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POLAND'S SYSTEMIC UNCOMPETITIVENESS. A FOCUS ON LEGAL AND TAX INFRASTRUCTURE

For a few years now, the level of economic activity in Poland, as measured by GDP per capita, has been declining. The country has also been facing a growing deficit, an increased level of unemployment, and growing social dissatisfaction. After exhausting simple methods for generating economic growth, the return to faster economic growth requires a methodological approach to developing Poland's systemic competitiveness. This paper focuses on two important determinants of systemic competitiveness, namely legal and taxation infrastructure. In Poland, poor legal infrastructure and fiscal activism negatively influence the amount of foreign direct investment and the level of entrepreneurial spontaneity by increasing transaction costs. In spite of numerous efforts undertaken by the Polish Government, Poland continues to have problems with the fundamental legal framework such as property rights, contractual obligations and legal entity formation. Similarly, the local fiscal system lacks clarity and allows for random interpretation. The concept of "systemic competitiveness" is used as the analytical framework for the paper. The concept emphasizes the importance of economic, social, and political factors determining the successful evolution of economic systems which are not systematically addressed by conventional economic theory.

Keywords: Poland, systemic, legal, fiscal, challenges

INTRODUCTION

For a few years now, the level of economic activity in Poland, as measured by GDP per capita, has been declining, and the country has been facing a growing deficit, an increased level of unemployment, and growing social unrest. The politicians, not always capable of understanding the economic mechanisms and their roots, make numerous social promises (Farrel, 1991; Glikman, 2002). Slowly, but systematically, economic processes slow down. The government machine grows. Prosecutors, the members of the Supreme Chamber of Control (*in Polish – Najwyższa Izba Kontroli*), and tax controllers excessively pursue business owners with the

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general claim that their conduct damages public interest (Matys, 2003; Matys and Milewicz, 2003; Krolak, 2003). This is a cause for concern.

The return to the path of faster economic growth in Poland requires a methodological approach to formulating an economic vision, which in the next decade will allow Poland to catch up with Western European leaders. However, an effective systemic infrastructure will not be built quickly. Its creation requires a methodological approach to the analysis of successful systemic solutions adopted in other nations and their insertion into the Polish reality. Only an approach of combining the results of international analysis with Poland's own experiences is likely to lead to the development of conditions necessary for improving Poland's systemic competitive advantage.

This paper focuses on two important determinants of systemic competitiveness, namely the legal and taxation infrastructure. Such an analysis is important for two reasons. Firstly, direct investment in Poland has been declining in the last two years. Poor legal and fiscal infrastructure regularly frustrate foreign investors (Sormani, 2003; Malme and Youngman, 2001), thereby negatively influencing the amount of foreign direct investment in Poland (Mitra and Stern, 2003; World Bank, 2002). As a result, Western companies move their existing operations elsewhere (Condon and Buttler, 2003) or commence their operations in a different country (Birnbbaum, 2002; Havlik, 2000). The implication here is that without strong foreign investment, Poland is not likely to participate in global production and distribution networks (Kaminski and Smarzynska, 2001; Smarzynska, 2000; Kaminski and Ng, 2001). Secondly, Polish citizens voted to formally join the European Union in 2004. When the initial euphoria associated with this has passed, Polish industries will be expected to compete with Western firms to an extent previously unimagined. Even the temporary protections may be insufficient if the systemic uncompetitiveness is allowed to continue (Kaminski, 1999). Poland will need to adjust many of its systemic solutions in order to benefit from the accession to the European Union (*Economist*, 2003).

1. SYSTEMIC COMPETITIVENESS

The term "systemic competitiveness" defines the economic, social, and political determinants of successful industrial development (Meyer-Stamer, 2003; Esser, Hillebrand, Messner and Meyer-Stamer, 1995). The World Bank defines it as "...the manner in which power is exercised in the management of a country's economic and social resources for development"

(World Bank, 2002). Attenburg, Hillebrand, and Meyer-Stamer (2003) view the term as “the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets, while simultaneously maintaining and expanding real incomes of people over the long term”. The concept emphasizes the importance of factors determining the evolution of economic systems which are not systematically addressed by conventional economic theory (Meyer-Stamer; 2003a; Attenburg, Hillebrand, Meyer-Stammer, 2003; Meyer-Stamer, 1995; Meyer-Stamer, 2003b). This is consistent with the arguments that macroeconomic conditions are not sufficient for successful industrial development (Nelson, 1992; Freeman, 1987). Dynamic industrial development is not only based on functioning markets and entrepreneurship, but also on collective efforts to develop an environment supportive for business growth and sustainability.

Determinants of systemic competitiveness

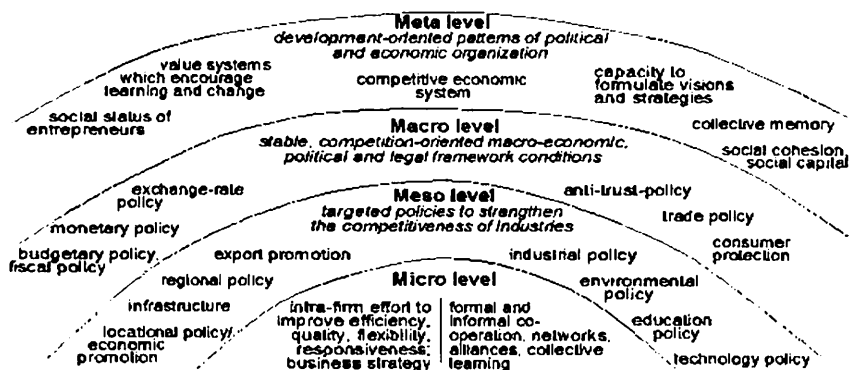


Fig. 1 Determinants of Systemic Competitiveness

Source: Mayer-Stamer, J. 2003a

Figure 1 above outlines the basic components of the systemic competitiveness model developed by a group of researchers at the German Development Institute in the early 1990's and widely applied by industrial

specialists and economists. The model defines four levels of successful industrial development: the *microlevel* of the firm in its interaction with its business environment, the *mesolevel* of social, political and economic institutions, the *macrolevel* of national economic infrastructure and conditions, and the *metalevel* of socio-cultural conditions.

One of the fundamental assumptions of this analysis is that the international trade will force all nations to improve their competitiveness. This will be based on a continuous search for areas of systemic competitive advantage. If the main assumption of a free market economy is the notion that firms behave in their self-interest and focus on profit maximization, the fundamental point in creating a nation's competitiveness must be that the economy needs to provide its economic agents with the ability to maximize their profit.

Value is created in the exchange process, in which economic agents trade amongst each other, thereby maximizing the level of economic benefit. The reduction of value created in the economy could occur as a result of indirect limitations in the creation of goods and services or a reduction of efficiency in economic exchange (i.e. by increasing transaction costs). In both instances, the sources of additional costs may come from excessive fiscalism (i.e. transaction and capital gain taxes), excessive formalism and bureaucracy (i.e. central administration costs), and limitations in protecting property rights (i.e. costs related to protecting property rights).

In a nation where value maximization is the only economic priority, the government's influence in economic activity would be limited to developing regulations, which would reduce the costs of production and trade. In such a nation, the absolute criterion for developing laws would be their economic efficiency. In reality, however, the economic infrastructure is a function of the nation's political environment, history, religion, legal tradition, and philosophy, as well as the level of awareness and temperament of its citizens. In Poland, the government has influenced the spontaneity of trade by developing a legal system, which, on one hand, attempts to optimize the level of economic activity, but, on the other hand, limits economic activity in the name of tradition, "homo sovieticus" ideology or the self-interest of the party in power (Wyrzykowski, 1993).

2. LEGAL INFRASTRUCTURE

Legal infrastructure may be defined as a set of laws regulating the nature of economic processes and, specifically, the laws relating to economic trade.

The main doctrine of the market economy is based on the belief that market participants maximize their utility by free will and competitive exchange of goods and services (Friedman, 1990). The fundamental elements of the legal infrastructure relate to property rights and the freedom of economic exchange, including the freedom to enter into a contract. In addition to confirming these basic rights, an effective legal infrastructure should optimize the exchange of property rights by protecting economic agents against unfair competition.

All regulations and laws with respect to economic processes must be a reflection of certain economic targets. Effective laws and regulations are based on a compromise between the government's long-term goals and the immediate demands and expectations of special interest groups. Assuming that the key objective of the government's regulations and laws is maximization of utility for the entire society, it needs to be assumed that the process of law creation requires an in-depth analysis of costs and benefits and developing mechanisms for motivating the behaviour of economic agents. No economic system is immune from the influence of special interest groups, which are able to effectively influence the government during the creation of special laws and regulations (Viscussi and Vernon, 2000).

2.1. Property Rights

Property rights relate to the right to use the object of possession and its free usage, which is protected by the government and the legal system against any claims of third parties (Demsetz, 1967). Simplistically, property rights may be defined as the use of available assets by economic agents (Libecap, 1989). The main function and consequence of property rights is the motivation for market participants to use them more than in relation to public property. Moreover, property rights create a situation where the costs of protecting these rights for economic agents are significantly less than the cost of protecting them for the entire society. This means that weakening property rights will lead to the reduction of motivation to create value and profit (Barro, 1997).

According to Polish law, private ownership is defined with some unclarity and guaranteed in a limited fashion (Sormeni, 2003; Malme and Youngman, 2001). The definition of property rights in the Polish legal system is not different than in other Western countries. Property rights are technically confirmed by the government and economic agents through laws (i.e. civil contracts, notarial deeds, entries in property registries).

However, even at the level of confirming property rights in Poland, there are some problems (Wyrzykowski, 1993; Bloomestein and Marresse, 1991; Piotrowska, 2003). A poorly designed system of central registries prolongs the time between acquiring property and becoming its actual owner, which, in turn, increases the cost of property transactions. There is also a silent social and legal "acceptance" of vandalism and the destruction of property. The criterion of "small public damage" on a country-wide scale becomes relatively expensive to property owners not only because of actual costs incurred by the owner when repairing damages, but also because of the psychological questioning of the safety of private property. Such practices destroy the trust of economic agents in the government's ability to protect property rights, thereby increasing the costs and risk related to property acquisition (Malme and Youngman, 2001).

The role of the government in the creation of stable property rights is critical. The existence of weak property rights encourages consumption and discourages investment in fixed assets and financial instruments (Libecap, 1989). Any efforts aimed at increasing the efficiency of property rights would decrease investment risk, thereby increasing the propensity to undertake long-term capital projects. Domestic and international investors appraise their investment risk by taking into consideration the government's guarantees in relation to property rights. Unclear property rights lead to an increase in investment risk and, at the same time, lower the value of properties in existence.

The most fundamental weakness in Polish property rights is the lack of "full protection" of ownership rights by the government (Wyrzykowski, 1993; Włodarczyk, 2002). This problem is apparent because of the lack of transparent procedures regulating the execution of these rights and an inefficient court system that is unable to appropriately protect them. In order to reduce the costs of obtaining external financing, the government should consider detailing in the constitutional law a requirement to protect the owners. The specific role in this regard belongs to the court system and the Constitutional Tribunal for creating important precedents in their rulings. Only a systematic and uncompromised approach to protecting property rights, even in cases where small monetary values are at stake, will inject a proper understanding and respect of these rights into the Polish society.

2.2. Legal Contracts

A contract is the main vehicle of economic trade. In a free market economy, economic exchange is captured in the form of a contract, which details the allocation of rights and responsibilities between the two parties. The entire society benefits from it because the rights are allocated in a way as to maximize their value and usage. The freedom to enter into legal contracts allows for the dispersion of the decision making process in the allocation of rights among members of the society who control these rights. Economic agents, who feel that they maximize value by willingly entering into legal contracts, are encouraged to enter into more legal contracts, thereby creating economic exchange. Therefore, the freedom to enter contracts naturally extends the democratic system and maximizes economic value, which the nation receives because of the effective allocation of legal rights and increased economic exchange.

Polish laws defining the nature of a contract do not differ, so it may seem, from those adopted in other Western countries. However, some of the legal practices and solutions adopted by governmental institutions could put in question the government's intentions and possible ways of interpreting various laws. This mostly relates to a poorly defined concept of "rules of social mutual relationship", which governs many other laws. How far will the government influence the freedom of entering into contracts in the name of "public benefit"? It is not surprising that the effectiveness of Polish law is declining in spite of significant revisions of Polish commercial law (Ramasetry, 2003).

An example of the influence of the courts in the freedom to enter into contracts may be a decision by one of the local courts, subsequently confirmed by the Supreme Administrative Court in Poland, with regard to managerial contracts. According to the local municipal court and the Supreme Administrative Court, the contract between the employer and employee, which included a clause giving the employee 12-month severance pay, was found to be illegal since it placed an excessive financial burden on the employer. The two courts subsequently reduced the severance pay to 3 months. In another instance, the Supreme Administrative Court questioned "excessive" managerial salaries and based its decision on the fact that the excessive salaries violated the "rules of social mutual relationship" (*Puls Biznesu*, 2002).

The ability of two parties to execute their rights in a contract and to receive compensation is a function of the effectiveness of the court system.

The inherent value of property rights or any other rights acquired when signing a contract are based on the definition of the law and an ability to execute the contract. Without the possibility of executing acquired rights, one can question their value and even existence. Consequently, the value of rights acquired in Poland is severely discounted by the market, thereby leading to a reduction in economic exchange.

It takes two or three years to obtain a ruling in the Polish court, though this could easily be extended by four or five years using procedural manoeuvring. The system of formal notification of the parties involved in the conflict works poorly while the procedural techniques of delaying court appearances offer strong possibilities. Economic agents are concerned that they need to rely on the poorly run court system to execute their rights. They further worry about the legal education of the state judges who rule in important cases without any support in the area of economics and finance. This situation forces market participants to enter into “costly compromises” which would not be necessary in more modern court systems. At the same time, the incurred costs do not cause any value to be added to economic agents or the entire economy. This situation diminishes the value of the contract as an instrument of economic exchange and discourages international investors from making significant investments in Poland.

2.3. Organization of legal entities

Economic trade is conducted between two legal entities whose behaviour is regulated by general laws. In economic theory, these legal entities are called firms. The firm is defined as a legal entity which engages in economic activity. In order to better understand the motivation and functioning of the firm, economists have attempted to construct its aggregated model, called the theory of the firm. The theory of the firm is a set of economic models that attempt to describe the mechanisms used by the firm to achieve its main objective, namely the maximization of profit or value. Developed economic models allow economists, financial specialists, and even lawyers to understand the processes related to control and decision making in the firm, its ownership structure, the relationship between owners, and restructuring activities.

The construction of laws that regulate the behaviour and functioning of the firm should be a dynamic process that adjusts legal norms to fit economic realities and reflects experiences confirmed by empirical research. The assumption that the government is able to create long-term laws (similar

to the Polish Commercial Code, created before World War I but still in existence today) is simply unrealistic.

The Polish firm, whether registered as a limited liability company or a joint stock company, is even at the moment of its conception in a significantly worse position than its Western counterparts (Sormeni, 2003). Private individuals who wish to begin economic activities are effectively forced by the government to undertake complicated, time consuming, and relatively expensive actions before the commencement of any trading activities and during their continuation. The entrepreneur, whose contribution to the development of the economy depends on his energy, creativity, and work ethic, spends valuable time in performing formalistic activities. This is especially critical for small business owners, whose limited scale of operations precludes them from using well-paid legal and financial advisers. Other business owners, who can afford to sub-contract these legalistic formalities, incur costs which reduce their overall competitiveness in the market place. The activities that need to be completed when a new corporation is formed are listed in Table 1.

Table 1

Company Registration Process: Poland and Western Countries (example based on U.S.)

Steps	Poland	Western countries
1.	Articles of Association	Company by-laws preparation Firm registration Formal announcement
2.	Notarial Deed	
3.	Share capital payment	
4.	Firm registration	
5.	Polish Statistical Office registration	
6.	Stamp preparation	
7.	Tax office application	
8.	Social Security registration	
9.	Formal announcement	
Total cost	PLN 53,000	PLN 1,000
% of GDP per capita	142%	0.9%

Source: Own research and calculations

3. TAXES

The activity of the government with regard to re-allocation of public assets is based on the distribution of taxation proceeds towards social purposes, investments and administration. The analysis below will briefly focus on taxation policy and tax collection.

3.1. Fiscal policy

The debate on the fiscal policy of Poland has continued for over ten years. It was fundamentally decided that the government would generate tax on business transactions and profits; the only debate now is the level of taxation. It appears that the route to introduce a linear taxation system (adopted in countries like Russia, Latvia, and Lithuania) is not acceptable to the Polish government even though the opposition parties raise this issue in their platforms. There is a general problem of social acceptability with a potential reduction of tax for the bigger earners. Therefore, the main focus for now should be on the optimization of taxation laws, which would allow the taxpayers to understand the basis for taxation and the rules of tax collection.

One of the main confusions in the Polish taxation system comes from lack of clarity as to whether the Polish government wishes to collect tax on profits generated by a firm or tax any revenue a firm received whether it actually generated any profit or not (in the past the government collected tax on revenue and profit). The Polish tax law does not clearly define "taxable proceeds", which leads to many situations involving unclear taxation responsibilities.

A good example of a problem in the Polish taxation system is a situation where similar economic transactions are treated differently in different types of legal entities, in this case a joint stock company and a limited liability company. The investor who chose a limited liability company as a legal entity effectively lost 22% of the value because of legal reasons. Anyone who reads this discrepancy in taxation treatment would wish to hear a rational explanation about the differing treatment of two different types of legal entities.

Table 2

Tax treatment of issuing shares for different types of legal entities (Joint stock and limited liability companies)

	Joint stock company	Limited liability company
Activity	Company issues 100 PLN of new capital; Company allocates 80 PLN to Company's Share Capital and 80 to Reserve Capital	Company issues 100 PLN of new capital; Company allocates 80 PLN to Company's Share Capital and 80 to Reserve Capital
Taxation	No tax	22.4 PLN (80 PLN x 28%)

Source: Own research and calculations

Another critical area of taxation relates to allowable deductions. Even small changes to the rules of treating certain expenses, which occur in Poland quite often, have a major impact on how various industries perform. A specific example may be the discrepancy in the government's approach to the firm buying / selling equity and debt. The cost of buying shares may be tax deductible at the time of selling shares. With respect to debt, the costs of buying / arranging debt are not tax deductible. The proposed solutions seem to imply that the government wishes to encourage market participants to focus on stocks rather than debt.

One of the fundamental points in developing tax theories is the "realization rule", which relates to crystallizing the value by selling assets above their purchase price. There are many examples where the Polish government would tax a firm on a paper transaction, resulting in little value created. If a firm wishes to "transfer" a small amount of capital from Reserve Capital to Share Capital (these are rules the government has imposed on firms to ensure that Reserve Capital has to be in certain proportion to Share Capital), the tax authorities would apply tax. They argue that the owners realized certain value by increasing the firm's Share Capital, totally discarding the fact that no more than a paper transfer had occurred.

Many of the current government's politicians and economists claim that taxes in Poland are similar to or even better than those in other Central European countries. This was presented in many government publications and widely proclaimed by pro-government economists. Table 3 presents effective tax rates for corporations in Poland, Hungary, and the Czech Republic. It shows that Poland is placed in the middle among the leading Central European countries, but lags significantly behind Hungary in terms of corporate taxation.

Table 3

A comparison of effective tax corporate tax rates in Poland, Hungary, and the Czech Republic

Country	Poland	Hungary	The Czech Republic
Corporate tax	24%	18%	31%
Withholding tax on dividends	20%	20%	15%
Capital gains	10%	N/A	31%
VAT	7-22%	12-25%	5-22%

Source: www.pwcglobal.com

3.2. Tax Collection

Random interpretations of the Polish tax laws and the instability of the passed laws are the main problems of the tax system. More clarification in taxation laws would help tax administration in performing their tax collection responsibilities in line with the intention of the government and the usage of laws. However, an improvement of the law will not be sufficient for tax authorities to work well.

Lack of clarity in the Polish tax laws creates situations where tax offices interpret tax laws differently and to their benefit. It is possible that the amounts of tax liabilities may differ and taxes may be due at different moments in time. This discrepancy in the application of tax laws creates chaos in the behaviour of economic agents, who try to alleviate or reduce tax liabilities by ordering a tax review by one of the reputable accounting firms. Such tax reviews cost around \$10,000 and often end with the conclusion that a firm should write directly to the tax office for interpretation. Once directly approached, the tax authorities usually respond after a few months, confirming that tax liabilities are to be paid and, without any explanation, leaving the final decision to a taxpayer with overdue tax debts.

In order to deal with some of these problems, the government needs to review its theoretical assumptions when assessing tax and its ability to meet desired targets and introduce a more precise system of definitions and rules, which would eliminate or reduce areas of uncertain interpretation over time. A new and improved system, again drawing from Western experience, could be based on some basic ideas:

- Local tax offices would not have the right to issue law interpretation statements;
- The Ministry of Finance would issue detailed interpretations on a regular basis with relation to the current and past laws;
- In the case of tax disputes, local tax offices would ask the Ministry of Finance for its opinion, which would subsequently be distributed to the public as a precedent case;
- The Special Tax Committee founded by Parliament should be more active in the analysis of interpretations issued by the Ministry of Finance to confirm that its interpretations are consistent with Parliament's objectives.

More systematic and clearly interpreted tax laws would reduce their abuse by local tax offices. The unlawful actions of certain tax offices

towards private owners pose problems that cannot be addressed on a case-by-case basis. These problems need to be dealt with as systemic problems.

If the objective of the government is to tax certain transactions, then local tax authorities should have sufficient authority to carry out their responsibilities. This authority, however, should be limited in such a way as to not harass taxpayers. Taking this point of view into consideration, the transparency of the tax system is of primary importance, since this is the only way to protect law-abiding taxpayers. However, if the objective of the government is to limit the ability of the average taxpayer to protect his or her rights, then one needs to question the efficiency of tax policies recommended by the government. Any attempt on the part of the government to “fog” rights and responsibilities would undoubtedly cause transaction costs to increase. This increase would be related to a continuous usage of tax advisors, battling tax disputes in the court system, and spending excessive time on reporting functions. It may be argued that leaving certain tax laws unclear would be to the benefit of the Polish government, since they could only interpret tax laws to their benefit.

The creation of a two-level court system is a priority, as courts would then be able to deal with tax disputes in a timely manner (it takes anywhere from two to five years to get a ruling from the regular court system or the National Administrative Court on a tax case). The two-level court system would ensure further transparency and consistency of tax ruling throughout the country.

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received: September 2003, revised version: February 2004