechanism of the investment funds. In the future, when this instrument will find its broader applications, it will be probably necessary to set its new regulation in the separate legal act.

The draft Act on the Investments Funds consists of:

- Economic and legal separation of the receivables can be done in one out of two ways:
  - Selling receivables to the funds
  - Selling the rights to benefits derived from the separated receivables without selling the receivables being securitized per se. (so called securitization by means of sub-participation);
- Possibility of raising the safety of the securities being issued is expected by means of allowing the funds to issue the certificates, which will be guaranteed (sureties and guarantees being issued respectively) by the credit institution (bank) or other entity, the rating of which will be evaluated at the investment level by the specialised rating agency, recognized at the international capital market.

- Two types of securitization funds are expected to be created: standardized and non-standardized. Legal construction and assumed level of risk associated with issued investment certificates differ these two types of funds among themselves.
- Diversity of the particular series of the investment certificates issued by the securitization fund as regards the property law is allowed.
- Receivables financed from the public funds based on the separate regulations are allowed for being the subject of the securitization.

#### **X.4. Sureties and guarantees**

##### **1. Sureties and guarantees issued by the State Treasury**

The table below shows the activity in the field of sureties and guarantees issued by the State Treasury from 2000 to 2002:

Table 10.1 Sureties and guarantees issued by the State Treasury (in PLN billions)

Year	2000	2001	2002	Cumulative for the period	Average for the period
Amount of the sureties and guarantees granted	4.0	11.2	6.7	21.9	7.3
• insurance guarantees for the air carriers	-	4.1	-	4.1	-
• other	4.0	7.1	6.7	17.8	5.9
Contingent liabilities resulting from the sureties and guarantees (in a percentage of GDP)	1.4 %	1.3 %	1.6 %	-	1.4 %
Contingent liabilities of sureties and guarantees	19.9	27.2	32.5	-	26.5
Expenditures of granted sureties and guarantees	0.3	0.2	0.2	0.7	0.2

In the years to follow it is expected to concentrate the State Treasury sureties and guarantees issuing activities mainly on the infrastructural and environmental projects, being realized from the European Union funds mainly. Sureties and guarantees are meant to speed up the economic growth through the investment stimulation in a way that is safe for the state budget, following the financial leverage (credits and bonds guaranteed by the State Treasury shall allow for getting the multiplication of funds from the EU sources versus their value)

Table 10.2. The forecast of the State Treasury sureties and guarantees (in PLN billion)

Year	2003	2004	2005	2006	Total for the period	Average for the period
Amount of the sureties and guarantees to be granted	10.5	9.0	9.0	9.0	37.5	9.4
Expected payments in virtue of sureties and guarantees (in a percentage of GDP)	1.7	2.1	2.1	2.0	-	2.0
Contingent liabilities of sureties and guarantees	33.9	38.6	42.7	47.8	-	40.8
Expenditures in virtue of granted sureties and guarantees	1.2*	1.8**	2.5	1.7	7.2	1.8

\* in line with a 2003 Budget Act

\*\* based on the preliminary estimates for the draft budget act for the year 2004

Note: for the years 2003-06 the pay-back of guaranteed by the State Treasury liabilities of the Agricultural Market Agency [ARR] is scheduled. The amounts are as follows: 0.4, 0.5, 0.8, and 0.3 respectively.

In line with the Polish Constitution and based on the Act on Public Finance, the amount of expected payments in virtue of sureties and guarantees increases the public debt while measured versus the GDP. Thus, in order to control the public debt to GDP ratio, it was assumed that in the course of the years 2003-2006 the ratio of expected payments in virtue of sureties and guarantees should not exceed 2.0% of GDP. The only exception are the years 2004-2005, since there is a risk that due to the high demand for sureties and guarantees supporting mining restructuring, Polish State Railways(PKP) reform and interventions on the agricultural market in 2003, the ratio can exceed the ceiling set by 0.1%

State Treasury sureties and guarantees will be granted based on the financial risk analysis of every particular project. It comes from the experience, that the sureties and guarantees being issued based on the special acts (sectoral) and not based on the general rules written into the Act on Sureties and Guarantees granted by the State Treasury and some other legal persons on 8 May 1997, create a danger for the public finances. Therefore, granting the sureties and guarantees based on special acts can be accepted only on the basis of decisions taken prior to. It is forecasted that the practice of granting the State Treasury sureties and guarantees to support the non-competitive and not holding promises sectors of economy and also to support the sectors which are under the restructuring process, will be limited in time, in line with the program adopted by the government.

State budget's burden for the next years in virtue the prospective payments related to the granted sureties and guarantees will be subject to further analysis. Public finance safety will be the main decision making criterion related to the State Treasury sureties and guarantees.

## **2. Sureties for the small and medium-sized enterprises**

Irrespective of the State Treasury sureties and guarantees the system of sureties and guarantees aimed at supporting the small and medium-sized enterprises will be also developed. Bank Gospodarstwa Krajowego (BGK) together with its National Fund of Credit Sureties (KFPK) will be the core of the system.

Thanks to the BGK and Polish Agency for entrepreneurship development (PARP) cooperation, together with the help from the EU, there will be created the network of regional and local sureties issuing institutions, capitally linked to the BGK and supported by the re-guarantees from that bank. As the regional and local funds are being developed, the role of the KFPK will be restricted to issuing the sureties encompassing the projects of the greater value (up to € 5m) being realized by the municipalities and small and medium-sized enterprises.

At the moment, the BGK can grant the sureties and guarantees from the KFPK sources that cover mainly the credit or bond issue which are aimed at investment financing. Moreover, the BGK sureties and guarantees can also encompass credits and bond issues, the proceeds of which are intended for the: establishing self-employment organizing own working place, establishing cooperatives by the graduates, preventing from or eliminating the natural catastrophes or technical failures which are marked with the natural disaster features, implementation of the new technical or technological solutions being the result of the research and development and financing the business activity of the small and medium-sized entrepreneurs.

Since the beginning of running its business, which is 31 December 2002, the BGK has granted 1264 sureties for the repayments of commercial credits, totaling PLN 342.6 m and 2707 sureties within the confines of portfolio of student credits, totaling PLN 22.1 m.

## **X.5. Public-private partnership**

1. Public-private partnership (PPP) – as a method of realization tasks by the private sector is the complex form of cooperation where the variety of instruments can be used, such as: credits, bonds, sureties, guaranties. There are many usage examples for this formula (municipal economy, environmental protection, transport and communication). PPP application can be very broad; from the health care, education and security to big rail and road undertakings.
2. PPP is a form of cooperation between the public and private sector aimed at realization of public tasks through the private capital or with his participation. Not only does it cover the realization of the necessary investments but also provision of services in a agreed, usually long term (even few decades’) horizon. The point is, that the private investor accepts not only the part of the investment risk but also the responsibility for provision of contractual services at the agreed level. Bringing in the capital and participating in the investment risk, private investor gets a guaranteed return on capital provided the undertaking being realized brings the projected economic and social effects. In this way, the public service projects acquire the commercial effectiveness and proper quality.
3. PPP as a principle is a highly formalized method which imposes sequence of ordered, logic actions. Very strict procedures and complexity give a greater transparency and rationality than other forms of public sector tasks’ realization. These features translate into the time-consumption and burden in realization the projects, but on the other hand they offer decision objectivity, economic effectiveness and social usefulness. PPP demands the long-term approach but this can affect positively the public finance discipline, in exchange.
4. Development of the public-private partnership will cause the growth of the investment capital accessibility in a way that it will multiply the limited public (budgetary) funds by employing the significant private funds, including the foreign ones also. PPP can be also used to realize the investment projects using the European Union funds. Both the EU and international financial institutions attach great and still growing importance to PPP as a form of realization public undertakings. PPP creates the additional chance for Poland to absorb EU assistance in virtue of the engagement of private capital into the realization of public undertakings.
5. In order to develop the PPP in Poland it is necessary to amend existing legal regulations and to promote good patterns derived from the EU and already appearing domestic experience. PPP requires some changes in:
  - Budget Law construction;
  - Act on local government units’ incomes, Public Procurement Law and Public Finance Law (wording amendments);
  - Number of specific legal acts, sectoral in nature, such as: transport, road and highways construction, environmental protection, health care, education. All of these will require some detailed legislative, procedural and logistical changes.

Outcome of the intense work and discussion for the sake of PPP development should be preparation of the assumptions to the prospective legal act regulating the Public-Private Partnership rules in Poland.

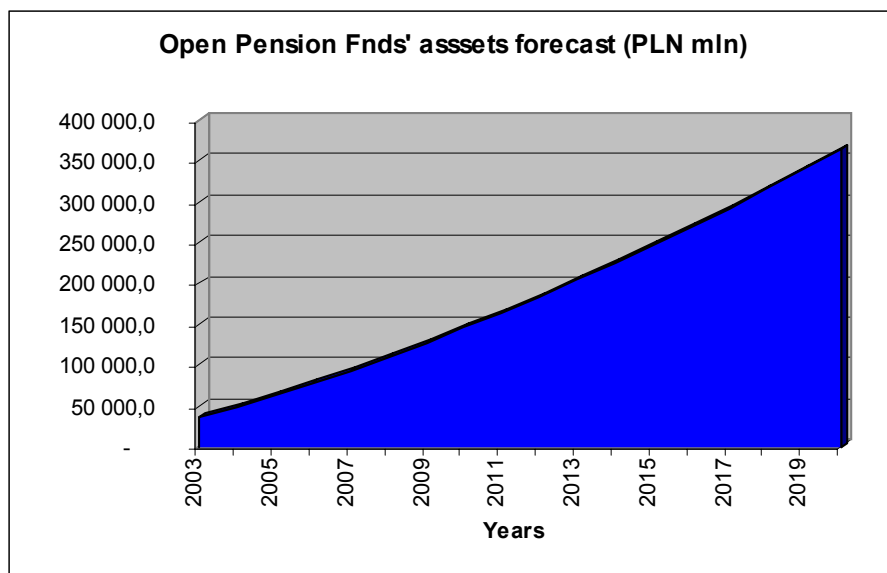
Legislation concerning the PPP shall prevent pathologies related to this form of public tasks realization abuses.

These pathologies consist, particularly, in:

- Application of the traditional form of PPP aimed at overcoming the regulations restricting the public sector assumptions;
- Unclear criteria for selecting the private partner in a situation when the problem arises of splitting the risk among the public and private investors (this could be corruption creating);
- Application of PPP without sufficient justification of the benefits resulting from, as a rule, higher expenditures while compared against the traditional model (the justification shall result from the benefits-expenditures analysis).

### **X.6. Gaining the funds from the Open Pension Funds (OFE)**

Limited risk funds, the part of which are open pension funds, by nature, make the high risk deposits on the very limited basis. At the same time, open pension funds manage the funds with a high rate of growth characteristics. It is estimated that these funds sum up to PLN 30 billion with a annual rate of growth of around PLN 10 billion.



Source: MGPIPS forecasts

Open pension funds are looking for the investments with a minimal credit risk level and moderate profitability decline risk. Funds have the possibility to invest into the municipal securities. However, their profitability is relatively low and the supply of the stocks and other municipal securities is also too low to satisfy the funds' needs. Therefore, there is a necessity to enrich the spectrum of financial instruments and their deposit characteristics to meet the funds requirements.

Combination of the open pension funds' capital resources and possibilities offered by the entities participating in the securitization of some of the public receivables together with opening special bank deposit facilities with a long maintenance period can open the flows supplying the infrastructural investments (and other) with a long-term return. Employment of the funds held by the open pension funds for the sake of realizing public utility investments is not only the rational way to find the infrastructural financing development

but also has a profound economic and social sense. We have to have in mind that Polish social security system runs a huge deficit, due to, among others, transfers part of the contributions to the open pension funds. Deficit is covered from the state budget which leads to the situation where the tax inflows instead of financing the infrastructural investments are transferred to the social security system, including open pension funds.

Open pension funds are not typical investment funds. First, they are one of the form of social security so their credibility is supposed to be high. Secondly, payments into the open pension funds for the contribution payer are obligatory so the pension's investment decisions have to be taken with a very low risk level since the State is obligated to assure the adequate return on payments transferred by the payer to the open pension funds. Participation in the open pension fund is not a classic investment decision so the OFE's commitments cannot be the same as it is the case of the typical investment funds.

Usage of the OFEs' funds for public utility projects financing can be done in two ways. Open pension funds can purchase the shares of public utility entities, for example under the public-private partnership umbrella. Funds accumulated in the open pension funds can be used for the new infrastructural projects financing. Therefore, open pension funds should be offered (mainly in a form of the securitization activities) financial instruments, which will meet these entities needs, such as:

- Investments should have a long-term characteristics;
- Investors and investment credit ratings must be high enough to minimize the investment risk;
- Instruments must have a market characteristics;
- There must be high market liquidity for these financial instruments trading since this guarantees the mark-to-market pricing.

There is a number of evidences, which prove that usage of funds for infrastructural projects financing is very profitable for both sides – public sector and OFEs:

- OFEs are looking for the long-term money (investments) and the infrastructural investments have this characteristics
- Lack of exchange rate risk
- Cost of the capital accumulated can be significantly lower when compared to the classic commercial financing commitment. However, from the OFE's point of view the return on capital invested can be greater than investments into the treasury securities
- Private capital participation in the investment projects realization put pressure on high effectiveness and eliminate the political risk
- Engagement in the infrastructural projects from the OFE's point of view constitutes very good way of diversification of the investment risk, especially as there is very little correlation between the infrastructural investments and other ways of capital engagement (e.g. on the capital market)
- Undoubtedly, the infrastructural development contributes to the higher economic growth, which translates into the greater and more profitable investment possibilities.

## Chapter XI

### Financial Discipline

1. In the coming years the manner of public funds management will gain special importance. So far, the inspection over disposal of these funds has been of national character. The internal audit in particular institutions and external audit of these institutions was conducted by regional auditing offices and Supreme Chamber of Control as well as the units of tax inspection. Accession to the EU and usage of Union funds requires strengthening of control over both national and union funds. According to the EU regulations misconduct in expenditure of public funds is punishable in the whole area of the EU. The appropriate changes are currently introduced into the Penal Tax Code
2. In 2002, Polish system of supervision over collection and spending of public funds and management of the property of units belonging to the public sector funds has been enhanced by internal audit. This term is used to name all actions allowing the manager of a unit to get an objective evaluation of its functioning in the field of financial management. The evaluation is conducted so as to the legality, prudence, purpose and correctness. The obligation of internal audit has been extended so far to 173 units (372 auditors have been employed). In 2004, this obligation will be farther extended to 440 units of municipalities and 160 other units of public finance sector, including tax offices, units under authority of the Ministry of Defense, healthcare units and cultural institutions. A benefit of evaluation performed by internal auditor is possibility to inspect the projections of expenditures (ex ante inspection), which can possibly prevent public funds from abundant spending.

The extension of scope of internal audit will be adjusted to the training capacity. In Poland the number of audit experts is still small compared to the needs.

The units of public finance sector, which are not obliged to create the internal audit, can be subject to inspection by audit units superior to them.

3. The public finance act specifies a list of events, which constitute breaching of financial discipline and are to be sanctioned. This list is to be reviewed and possibly extended according to the rule that union funds are to be legally protected in the same way as national ones.
4. Several years of public finance act being in power indicate that some of the regulations have to be made more precise, because the possibility of various interpretations lead to misuse in the spending of public funds. Among such regulations are:
  - Regulations on subsidies. Imprudent and inappropriate usage of subsidies is subject to sanctions. There is a disagreement among the lawyers if all public funds directed for particular task should be treated as subsidy. For instance the subsidy for restructuring of healthcare units (ZOZ) according to the view presented by some lawyers ceases to be subsidy after being deposited into the account of funding entity. This interpretation would imply that healthcare unit is authorized to spend the subsidy for any purpose. In the new regulations of act on public finance this matter will be definitively resolved;
  - The regulations on the disposal of the surpluses above the planned revenues of the budget need new redaction. The initial legislator's intention was to direct these funds for diminishing the deficit. The same purpose was intended for the usage of savings in



expenditures. They were to be directed primarily for settlement of liabilities and diminishing the deficit. It turned out that particular regulations were not univocal;

- It is necessary to introduce regulations regarding possible amendment to the act on public finance in the event of economic slowdown in order to avoid sudden increase in budget deficit, which increases the public debt and creates burden for the budget expenditures in the next periods
5. The changes specifying the obligations of particular departments so as to preparation of particular documents required by the EU (Convergence Program, Stabilisation Program) have to be introduced in the act on public finance. The necessity to prepare these programmes and works on multi-year state budget projects are long term actions aimed at increasing the public finance discipline.
  6. The financial operation of special purpose funds and other public finance units needs to be subjected to special supervision. In order to do so:
    1. All bank accounts of the state special purpose funds and state treasury agencies will be held with Bank Gospodarstwa Krajowego.
    2. Special purpose funds financing pay-outs of pensions and budgetary means directed for this purpose will be subjected under management of the Minister responsible for matters of social insurance until the end of 2003.
  7. As a part of public means spending rationalization, the legal and organizational conditions for realization of a big part of public procurement by electronic means will be implemented. Centralized purchasing of goods for the whole administration, education, healthcare etc. through internet reverse auctions will lead towards savings because of lower prices obtained, lower costs of administration, greater transparency in public procurement and limiting the possibilities of corruption.
  8. As big part of both national and union public funds will be directed under management of local government units, the supervision over municipal finances should be enhanced. It is necessary that the supervision so as to the legality, over regional auditing offices is granted to the minister relevant in the matters of public finance. The change in the scope of supervision over regional auditing offices, whose mandate is connected to the operations of municipalities in respect of finance, financial management and applying public procurement law, will concentrate all the aspects of public finance in the hands of one administrative body and thus will allow for:
    - Using standardised rules on inspection and supervision over the usage of public funds remaining in the disposal of the units supervised by regional auditing offices;
    - Making the system of supervision over financial operations of municipal units more elastic by creating a possibility of performing inspections oriented only on selected fields of municipal finance, e.g. the level of debt;
    - Increasing the transparency of supervision system performed by regional auditing offices.
    - Enhancing the co-operation with regional auditing offices in their current operations in the field of local government units' finance, budgetary reporting and in questions regarding changes in legal regulations pertaining to financial operation of municipalities.

9. Consolidation of treasury authorities including tax and customs authorities.

At the moment, the last, third stage of this process is being carried out. The first two stages have been realized by removing, as of 30 April 2002, the office of the President of the Chief Customs Office and, as of 30 June 2002, the office of General Customs Inspector. It resulted in decentralization of jurisdiction in customs cases, limiting the bureaucracy and eliminating repetition in competences in the process of management and decision taking regarding exchange of goods with outside world.

The realization of the third stage is being carried out by implementation of the solutions put forward in the governmental draft act on establishing Regional Treasury Councils and changes in some acts regulating tasks and competences of organs and organization of organizational units under authority of the minister relevant in the matters of public finance, which is currently being debated by the parliament.

After several months of works by parliamentary Public Finance commission, the Parliament on 20 May passed the act on establishing of Regional Treasury Councils and changes in some acts regulating tasks and competences of organs and organization of organizational units under authority of the minister relevant in the matters of public finance.

The customs service is currently being headed by the Head of Customs Service reporting to the Minister of Finance and performing in his name the duties towards customs functionaries. A part of the competence of the former President of the Chief Customs Office has been moved to lower organizational levels of the customs service, at the same time the tasks of former Customs Inspection have been moved to tax inspection, which as a service of more power and of more experience will perform the joint tasks better. The current stage of the reform leads towards consolidation of treasury service in the whole country. The changes being introduced in the competences of all these services will lead to better effectiveness of treasury service.

The establishment of Regional Treasury Councils is a novelty. Their task will particularly be coordination of tax service, customs service and tax and customs inspection in the area of Voivodships. It will allow for more rational planning of inspections and performing them in a manner less cumbersome to the entities subjected to the inspections.

The draft act allows for establishment of tax offices specializing in servicing “large tax payers”. It will facilitate servicing of large entities and allow for the inspections to be less cumbersome for the inspected entities. “Small tax payers” will also benefit from that, since they will gain better access to tax offices. The draft allows for creation of small tax offices with limited scope of operation, giving small tax payers better access to the offices because of their specialization and proximity.

The draft act taking after the standards used in the European Union introduces important changes in the competence of customs service. One of them is granting the customs organs the status of tax organs so as to the VAT and excise tax in import, which will speed up jurisdiction in tax cases when the decisions are taken in customs cases having impact on taxes. For importers it will mean that they will receive the decision so as to both taxes and customs duties in connection with import of goods in one office i.e. customs office (rather than in two offices: tax and customs as it is the case currently).

Customs organs will get authorization to perform special tax supervision and will overtake tasks and competences so as to 'domestic' excise tax. It will mean concentration in the hands of customs administration all cases regarding domestic excise tax and excise tax on imported goods and as a consequence will facilitate the turnover of goods taxed with excise tax.

The customs service will also get authorization to control legality of the employment of foreigners, which will enhance the protection of domestic labor market from illegal employment of foreigners.

The changes in competences of treasury service are accompanied by solutions aimed at enhancing control over these services and counteracting corruption among customs and tax officers.

The draft of consolidating act also assumes a significant broadening of operation of treasury inspection, particularly enhancing effective operation necessary after Poland's accession to the European Union i.e. authorization in respect of control of assistance funds and domestic co-financing.

Another change is personalization of tax organs. After entering into force of consolidating act the organs will be head of tax office and director of tax chamber. Hence the rule of symmetry between customs service and tax inspection (the director of tax inspection offices are organs from 1 July 2002). Personalization of organs increases the responsibility for taken decision. It will also enhance the supervision over the whole scope of activity of organizational units under authority of Minister of Finance.

The organ post – the heads of all the organizational units under authority of the Minister of Finance - will be filled by competitions. It will allow to choose the staff of high qualifications and meeting the highest professional and ethical standards.

As of 1 January 2004 a part equivalent to 60% of remunerations paid from special funds as of state budget act for the year 2003 will be shifted from the special funds to the budget. It will lead to greater transparency in financing of treasury system under authority of the Minister of Finance. Possible remaining means from the special fund will be granted to employees exclusively in reward for extraordinary achievements at work.

## Chapter XII

### **Methodological adjustments to international norms**

Integration with European Union results with necessity for gradual adjustment of Polish norms in public finance to international standards. Such adjustments will deal with:

- accounting in the state budget of own resources paid in to European Union;
- classification of incomes, revenues, expenditures and outlays;
- accounting and reporting;
- financial flows.

#### **I Own resources**

The dues paid in to the EU's general budget (so called own resources) will constitute state budget spending accounted in a separate budgetary part. In that part particular items paid in to the union budget will be specified. Introduction of this solution requires changes in the ordinance of the Minister of Finance on classification of budgetary parts and naming its disposers.

#### **II Incomes, revenues, expenditures and outlays**

1. In the budget act there will be uniform rules on accounting inflows from privatization and directions of their use by creating in the part 98 of a separate breakdown entitled "Revenues from privatization and their use". The revenues will encompass the gross amount of revenues from privatization and on the outlays side there will be their full usage on item, which currently are to be found in various parts of the budget act (e.g. compensations, subventions to Open Pension Funds) and also for purposes not being indicated so far (meeting the claims of former owner of the property overtaken by the State Treasury, restructuring aid, costs of privatization and management of the property of the State Treasury, research and development). Introduction of these changes requires amendment to the act on the system of social insurance and ordinance of the Minister of Finance on specific classification of income, revenues, expenditures and outlays. On top of that, there would be required an extra item on the revenue side in the financial plan of social insurance.
2. Another step in clearing the regulations of presentation of revenues and outlays will be classifying capital payouts to international organisations (e.g. payouts to European Investment Bank) in this budgetary part. The payouts in the form of dues will be classified in the same way as so far – as expenditures of the state budget.

#### **III Financial flows from EU's structural funds and cohesion fund**

EU's funds require special treatment and particular regulations so as to their spending and reporting. Particular classification of means from structural funds and their flows are presented in Attachment 12.1

1. Enhancing the effectiveness of management of public funds (systems: State Budget Management, Public Debt Management).

2. Enhancing the effectiveness of administration in the field of public finance (systems: Poltax, KEP, Cadastral, General Inspector's of Tax Inspection, General Inspector's of Financial Information, Customs' Inspection )
3. Simplification and facilitating payments of citizen's obligations ("friendly administration", e-tax)
4. Adjusting the software systems of customs administration to the requirements of EU (Systems: Celina, Zefir, Customs Rate Management, Transit, Goods and Customs Storage Inspection, Levying and reporting VAT, Exchange of information about tax payers and transaction in respect to VAT)

Realization of the above strategic goals will lead to the state in which public administration, having modern tools for effective management of public finance will be more successful in increasing the budgetary revenues from taxes, customs duties while audit organs and internal audit will be more efficient in realizing their statutory tasks in respect of prevention and revealing of criminal offence and effective mechanism to prevent corruption in state administration will be put in place.

Optimalisation of structures and division of tax and customs administration's tasks will result in creating of organization capable of effective realization of tasks resulting from Poland's accession to the EU.

#### **IV Standardizing of budgetary accounting regulations**

The world tendency towards more effective and transparent management of public funds has stimulated introduction of financial reforms in a numerous group of countries. These reforms require the governments to shift from cash flow based accounting system to accrual based accounting system (Australia, New Zealand and Great Britain), modified accrual accounting (Finland, Island, Canada and Italy) and modified cash flow accounting (Denmark, USA). Some countries (the Netherlands, Canada, Korea, Sweden, Switzerland, Denmark, Germany and Portugal) plan changes in presentation of their data towards full accrual based accounting or additional information based on accrual base. In Poland the works towards implementing accrual based reporting have already begun. Special purpose funds build their reports according to these rules.

#### **V Standardizing the rules of reporting**

The sending of reports by domestic entities to the Ministry of Finance should be performed in an agreed standardized, electronic form, which will allow for fast, accurate and correct analysis. On top of that the reporting deadlines should be adjusted to comply with reporting of Eurostat and European Commission.

Adoption of transparent regulations of both accounting and reporting will allow for evaluation of the degree to which the criteria on currency convergence are met. It will also input into transparent and effective management of public funds. Meeting convergence criteria constitutes the proof for the existence of effectively functioning public finance, strict control to the public debt, optimal money supply, hence existence of conditions for low inflation in the long term. This kind of market is a favorable spot for making

multiyear investments, which enhances the competitiveness of the whole economy and establishes good conditions for creation of the jobs and guarantees sustainable growth and improvement in the peoples standard of life.

The fiscal criteria so as to maximum level of deficit (government and municipal institutions' sector deficit must not exceed 3% of GDP) and public debt (government and municipal sector debt must not exceed 60% of GDP) should be met in the year 2006.

## Chapter XIII

### **Abandonment of restoration of public finance – scenario of economic stagnation, financial and socio- economic crisis**

1. Failing to undertake – now, complexly and dynamically – Public Finance Reform Program would result in numerous negative consequences for Polish economy and society in both the short- and the long-run
  
2. The most painful consequence in the short-run would be loss of chance for absorption already from the year 2004 of significant EU funds and lack of possibilities for using all instruments of Common Agricultural Policy. In such situation the budget wouldn't be able to finance at the same time dues to the EU and all the payments for agriculture. If the decision was taken to finance these expenditures by increasing the state deficit, there would be lack of funds in the state budget and municipal budgets necessary for obtaining EU's structural funds. In such case no increase in investments would be observed, which would negatively affect the labor market; unemployment instead of falling – this tendency is already observed since March – would increase over the socially and politically acceptable levels. A negative spiral would start working: economic growth slow-down, low investment, growing unemployment, wide-spread poverty and social exclusion. Difficulties that will appear in the public finance sector in 2004 will only be a beginning of barriers that will multiply in the next years. It would mean an open and long-lasting crisis not only in the financial respect but also in respect of socio-politics.

Table13.1 Basic economic indicators in the years 2002-06, stagnation scenario.

Item	2002	2003	2004	2005	2006	Index 2006
	Previous year = 100 (constant prices)					2002 = 100
GDP	101.3	102.5	101.7	99.5	99.0	102.7
Consumption	102.9	102.6	101.8	100.9	100.7	106.1
Investment	92.8	102.2	102.1	99.0	96.9	100.1
Average employment in the economy (in thousands)	8753	8637	8625	8579	8558	x
Unemployment rate (as of end year) in %	18.1	19.4	19.9	21.0	21.8	x

3. Gross domestic product until the year 2006 would grow at the pace of average annual rate not larger than 0.7%, hence below the level of social perception. It would mean return to stagnation present from the middle of previous year and resulting from unnecessary over-cooling of the economy. While the positive scenario, taking into account the restoration of public finance sector, will allow GDP to grow by 21% in the years 2003-06, at the same time refraining from these reforms GDP in the year 2006 can be higher in real terms only by 6-7% compared to current level. compared to the year 2002 the investments would not change. The employment in the national economy would fall below the level of the year 2002 and the unemployment rate already in 2005 would exceed 21%. It would be

structural unemployment, resulting from loss of expansionary possibilities in the economy (Table 13.1).

Table 13.2 Projection of state budget for the years 2002 – 06 as of scenario of stagnation and financial crisis.

Item	Year				
	2002*	2003*	2004**	2005**	2006**
	PLN bn				
1. Revenues	145.1	151.0	154.6	156.4	157.6
2. Expenditures	185.1	194.4	213.6	226.1	235.3
3. Deficit	40.0	43.4	59.0	69.7	77.7
Public debt	366.3	411.8	480.1	552.1	635.1
In relation to GDP(%)	47.6	52.5	58.8	67.2	77.0

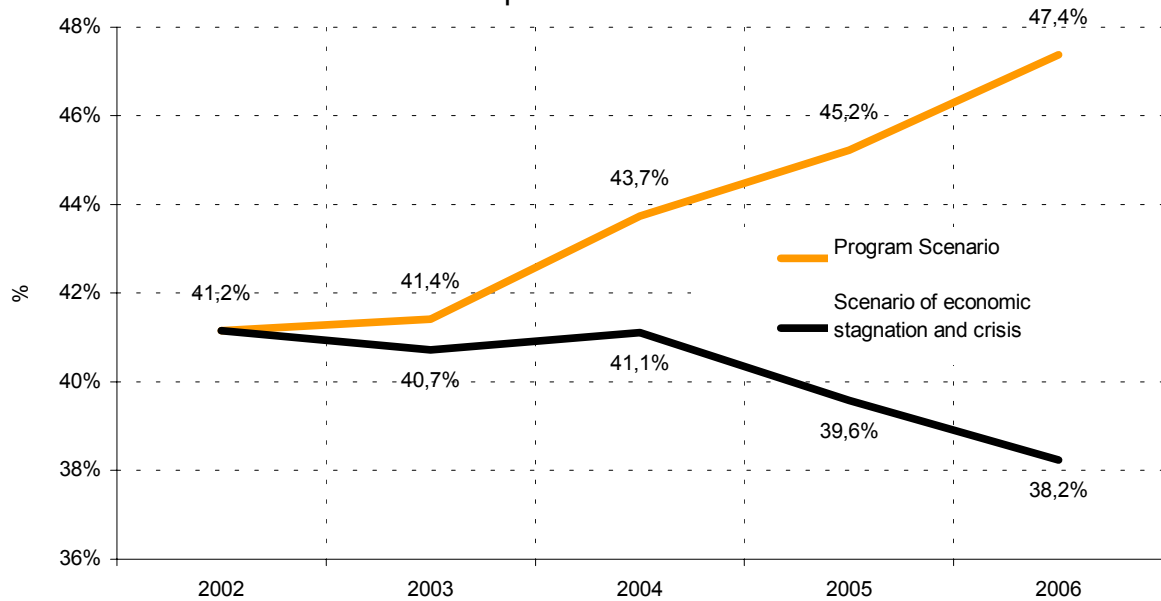
\* budget act \*\* forecast

4. Such a scenario would mean the break-down of the public finance system. Realization of budget act for the current year would be limited and in the next year the ration of debt to GDP would exceed the 55% limit. As a consequence in the year 2005 the maximum permissible level of the deficit would be PLN 44.4 bn, which would require reduction by almost PLN 25.3 bn. Already in 2004, no State Treasury and municipalities guarantees or sureties could be issued. In the year 2006 the state budget and the municipal budgets would have to be balanced, which would require reduction in the level of expenditures to PLN 157.6 bn. Such a scope of cuts would not be possible and Poland would be in a very complex crisis in respect not only to public finance but the whole state and its institutions.
5. This scenario of development – or more precisely stagnation – of Polish economy presents a risk of entering into a phase of long-term crisis. It is a scenario of building social pressures resulting, between others, also from low dynamics of consumption. At the same time in the scenario of fast growth it is possible to achieve the dynamics of consumption on the level of 15%.

Thus the stagnation scenario would mean loss of the chance for development, which is currently available to Polish economy. Moreover, accession to the EU – instead of expected invigorating of economy and improvement in the people's material situation – would lead to growing burdens for the state budget from membership dues and society's disappointment, enhanced by the fact that the gap between Poland and the GDP level of current members would be growing (Chart 13.1).



GDP per capita by CPI in relation to average GDP level in EU –  
the comparison of variants\*



\* Calculations made with assumption, that median nominal growth in EU will be 3,2% p.a. , CPI in condition of year 2002.

Such a scenario should be avoided by all means. And it can be avoided by immediate undertaking the consequent realization of the Public Finance Reform Program. In such a case the distance between Poland and current members of the European Union and other developed countries would be gradually decreased. It will provide for better condition of Polish state, the competitive position of Polish corporates will be better, the standard of living of Polish families will be higher and the links integrating Polish society will be stronger. Poland will be better.