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## HEALTHY FINANCIAL SYSTEM OF LOCAL GOVERNMENT ON THE EXAMPLE OF POLAND

### Abstract

A healthy local government financial system lays the foundation for the ability of local government units (LGUs) to carry out public tasks at the current qualitative and quantitative level and to meet their obligations in the short and long term. A healthy financial system of local government is a system that is adequate, stable, unified, consistent, transparent, diversified, counter-cyclical, guarantees the financial independence of LGUs, and activates to take measures to increase revenues and efficiency of expenditures. The purpose of the article is to answer the question of what are the characteristics of a healthy financial system of local self-government, assess the system operating in Poland, and formulate recommendations for changes aimed at healing this system. Descriptive analysis, comparative analysis, inductive and deductive reasoning, and critical analysis of the national literature on the subject by economists and lawyers were used.

**Keywords:** financial system, local government.

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## 1. Introduction

Fiscal health is an important issue in the economic literature. Research in this area focuses on the analysis of the state of imbalances in public finance, public debt, the efficiency of public expenditure, and the impact of fiscal policy on the economy. Fiscal health is understood as the ability of public authorities (central and local government) to balance the level of liabilities with the level of revenues. The fiscal health of a local government unit (LGU) makes it possible to assess whether it is raising, spending, borrowing, and planning financial resources in a way that allows it to be resilient and take advantage of opportunities. In addition to economic (including financial) risks, political, and legal (regulatory) risks are increasingly important in the activities of LGUs. Difficulties may result from a change in the political option (reforms centralizing or decentralizing public finance), a crisis in public finance (transferring to LGUs public tasks previously financed from the state budget without guaranteeing funds for this purpose, or a significant reduction in subsidies and subventions from the state budget), a financial gap (transfer of public funds by the central level that does not fully cover the cost of implementing tasks by LGUs). Thus, the shape of legal solutions determines the position of the LGUs and the relations between the central and local governments. Legal regulations on the financing of LGU activities are of fundamental importance for the financial health of LGUs. It is therefore crucial that the financial system of the local government is conducive to the decentralization of public finance and the implementation of the principle of subsidiarity and independence, thus laying the foundations for the functioning of the local government in the long term. Thus, the question may be asked whether in Poland, in 33 years of functioning of the local self-government after its reactivation in 1990, it has been possible to create mechanisms of decentralization and financing of the local self-government that ensure effective and efficient implementation of its tasks, constitute the foundation of its independence and allow for rational local self-government financial management of public funds (whether this system is healthy and serves the fiscal health of the LGUs).

## 2. The essence of the local government financial system and its place in the public finance system

The separation of local government finance should be linked primarily to systemic considerations, as there is a close connection between the nature of the state, its systemic assumptions, and the role of local government bodies and their financial management. Local government finance is an integral part of public finance. It is related to the organization and

structure of the state's territorial division, the rules for the distribution of public tasks among the various levels of government and public administration, the support of local and regional development, and the extent of decentralization of public finance [Nykiel 1993:7].

The key features of the local government financial system are the decentralization of public finance and the degree and extent of local government financial independence. However, this does not mean that decentralization and a very high degree of financial independence of LGUs is exclusively a desirable process. This is due, for example, to the need for coordination and convergence of objectives pursued by central and local governments. The level of development of civil society, the sustainability of democracy, and the strength of the institutions of social control of power at different levels of government determine whether a certain level of decentralization and financial independence of LGUs is optimal for a country at a certain time [Kata, Czudec, Hare, Zawora 2022: 98].

The scope and scale of decentralization depend on: the territorial organization of the country, appropriate ownership transformations, and equipping LGUs with the appropriate powers and the means of their implementation (local government budget, local government property, own sources of revenues). The simultaneous decentralization of expenditures and revenues (taxes) allows for a direct link between the costs and benefits of providing public goods and services and thus leads to a reduction in the size of the public finance sector. In contrast, the decentralization of expenditure linked to the share of central budget revenues eliminates the link between accountability and public assessment, failing to achieve this result [Wojtyna 2000: 13-30].

Decentralization, understood as an increase in the tasks and sources of financing of local government, at the expense of reducing the tasks of the state budget, causes the dispersion of public finance and the difficulty of their central control, but brings financial decisions closer to local communities, which in turn means the possibility of citizen control of the management of public funds at the local and regional levels. Hence, transferring tasks to the local government level can contribute to increasing the transparency of the public finance sector. However, for this positive effect of decentralization to occur, a reporting system must be in place to assess the state of public finance on a sector-wide basis [Mackiewicz 2001: 68-69].

Decentralization of public finance results in complicated fiscal relations between the state and local governments. Difficulties arise especially when there is a crisis. In practice, an increase in the scope of centralization of public finance occurs under conditions of high financial stress caused by the economic crisis [Guziejewska 2022: 76].



Decentralization of public finance by increasing the scope of tasks and sources of financing of LGUs creates the basis for their financial policy as a conscious and purposeful activity in determining the objectives, methods, and instruments for achieving the goals of collection and spending of public funds by them [Jastrzębska 2004: 19]. Ensuring that LGUs can independently and flexibly shape financial policy and use available financial resources is almost as important as ensuring that they can raise funds appropriate to their tasks [Misiąg 2015: 5].

The model of local self-government formed in Poland is closer to administrative federalism. If local self-government has much greater powers to resolve the types of services provided to residents, one can talk about de-concentration rather than the decentralization of public administration, as local government institutions remain part of the state administration [Bird 2012: 13-14].

A financial system is a set of financial and legal institutions combined purposefully into a certain whole, serving to collect and organize monetary resources and their distribution [Brzeziński, Matuszewski, Morawski, Olesińska 1999: 18].

The financial system of local government consists of legal institutions defining financial relations between the state and local government; institutions for the collection (taxes, fees, earmarked subsidies, subventions, shares in state taxes), organization (budget) and disbursement of funds by local governments (defined in specific laws forming the basis for public expenditures); legal constructions for local government expenditures; solutions for local government debt, bodies and forms of control and supervision over the financial activities of local governments [Borodo 2004: 75]. Individual legal and financial institutions may be common to the financial management of LGUs of all levels or only to the financial management of LGUs of a particular level [Rogalska, Stachowicz 2021: 39-40].

The basic legal and financial institution of the organization of monetary resources of LGUs is the budget, which is formed by legal norms relating to the principles of revenues and expenditures planning, handling of accumulated monetary resources, competence to make planning, implementation, and control decisions in the field of budget management. One of the basic principles of the local self-government system is the independent conduct of financial management based on the budget by individual LGUs [Miemiec W., Sawicka, Miemiec M. 2013: 52-53].

Local government units conduct financial management based on national law, international financial law, and European Union financial law. The range of legal regulations that apply to the financial management of LGUs is wide, while there is a lack of codification of the financial

law of local government since the financial management of LGUs is addressed to regulations common to all units of the public finance sector, as well as those that are addressed only to LGUs or to a specific level of local government. This means that among the sources of local government financial law are not only laws and regulations but also local acts [Kosikowski 2012: 45].

### 3. Features of a healthy local government financial system

The design of the local government financial system depends primarily on the state system and the place of local government in it. To create a healthy financial system for local government, it is necessary to adhere to the principle of subsidiarity and limited independence of LGUs, as well as the proper course of democratization and decentralization processes.

A healthy local government financial system is a system:

- linked to the social and economic environment,
- forming the foundations of LGU's ability to carry out public tasks at the current qualitative and quantitative level and to meet its obligations in the short and long term,
- allowing rational management of public funds by LGUs, including the implementation of specific objectives (system effectiveness) and the achievement of specific results (system efficiency),
- taking into account not only the equalization of revenue levels but also the differing expenditure needs of individual LGUs,
- creating opportunities for the LGUs to respond more quickly to changing social needs and emerging crises,
- activating LGUs to take measures to increase revenues and efficiency of expenditures (pro-efficiency and pro-quality system),
- activating LGUs to take measures to increase openness and transparency, as well as responsibility and accountability (the rules of responsibility for violation of regulations, control mechanisms leading to the detection of violations, and sanctions for the occurrence of irregularities are clearly defined),
- guaranteeing the financial independence of LGUs, which is determined by the level of revenues, the scope of fixed expenditures, and the scope of mandatory tasks.

Therefore, the financial system of local self-government should be:

- adequate to the scope of tasks performed by LGUs, which means shaping the system of sources of power for LGUs according to the legally formed scope of tasks of LGUs (shifting tasks to LGUs without adequate financial compensation and the lack of standardization of the level of costs of task implementation by different categories of LGUs hurts the implementation of this feature of the system),
- unified and consistent (internally consistent) - rules, principles, and mechanisms for budgeting in LGUs, financial control and reporting, and auditing should unite the various elements of this system, which depends on the quality of the law; unreliable consultations, secret drafts, parliamentary injections, lack of concept, haste, over-regulation and instability of the law deteriorate this quality [The 7 Deadly Sins of Lawmaking in Poland: 6-7],
- stable - ensuring continuity of the functioning of LGUs even in difficult economic conditions; frequent changes, temporary solutions, introduction of new legal regulations without analysis of their real effects on particular groups of LGUs destabilize the system,
- transparent - legal regulations should be understandable and precise; the complexity and excessive detail of existing legal regulations limit the transparency of the system,
- diversified and flexible in terms of revenues and expenditures, i.e., containing adjustment mechanisms that make it possible for LGUs to respond to changing economic and social conditions; too strong dependence of LGUs' revenues on too few sources of supply is risky, especially during economic downturns,
- fiscally efficient and counter-cyclical, i.e. allowing for effective implementation of the basic functions of LGUs regardless of economic fluctuations.

The stability of the local government finance system is of particular importance for the fiscal health of the local government. It is understood as a relatively permanent state in which local governments can provide a range of adequate quality public services appropriate to the needs of the territorial community, as well as being able to stimulate socio-economic development. Long-term fiscal sustainability lays the groundwork for the provision of local and regional public services continuously and efficiently (service dimension), as well as for settling the financial obligations associated with this (debt dimension). Local government financial system to ensure long-term fiscal stability, should be characterized by fiscal efficiency, counter-cyclicity, and constancy. The opposite of fiscal stability is a state of financial instability, which can result from both internal causes related to dysfunctions in the financial management of local governments and external factors of a macroeconomic, legal, social, political, and environmental nature. Some of these factors may be controlled by local

governments or institutions overseeing their operation, while others are completely independent of the local government, which does not mean that the local government finance system should not respond to certain threats of fiscal destabilization by limiting their negative effects through appropriate legal regulations [Wójtowicz 2019: 85-87].

The fiscal health of LGUs is significantly affected by the system of LGU revenues and the distribution of public tasks between the central, regional, and local levels. Revenues of LGUs (including the sources of these revenues) should be stable (no fundamental changes are made in their legal construction), adequate (appropriate to the cost-intensity of the tasks performed by LGUs and related to the scope of tasks of LGUs), efficient (allowing to obtain the highest possible revenues without compromising the source of collection), counter-cyclical (certain and predictable with low sensitivity to changes in the economic situation), independent (granted to the exclusive disposal of LGUs with appropriate scope of local tax and fee authority within the limits set by laws), optimal (revenues possible to obtain and linked to the benefits of entities obliged to pay them). In addition, expenditures of LGUs should be efficient, timely, and serve the purpose of the task. It is also necessary to limit debt and debt service disbursements and eliminate hidden debt [Malinowska-Misiąg, Misiąg 2021: 22-23].

#### **4. Evaluation of the financial system of local government functioning in Poland**

Law is an expression of the social oversight function performed by social institutions. This approach to law is closely related to public finance and financial law, as the sender-state and recipient-citizen pair play a special role in this arrangement [B. Dupret 2010: 165, 216]. Therefore, the sophistication of democracy and the quality and effectiveness of the law are important in evaluating the financial system of local government. In assessing in this regard, international rankings can be used.

The Economist Intelligence Unit (research unit affiliated with the Economist weekly newspaper) has been ranking countries since 2006 using a democracy index derived from surveys on five categories, namely electoral process and pluralism, government functioning, political participation, political culture, and civil liberties. Countries are classified into four groups: full democracy, flawed democracy, hybrid system, and authoritarian system. Poland is included in the group of countries with flawed democracy. The democracy index in 2015 was at 7.09 points out of a 10-point maximum and in 2022. 6.8 points with the average for Central and Eastern Europe at 5.55 and 5.36 respectively, and for Western Europe at 8.40 and 8.30 [Democracy Index 2022: 11.51].



The World Bank develops Worldwide Governance Indicators (WGI), which play an important role in the rating methodologies of Moody's and Fitch, for example. The indexes address six areas of governance, i.e. Voice and accountability – citizens have the right to: participate in the election of government, freedom of speech, association and an independent press; political stability and absence of violence/terrorism – the likelihood that the government will become destabilized through the use of unconstitutional and violent means, including terrorism; government effectiveness – the quality of public services, the capacity of the public service and its independence from political pressures, the quality of policy-making; regulatory quality – the ability to provide logical policies and regulations that enable and encourage private sector development; rule of law – the area in which participants trust and are governed by the public – the quality of property rights, the police and courts, the level of crime; control of corruption – the area in which power is used for private gain, including petty official corruption, as well as the "looting" of the state by elites [Kaufmann, Kraay, Mastruzzi 2011: 4-5]. In 2021, compared to 2020, the level of indicators for Poland in all six categories decreased, with the greatest decline in the rule of law from 0.53 to 0.44 points (max. 1.00), control of corruption from 0.65 to 0.57, and government effectiveness from 0.36 to 0.29. Regulatory quality is rated highest, but there was also a drop from 0.86 to 0.84 points [Poland recorded a decline in all World Bank WGI indicators for 2021].

The financial system of local government can be evaluated both in the context of a certain exclusion from the system of public finance, as well as in the context of fiscal relations between the state and local government. In the evaluation of fiscal relations between levels of public authorities, the problems of task allocation and public spending are analyzed – the extent of decentralization, the size of local governments, overlapping tasks and responsibilities, social transfers, and redistributive services; the rules of financing local governments – tax authority, tax competition, targeted subsidies, compensatory subsidy programs; macroeconomic policy in a decentralized system of public finance – consistency of macroeconomic policy, fiscal rules, market discipline; openness and transparency – access to information and the quality of the information provided [Guziejewska 2013: 35-36].

The current financial system of local government creates mechanisms for supplying LGUs with their own revenues and those transferred from the state budget; enables LGUs to decide on the allocation of their resources (within the scope of the powers granted); allows them to maintain financial equilibrium (although in many LGUs this is done at the expense of investments, as well as the quality of public services provided); allows local governments to achieve a higher efficiency of public expenditure than central authorities, understood as the





ratio of the economic and social effects obtained to the outlays incurred [Kata, Czudec, Zając, Zawora 2022: 98].

Based on selected national literature on the subject [Self-governance Index 2023: 7; Diagnoses and prescriptions for the main problems of local government 2023: 2, 4, 13; Patrzalek, Poniatowicz, Guziejewska, Kańduła 2022: 97-101; Kata, Czudec, Zając, Zawora 2022: 99-100; Kowalska I. 2018: 93; Borodo 2020: 77-79; Piotrowska-Marczak 2016: 26; Piotrowska-Marczak 2012:242; Surówka 2013: 23, 25, 26; Jastrzębska 2002: 24-25] it is possible to identify several defects/weaknesses in the functioning local government financial system that result in the limitation of independence of LGUs, including financial independence in terms of revenues, expenditures, ability to incur and service debt.

Limiting the independence of local and regional communities through the introduction of certain statutory regulations and increased interference by the government administration in the implementation of LGU`s own tasks. This leads to the incapacitation of LGUs in the organization and financing of municipal management and other local and regional public services.

The limitation of revenue independence is primarily due to the limited stability and efficiency of own revenues caused by the low efficiency of local tax sources and fairly frequent changes in legal regulations directly or indirectly affecting the system of revenues of LGUs. In addition, the scope of the local tax authority is limited and the system of equalizing the revenues of LGUs (the so-called Janosikowe) is dysfunctional.

Fluctuations in the economy have a particularly strong impact on the volatility of LGU's own revenues, and a drop in their level forces LGUs to reduce investment expenditures (local government investments show a high pro-cyclicality and are very strongly determined by the availability of non-refundable sources of financing, especially EU funds). The financial situation of LGUs depends on the economic situation and the financial situation of the public finance sector, with a lack of instruments that would act as automatic stabilizers of the revenues and expenditures of LGUs.

The revenue independence of local governments is shaped not only by the share of own revenues in the structure of total revenues but also by the share and internal structure of funds transferred to local government budgets from the state budget, i.e. the relationship between general subsidy and targeted grants. In recent years, the importance of transfer revenues has been increasing and there has been a transformation of subsidy transfer into grant transfer. Attention should also be paid to the one-time nature, variability of the amounts, timing, and rules for the distribution of the additional money that the government

transfers to LGUs as compensation for their lost revenues as a result of the Polish Deal tax reform. Each time, the arbitrary and non-transparent method of distributing the transferred amount is not consulted with anyone, which is contrary to Article 9(6) of the European Charter of Local Self-Government. Moreover, the construction of the general subvention is complicated, limiting the possibility of effectively equalizing financial disparities (especially between large urban centres and other municipalities). It should also be emphasized the omission in the formation of the revenue system of LGUs of justified differences in the costs of performing public tasks by different categories of LGUs. Financing of LGUs with targeted subsidies does not promote rationalization of expenditure, as it does not give local authorities incentives to manage funds sparingly and does not enable them to reallocate funds to perform other, more efficient tasks. Moreover, earmarked subsidies can lead to a situation in which local governments make decisions contrary to their long-term economic interests, which limits natural adjustment reactions and sets in motion a mechanism of unfavourable feedback that perpetuates the low level of revenues of underdeveloped LGUs. Local government units with a high share of their own revenues in the structure of total revenues are less supplied with targeted subsidies, and thus the phenomenon of underfunding from the state budget necessary for the implementation of the tasks entrusted to them may arise. The central authorities are counting on the fact that LGUs with significant economic potential and an efficient own revenues base will themselves seek funds for the implementation of tasks, especially investment tasks [Krajewski 2001: 77].

Expenditure autonomy means the freedom of local government bodies to decide on the direction of budget expenditures, that is, to set their goals and priorities, as well as the freedom to use funds raised from debt instruments. Expenditure independence is weakened by the financing of LGU tasks with the funds of special purpose funds included and not included in the public finance sector. In addition, the tasks carried out by LGUs are mainly focused on education, social needs, and communications, as a result of the statutorily defined scope of tasks of LGUs. In addition, the transformation of government administration tasks, which have the character of permanent tasks, into LGU's own tasks perpetuates the negative consequences for local government budgets due to the lack of reliable valuation of the implementation of these tasks (for many years there has been the imposition of additional tasks on LGUs without adequate financial compensation). It is also worth noting that there is a phenomenon of dispersion of local government finance, which may cause duplication of expenditures of LGUs, especially at the local level - the problem of financing the tasks of municipalities and rural districts [Borodo 2020: 77-79].

An important element in shaping the financial autonomy of LGUs is the ability of LGUs to incur financial liabilities through debt instruments, such as loans, credits, and municipal bonds. The need to inject revenues into LGUs by incurring primarily long-term liabilities is due to: the need to reduce the infrastructure gap in public investment; the specifics of municipal investment; the need to increase access to EU funds; the need to stabilize the financial system; growing social needs resulting from technological progress, an aging population; national and international regulations [Restrictive formal and legal mechanisms for limiting the debt of LGUs harm the investment activity of LGUs and tend to push debt outside the budget (most often to municipal companies, which generates the risk of indirect debt of LGUs), in addition to which the supervision of LGUs finance is excessively burdensome and not always effective. The low share of own revenues in the structure of total revenues significantly limits the use of repayable sources of financing by LGUs [Poniatowicz, Jastrzębska 2021: 148-150].

In conclusion, it can be said that the reform of the local government's financial system is necessary. To confirm this postulate, the results of research by Polish scientists on the task-financial potential, political power, and systemic strength of local self-government, as well as the prospects for changing the financial situation of LGUs and their ability to implement investments can serve. According to the research conducted by the Stefan Batory Foundation, the result of which is the development of a self-governance index for municipalities and cities with county rights (a synthetic index describes the state of the local-government relationship with the central government, based on the measurement of the key dimensions of local life and the functioning of the local government for this relationship), the level of the self-governance index decreased by 17 pp between 2014 and 2021 - from 73.58 to 56.68. The largest decline is in political strength - from 20.75 to 11.75, followed by systemic strength - from 18.89 to 14.31 and, to a small extent, task and financial potential - from 33.94 to 30.62 [Self-governance Index 2023: 7]. On the other hand, a team of researchers from the Warsaw School of Economics has come up with an index of local government development activity in 2023. The study aims to forecast the future development capabilities of local governments based on opinions collected from local government managers. Thanks to the collected opinions of mayors, city mayors, county heads, and provincial marshals on the expected level of investment expenditures, the level of services provided, employment, fees from residents, and changes in debt, the indicator is calculated. Local government officials are not very optimistic about the prospects for improving the economic situation of LGUs in 2023. The highest level of the indicator can be recorded in local government provinces, while the lowest level can be recorded in



municipalities and cities with county rights. Managers of these LGUs expect economic stagnation and have limited development prospects [Local government development activity index 2023: 6].

#### **5. Recommendations for changes to make the local government financial system healthy and serve the fiscal health of local government units**

A coherent system of local government financial law creates a regulatory framework that ensures the stability of LGU operations and promotes their development. The system currently in force in Poland raises many doubts from the point of view of its coherence, internal order, and the logic of the interrelationship of its components. In making changes to this system, central authorities should take into account the voice of local government representatives, as local communities should be consulted, as far as possible, at convenient times and in an appropriate manner, during the planning and decision-making processes on all matters directly affecting them (Article 4(6) of the European Charter of Local Self-Government). In addition, financial sciences should play an important role in the reform of the system of local government finance, corresponding to the outlined constitutional principles, e.g. work on cost standards for the performance of public tasks, definition of the minimum standard of public services, the algorithm of subsidies and grants [Ruśkowski 2017: 67].

In the public debate, piecemeal proposals for changes in the financial system of local government appear, which are most often of a nature resulting from current needs related to problems in the practice of the functioning of LGUs. Entities presenting proposals for changes to the local government financial system include the National Council of Regional Chambers of Accounts, the Joint Government and Local Government Commission, the Ministry of Finance, the Senate, the Union of Polish Municipalities, the Union of Polish Cities, the Union of Polish Metropolises, the Union of Polish Counties, the Union of Voivodeships of the Republic of Poland.

Attempts to repair the local government financial system by piecemeal changes do not take into account the principles of system balance and may be an element of its deregulation. Ensuring the financial stability of local governments is possible under the condition of coordinated and long-term actions of the government and local governments, as economic factors (impact on the revenues base, especially taxation) and political factors (impact on the scope of decentralization and independence of local governments) affect the financial stability of local governments [Ruśkowski 2012: 216-219].



Changes in the financial system of local government should be systemic, deliberate, orderly - based on developed priorities, and not operational (current, ad hoc). In addition, changes to this system cannot abstract from the global conditions in which LGUs operate. Making these changes depends on political consensus [Guziejewska 2013: 27-28].

Changes to the system of local government finance in Poland should focus on legal regulations on revenue, expenditure, deficit, and debt of LGUs in a way that promotes the fiscal health of LGUs, i.e. their ability to manage their finance sustainably and efficiently. Particularly important in this regard is the reform of the revenue system of LGUs [Diagnoses and prescriptions for the main problems of local government 2023: 2, 4, 13; Katz 2023: 286; Kopanska: 90 and 103; Wallach T. 2021: 433-434; 437-438].

There should be a strengthening of LGU's own revenues by: increasing the share of PIT revenues, including the inclusion of lump sums on registered revenues in the group of taxes in which LGUs have a share. It is also necessary to work on local tax reform and introduce mechanisms to better adapt local tax policy to economic prosperity.

It is also necessary to limit the amount of payments for the balancing subvention (the so-called Janosikowe) and to introduce a mechanism for refunding the goods and services tax paid by LGUs in connection with implemented investments.

The mechanism for redistribution of funds among individual LGUs of a given level (horizontal redistribution) should be based on stable criteria that take into account the volatility of the economic situation, and should serve to reduce disparities in LGUs' own revenues, but not to eliminate them.

Stability in the construction of local and shared taxes is also extremely important. Any changes in central taxes that cause a depletion in the revenue of LGUs should be offset not by ad hoc increases in general subsidies or discretionary grants, but by permanent changes in the system of revenues transferred from the state budget or in other taxes that could compensate for the losses incurred by LGUs.

It is also very important to build counter-cyclical mechanisms into budget transfers, in particular a mechanism to support local government investment during a downturn.

The subsidy and grant model of LGUs should be based solely on objective criteria (e.g., the scope of public tasks carried out, and the tax potential of LGUs measured by the amount of tax revenue per capita).

It is necessary to maintain the principle of the adequacy of LGU's financial resources (own and transfer revenues) to the specific tasks and competencies implemented by a given level



of public authority through the use of an index of LGU's expenditure needs and a radical reduction in the scope of outsourced tasks or their abolition.

Fiscal transfer policy should be guided by the following principles: consistency in the construction of transfers with a single purpose; the use of simple and explicit criteria for the allocation of financial resources; the creation of incentives for the competitive provision of services; the creation of incentives for rational and prudent financial management; the introduction of flexibility in the use of funds and responsibility for results; ensuring the stability and predictability of the system and its instruments; relying on equity (the amount of funds allocated is proportional to financial needs and inversely proportional to the ability to raise own revenues); differentiating according to the type of LGU; introducing elements of periodic control of the use of funds from transfers in confrontation with attention to own revenues [Guziejewska 2007: 84].

The level of investment activity of LGUs is highly variable, making it difficult to implement long-term strategies for local and regional development. Investment expenditures of all types of LGUs are linked to access to foreign funds supporting investment (especially EU funds).

In addition, this activity is determined by the restrictive debt limitation rule of LGUs. Because of the above, local governments should be provided with alternatives to EU funds and mechanisms for financing development investments. These should be stable mechanisms for financing local government investments, rather than ad hoc activities and discretionary support, even despite the competitive formula for financing projects submitted by LGUs.

So, the local government finance system should be focused on the pursuit of development at the local and regional levels. This requires actions in the following spheres: social, economic, and ecological-spatial. It is necessary to take into account the elements that make possible the historical differentiation of development and how to achieve a relative balance in this regard. The level of flexibility of revenue and expenditure of LGUs plays an important role here [Kogut-Jaworska 2008: 11].

An increase in LGUs' debt may hurt the ability of over-indebted LGUs to absorb EU funds. It is, therefore, necessary to seek new mechanisms for financing investment projects, with the participation of public funds, and solutions to reduce the debt of LGUs and debt service costs, for example, by developing new rules to limit the debt incurred by LGUs. In addition, it is very important for the central authorities to initiate good practices for the rational financial management of LGUs, e.g. encouraging LGUs to supplement the traditional budget with a task-based budget, allowing verification costs, but also introducing elements of public

choice, and to merge into a single entity or consolidate certain public tasks within the framework of special purpose unions (development of shared service centres).

## 6. Conclusions

The efficient and effective performance of public tasks by LGUs depends on ensuring them adequate financial resources and on the rules of their management. A healthy financial system of local government is a system that: ensures appropriate financial independence of LGUs, creates the foundations for the ability of local government units to carry out tasks, promotes sustainable socio-economic development of LGUs, and activates them to take actions that increase the efficiency and openness and transparency of local funds management. Such a system should be stable, uniform, coherent, transparent, diversified, and countercyclical.

The reform of local self-government in Poland was intended to increase the scope of responsibility of LGUs, but also to increase the scope of their independence, including financial independence. However, these goals are impossible to achieve without a real decentralization of public finance and an adequate distribution of public funds between the central and local government levels by the scope of the tasks performed. Instead of continuing the processes of decentralization of public finance processes of deconcentration and debudgetization are taking place. And yet the goal of decentralization of public finance was to concentrate public finance in the state budget and local government budgets.

The system of public finance operating in Poland gives the advantage to centralized solutions. Local government units are now less and less independent, more and more dependent on the government and its decisions are more and more of their budgets are transfer revenues. As a result, they have fewer and fewer resources of their own to decide for themselves what to spend them on.

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