Leviathan and Restricted Local Financial Independence as the Consequences of the COVID-19 Crisis: The Case of Poland

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Abstract

The article discusses selected impacts of the fiscal policy conducted by Poland's government from 2020 to 2022. The countermeasures it implemented in the public finance area in response to the COVID-19 pandemic to support industries most affected by lockdowns and local governments, mainly through special-purpose funds, entailed an uncontrolled surge in public spending, as well as increasing public debt, the centralisation of decision-making, and the obscurity of the public finance system. The unfolding pandemic crisis was aggravated by the war in Ukraine and its consequences. The article's main focus is on analysing local governments' financial independence, which suffered from the establishment of special-purpose (off-budget) funds and the national tax system reform. Changes in local financial independence are examined based on structural ratios of local authorities' own and total revenues and less quantifiable measures enabling the government to gain more authoritarian executive power. The analysis is set in a wider historical context outlined by Michael Wohlgemuth, a German economist, philosopher, and historian of ideas, in relation to the COVID-19 pandemic and the Leviathan hypothesis. Special measures and regulations that governments use to tackle crises and extraordinary situations may impair the mechanisms of democratic control and serve as an excuse for governments to expand their executive and political powers. Historical experience shows that special processes, instruments, and practices are difficult to eliminate; consequently, they become part of the post-crisis system, which frequently leads to the emergence of Leviathan.

Keywords: Fiscal Decentralisation, Local Self-Government, Leviathan Hypothesis

1. A Brief Introduction to the Leviathan Hypothesis and Its Evolution

Leviathan is an Old Testament sea monster whose name is used today to denote a state that is both ineffective and challenges the standards of democratic government. The risk of states turning into Leviathan was noticed by J.M. Buchanan in his 1975 book "The Limits of Liberty: Between Anarchy and Leviathan". Five years later, Buchanan and Brennan (1980, p. 185) formulated a Leviathan hypothesis, according to which: "*Total government intrusion into economy should be the smaller, ceteris paribus, the greater the extent to which taxes and expenditure are decentralised*". The hypothesis, which also applies to the public sector in general and its efficiency in decentralised government systems, is understood by economists quite broadly and has been studied with respect to various components of the public sector. Brennan's and Buchanan's early interests focused on the capacity of a state to generate revenue depending on legislative solutions in force and the relationship between the construction of taxes and the level of revenues and taxpayers' reactions. The empirical evidence from later years has confirmed on many occasions that the inclination of all tiers of government to borrow is associated with the election cycle. Brennan and Buchanan have identified several factors that can potentially reduce the authorities' ability to generate revenue and concluded that a federal (decentralised) government system can contain the public sector's fiscal tendencies and its expansion if public revenues and expenditures are decentralised and there exist a large number of relatively homogenous territorial units of government that compete with one another. This assumption was immediately and heavily criticised because high mobility of taxpayers is specific to the United States of America, whereas in Europe, where unitary countries markedly outnumber federal countries, it is much lower. In 1986, M.A. Nelson (1986) published the results of a study that used a simplified model of the political and fiscal behaviours of different levels of government to determine how particular elements of a federal structure contribute to the total amount of public revenues. Nelson's study largely confirmed the assumptions of the Leviathan hypothesis, unlike many other investigations, which yielded ambiguous results (Ashworth, Galli, Padovano, 2013). Nevertheless, economists tend to agree that the quality of decentralisation and the true autonomy and fiscal independence of local governments are of crucial importance (Guziejewska, 2018, 2021a). One factor contributing to the conflicting findings of econometric studies is different designs of tax systems and discrepancies in the extent and quality of decentralisation of public finances.

Faced with extraordinary situations, governments tend to reach for extraordinary measures and regulations that may weaken democratic controls and push the boundaries of governments' executive and political powers. History shows that special procedures, solutions and practices may stealthily grow into the system in place and are hard to eliminate. One of the first researchers to consider this process from the Leviathan hypothesis standpoint was Michael Wohlgemuth (2021), a German economist, philosopher, and historian of ideas. He observed that Germany's spending kept increasing throughout the post-war period, that the scale of interventionism during the pandemic was particularly large, and that a portion of the German public favoured the centralist model of government and central decision-making, particularly in extraordinary circumstances. This made him conclude that the German belief in the government's responsibility for handling nationally important matters even strengthened during the pandemic. His findings on Germany can be summarised as follows:

1. Past experiences imply that many of the measures and solutions that the German government designed and implemented to fight the pandemic will very probably be maintained after it goes away.

2. The last hundred years of German history prove the existence of Leviathan. Germany exceeds the Scandinavian countries in terms of tax burden and social policy, the latter consuming 45% of all government spending. Wohlgemuth's partially attributes this to the unification of Germany, which was also an extraordinary event.
3. Germany's spending on pandemic countermeasures was greater than in any other country; as a result, the national debt level and borrowing in 2020 reached about 5% of the country's GDP. Yet, no attempt was made to review public expenditures and special laws on borrowing were re-authorised for future years.
4. The pandemic disturbed the balance of powers between the federal government and the federal and state legislatures. The ensuing crisis provided space for the federal government to make decisions based on questionable procedures, resulting in courts revoking a number of COVID-19 regulations.

States turn into Leviathans gradually and barely noticeably. Societies facing menacing situations, such as the COVID-19 crisis, whose scale and demands have been unprecedented in modern history, are willing to accept most measures proposed by the government. But allowing authorities to keep them longer than necessary involves many risks because they may shield those in power from democratic and political accountability. Thus, their impacts and consequences must be closely watched for symptoms of Leviathan.

2. The Directions of Poland's Fiscal Policy During the COVID-19 Pandemic

A distinctive feature of the Polish government's response to the pandemic was the creation of special-purpose funds to protect vulnerable sectors and areas.

Politicians' tendency to 'corrupt' public finances has a long history and is frequently debated and discussed in many countries. In Poland, it is usually interpreted in terms of excessive public borrowing, irrational spending, tampering with public the deficit and debt, and establishing special-purpose funds and similar vehicles for the off-budget management of public funds (Jastrzębska, 2022, Poniatowicz, 2022). In recent years, the use of such solutions by decision-makers has increased on the excuse of fighting the COVID-19 pandemic. Poland's government's inclination to shift expenditures and debt off the budget has reached the dimensions of a serious problem.

The 2020 macroeconomic situation in Poland and the public finance sector's ability to collect and spend revenues were affected by the unfolding COVID-19 pandemic. The severity of its impacts required special financial effort to ease them. Most anti-pandemic funds were obtained from off-budget sources, including (Report on the State's Budget Performance from 1 January to 31 Dec. 2020, Warsaw 2021):

- the national budget and the EU budget – PLN 23.2 bn,
- the COVID-19 Response Fund – PLN 92.7 bn,
- Financial Shields of the Polish Development Fund – PLN 63.5 bn.

The bill of the New Order (officially called the Polish Order), released by the ruling coalition in May 2021, corroborated its inclination to manage public funds off-budget through a growing number of special-purpose funds. The creation of a fund dedicated to financing the modernisation of the country was announced, whose resources, in conjunction with the PLN 770 bn available under the EU's coherence policy and the Recovery and Resilience Facility, were to support local investment projects to move Poland closer to the "European" standard of living promised by the government. Also made public were the plans to launch several other programs, probably also funded through special funds.

A serious problem in Poland's finances is the level of debt, which drew reservations already in 2020 following the amendment of the budget act. The economists discussed it in the wider context of the liabilities of the Polish Development Fund, the COVID-19 Response Fund, and Bank Gospodarstwa Krajowego – BGK (Bratkowski, 2020). W. Misiąg's (2020, pp. 3-11) expert opinion warned against a policy of creating various types of reserves and an ostensible reduction of the 2020 *bill* budget deficit by around PLN 21 bn by shifting some expenditures to special-purpose funds and using Treasury securities to finance selected beneficiaries. A case of particularly poor budgeting practice was the decision to mandate the payment of so-called thirteenth pensions, social disability pensions, and funeral allowances to the Solidarity Fund, as such payments are customarily made by the Social Insurance Fund (FUS). However, the decision made it possible for the government to claim that the financial situation of the FUS, which usually runs at a deficit, was good and consequently reduce the government grant for it. An unprecedented event regarding the transparency of public finance management was the 2020 budget act failing to explain how the Solidarity Fund's expenditures exceeding its revenues would be funded (Guziejewska, 2021b).

A lack of transparency is also a serious problem regarding the cooperation between the BGK and the COVID-19 Response Fund, which was established to support the public sector. The BGK was appointed as an institution responsible for enabling the COVID-19 Response Fund to accomplish its goals, securing its liquidity, and financing it, mainly through the issuance of bonds. In 2021, the BGK projected bond issues worth up to PLN 39.7 bn. However, such information frequently has to be sought from PAP Biznes because it is not provided in the budget act, or from BGK's communications. For instance, the BGK's communication of 30 Nov. 2021 informed about the possibility of the National Bank of Poland holding a single competitive sale of BGK's bonds on behalf of the COVID-19 Response Fund in December 2021. However, the announcement made an interesting reservation from the national debt perspective that the date of the sale was contingent on the market situation and the Fund's financial needs. It implied a limitation of the Ministry of Finance powers over public debt management.

3. (Un)Restricted Financial Independence and Autonomy of Local Governments or Non-transparency of Public Finances as a Consequence of the COVID-19 Pandemic

The following analysis compares Polish municipalities in terms of their financial independence before and after the COVID-19 pandemic based on the structural debt-to-revenue ratios. Municipalities constitute the basic tier of local government. A thesis is formulated that although the government did not make direct changes to the local government financing system in the period under study, its indirect actions reduced municipalities' financial independence. Although intended to defuse and mitigate the adverse impacts of the pandemic, the government's policy also brought lower transparency of public finances and lower autonomy of local governments. However, the statistics do not clearly show the other effect because some data from the analysed years are not comparable, some of the funds municipalities received from the special-purpose funds were misclassified as their own revenues, and budget transfers intended to compensate municipalities for the consequences of new legislation have made the local financing system even less transparent than it was. Furthermore, as of 1 June, municipalities ceased to disburse benefits under the Family 500+ programme, for which they received specific grants from the budget. Therefore, the incomparability of the structures of municipalities' own and external revenues is due to the confluence of several factors. Tables 1 and 2 contain selected numbers that give an insight into the structure of municipal revenues and demonstrate that even a small change to how data are presented may render them incomparable and ambiguous.

Table 1. Municipal revenues and their structure in 2018 and 2019

Specification	2018	2019			
	Performed (PLN thousands)	Performed (PLN thousands)	% of plan	change (2018=100%)	structure (%)
Total revenue, in which:	**121,425,597.4**	**135,161,458.3**	**98.6**	**111.3**	**100.0**
own revenues	52,529,209.6	58,482,654.5	100.8	111.3	43.3
Specific grants, incl.:	40,537,117.0	46,258,738.2	95.0	114.1	34.2
- commissioned tasks, incl.:	29,113,294.2	34,715,915.9	99.3	119.2	25.7
- "the Family 500+" programme	16,696,699.3	21,910,362.4	99.6	131.2	16.2
General grants	28,359,270.8	30,420,065.5	100.1	107.3	22.5

Source: Sprawozdanie z działalności Regionalnych Izb Obrachunkowych i wykonania budżetu przez jednostki samorządu terytorialnego w 2022 r. (Report on the Activities of the Regional Chambers of Audit And Local Governments' Performance of Their 2022 Budgets), RIO, Warsaw 2023.

Table 2. Municipal revenues and their structure from 2020 to 2022

Specification	2020	2021	2022			
	Performed (PLN thousands)	Performed (PLN thousands)	Performed (PLN thousands)	Performed (%)	Structure (%)	Rate of change (2021=100%)
Total revenues, incl.:	**149,090,469.5**	**163,483,714.8**	**171,813,485.5**	**96.1**	**100.0**	**105.1**
General grants	31,611,735.5	40,891,984.0	34,902,604.1	100.1	20.3	85.4
Grants and funds	59,634,894.4	56,819,753.6	60,835,186.2	90.2	35.4	107.1
Shared taxes (PIT and CIT)	24,167,399.8	27,488,842.5	31,652,503.0	103.1	18.4	115.1
Other revenues	33,676,439.8	38,283,134.7	44,423,192.2	96.8	25.9	116.0

Source: see Table 1.

The tax system changes introduced by the Polish Deal in 2021 decreased municipalities' revenues. The attempts to mitigate their impact undermined and dismantled the existing local self-government financing system. They were also criticised for being inadequate, and the special-purpose funds and governmental programmes distributing compensation funds were accused of using political criteria. The Union of Polish Metropolises estimated the municipal revenue loss in the last decade at as much as PLN 145bn.

The expansion of municipalities' debt between 2016 and 2020 was followed by a downward trend from 2021 to 2022, related to pandemic-related lockdowns and the EU tightening its investment budget.

Table 3. Municipal debt level and debt-revenue ratios between 2016 and 2022

Year	2016	2017	2018	2019	2020	2021	2022
Total debt (PLN thousands)	23,863,530	24,838,221	30,095,513	32,410,134	34,235,950	34,175,694	34,105,690
Debt-revenue ratio	32.4%	22.3%	24.8%	24.0%	23.0%	20.9%	19.9%

Source: see Table 1.

4. Conclusions and Final Remarks

The above discussion demonstrates that the publicly available financial statistics and ratios need to be carefully examined in terms of their qualitative contexts, because numbers alone do not show the extent to which the financial independence of Poland's municipalities changed in the period under study. The incomparability and lower transparency of local government statistics are due to the non-standard and extraordinary measures that the government implemented in the public finance area. Local government officials and advocates, economists, and researchers studying financial decentralisation have for several years been trying to call attention to a regression in decentralisation processes in Poland. As a result of the steadily increasing number of off-budget vehicles during and after the pandemics and the misclassification of transfers from the special-purpose funds to local governments as own their revenues, the Regional Chambers of Audit's statistics have become incomparable. Worse still, following Russia's invasion of Ukraine in February 2022, processes obscuring public expenditures, financing public tasks through special-purpose funds rather than the budget, and cases of public procurement rules being rejected on account of the extraordinary situation became even more common. The Polish government's financial policy in the crisis years threw the public finance sector into chaos and obscurity. Analysing municipalities' budget deficits and liabilities to determine their real financial condition has become of little avail because, in the wake of lockdowns, they put on hold many investment projects, including those co-funded by the EU. The policy of centralisation and off-budgeting practices adopted by the Polish government between 2020 and 2022 (in response to the COVID-19 pandemic and the war in Ukraine) evidently contributed to the non-transparency of public finances. The problem of dwindling local self-governance, unreported by official statistics and implying the presence of Leviathan, has been raised in public debates by local officials for several years. One may wonder, therefore, why official statistics do not show local governments' financial problems when economists widely criticise the poor transparency of public finances.

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