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Maciej BANASIK

CHANGES IN MACRO AND MICRO-PRUDENTIAL SUPERVISION IN THE EUROPEAN UNION AND POLAND AFTER 2008

Summary
The financial crisis in the first decade of this century made economists, politicians and financial institutions realize the need for changes, especially in the area of supervision over markets. It should take place both at the micro and macro scale. Globalization processes force governments to cooperate on an international scale to avoid the so-called “domino effect”. A lot of households, which should be protected at macro level, lost their confidence in the financial markets because of the crisis. The purpose of this paper is to analyze the most important changes, which have been introduced after the crisis, in the legal regulations concerning supervision and safety of financial markets, both in the legislation of the European Union and Poland.

Key words: supervision, crisis, financial markets, risk.

Introduction
A well-functioning financial system is the basis for economic development and growth of any country. Individual countries have worked out their own systems for providing supervision and security during development of financial systems. The shape of those systems is reflected in legal regulations. The above mentioned crisis turned out to be the type of a test to check how those systems and regulations work. In many countries the supervising systems failed, although, they had seemed to be well regulated. Many institutions collapsed, people lost their savings and pensions and governments spent hundreds of billions of dollars on emergency aid programmes for many companies and institutions.

Financial crisis, as an economic phenomenon, is nothing new. The
solutions to end a crisis must be complex in the contemporary globalized world in which there are no banks or financial institutions of a given national origin, they are all international corporations. Imbalance on one financial market triggers the situation called “the domino effect” on other markets. It is necessary to perceive such a situation in terms of both micro and macro levels in order to prevent its symptoms. The crisis has exposed weaknesses in the regulations in both areas and showed the need for international cooperation of all market participants.

The aim of this publication is to present and analyze changes, in the supervisory regulations in both macro and micro approaches, resulting from the crisis of 2007-2008 and how those changes have affected the increase in safety and reliability of financial market institutions. The date included in the paper refer to the European Union and Poland.

The household sector, which plays a very important role in the formation of internal savings of any country, should be perceived as the main goal of the protection. The actions taken must be aimed at increasing the sense of security of those savings and investments in financial markets. Unfortunately, the crisis has weakened the feeling.

Janusz Szewczak is right, to a certain extent, when posing a fundamental question whether “we have already been deprived of chances for better, peaceful and sustainable future. Was the situation caused by big banks, credit institutions, toxic financial products and the money used for illegal purposes? [...] Banks in the contemporary globalized and demoralized world are apparently too big to fail, but not so powerful to pick up hope for a better tomorrow.”¹ In the aftermath of the crisis, banks are not seen as trusted institutions but as mere players in the global casino (financial market) where their win is the highest possible gain. "Money and debts, like no other things in the world, create many excellent opportunities for variety of irregularities and fraud. They give the opportunity to influence human destinies, stimulate their hopes, change their perspective. [...] Nowadays, big banks, by transforming homo sapiens into homo creditus, have described the fate of millions of people around the world. Contemporary bankers tell us straightforwardly that they are doing the work of God on Earth."² Moreover, they claim that

²“I do the work of God”. Lloyd Blankfein (President of Goldman Sachs) defended himself during the interview for the British newspaper The Times, arguing that he was providing life-saving money to businesses that helped companies produce and hire people. The interview triggered a scandal. Forbes named Blankfein "the most annoying
their task is to give the nations and generations not what they want and really need, but what the bankers decide that nations and generations want and need”. Therefore, the need for supervision of finance is vital to restore a sense of security and faith that the financial market is not only a place of gambling and speculation. Financial education of societies which allows to understand mechanisms governing financial markets, also seems to be a very important issue.

1. Financial crisis and risk

In literature there are many definitions describing financial crisis. When it occurs several elements of the financial system can be involved and it is generally associated with the collapse of the currency of a country concerned. The collapse of the currency means a loss of confidence of financial investors to the currency, causing its massive and rapid clearance sale and the escape of capital abroad. Such a situation induces a devaluation of the currency.

The currency crisis may be accompanied by a crisis in other segments of the financial market such as Stock Market crisis, banking crisis or monetary crisis noticed as a significant increase in interest rates and a decrease of amount of money in circulation. In addition, the debt crisis may cause a situation when a government is not be able to service its foreign debt.

The most adequate definition of the current crisis says that a financial crisis is a disruption of functioning of financial markets. It can cause the lack of financial stability, and its manifestation is a significant decline in asset prices of a large group of financial institutions, debtors and intermediaries (the market value decreases and is less than their liabilities). These problems, then, grow and spread throughout the financial system, disrupt market abilities to an efficient allocation of capital and lead to bankruptcy of many operating entities and to a government intervention.
According to Robert Skidelsky, last financial crisis resulted from three parallel defeats. Firstly, it is an institutional failure; banks were turned into casinos, and financial innovations got out of control because they were not under any control. At the beginning, the market of mortgages, the type of subprime, was infected by their negative effects and, then, they were transferred into the entire global banking system. When banks ceased to lend, negative effects of the situation influenced other sectors of the economy. People, responsible for the financial policy, assumed that the market is efficient in itself. Furthermore, market fundamentalists assumed that the financial market is capable of proper valuation of assets or securities, and mistakes are only temporary, so the market needs a very small amount of regulations. This approach resulted in the emergence of the second disaster called intellectual. According to R. Skidelsky, the faith in the idea of absolute market efficiency leads to the collapse of economic thinking in the mainstream. Therefore, economists were unable to predict or explain today's financial collapse.

The third dimension of the current crisis is a moral failure of a system based on debt. While, once, a debt was a sin, today, it has become almost a duty, as a "lever" of rapid development. The problem does not concern the moral inadequacy of the virtues associated with capitalism, but their disappearance. Caution or the ability to self-limitation, once, appropriate for capitalism, are now in retreat – in the western world everyone borrowed as much as they could.6

The crisis of 2007 and 2008 was associated with the real estate market and based on the securitization of subprime mortgages. Securitization is the process of combining individual loans in packages with different levels of risk, which may be sold by the lending bank. The real boom for that kind of loans occurred after 2000 and was the result of three decisions:

- in 1999 the US Glass-Steagall Act of 1933 was repealed. It forbade the retail banks to engage in investment activities, such as sureties or sale of insurances,
- the US President Clinton’s decision, according to which a market of credit swaps was not under any control,

6Nobody knows what will happen next (Maciej Nowicki is talking with the British economist Robert Skidelsky) [interview] Dziennik 24–25 January 2009.
• in 2004 the American Commission of Securities and Exchange Commission issued a decision, which allowed banks to increase their leverage ratios. It changed the ratio of total liabilities to net worth from ten to one into thirty to one.7

The ongoing financial crisis can be divided into four consecutive, although incomplete phases, the consequence of which is economic downturn (slowdown or recession depending on the region), with some spells of recovery:
• private debt crisis - the crisis of subprime loans in US banks,
• banking crisis - the crisis in the global banking system after the proliferation of the US subprime crisis throughout the world. At the beginning, this phase appeared as the liquidity crisis resulting from the crisis of confidence and trust,
• public debt crisis - that is, on one hand, acute debt crisis in the peripheral countries of the Euro zone and, on the other, the medium-term problem caused by a huge debt accumulated in the largest developed countries,
• political crisis – how to work out and implement reforms leading to fiscal consolidation.8

Identification and estimation of risks in the financial system play an important role in preventing financial crises. It is essential to get to know how difficulties of a single institution can be transferred, in a way of domino effect, to other market participants and, finally, to the entire financial system. Recognition and assessment of risks is hampered by complicated structures and interactions among financial market participants. This kind of relationships have not been taken into account in research, yet. Therefore, the aim of research is to obtain a wider knowledge of the size and structure of risks in the financial sector and finding out connections that exist among companies.9

Systemic risk is mainly the risk which occurs during interdependent operations of financial institutions and markets. The theory of finance describes many types of risk such as: liquidity risk, credit risk, currency

Changes in macro and micro-prudential supervision...

risk or operational risk. They are usually considered as distinct and separate. The interaction of these risks may lead to the outbreak of crisis. The new type of risk here is called “systemic risk”.

The definition, which also emphasizes the relationships and interdependencies that occur in the financial system, is described as: “Systemic risk is the risk caused by simultaneous occurrence and spread of different kinds of risk. The risk is also described as “an aggregated risk”. The signs of the emergence of the systemic risk are: credit boom, high “financial leverage”, correlated investment strategies, related and focused borrowers, appearance of misleading information and insufficiently developed infrastructure of the financial system. According to BIS (Bank for International Settlement) systemic risk is described as the risk that seriously impairs the functioning of the entire financial system and causes its total collapse. Systemic risk can also be defined as a sudden, unexpected event that can break down the financial system to such an extent that economic activities may be in jeopardy on a large scale.

2. Macro and micro-prudential supervisions

Macro-prudential supervision (macroprudential, macro prudential, macro-prudential supervision/oversight) is defined as a supervisory approach (perspective) focusing on the condition of the entire financial system, contrary to micro-prudential supervision, which assesses the stability of individual entities. It is also possible to distinguish macro-prudential policy, the aim of which is to prevent the increase of excessive risk in the financial system (capital and liquidity buffers, which increase shock resistance, can be used by financial institutions). In other words, it is a narrow approach of macro stabilization policy which is responsible for preventing macro-financial imbalances in the entire economy. The basis of macro-prudential approach is the belief that the stability of each part of the system does not provide the stability of the system as a whole and is not a simple "sum". Links between entities (including feedback effects) and the channels, through which an infection can be carried,

11 Ibidem.
should always be taken into account.\textsuperscript{12}

The micro-prudential supervision adopts the perspective of a bottom-up approach and treats threats as exogenous shocks, while the macro-prudential oversight applied a top-down approach and looks for sources of endogenous shocks. The micro-prudential approach is not sufficient to ensure the stability of the financial system, because the stability of each individual institution does not mean stability of the whole system. If a financial institution starts to perform rationally, according to its point of view, and when a significant group of entities begins to imitate it, the situation can lead to disorders affecting the entire system in a negative way (e.g. tightening of credit policy). The both approaches should not be treated as mutually exclusive, on the contrary, they are complementary. Conclusions of the two studies allow to achieve a full assessment of the stability of the financial system and its components.\textsuperscript{13} The comparison of both supervisions is shown in the table below.

Table 1. Micro-prudential and macro-prudential supervisions

<table>
<thead>
<tr>
<th>Type / feature</th>
<th>Micro-prudential supervision</th>
<th>Macro-prudential supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct target</td>
<td>risk limits to a single financial institution</td>
<td>reducing the threat to the stability of the entire financial system</td>
</tr>
<tr>
<td>Final target</td>
<td>protection of investors and depositors</td>
<td>reducing macroeconomic costs of the crisis (instability)</td>
</tr>
<tr>
<td>Approach</td>
<td>bottom-up</td>
<td>top-down</td>
</tr>
<tr>
<td>Analysis subject</td>
<td>single institution</td>
<td>the entire financial system</td>
</tr>
<tr>
<td>Type of basic actions</td>
<td>preventive /intervention</td>
<td>mainly preventive</td>
</tr>
<tr>
<td>Relationships and interlinkages among financial institutions</td>
<td>not very important</td>
<td>very important</td>
</tr>
<tr>
<td>The main source of shocks</td>
<td>exogenous</td>
<td>endogenous / exogenous</td>
</tr>
<tr>
<td>Responsible institution</td>
<td>separate supervisor or central bank</td>
<td>usually central bank or coordination body within the financial safety net</td>
</tr>
</tbody>
</table>


\textsuperscript{13} Ibidem.
Changes in macro and micro-prudential supervision…

<table>
<thead>
<tr>
<th>Type / feature</th>
<th>Micro-prudential supervision</th>
<th>Macro-prudential supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>The main areas of analysis</td>
<td>various risks (e.g. liquidity), capital adequacy, meet supervisory standards</td>
<td>systemic risk, infection effect, the risk of the &quot;tail&quot;</td>
</tr>
<tr>
<td>The method of supervision</td>
<td>small differences in the methods and the &quot;intensity&quot; of supervision to institutions, on-site inspections and &quot;behind the desk&quot;</td>
<td>scale of supervisory involvement dependent on the systemic importance of institutions, issuing warnings and recommendations (as well as monitoring their performance)</td>
</tr>
</tbody>
</table>


There is no one model according to which the macro-prudential policy should be organized. Solutions depend on many factors, including historical experiences of a country, the organization of the financial safety net, development and structure of the financial system, as well as, legal determinants. However, it is important to mention that they should be suitable to form an accurate identification of the systemic risk and allow its rapid elimination or reduction. On the basis of the publication of the IMF (International Monetary Fund) and the recommendations of the European Systemic Risk Board, it is possible to formulate four key principles that should be treated as a guide for governments when creating an institutional framework for the macro-prudential policy. They are:

- clear assignment of responsibility,
- providing access to data and information,
- granting powers to use instruments,
- ensuring a significant role in shaping macro-prudential policy of the Central Bank.  

3. Financial supervision architecture in the European Union

The European System of Financial Supervision (ESFS) is a decentralized, multi-level system of micro- and macro-prudential

---

instruments, which was created to ensure a consistent and coherent financial supervision in the EU. The surveillance system is being changed due to the creation of a banking union. The legal basis is provided by Articles 26 and 114 of the Treaty on the Functioning of the European Union (TFEU), Art. 290 TFEU (delegated acts), Art. 291 TFEU (implementing acts) and Art. 127 para. 6 TFUE.\(^\text{15}\)

ESFS is composed of the competent supervisory authorities of the Member States and three supervisory authorities performing this function in three segments of the EU financial market. They are: the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). They form the Joint Committee of European Supervisory Authorities (ESAs). The European Council for Systemic Risk performs macro-prudential oversight within the competence of the European System of Financial Supervision.\(^\text{16}\)

In the EU the micro-prudential supervision, which means the supervision of individual institutions, is performed by a multi-level bodies. Each level can be divided according to areas of supervision: banking, insurance and securities markets and the level of monitoring and regulation (European and national). Various bodies and instruments of coordination have been established in order to ensure cohesion and comparability among different levels. Moreover, it is important to coordinate actions of various institutions at international level.\(^\text{17}\)

Joint Committee of the European Supervisory Authorities and the competent national supervisory authorities are responsible for the micro-prudential supervision. The European Supervisory Authorities consist of:

- The European Banking Authority (EBA) which controls activities of credit institutions, financial conglomerates, investment firms and payment institutions. In accordance with the regulation, EBA is entrusted with the tasks which include: ensuring the stability, efficiency and consistency of regulations and supervision, contributing to the stability and efficiency of the financial system; preventing regulatory arbitrage, providing the same level of supervision, consumer protection, strengthening of international coordination of financial supervision and appropriate supervision of credit institutions.

\(^\text{15}\)http://www.europarl.europa.eu/atyourservice/pl/displayFtu.html?ftuId=FTU_3.2.5.html [10 May 2016].

\(^\text{16}\) W. Szpringer: *Prawo i ekonomia...*, op. cit., p. 119.

\(^\text{17}\) Ibidem.
EBA contributes to the creation of a unitary set of rules by developing regulatory projects and executive technical standards, which are, then, adopted by the Commission as delegated acts or implementing acts. EBA issues guidelines and recommendations and also has specific competence to act when the EU rules are violated by national supervisors.

- European Insurance and Occupational Pensions Authority (EIOPA): the office operates on similar principles as the EBA but its activities are mainly related to the insurance companies.

- European Securities and Markets Authority (ESMA) works similarly to other European Supervisory Authorities, however, its activities are mainly related to securities markets and participating institutions. In the European Union this office is only responsible for the registration of rating agencies and their supervision.

Joint Committee of European Supervisory Authorities is responsible for the overall and cross-sectoral coordination of activities aimed at ensuring cross-sectoral consistency of supervision. According to the regulation on the European Supervisory Authorities, Joint Committee activities include the following areas: financial conglomerates, accounting and auditing, micro-prudential analysis of a situation development, analysis of risks and weaknesses of financial stability on cross-sector level, retail investment products, prevention of money laundering; exchange of information between the ESRB and the ESAs and, finally, the development of relations between the two institutions. The Joint Committee is responsible for the settlement of cross-sector disputes among the ESFS authorities.

Joint Committee consists of the chairpersons of all the European Supervisory Authorities (and any sub-committees). It is chaired by a chairperson of one of the ESA elected for a 12 month rotational term. Currently, the chairperson of the Joint Committee is the vice-president of the ESRB. The Joint Committee must meet at least twice a year. The staff of the ESA perform secretarial functions. According to various legislative measures applied in the area of financial services, each Member State sets its own competent authority or authorities which are part of the ESFS.

European Systemic Risk Board (ESRB), headquartered in Frankfurt upon Main in Germany, is responsible for the macro-prudential oversight at the European level. The Board’s performances include limiting and
preventing systemic risks in the area of financial stability in the European Union due to macroeconomic changes. The founding regulation entrusts the ESRB with different tasks and proper instruments have been provided to perform these tasks, such as: collection and analysis of relevant information, identifying risks, ordering risks in terms of validity, issuing of warnings and recommendations, monitoring follow-up performances, issuing confidential warnings and providing the Council with assessments if the ESRB considers that the emergency situation may arise, cooperation with all other parties to the ESFS, coordinating its actions with the international financial institutions such as the International Monetary Fund and the Financial Stability Board and performing other tasks set out in EU legislation. The European Central Bank (ECB) provides the support for the Secretariat of the ESRB and the President of the ECB chairs the ESRB as well.

4. Changes in European regulations

The legal bases for creating the European System of Financial Supervision are:


- The regulation of the European Parliament and of the Council (EU) No 1092/2010 of 24 November 2010 on the union macro-prudential oversight of the financial system and establishing a European Council of Systemic Risk,
Changes in macro and micro-prudential supervision...


The last global financial crisis has shown that the mere coordination of financial supervision, conducted by the ESFS, is not efficient to prevent the fragmentation of the European financial market. To meet this challenge, in mid-2012, the Commission proposed creating a banking union, which would adopt a more integrated approach and which would complement the Euro zone and the single market. This framework included a single supervisory mechanism, a unified mechanism for restructuring and orderly liquidation and a common deposit guarantee system. It complemented both the unified set of rules and the unified book on supervision. In the meantime, a unified supervisory mechanism and a unified mechanism for the orderly restructuring and liquidation were created.18

EBA’s imperious interference into legal and actual situations of credit institutions may be implemented only in exceptional circumstances and application of appropriate procedures, in that case, can be extremely confusing. It was decided that an institution within EU must be to entrust with a genuine pan-European banking supervision (it means the one, which includes both the control and the possibility of issuing imperious decisions which interfere into the legal and actual situation of credit institutions throughout areas of their performances). The European Central Bank was chosen for such a purpose, although, its responsibility for supervision was limited only to credit institutions based in Member States of the European Economic and Monetary Union (EMU), it means, in the countries that have adopted the Euro currency. On 15 October 2013 the Council’s Regulation (EU) No 1024/2013 was accepted and came into force, according to it, the European Central Bank was entrusted with specific tasks regarding the prudential supervision policy of credit institutions (Acts. Office. EU L 287 of 29 October 2013., Regulation No. 1024/2013). ECB has been able to perform its supervisory powers since 4 November 2014. The new body called Board for Supervision, created within the organizational structure of the ECB, was entrusted with those powers. Although, the Regulation came into force, the relevant supervisory authorities operating in the countries, included in the Euro

18 ttp://www.europarl.europa.eu/atyourservice/pl/displayFtu.html?fuId=FTU_3.2.5.html [10 May 2016].
zone, were not liquidated. They and ECB form so-called the unified supervisory mechanism (Single Supervisory Mechanism – SSM) but the European Banking Authority still retains its powers.¹⁹

Union Bank is based on 3 pillars:

- single supervisory mechanism (SSM - Single Supervisory Mechanism),
- single mechanism restructuring and orderly liquidation (SRM - Single Resolution Mechanism),
- related financing mechanisms include the uniform restructuring fund and orderly liquidation of banks, deposit insurance systems and common mechanism of protection (credit line)²⁰.

The European Central Bank was entrusted, according to the Regulations No 1024/2013 and 1022/2013, with an authority to supervise banks in the Euro zone and other participating countries. Practical principles of democratic control over the actions of the ECB within the single supervisory mechanism are described in the European Parliament interinstitutional agreement - the ECB of 23 November 2013.

Unitary rules and unitary procedures for restructuring and orderly liquidation (SRM - Single Resolution Mechanism) should be used by the Council for Restructuring and Ordered Liquidation and national authorities for restructuring and orderly liquidation in accordance with the unitary mechanism established by Regulation No 806/2014. Restructuring costs and orderly liquidation of banks costs are borne mainly by shareholders and creditors. The Single Resolution Fund, financed by contributions paid by banks, is the last one on the list to bear those costs. The unitary mechanism for restructuring is valid in the countries covered by the single supervisory mechanism. Other Member States have to apply the rules described in the Directive 2014/59/EU of 15 May 2014, which includes actions taken by national bodies and restructuring mechanisms.

Moreover, a unified rulebook for financial services was developed. This is the basis for a banking union performances and it includes:

¹⁹W. Szpringer, Prawo i ekonomia..., op. cit., p. 119-120.
Changes in macro and micro-prudential supervision...

- Directive No. 2013/36/EC and Regulation No 575/2013 of 26 June 2013 on prudential requirements - package CRDIV/CRR (called IV Capital Requirements Directive and Capital Requirements Regulation),
- Directive (recasted) No 2014/49/EU of 16 April 2014. The European deposit guarantee scheme - DGS (Deposit Guarantee Scheme),
- Regulation 2015/2365 of the European Parliament and of the Council on reporting of securities financing transactions and the transparency of those transactions (“Regulation on reporting and transparency of securities financing transactions” (called Regulation on reporting and transparency of securities financing transactions -SFTR) - came into force on 12 January 2016,
- a project of a regulation on structural measures to increase the resilience of credit institutions, COM (2014) 43 of 29 January 2014.

The Council is examining a draft regulation on structural solutions to increase the resilience of credit institutions of the EU. The regulation is intended to protect the EU’s financial system against systemic risk, which could cause the bankruptcy of large, highly complex, interrelated credit institutions. The new rules can limit such a risk, because they would order to separate highly risky bank activities (primarily, trading on their own account) from its main performances, such as taking deposits and retail payment services. The basic activity of banks is vital for the economy, therefore, requires special protection. Expected benefits from the implementation of the Regulation:

- better stability of financial markets,
- better protection of taxpayers' money, because smaller banks can be restructured and liquidated orderly without the use of public funds,
- less temptation to fraud because large banking groups could no longer rely on the public subsidies,
- better coherence of the rules on credit institutions in EU Member States, which should provide banks with the same financial conditions throughout the internal market and reduce possibilities of circumvent regulations (or "regulatory arbitrage"),
reduce distortions of competition among banks.\textsuperscript{21}

Establishing a banking union raises many reasonable doubts. The most important of them is the fear that the financial envelope will be too small in the event of an outbreak of a new financial crisis in the Euro zone. These arguments are, to some extent, weakened by the fact that expenditure on bank restructuring will come mainly from their shareholders and creditors, then, from the holders of deposits over 100 thousand Euros and, finally, from the SRP. Another controversial issue is connected with constitutional solutions adopted for the banking union because it provides the German and French governments with a significant impact on a banking union performances. The German government manages to secure the process of bank restructuring in the Euro zone with numerous safeguards which strengthen their position in the decision-making process (e.g. in the Unified Board for Ordered Restructuring and Liquidation), but also complicate the functioning of a banking union.\textsuperscript{22}

5. Regulations and changes in safety and surveillance in Poland

The EU countries have developed various practical solutions concerning financial market supervision, which differ mainly in the scope of integration and degree of involvement of the Central Bank. Some models for the organization of financial market supervision system can be distinguished due to the criterion which describes integration range of supervision of individual financial market segments. They are:

- sector supervision means multi-institutional, diverse, consisting of functioning of some supervisory institutions, each of which supervises its respective segment of the financial market,
- integrated supervision, called one-institutional, performs supervisory functions over all segments of the financial market by a single supervisory authority often called the mega-supervisor,
- partially integrated supervision which assumes that there are two supervisor institutions, one of which is responsible for the prudential

\textsuperscript{22}W. Szpringer: Prawo i ekonomia…, op. cit., p. 121.
supervision of all financial institutions, and the other one for consumer protection.\textsuperscript{23}

In Poland, the Financial Supervision Commission has supervised the financial market since 1 January 2008 under the Act of 21 July 2006.\textsuperscript{24} It is called the integrated supervision including bank supervision, insurance supervision, pension supervision, capital market supervision, supervision of payment institutions and payment services offices, follow-up supervision and supervision of cooperative bank sector.

On 27 October 2012 a new law, established on 5 November 2009 on Cooperative Savings and Credit Unions (SKOK) came into force.\textsuperscript{25} It replaced the Act of 14 December 1995 and includes the rules of establishing, organization and activities of SKOK and KSKOK (Kasa Krajowa SKOK - National Credit Union of SKOK). The most significant changes concern the rules about maintenance of 5% solvency ratio by Credit Unions (earlier, the National Credit Union had defined the rules of its calculation) and the changes concerning the supervision of Credit Unions by the Financial Supervision Authority which receives some of KSKOK’s competencies. FSA is equipped with the powers to supervise Credit Unions, the same ones concerning banks, and the status of the National Fund has been changed. FSA has not lost the status of institutions uniting cooperative banks and controlling their activities in compliance with provisions of the Act and oversight regulations but, now, its role is also to secure financial liquidity of cooperating banks and management of the stabilization fund. In January 2014 some changes in the Act on NBP (the National Bank of Poland) were introduced. According to them, Credit Unions and National Credit Union are obliged to maintain the capital reserve, which is required from other cooperative banks (Credit Unions discharges capital reserve to the National Credit Union and then to National Bank of Poland. National Credit Union is allowed to get a loan from NBP to fund the stabilization fund in the case of liquidity threat of cooperative banks.\textsuperscript{26}

\textsuperscript{25}Act of 5 November 2009 on Cooperative Savings and Credit Unions (Journal of Laws No. 201 item 1910).
\textsuperscript{26}E. Miklaszewska (ed.), \textit{Małe banki i instytucje okołobankowe w świetle pokrywowszych regulacji}, Kraków University of Economics, Kraków 2015, p. 43.
The most important changes in the law on the Bank Guarantee Fund were introduced in 2008, 2010 and 2013 after the crisis. In 2008 two amendments to the law on the Bank Guarantee Fund were made. The first one, of 3 October 2008, was associated with changes in the Banking Act of 2007 which influenced the principles of calculating obligatory annual fee paid by banks to the Bank Guarantee Fund. Under the power of the second one, of 23 October 2008, the level of deposit guarantee was raised from 22.5 thousand euro to 50 thousand euro (after the conversion into PLN taking into account the average exchange rate of the National Bank of Poland). All funds in bank accounts for this amount of money are covered by the guarantees due to the resignation from the principle of co-insurance. Another important amendment to the Act on the BGF was added in 2010. The aim of the introduced rule was to adjust Polish law to Directive 2009/14 / EC. The most important changes include:

- increasing the deposit guarantee from the equivalent of 50 thousand Euros into PLN into the equivalent of 100 thousand Euros into PLN,
- shortening the payment deadline of the guaranteed means within 20 days,
- impose the obligation on banks to create and keep up updated list of depositors,
- shortening of deadlines, within which the Financial Supervision Authority has to take a decision on suspending activities of a bank, if it does not regulate its obligations regarding the payment of guaranteed funds for reasons directly related to its financial situation.28

A very important decision was transforming the deposit guarantee system into the cash fund within the Bank Guarantee Fund (BGF) - since the introduction of the amendment, the rules concerning guarantee of deposits accumulated in cooperative banks have became similar to the obligatory system for banks (BGF’s guarantees to the equivalent of 100 thousand Euros).

Until 8 October 2016 the guarantee fund system functioned pursuant to the Act of 14 December 1994 on the bank guarantee fund. Since 9 October 2016 the regulations in force refer to the Act of 10 June 2016 on

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28 Ibidem, p. 45.
the bank guarantee fund, deposit guarantee scheme and resolution\(^29\), legal regulations adopted in this Act are in line with the Directive of the European Parliament and Council 2014/49/EC of 16 April 2014 on deposit guarantee schemes (text with EEA relevance).

Finally, it is necessary to mention the Act on the macro-prudential oversight of the financial market which came into force on 1 November 2015\(^30\). The regulations included in the Act strengthen the stability of the financial system and reduce the likelihood of a next financial crisis.

The Act adjusts the Polish law to the new European Union directives issued some time after the financial crisis. It assumes that the macro-prudential oversight of the financial system should include "an assessment, monitoring of the systemic risk arising in the financial system or its environment and undertaking actions to eliminate or reduce this risk with the use of macro-prudential instruments. The objective of the macro-prudential supervision is strengthening the resilience of the financial system in the case of appearance of systemic risk and supporting, in compliance with law, a long-term sustainable economic growth of the country". The entire financial system is under the macro-prudential supervision and the body responsible for that supervision, in Poland, is the Financial Stability Committee. FSC already exists, under the Act of 2008, but thanks to the new regulations its entitlements are strengthened.

If a direct threat to financial stability appears, the Financial Stability Committee is also responsible for performance relating to crisis management. The members of the Committee are: the President of Polish National Bank, the Minister of Finance, Chairman of the Financial Supervision Commission and the President of the Bank Guarantee Fund. The crisis management in the financial system includes actions to maintain or restore financial stability in case of a direct threat to this stability. When the sources of systemic risk in the financial system or its environment are identified FSC may inform on the type of sources, the extent of its impact and anticipated effects to the financial system. FSC may issue a recommendation to appropriate bodies, in which it indicates the need to take action by those entities to reduce the systemic risk and it

\(^{29}\) Act of 10 June 2016 on the bank guarantee fund, deposit guarantee scheme and resolution, Journal of Laws 2016, item 996.

\(^{30}\) Law of 5 August 2015 on macro-prudential oversight of the financial system and crisis management in the financial system (Journal of Laws, 2015, item 1513).
can also determine deadlines for those activities.

**Conclusion**

On the base of the review of legal and institutional changes, it is possible to notice that far-reaching changes in the structure of supervision have been made since 2008. The European architecture of financial supervision was created in the European Union, and in 2016 a banking union was established. In the future, it will be possible to analyze changes and how supervisory institutions work in times of crisis. Those rules are in force in the European Union and the Economic and Monetary Union (the countries where the Euro currency is obligatory). Solutions that go beyond the EU should be taken into consideration, because there is no limit to the capital in the globalized world. The USA, is one of the example, where absolute faith in a market and lack or limited oversight of it led to the crisis of the first decade of the 21st century.

Also, in Poland there have been many changes. The integrated surveillance was introduced, which also covers the Credit Unions. Many of the regulations had to be adapted in order to comply with the regulations of the EU, for example, deposit insurances.

The crisis, the largest that has ever happened, caused a state intervention to rescue banks and financial institutions. The amount of funds allocated for this purpose was a few trillion dollars. For the first time, central banks intervened on such a large scale. A false ideology and wrong assumptions led the world of finance to such a situation, furthermore, the absolute faith in the market and its participants, who seemed to take rational decisions, led the world almost on the verge of bankruptcy. It should also be noted that the rescue of banks with taxpayers' money is a violation of the principles of liberal economy.

All the conclusions resulting from the crisis should help to overcome the next one. It is necessary to remember that the financial market is in the process of constant change, evolves, there are new financial products and, thus, new threats. This means that further adjustments to rules on supervision are the need in the future. The best solution seems to be continuous monitoring of changes in the financial market and the implementation of new regulations in response to those changes.
Changes in macro and micro-prudential supervision...

Legal acts


Literature


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Halina ŁAPIŃSKA

FINANCING OF NON-GOVERNMENTAL ORGANIZATIONS FROM PUBLIC FUNDS

Summary
The third sector consists of social, private and non-profit organizations. Most of non-governmental organizations carry out socially useful tasks. Those organizations have different organizational and legal forms and different scopes and ways of activities. The aim of the paper is to show different sources of financing of NGOs’ activities.

JEL Classification: L31, L38

Key words: non-governmental organisation (NGO), public funds, public institutions, local government unit

Introduction

Non-governmental organizations belong to the so called third sector. This term results from the threefold division of socio-economic activities. According to this division, the first sector is known as public administration, also referred to as state sector. The second one, called private sector refers to business and consists of institutions and organizations whose activities are profit-oriented. The third sector consists of all private organizations performing socially and not for profit. What most NGOs have in common is the provision of socially useful works but they may have different organizational and legal forms, different scope and ways of activities. The aim of the paper is to show different sources of funding of NGOs activities, mainly from public funds. The author not only has noticed the significant development of the third sector in recent decades, but also increased participation of citizens in the process of planning of public policies on a national and European Union level as well as growing importance of social activities in local

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1. General characteristic of non-governmental organizations

The term ‘non-governmental organization’ emphasizes independence of these organizations from government administration (government), then, the term ‘non-profit’ distinguishes them from business organizations and emphasizes that their activities are not profit-oriented. Such organizations sometimes are described as voluntary, because their activities are largely based on volunteer work and volunteering. Another term frequently used is ‘social organization’ or ‘utilities organization’ which emphasizes that activities of such organisation are socially useful and relevant to a particular community. A commonly used term which is recognized internationally is an NGO (English abbreviation for non-governmental organization), this term is also becoming more and more popular in Poland.

The definition of ‘non-governmental organization’ did not exist in Polish legislation until 2003. The Act of 24 April 2003 on public benefit activities and volunteering introduced this definition as a legal one (article 3, paragraph 2). According to the definition non-governmental organizations are:

- units which do not belong to the public finance sector, regarding Act of 27 August 2009 on public finances, or companies, research institutes, banks and commercial law companies which are state or local government entities,
- performing not to make a profit; legal entities or organizational units without legal personality, which due to a separate statute receive legal capacity, e.g. foundations and associations.

According to the Act (Article 3, paragraphs 2-4) this term does not apply to:

- political parties;
- trade unions and employer organizations;
- professional local government units;
- foundations created by political parties.

The characteristics describing non-governmental organizations:\(^2\)

- organizational structure and formal registration;
- independence from public authorities;

Financing of non-governmental organizations from public funds

- non-profit character;
- sovereignty and local government;
- voluntary affiliation.

The number of active organizations is changing. Some of them exist only formally after performing a specific task.

Table 1. Number of non-governmental organizations, 2014 year (in thousands)

<table>
<thead>
<tr>
<th>TOTAL RECORDING ORGANIZATIONS</th>
<th>100,7</th>
</tr>
</thead>
<tbody>
<tr>
<td>including Public Benefit Organizations</td>
<td>8,6</td>
</tr>
<tr>
<td>associations and similar social organizations</td>
<td>72,0</td>
</tr>
<tr>
<td>foundations</td>
<td>10,7</td>
</tr>
<tr>
<td>social religious entities</td>
<td>1,8</td>
</tr>
<tr>
<td>economic and professional self-government</td>
<td>2,9</td>
</tr>
<tr>
<td>machinery rings</td>
<td>1,2</td>
</tr>
<tr>
<td>others</td>
<td>1,7</td>
</tr>
<tr>
<td>employer organizations</td>
<td>0,3</td>
</tr>
<tr>
<td>unions</td>
<td>12,9</td>
</tr>
<tr>
<td>political parties</td>
<td>0,1</td>
</tr>
<tr>
<td>unregistered organizations</td>
<td>67,1</td>
</tr>
<tr>
<td>ordinary associations</td>
<td>6,0</td>
</tr>
<tr>
<td>Catholic church organizations</td>
<td>61,1</td>
</tr>
</tbody>
</table>


In Poland, the largest group of non-governmental organizations consists of associations and foundations which are often identified with the non-governmental sector. One example of them may be the Voluntary Fire Brigades which have legal form of an association but due to its specific nature (methods of its financing differ from most associations, since each community has a duty to subsidize it) the description goes beyond the narrow definition of a non-governmental organization.³ Non-

governmental organizations are involved in various spheres of social and economic life, but for many years the main field of their activity (34% to 39%) was sport, tourism, recreation and leisure. The next group embraces organizations devoted to education and nurture (10% to 15%), another group (12% to 17%) chose as the main field of their activity culture and art. Social services, social assistance and healthcare are essential activities for about 8% of organizations. In 2015 6% of NGOs were involved in activities performed locally (in 2008 only 4%). Approximately 2% of organizations performed their tasks for the sake of environment protection, labour market, employment, occupational activation, scientific research, law, human rights, political activity, occupational and employee issues (Table 2).

Table 2. Main areas of NGOs’ activities in %

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>sport, tourism, recreation, leisure</td>
<td>39</td>
<td>39</td>
<td>38</td>
<td>36</td>
<td>38</td>
<td>34</td>
</tr>
<tr>
<td>education and nurture</td>
<td>10</td>
<td>10</td>
<td>13</td>
<td>15</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>culture and art</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>14</td>
<td>17</td>
<td>13</td>
</tr>
<tr>
<td>social services and social assistance</td>
<td>10</td>
<td>10</td>
<td>11</td>
<td>7</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>health service</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>7</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>local development</td>
<td>7</td>
<td>6</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>environment protection</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>labour market, employment, occupational activation,</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>scientific research</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>
Financing of non-governmental organizations from public funds

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NGO support and civic initiatives</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>law, human rights, political activity</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>occupational, employee and industry issues</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>rescue, security, defence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>religion</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>International activity</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>other activities</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>


The majority of non-profit organisations have local scope of activities. In 2014 about 5% of organizations performed their tasks in their immediate vicinity, about 32% of them performed tasks for their own local community, 25% of them were active in the area bigger than a voivodeship, whereas 28% of social entities were active nationwide and 10% internationally. Chart 1.

**Chart 1. Structure of non-governmental organizations in 2014 according to territorial scope of their activities**

2. Forms of cooperation between public institutions and non-governmental organizations

According to the Act of 24 April 2003 on public benefit activities and voluntary activities, public administration bodies perform tasks in the sphere of public life, as described in Art. 4 of the Act, in cooperation with non-governmental organizations and entities mentioned in Art. 3 sec. 3. Entities carry out public benefit activities of those bodies and within areas of public administration activities. Cooperation between public administration bodies and non-governmental organizations and equalized entities may be of financial and non-financial nature. It takes place on the grounds of subsidiarity, sovereignty, partnership, efficiency, fair competition and transparency:

- in accordance with the principle of subsidiarity, problems should be solved at the lowest possible social level. Therefore, people experiencing difficulties can overcome them by themselves. Such a situation reduces the interventionism of administrative bodies to the lowest necessary dimension. This principle is also a guarantee of social participation in the management and decision-taking process;
- in accordance with the principle of sovereignty, public institutions respect independence and distinctiveness of communities and social organizations, by recognizing their rights to independent identification and solving social problems. The symmetry of the rights and obligations of parties to cooperate is crucial for the implementation of this principle;
- the principle of partnership is close cooperation between public institutions and non-governmental organizations carrying out common

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4Pursuant to Article 3 of the Act public benefit activities may also be conducted by:
- legal entities and organizational units operating under provisions of the relationship between the State and the Catholic Church in the Republic of Poland, the relation of the State to other churches and religious associations, and guarantees of freedom of conscience and religion if their statutory purposes include conducting public benefit activities;
- associations of territorial self-government units;
- social cooperatives;
- joint stock companies and limited companies and sports clubs which are companies operating on the basis of regulations of the Act of 25 June 2010 on sport (Journal of Laws 2014, item 715) which do not perform for profit and allocate all income for achieving statutory goals and do not allocate profit to shareholders and employees.
goals for the society. The principle introduces so-called synergy effect, according to which combined actions guarantee the best result;

- owing to the principle of effectiveness, public funds should be spent in a rational manner. This means that entrusted resources should be disposed in conscious, purposeful, economical and planned way. The essence of this principle is to choose the most effective management method to achieve the highest quality results;

- the principle of fair competition is based on the assumption that both public administration bodies and non-governmental organizations have equal opportunities and the same rights in a competition for performing public tasks. Therefore, it is easier to choose the best performer following this principle. The principle implies avoiding conflicts of interest;

- the principle of transparency gives partners of a joint undertaking complete information (including data sharing). Having a genuine and reliable knowledge both parties are intended to build partnerships and mutual trust.

Furthermore, cooperation of public institutions with non-governmental organizations at all levels should be based on the principle of reciprocity. This means that each party is committed to applying established partnership rules. The third sector is expected to ensure high quality standards for its operations, rational use of entrusted funds, diversification of funding sources, reliability of data and facts presented, predictability, consistency and coordination of activities. Non-financial co-operation between public institutions and non-governmental organizations in creating public policies consists of:

- mutual exchange of information about planned directions of activities;

- consulting based on work of focus groups, with non-governmental organizations on draft normative acts in the areas of statutory activities of those organizations, taking into account participation of citizens or direct beneficiaries;

- consulting draft normative acts concerning spheres of public tasks, mentioned in Article 4 of the law of 24 April 2003 on public benefit and volunteer activities, with the Public Benefit Board and other consultative and advisory bodies, taking into account both knowledge, information from citizens and interests of citizens;
creating joint advisory and initiative teams consisting of representatives of NGOs and representatives of relevant public institutions.

Financial co-operation of public institutions with non-governmental organizations in the field of public tasks is carried out in the following ways:

- entrusting the performance of public tasks, including grants to fund their implementation;
- supporting the performance of public tasks, including grants to fund their implementation.

Assigning and supporting an implementation of public tasks

Considering the Act on public benefit activities and voluntary service, a local government may order a non-governmental organization to perform a public task in the form of entrusting or supporting a task. A local government unit should guarantee a NGO all funds for the implementation of a project. However, a local government unit should prefer a form of contracting described as supporting the implementation of a public task carried out by a contractor with its obligatory contribution of funds. Entrusting or supporting is based on an agreement signed with a non-governmental organization, which was selected on the basis of an open tender by a local government unit. An agreement defines rules of a project implementation and obliges a local government unit to transfer funds to perform a task. It can be a long-term contract.5

Regranting

A non-governmental organization that won an open call for tenders and is carrying out a public task ordered by a local government unit, may subcontract some tasks to other organizations. This solution is called regranting. In the selection process of subcontractors to perform specific tasks, the holder of the ‘large grant’ is obliged to ensure fair competition and openness. Thus, an entity to which a public administration body contracted a task is responsible for the proper performance of a public task, but not organizations to which the main contractor transferred funds under the regranting scheme.6

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5 Article 11 paragraph 1 of the Act of 24 April 2003 on public benefit and volunteerism.
6 Article 16 paragraph 7 of the Act of 24 April 2003 on public benefit and voluntary activities.
Small grants

The small grant scheme is a simplified model showing how public tasks are commissioned to non-governmental organizations. The basic difference, in relation to the basic contracting procedure for public tasks considers abandoning competition procedures for grants, introducing the limit of a grant (PLN 10,000) and describing temporary performance of tasks (no longer than 90 days). Moreover, granting a small grant is possible only upon request of a non-governmental organization but not from the initiative of a local government unit. The amount of funds allocated within small grants given by a local government cannot exceed 20% of grants planned for the financial year for implementation of public tasks by NGOs.\(^7\)

Local initiative

Local initiative can be described as performing specific tasks at the request of a group of inhabitants of a local government unit (usually a community) and with participation from members of this community. Residents, with assistance from a non-governmental organization or directly by themselves, may request local authorities to perform a specific public task, such as repairing roads, pavements, playgrounds, parks or other public spaces. Local initiatives may also concern educational, cultural, sports or nature-oriented activities or protection of public order and security. Local initiative is an innovative tool that reflects the concept of governance, because it clearly emphasizes, not only, the need for cooperation between administration bodies and civil society but also ‘merging’ of public and private resources to meet collective needs.\(^8\)

Participatory budget

Participatory budget is a mechanism (or process) thanks to which citizens decide or take part in deciding how to allocate public funds. Participation in the process of budget preparation can be a kind of ‘civic school’, because real contribution of citizens into the decision-making processes allows them to understand, not only their rights, but also their obligations and duties that authority has towards them. Furthermore,

\(^7\)Article 19a of the Act of 24 April 2003 on public benefit activity and voluntary service.
\(^8\)Article 19b-19h of the Act of 24 April 2003 on public benefit activities and voluntary service.
citizens acquire abilities to negotiate the most important public policy objectives and financial resources to be spent on their implementation not only with one another, but also with authorities. Participation also increases the transparency of governing. Owing to direct participation in decision-making processes, citizens gain broader access to public-sector information. This model of budget procedures was introduced, for the first time, at the turn of the 1980s and 1990s in the Brazilian city of Porto Alegre. Then it spread on a global scale, and in recent years it has gained considerable popularity also in Poland.

**Partnership agreement**

In the scope defined by the managing institution, it is possible to enter into partnerships with entities who can contribute: human resources, organisational resources, technical or financial resources into the project. The joint project is referred to as a partnership project and is regulated by the conditions written down in an understanding or partnership agreement. Usually partnership agreements are formed to implement projects financed by operational programmes. The institution of partnership agreements determines legal framework for the implementation of projects which use the potential of partners and may also involve the potential of the local community members. In the long-term perspective it fosters wider integration of public administration with non-governmental sector. The limit on the freedom of decision imposed on the parties is the necessity to choose a partner using the official call for proposals mode and paying respect to transparency and the rule of equal treatment of partners.\(^9\)

**Loans, sureties, guarantees**

Local government units may grant loans, guarantees and sureties to non-governmental organizations and non-governmental entities, having equal rights as non-governmental entities, to carry out tasks in the area of public benefit, in accordance with the regulations described in laws on local government, county and voivodeship, public finance act and the civil code. A loan agreement and a surety agreement are defined by the provisions of the civil code. Due to the lack of civilian regulations of a guarantee agreement, in practice, local government units follow

\(^9\)Article 5 paragraph 2 item7 of the Act of 24 April 2003 on public benefit and voluntary activities, Article 28a of the Act of 6 December 2006 on the principles of development policy.
Financing of non-governmental organizations from public funds

Regulations of the guarantee contract included in the bank law. A procedure for granting loans and sureties requires not only the adoption of a resolution by local government units which describes their maximum amount in a given financial year, but also signing a loan agreement or suretyship by the executive body of a local government unit. In contrast, in the absence of a similar statutory regulation, granting a guarantee by an executive body of a local government unit does not require a prior approval of a governing body. Granting of loans, sureties and guarantees should relate to the implementation of public tasks within the scope of competence of a local government.10

Investment grant

Entities that are not included in the public finance sector and do not perform for profit may receive targeted subsidies, not only, for public purposes, associated with implementation of their tasks, but also for co-financing of investments related to implementation of those tasks from a local government unit budget. As the phrase ‘public purpose’ does not exist in the literature on the subject, it is assumed that the realization of public purposes should be associated with activities aimed at satisfying collective needs of a local government community. This excludes the possibility of granting an investment subsidy on objectives satisfying individual interests. In court case law, it is considered unacceptable to finance, by investment subsidy, renovation of catechetical rooms in parish buildings, renovation of residential community buildings or investing in professional sports. The legal institution, which is the centre of the author’s deliberations, provides local government units with the possibility of providing financial support in the form of targeted subsidies to implement tasks of those units, including investments made by non-governmental organizations and entities equalized with them in their rights.11

Public-private partnership

Under a public-private partnership agreement, a private partner undertakes to carry out a project for remuneration and incur all or part of expenses or they are incurred by a third party, furthermore, a public entity undertakes to cooperate in achieving objectives of a project, especially, by making its own contribution. The subject of public-private

10 Article 5 paragraph 8 of the Act of 24 April 2003 on public benefit and volunteerism.
11 Article 221 par. 1 of the Act of 27 August 2009 on public finances.
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partnership is joint implementation of a project based on the division of tasks and risks between a public entity and a private partner. A private partner’s payment depends, primarily, on actual use or actual availability of a subject of public-private partnerships. Only an entrepreneur can be a private partner. Therefore, NGO's implementation of a project in the form of public-private partnership in the scope of its public benefit activities is excluded.  

3. Sources of funding activities of non-governmental organizations

Public funds are predominant in the structure of revenues of the whole sector of non-governmental organizations. In 2014 59% of revenues were non-market public funds (28% of which came from local government or government sources and 16% from foreign public sources). Market revenues accounted for 35% (this refers to: business activities 14%, paid statutory activity 16%, orders submitted under the Public Procurement Act 4% and interests and dividends 1%). The remainder of collected funds (17%) came from sources that could not be assigned to the two groups mentioned above – they are mainly donations from individuals and private institutions (12%), membership contributions (4%) and public fundraising (1%). Funds from the European Union budget are the main foreign source of income of NGOs. The scope of use of EU funds varies among those organizations.  

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12Article 1 par. 2 and Article 7 of the Act of 28 July 2005 on public-private partnerships.
Financing of non-governmental organizations from public funds

Table 3. The structure of revenue of NGOs in Poland in 2014

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market revenues</td>
<td></td>
</tr>
<tr>
<td>from business</td>
<td>14</td>
</tr>
<tr>
<td>from paid statutory activities</td>
<td>16</td>
</tr>
<tr>
<td>obtained under the Public Procurement Act</td>
<td>4</td>
</tr>
<tr>
<td>interest and dividends</td>
<td>1</td>
</tr>
<tr>
<td>Non-market revenue</td>
<td></td>
</tr>
<tr>
<td>from public sources</td>
<td>46</td>
</tr>
<tr>
<td>from local-government administration</td>
<td>17</td>
</tr>
<tr>
<td>from government administration</td>
<td>11</td>
</tr>
<tr>
<td>from foreign sources</td>
<td>16</td>
</tr>
<tr>
<td>from transfers of 1% PIT tax</td>
<td>3</td>
</tr>
<tr>
<td>from non-public sources</td>
<td>13</td>
</tr>
<tr>
<td>donations</td>
<td>12</td>
</tr>
<tr>
<td>raising money</td>
<td>1</td>
</tr>
<tr>
<td>Member contributions</td>
<td>4</td>
</tr>
<tr>
<td>Others</td>
<td>2</td>
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</tbody>
</table>


The European Social Fund (ESF) is one of the main funds through which the European Union supports socio-economic development of member states. The main source of spending ESF funds in Poland, during the programming period 2007-2013 was the Human Capital Operational Program which supported projects up to 2015. This program was the source of support, from which non-profit entities benefited the most, what is confirmed by the number of signed contracts, in comparison with other programs. According to records dated June 2015, agreements signed with non-governmental organizations within HCOP accounted for 25.6% of all signed contracts (from the beginning of the program), and represent 14.3% of the value of those agreements.  

Between 2007 and 2014 about 58% of organizations, for which local development is the main field of action, applied for EU funds, but only 42% received them. Then, 45% of organizations that focused on education and nurture, applied for EU funds, and only 29% of them applied successfully. 40% of organizations whose area of activity was social service and social welfare applied for EU funds, and only 23% successfully; culture and art - respectively 36% and 24%, in the field of health care 31% and 15% respectively and sport, tourism and recreation only 22% applied for funds, and received 12% (Table 4).

Table 4. The use of EU funds in years 2007-2014

<table>
<thead>
<tr>
<th>Basic field of organization activities</th>
<th>Organizations that received a grant</th>
<th>Organizations that applied for funds but did not receive them</th>
<th>Organizations that did not apply for funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local development</td>
<td>42%</td>
<td>16%</td>
<td>42%</td>
</tr>
<tr>
<td>Education and nurture</td>
<td>29%</td>
<td>16%</td>
<td>55%</td>
</tr>
<tr>
<td>Social services, social assistance</td>
<td>23%</td>
<td>17%</td>
<td>60%</td>
</tr>
<tr>
<td>Culture and art</td>
<td>24%</td>
<td>12%</td>
<td>65%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>15%</td>
<td>16%</td>
<td>69%</td>
</tr>
<tr>
<td>Sport, tourism, recreation, hobby</td>
<td>12%</td>
<td>10%</td>
<td>78%</td>
</tr>
</tbody>
</table>

Source: *The Use of European Funds by NGOs*, http://fakty.ngo.pl/wiadomosc/1889384.html (day of access 03.11.2016).

It is surprising that more than half of the organizations did not apply for EU funds in the years 2007-2014. It can be noticed by analyzing NGOs` activities in applying for EU funds taking into account location of those organizations. The smallest activity of organizations was noticed in towns with populations between 50 and 200 thousand; 73% of them did not even attempt to obtain EU funds. On the other hand, organizations in Warsaw are distinguished by the biggest activity, 48% applied for funds and 31% received them. 28% of organizations operating in rural areas received EU funds, but another 58% of them did not even apply for funds (Chart 2).
Chart 2. Differences in the use of EU funds in the years 2007-2014 according to the location of organizations

<table>
<thead>
<tr>
<th>Location</th>
<th>Organizations that received grants</th>
<th>Organizations that applied for grants but did not receive</th>
<th>Organizations that did not apply for grants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warsaw</td>
<td>31%</td>
<td>17%</td>
<td>52%</td>
</tr>
<tr>
<td>Towns (population over 200 thousand)</td>
<td>23%</td>
<td>12%</td>
<td>65%</td>
</tr>
<tr>
<td>Towns (population 50-200 thousand)</td>
<td>17%</td>
<td>10%</td>
<td>73%</td>
</tr>
<tr>
<td>Towns (population to 50 thousand)</td>
<td>19%</td>
<td>12%</td>
<td>69%</td>
</tr>
<tr>
<td>Village</td>
<td>28%</td>
<td>14%</td>
<td>58%</td>
</tr>
</tbody>
</table>


According to a survey of Klon/Jawor Association, the bigger the level of knowledge about EU funds the more non-governmental organizations apply for them. This may mean that the more organizations know about funds available in the new programming period, the more they are interested in obtaining them. 29% of all organizations definitely want to apply for EU funds in the coming years, but 27% of organizations claimed that they are not going to apply for EU funds in the years 2014-2020. The most important reasons that discourage organizations from applying for EU funds are formalities and bureaucracy related to the application process, requirements with respect to documentation and reporting, insufficient funds for own contribution or fear of lack of financial liquidity during the project implementation phase. Another important obstacle is that 12% of organizations cannot meet the competition criteria to apply for EU funds. However, 13% of organizations declare that there is no need for them to apply for EU funds (Table 5).
Table 5. Obstacles in applying for EU funds

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>too much formalities</td>
<td>47%</td>
</tr>
<tr>
<td>high self-contribution</td>
<td>26%</td>
</tr>
<tr>
<td>no qualified people to prepare projects</td>
<td>25%</td>
</tr>
<tr>
<td>project preparation too time consuming</td>
<td>16%</td>
</tr>
<tr>
<td>there's no need</td>
<td>13%</td>
</tr>
<tr>
<td>NGO does not meet the requirements</td>
<td>12%</td>
</tr>
<tr>
<td>no people who would deal with projects</td>
<td>12%</td>
</tr>
<tr>
<td>no suitable programs</td>
<td>9%</td>
</tr>
<tr>
<td>statute does not allow it</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: NGO Portal http://fakty.ngo.pl/wiadomosc/1889384.html (access 02.11.2016)

32% of organizations declare that their knowledge about the possibilities of applying for European Union funds, within the funding perspective in the years 2014-2020 is sufficient, 47% claim that they know something but still not enough, and 16% know nothing or almost nothing about the future programming period and funds available.

Conclusions

Non-governmental organizations increasingly affect the contemporary image of social life in Poland. They are able to implement activities that change the living conditions of local communities. They undertake steps to help solve a variety of problems faster than local government units or government agencies. NGOs are more flexible than public authorities and more creative for that matter, they are seen as innovators of social changes. Due to their specific characteristics they

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Financing of non-governmental organizations from public funds
differ from governmental, political or commercial institutions. ‘All this means, that NGOs are sometimes the best or even the only institutions that can meet specific human needs and perform important social functions in democracy.’15 Their value and strength is based on diversity and social activity. They are increasingly complementing activities of public administration not only at the local level. A stable source of funding is needed in order to meet those important tasks. Although it seems that there are many sources of funding, financial problems are the most serious obstacle to their activities or even the cause of withdrawal from the area of action. Not all sources are available for all types of organizations, e.g. the implementation of EU projects requires a lot of expertise, professional technical background (e.g. good bookkeeping) or cash contribution. Most often it is the case that public funds can guarantee permanent financial support, but for organizations raising funds from the public sector these funds may not constitute an aim in itself.

Literature
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2007 2013.gov.pl/AnalizyRaportyPodsumowania/


Jan OSTOJ*

INTELLECTUAL CAPITAL OF SOCIO-ECONOMIC REGION: MEASUREMENT AND STRUCTURE

part. I. Definition problems and value

Summary
This work is the first out of the series of three papers devoted to the estimation of value of intellectual capital of a given socio-economic area: voivodeship, municipality, country, region, etc. The concept of this estimation is based on the assumption that value of any socio-economic region, for its residents, is the amount of income that can be gained by locating their activities in the area they live. The layout of the presented method makes it possible to estimate all elements of intellectual capital, regardless of whether or not we are aware of their existence. In this paper, for the sake of estimation, definitional problems of the concept of intellectual capital are solved and the method which can estimate area value for its residents is proposed in order to derive a method for estimating intellectual capital of a given area as well as of each and every voivodship in Poland.

Key words: intellectual capital, region, voivodeship, value estimation

Introduction

In the presented series of papers a relatively simple method of evaluation of intellectual capital assigned to a given socio-economic region is presented. For this reason, it had been initially assumed that this research problem would be covered in one paper only. However, as the paper progressed, it turned out, somehow ‘by the way’, that a number of additional problems of theoretical nature had to be solved. This was, from the point of view of research workshop, a necessary condition for justifying substantive correctness of the proposed method. In a series of ‘additional problems’ the first one, which appeared just at the outset, was

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the lack of a generally accepted definition that unambiguously exposes an essence of the definition of intellectual capital. Another barrier to overcome was connected with indicating a method which would allow to find, within an area taken into account (e.g. a region), a relevant equivalent showing the value of intellectual capital in an organization as an expression of a gap between the market value and book value, the presence of which caused that a phenomenon known as ‘intellectual capital’ was recognised. Finally, the results had to be illustrated. All these circumstances made the text grow beyond the expectations of the author. Therefore, the deliberations were divided into three parts which the author strongly recommends to the reader.

The main purpose of this three-part publication is to present a method, to be used in economic reality, which would allow to assess the value of intellectual capital of any socio-economic region: a country, region, province etc. The presented solution uses macroeconomic values and allows to perceive all elements which constitute potential of any area and to call it intellectual capital, regardless of whether or not all the components of its structure are fully recognised. Thanks to this, a complete value estimation of the researched phenomenon can be obtained, creating a base for further research into unknown aspects of intellectual capital and identifying actions to increase that potential.

Therefore, the author departed from the commonly used methods of assessing intellectual capital, based on evaluation of its partial elements, since there are some reservations not only about completeness of subjectively isolated partial phenomena included in the assessment, but also accepted measures of those phenomena and their aggregation into one global size. The uniqueness of the method, is its complex nature as it fully describes a substantive definition of the phenomenon of a gap between market value and accounting value identified with intellectual capital. On the other hand, most authors concerned with intellectual capital of any socio-economic region (often region or country), assume that substantive relevance of the studied phenomena to the content described by the term "intellectual capital" can be better or worse. The mentioned authors frequently present a list (often not fully closed) of "softly defined" main features of the phenomenon. Such a list can include, for example, "hidden values" of people, enterprises, institutions,
communities and regions\textsuperscript{1}. Intellectual capital assigned to socio-economic region (Poland in this case) is also seen as all intangible assets of people, enterprises, communities, regions and institutions, which may be sources of present and future well-being if properly used.\textsuperscript{2} Others define intellectual capital assigned to a given area as a set of knowledge-based assets which significantly influence creation of its value.\textsuperscript{3} According to other authors intellectual capital of a region is not a resource, but feature, defined as "non-observable directly attributes of residents, enterprises, institutions, organizations, communities, and administration bodies that are current and potential sources of future social well-being improvement and economic growth".\textsuperscript{4}

According to the assumption of \textit{completeness}, introduced in this paper, the object of analysis, in terms of content, corresponds to the phenomenon of intellectual capital, in the form in which it was first noticed, it means, the difference between \textit{a surrogate} of the market value of a given economic structure and the value of its net assets. In the process of the analysis, the triple complexity of intellectual capital of a region was identified. A valuation attempt was made to estimate the value of intellectual capital located in any voivodship in Poland. The findings show that there is an interesting relationship between intellectual capital, the number of inhabitants and the value of fixed assets situated in the regions they live.

From the point of view of economic practice, it seems that the obtained findings are significant. It has been proven that there is a direct link between intellectual capital assigned to any socio-economic area and Gross Domestic Product in that area. So well-thought-out investments in intellectual capital (e.g. in a region) ensure growth of GDP generated in that region, and boost the well-being of its inhabitants.

1. Definition problems

The definition of "intellectual capital" is a relatively new concept. It was formulated, for the first time in 1958 by observing records of small listed companies. Stock market analysts noticed differences between records of small listed IT companies and the book value of their assets. They called the phenomenon of too high listing of those companies "intellectual bonus", while claiming that "intellectual capital of such companies is probably the most important component".5

In the 1990s there was a widespread view (represented by Steven M. H. Wallman, SEC commissioner) due to which intellectual capital of a company consists of "assets having zero value in a balance sheet".6 According to this statement, it is possible to conclude that intellectual capital, like all other assets, has a structure composed of certain assets, a sum of which shows its value. This approach seems to be fully justified because the term "intellectual capital" suggests that it is a kind of resource, a potential, that can be used to achieve the goals of an enterprise.7 Therefore, placing intellectual capital, as intellectual property, on the asset side in a balance of "resource reflection" is fully justified.8 Resourceful reflection of intellectual capital also provides a systematic approach coherent with methods used so far. The analysis of the phenomenon which distinguishes differences between a value of available resources and a value gained after running those available resources. The same order applies to an analysis of standard assets: the book value of a firm depends on availability of assets (e.g. machines) but not on the degree of their activation in relation to other resources (effective machine hours) which affects a company's goodwill.9

9It should be remembered that, according to the canon of microeconomics, market value of a resource has a significant connection on benefits of launching a resource. This is mentioned in the theory of the use of material capital according to which a buyer should not pay more for it (market value) than a sum of discounted planned revenue earned by a buyer thanks to its use. See eg Begg D., Fischer S., Dornbusch R.: Microeconomics. 383 et seq.
Similarly, the value of intellectual capital should depend on the potential represented by, for example, its client capital and its other components but not on the degree of their activation. Moreover, as well as a sum of asset value gives information about value of company's assets, also a sum of values of individual components of intellectual property should give information about the overall value of intellectual property (assets) which equals to a company's intellectual capital (liabilities). There is no doubt that with such an approach, on the liability side, where sources of funding of company's resources are recorded, those sources should have the nature of commitment with respect to intellectual capital. This situation is similar to deliveries with deferred payment e.g. raw materials. Components of intellectual capital are provided by various entities (and their groups) or are created in the process of a company's performance and must be given back (they are lost permanently) at the time of liquidation or a company breakup.

H. Saint-Ogne has a different point of view on “resourcefulness”. In his opinion the value of an enterprise is not derived directly from any single element of intellectual capital but it is a result of relations between all components, elements and categories. The bigger the interaction, the bigger value of an enterprise.10

From the point of view of contemporary science, the results of research, carried out in the company Skandia, turned out to be a giant step in revealing the essential nature of the term "intellectual capital". The team, led by L. Edvinson came up with three conclusions11:

- Information on intellectual capital is additional, complementary but not subordinate information to financial information.
- Intellectual capital is non-financial capital, reflecting a hidden gap between market and accounting value.
- Intellectual capital is a commitment, not assets (assets). "

According to authors, the third conclusion, widely cited and thought to be fundamental in the mentioned book, should be particularly focused on. It means that intellectual capital, defined in such a way, should be perceived as a capital, similar to others in a company, borrowed from

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company's stakeholders: customers, employees, suppliers, etc., what was already mentioned above.\textsuperscript{12}

By analyzing the definition of intellectual capital quoted in literature, it is worth pointing out that its authors aimed at describing only a part of the content of the phenomenon called intellectual capital, its "essential character", as they explained. However, if it is assumed that a hidden gap between the market value and accounting value of a company appears because of intellectual capital (proposal 2), it may raise a lot of doubts whether the term 'intellectual capital' is adequate to the substantive content of a phenomenon being researched.

Assuming that a company is a subject of a transaction/market valuation as an organized whole, it is possible to formulate the following question: “which company will be more expensive on the market?”:

- a company with educated workforce who is in very good physical and health condition,
- a company similar to the first one in terms of assets and workforce, except for its physical and health condition, which is worse.

The answer is obvious - it will be the first one.\textsuperscript{13} Since the accounting value of both companies is the same (physical and health condition is not recorded), the difference between market value and book value, in case of the first company will be higher than the second one, because of higher value of intellectual capital.

Similarly, we can verify substantive content of a hidden gap between the market value and accounting value which refers to intellectual capital of identical companies that differ in another chosen dimension. This dimension may, for example, be a filling level of an internal landfill site with worthless, hazardous, non-recyclable and non-disposable waste. It is known that such waste does not submit to register because it does not have valuation. Utilisation records of its disposal do not exist because such activities are impossible. In this situation, waste becomes a problem only at the moment of a company’s breakup. It may turn out, that in a traditional valuation process, the book value of both companies will be the same. However, it is known that a company with an empty waste landfill site will have a higher price. For this company, a hidden gap between market value and accounting value referring to intellectual


\textsuperscript{13}It is to be expected that capital market estimates higher prices of shares of the first company.
capital, will be higher. But, what does non-valuable hazardous waste have common with intellect?

Another aspect of this verification process refers to the issue of identical companies which differ in the level of quality of the same fixed assets used in the main manufacturing process\textsuperscript{14}, assets which are leased for the same period and under the same organizational and financial conditions. It is known that market value of an A company, renting better equipment, will be higher considering the same book value of both companies. This means that company A has bigger intellectual capital. In this case, the direct source of a company’s value is bigger expected potential of available services (use) of an excavator with less failure during rental time. It is worth pointing out that a service is provided by a non-hidden asset, which is not an intangible asset, but in this example, it is an excavator which, in addition, has a market valuation and is subject to record. A specific asset component, that is not subject to record, is a company’s potential, at disposal, of available additional services of an asset which is expected to be failure-free.

In presenting real life situations, a phenomenon of negative value of a company cannot be overlooked. It occurs when a cost of acquiring a company, as an organized entity, is less than its book value. This phenomenon had been noticed so often that appropriate regulations were introduced into the Accounting Act\textsuperscript{15}. In literature, "negative intellectual capital" is not mentioned, although, there are frequent signals that negative components of intellectual capital can appear and lead to a situation in which an owner wants to get rid of a company at a lower price than its book value or to pay for a negative component of intellectual property to disappear (e.g. bad opinion of some potential buyers’ about a company).

During research on intellectual capital, it was also noted that real value of intellectual capital may be bigger or smaller than the difference between market value and book value. According to K. Standfield (1998), the creator of the IAMV (investor assigned market value) model, "such a situation can depend on market fluctuations and expectations of

\textsuperscript{14}For example, the same excavators were hired, but in the case of a second company, it is known that possible failure of the rented excavator is higher.

\textsuperscript{15}Act 4 art. 31 Accounting Act states: "If the cost of acquisition of an entity or an organized portion is less than fair value of net assets acquired, the difference is negative value of a company." See: Act of 29 September 1994 on Accounting, Journal of Laws 1994 No. 121, item. 591 along with later. d.
investors that determine market value." Thus, the discovered discrepancies between a merit of a gap between market and book values and a merit of "intellectual capital" resulted from reasons which affect a share price of a valuated company, so other reasons than those mentioned above. Nevertheless, their presence influenced further development of the research.

Some researchers, while constructing methods of assessing intellectual capital of a particular economic structure, try to take into account, mainly, those elements which substantively relate to a content of this concept. Others refer, in their studies, to a phenomenon that allows to describe, what is now called, intellectual capital assuming a gap between market value and book value of a phenomenon as a criterion. This fracture is also described by L. Edvisson and M.S. Malone in his work: intellectual capital reflects a gap between market value and accounting value\(^1\), and the definition of intellectual capital given below, says that: "Intellectual capital means knowledge, experience, organizational technology, customer relationships and professional skills that give Skandia company a competitive advantage in the marketplace."\(^2\) This means that physical condition of human capital is excluded from the definition of intellectual capital, although, it affects a gap between market value and accounting value of a company, and although, the term "human capital" includes physical (vitality) and health condition of employees within its definition.\(^3\)

In conclusion, it can be pointed out that the content of a gap between market value and accounting value of a company does not substantially match the concept of intellectual capital. The impact of the physical condition of human capital on the value of an enterprise can be an example. Nevertheless, an approach that identifies these concepts has become widespread in literature. It is justified in some way, because, at first a gap between market value and book value of a company was noticed, and only then its existence was explained by identifying the importance of knowledge and skills of a human factor. For IT companies and dynamically developing companies such a situation was not

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surprising. Analyzing intellectual capital of any socio-economic region, we can react appropriately to the phenomenon whose historical presence enabled us to see that capital. The size of intellectual capital of any economic structure depends on the difference between its value as an organized whole and accounting value, and everything that affects the volume of that difference. On the other hand, it is irrelevant whether the phenomena affecting the mentioned difference, substantially are the content of the term “intellectual capital” resulting from its name or not.

2. Economic structure value as an organised whole

Applying the above-mentioned criterion for definition of intellectual capital of a company, one should become familiar with its market value as a whole. This knowledge is relatively easy to gain with reference to listed companies\(^{20}\). The situation is different in case of companies not listed, which even for their entire existence at the request of the owner are not subject to a purchase/sale transaction. Therefore, how to estimate the value of a company, which shall never be a subject of a market turnover? Is there a method of which at least theoretically, beyond argument, allows an estimation of the market value of this company? Is it possible that this method is applicable to an estimation of a region’s value as a certain organised whole, despite the fact that the region, by definition, cannot be subject to a market turnover?\(^{21}\)

Currently, with reference to intellectual capital of a company, two main types of approach may be distinguished:

- based directly or indirectly on the criterion of a difference between the market value and the value of particular components of the company’s assets as an unorganised whole;
- based on a disclosure of particular components of intellectual capital, their pricing (or appraisal), and aggregation to the same level.

When it comes to the first group, it involves methods based on Tobin’s “Q”, the market value to the book value MV/BV, and methods based on the return on assets (ROA) – the method EVATM, CIV

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\(^{20}\)This knowledge is approximate, due to the currency fluctuation, which the cited above K. Standfield referred to.

\(^{21}\)It should not be assumed that something that cannot be subject to a purchase-sale transaction (the market turnover) is not subject to a pricing. There are many examples of such a pricing in case of a property loss, losses due to natural disasters, etc.
(Calculated Intangible Value), KCE (Knowledge Capital Earnings) and others. The second group consists of methods of direct pricing of the intellectual capital components: IAV (Intangible Assets Valuation), TVC (Total Value Creation), IVM (Inclusive Valuation Methodology), and also score-based assessment methods – e.g. BSC- Balanced Scorecard.22

Nevertheless, despite the eventual and complete content of “intellectual capital”, according to the original separability criterion, in terms of the value and the substantive side, it fills the gap between the market pricing of the company’s value as an organised whole and the sum of the values subject to a separate pricing of the particular components of the company’s assets reduced by its liabilities.

In practice, with reference to both non-listed companies and the region, there are no applicable terms such as stock exchange listings, stock rate, net income per share, etc. Therefore, neither of the mentioned-above evaluation methods of the market value cannot be adapted to a method of evaluation of the region value, or any other social-economic area. Moreover, contrary to the company, the region as an organised whole cannot be subject to a market transaction. Therefore, it also cannot be subject to pricing by the market mechanism. However, it does not mean that the region does not have any value and cannot be subject to a pricing at all.

When determining the value of the company, there often arise questions on what value of the company as an organised whole it is to the owner, considered in terms of the right to a definite income, properly spread over time, at a certain risk level of its loss. On this assumption the income method of the evaluation of the company’s value is based.

In case of the region the same steps can be taken – by asking what value the region represents, e.g. for the whole group of residents active within the region in terms of their income, due to activity localization in this area. It makes the income method of the evaluation of the company’s value useful in terms of the purpose of this paper, provided it can be proved that at least the evaluation theoretically obtained through this method is close to the market value. The proof is presented below. Therefore, in case of application of the income method, the company’s value \( W_d \) for the owner is defined by the formula (1):

\[ W_d = \text{Income Method} \]

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\[ W_d = \sum_{i=1}^{n} \frac{D_i}{(1+(r_n+r_r))^i} \]

Where:

- \( D_i \) – the annual income of the company’s owner in terms of the funds that the owner can withdraw from the company for \( n \) years in the \( i \)-th year without an infringement of the multiannual scenario of the company’s operation;
- \( r_n \) – the risk-free return on assets;
- \( r_r \) – the risk premium \( r \) expressed by an additional return on assets required by the investor.

The application of formula (1) for the evaluation of the company’s value is possible, provided that the acquisition of the company as an organised whole is considered as the acquisition of the right to a definite income \( D_i \) spread over time, at a certain risk level \( r \). The income \( D_i \) is understood as all non-repayable and free of charge net profits, expressed in money terms\(^{23}\) that can be obtained by the company owner in the \( i \)-th year, with the assumed unchangeable operation and development plan. As a standard, in the \( i \)-th year \( D_i \) includes (with a plus sign): the net profit, a part of the sales revenue covering the costs of amortisation, the funds obtained from the planned liquidation of the fixed assets and – from the assumed reduction of the current assets, and with a minus sign – the expenditures on physical investments, overhauls and the increase of operating funds.

In line with this approach, the minimum price \( W_{c_{\text{min}}} \) which the owner of the company as an organised whole should require from the potential buyer, without any loss, shall be equal to the value of \( W_d \) to the defined income \( D_i \) equal to the sum of discounted income \( D_i \) and is expressed by the formula (2):

\[ W_{c_{\text{min}}} = W_d = \sum_{i=1}^{n} \frac{D_i}{(1+(r_n+r_r))^i} \]

Where:

Designations as above.

\(^{23}\)i.e. reduced by the expenditures made by the owner in \( i \)-th year on investments, overhauls, necessary for the maintenance of the assumed plan for the company’s operation.
According to the above, it is a standard formula for the income value of the company. Obviously, it should be assumed that the seller accepts each price higher than the minimum selling price.

The buyer does not have to be familiar with the minimum selling price. They may assume a different operation and development plan of the company, which in consequence is corresponding with a different income sequence - \( D^i \) and a risk level \( r_i \). As a result – from the buyer’s perspective the maximum price \( W_{c \text{ max}} \), which they are ready to pay for the company concerned may be higher than the seller’s minimum price. Then, there arises the price negotiation space – see Fig. 1 (a).

**Fig. 1. Models of the market transaction**

![Diagram showing price negotiation space](source)

Therefore, it may be stated that depending on the negotiation skills of the parties, the market price should be located between the seller’s minimum price and the buyer’s maximum price, because only then mutual profits of the transaction parties are guaranteed.

However, if the buyer and the seller do not have any other profitable idea for the company’s development, and as a result, they provide the same scenario of its development, then the prices accepted by them shall be equal (Fig. 1 – b). Therefore, the transaction price under the market conditions is the market price estimated according to the formula (1).
Then, \( P_{\text{max buyer}} \) shall be equal to \( P_{\text{min seller}} \) with no mutual profits and theoretically, it shall be the only possible price of the market transaction\(^{24}\). Thus, in this case the market price is equal to the evaluation of the income value for the option that assumes the best possible management of the resources in terms of the owner’s business/manager of the given economic structure.

Summing up, the important fact is that when valuing their company by income method, the company owner defines the minimum price which should be acceptable for them when offering the company as an organised whole for sale. If potential buyers do not have a reason to think that because of any change to the operation plan of the company, its value may be increased – their pricing, with the same risk ratio as its owner’s, shall be the same. It means that in this situation the evaluation by income method conducted from the owner’s perspective is the market price.

At this stage of the analysis, the question is how the conclusions relate to the value of a given social-economic area – a region, for example. For whom is a region valuable if it does not have the owner and is not subject to the market turnover? First, it should be noticed that the company owner obtains certain profits through the access to the company’s resources at their disposal, which are not necessarily their property. It is worth mentioning that the key resource that the company owner cannot acquire are the employees. They were not acquired but they only voluntarily obliged themselves to work based on an employment agreement or other civil law agreements.

Properly understood \textit{per analogiam}, in case of a region it may be stated that its residents obtain certain income through the access to the resources located in a given area, whereas the resources are not necessarily their property\(^{25}\). Nevertheless, the condition of the access to the resources is the location of the business exactly in this region. Therefore, as the company to the owner, the region constitutes a value to all its residents (the whole community), no matter if these are

\(^{24}\)The transaction may be conducted, provided that the mutual profits are determined by other factors – e.g. age of the owner that does not allow the continuation of the business, or a high risk taking of the buyer. The high risk taking is reflected in a lower level of a risk premium required by the buyer in this case, which causes an overvaluation of the accepted maximum price of the company \( W_{\text{c max}} \).

\(^{25}\)E.g. a possibility of employment in accordance with the learned profession, an access to the infrastructure, natural environment, education possibilities, etc.
households, companies or landowners. For example, businessmen obtain the access to a certain quality of workforce, road infrastructure, natural resources, outlets, and the employees – the access to a better or worse employment conditions, education, a possibility of keeping a proper physical and health condition, and the property owners and landowners – the access to better or worse conditions of their property management.

Each of those entities provides services, which are used in the manufacturing process and rewarded with the proper primary income. Lands services are rewarded with a rent, capital goods services – the profit increased by the revenue from the sales for covering the amortisation costs, and the work is rewarded with a salary. Therefore, knowing the income, it is possible to define the income value of the region for their residents, adequate to the income value of the market.

In terms of self-government, all residents of a given economic area are its co-managers. Self-government territorial units, the authorities of which are elected in democratic elections and therefore representing the interest of the manager - the residents of the area, are responsible for this area. The operation and development plans are consulted with the representatives of this community, such as councilpersons, and their realisation is financed from the public resources. The allocation of the remaining resources is conducted through the market. On this basis it can be stated that from the perspective of the co-managers of a given social-economic area there is realised the best-known and possible management of the regional resources. Therefore, the income method of the evaluation of the value is applicable and – in the light of the conclusions from the analysis conducted with reference to the company, the obtained result constitutes a surrogate close to the market value, established “in the absence of a better idea” for the use of the available resources.

Hence, formally it may be stated that the income value of the region \( W_{d,\text{reg}} \) may be evaluated on the basis of the formula:
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\[ W_{d_{\text{reg}}} = \sum_{i=1}^{\infty} \frac{D_i}{(1+(r_{n}+r_{r}))^i} = \sum_{i=1}^{\infty} \frac{Z_i + Am_i + Pl_i + Cz_i}{(1+(r_{n}+r_{r}))^i} \]

Where:

\[ W_{d_{\text{reg}}} \] – the income value of the region
\[ D_i \] – the income obtained in the region
\[ Z_i \] – the aggregate profit obtained in the i-th year by the companies located in the region
\[ Am_i \] – the aggregate cover of the amortisation costs with the income in the i-th year in all the companies located in the region
\[ Pl_i \] – the aggregate salaries obtained by the residents in the i-th year – the employees locating their business in a given region
\[ Cz_i \] – the aggregate rents obtained by the residents in the i-th year – the owners of the properties locating their business in a given region
\[ r_n \] – the risk-free return on assets
\[ r_r \] – the risk premium r expressed by an additional return on assets required by the investor.

Due to the fact that the sum of all the primary incomes obtained in a given area within the i-th year expressed by the sum \((Z_i + Am_i + Pl_i + Cz_i)\) - is the rate of GDP made in the i-th year in this area, it may be noted down\(^{26}\):

\[ W_{d_{\text{reg}}} = \sum_{i=1}^{\infty} \frac{D_i}{(1+(r_{n}+r_{r}))^i} = \sum_{i=1}^{\infty} \frac{Z_i + Am_i + Pl_i + Cz_i}{(1+(r_{n}+r_{r}))^i} = \sum_{i=1}^{\infty} \frac{PKB_i}{(1+(r_{n}+r_{r}))^i} \]

Where:

\[ PKB_i \] – Gross Domestic Product in the i-th year by residents in a given region

The other designations - as in the formula (3).

Conclusion

Summing up and simplifying the conclusion, it may be stated that from the perspective of the residents, the region is worth as much to them as the primary income obtained in this region – now and in the future. It

is equivalent to the sum of discounted rates of GDP made in the following years within a given social-economic area. However, there arises a question if the discount count should be continued – the activity of the residents is limited in time – by the lifespan, for example. Several different solutions may be accepted. According to the author of the paper, the intellectual capital of the region is timeless value, which may be used not only by the contemporary residents (businesspersons, employees and other members of the households), but also the future generations. It justifies the assumption of the Infinite primary income sequence.

Moreover, it should be noted that in terms of the income value (including the company), the net primary income (after taxation) is included, and in GDP - the gross income. There also appears the matter of the investments spread over time, in the analysed social-economic area, necessary for the maintenance of the assumed income sequence of the residents, which reduce at the same time this income as for the income value. The next paper refers to the solutions of the problems mentioned above, which is titled: *The intellectual capital of the social-economic area: the measurement and structure*, subtitled part II: *The intellectual capital of the company and the value of the intellectual capital of the social-economic area*. The author invites the readers to become familiar with this publication.

**Legal acts**


**Literature**

(for all three parts)


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Summary
In recent years, the idea of non-financial information has been gaining more and more popularity. Its meaning in the decision-making process has been underlined by the European Parliament. To provide users of financial statements with access to the non-financial data, Directive 2014/95/UE was proposed to be implemented into national legislation systems. The aim of the paper is to examine whether the changes in the accounting law would result in reduction of information loopholes of reports recipients' and could increase the quality and comparability of statements published by the companies. Research methods applied in the article include critical analysis of the literature and legal acts and a comparative analysis of the survey results.

Key words: non-financial information, The Accounting Act, Directive 2014/95/UE, financial report

Introduction
Socio-economic conditions, in which organisations operate exert a significant influence on the accountancy system. So far an accounting paradigm has been based on an economic measure1. Nowadays, the challenge involves presenting non-financial information in financial reports. It is a result of promoting the idea of moderation economy, which places a great emphasis on sustainability: economic, social and ecological2. Reports' users not only expect standard financial data but

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also non-financial information. Providing this type of information would undoubtedly require new, innovative research. Both theory and practice of accountancy would have to elaborate standards to meet reports' recipient expectations, while preserving the highest quality features.

The necessity to introduce amendments of the reporting system was noticed by the European Union. Directive 2014/95/UE imposes on the Member States an obligation to implement home legal provision systems concerning the necessity to disclose non-financial information by public interest units. An actual reply to the Directive is prepared by the Ministry of Finance in the form of the amended bill of the Accounting Act. It encloses a directory of new reporting obligations within non-financial information. Preparing the amendment bill of the Accounting Act, public consultations were introduced in the areas where the Directive allowed countries for freedom of solutions.

The purpose of the paper is a critical analysis of a research literature, domestic and foreign legal acts, which will enable to explain assumptions of the Directive. The following questions should be answered: whether changes made in the accounting law would significantly influence a reduction of the information loopholes or would allow for data comparison within the European Union? Will the amendments bill of the Accountancy Act impact the quality and utility of non-financial data? Is it possible to meet the information needs of reports' recipients without charging companies?

The paper consists of two parts – the first is theoretical, the second one empirical. In the first two chapters the analysis of literature was used as a research method, as well as the analysis of domestic and foreign legal acts. The third chapter is based on a comparative analysis of surveys' data collected by the Ministry of Finance as a result of public consultations.

1. The importance of non-financial data in the report

A financial report as a document presenting a status of accounting records of a unit is inseparable with the most important function of the

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accounting system – informative function⁴. Data presented in the financial statement are key elements influencing decision-making process of a wide group of reports' recipients. Receivers expect reliable, up-to-date information, compatible with rules defined in the Accounting Act⁵. As far as preparation of financial statements is concerned, entities have to preserve the highest quality level of the information disclosed⁶. Over the past years, a huge interest accompanies a concept of social responsibility and sustainability⁷. Consequently, there is an increasing need for non-financial data⁸. Non-financial information is supposed to support financial data in creating a view on the value of an enterprise. Amongst non-financial information published by organisations, the most frequent ones are: information connected with social business responsibility, companies sustainability, corporate governance, business model, and the future prospects⁹. A change in the approach to information of the financial statement and increased interest in non-financial data resulted in the development of additional reports addressed to investors. The reports enclose information that go beyond the framework of a standard financial statement. They include inter alia ¹⁰:

- CSR – Corporate Social Responsibility
- ICR – Intelligent Character Recognition
- Environmental Responsibility Report

Publication of data as separate reports is a result of current market trends and a code of good practice, used by more and more companies,
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also in Polish reality\textsuperscript{11}. Amongst tasks, which are to be implemented before issuing additional reports, there are, inter alia, a reduction of information asymmetry between reports' recipients and an organisation. Data presented in non-financial statements ensure investors an access to information which so far has been reserved only for people close to the company environment\textsuperscript{12}.

The above mentioned reporting is entirely independent from regulations of the accounting law and it is employed optionally by companies as a way of creating a positive image. Though, it should be noticed how the regulations of the accounting law relate to the issue of non-financial information. The Accountancy Act, Article 49, paragraph 1 imposes an obligation to prepare reports of unit activity on managers of limited companies, joint-stock partnerships, mutual insurance companies, cooperatives and state-owned companies, as well as unlimited companies and limited partnerships, whose all partners with unlimited liability are capital companies, joint- stock partnerships, or companies from other member states of a similar legal arrangement to the above companies. The report should enclose substantial information concerning company's assets and financial situation, including assessments of obtained results and indication and description of risk factors.

Stronger reporting obligations were imposed on companies listed on a government-recognised stock exchange. According to the regulation of the Minister of Finance of 19 February 2009 on current and periodic information provided by issuers of securities, and the conditions for the recognition of equivalent to the information required by the law of the Member State which is not a Member State, companies are obliged to prepare a detailed activity statement. A list of obligatory disclosures is very extensive, data resulting from the Regulation include inter alia: a description of important risk factors, information concerning domestic and foreign sales markets, changes of the basic rules of company's management\textsuperscript{13}.

\textsuperscript{11} P. Nowak, Czekają nas kolejne zmiany w prawie bilansowym, [in:] A. Pokojska (ed.) Rachunkowość i audyt, Dziennik Gazeta Prawna nr 45 (4192), Warszawa 2016.

\textsuperscript{12}M. Marcinkowska, Kapitał relacyjny banku. Ocena banku w kontekście relacji z interesariuszami, Łódź University Publishing House, Łódź 2013.

\textsuperscript{13} Regulation of the Minister of Finance of 19 February 2009 on current and periodic information provided by issuers of securities and the conditions for the recognition of equivalent to the information required by the law of the Member State, which is not a Member State (Journal of Laws from 2014, item 133).
The International Accounting Standard No. 1 *Presentation of financial statements* describes the basis of an entity's activity financial statement. It constitutes that many companies apart from the financial report prepare additional reports and statements which disclose information regarding investment policy, funds resources, influence of entity's activity on natural environment, as well as concerning gained value added\(^\text{14}\). However, the reports are optional.

The legal acts mentioned above prove that information that goes beyond the framework of a standard financial statement is essential for companies. The problem that is faced by individuals responsible for the reports preparation is a wide margin of discretion as far as the content is concerned, as well as mostly discretionary nature, which cause codes of good practice and framework guidelines with *Global Reporting Initiative (GRI)* to become the leaders over legal acts.

### 2. The European Union regulations concerning non-financial data disclosure

Non-financial data and need of their disclosure have been investigated over a few years by the European Union Institute in a form of legislative work. In 2011 the European Commission announced publicly the need to increase social and environmental information released to the public *Single Market Act - twelve levers to boost growth and strengthen confidence - working together to create new growth*\(^\text{15}\). The European Parliament emphasised that disclosure of information by companies concerning social and environmental factors, as well as data connected with sustainability, increases both investors and consumers' trust. Non-financial information is very useful for purposes of measurement, supervision and management with the reference to entities results.

The above arguments caused that the European Parliament applied to the Commission regarding a preparation of a legislative proposal concerning the disclosure of non-financial information. The reason

\(^{14}\) International Accounting Standard 1, Presentation of Financial Statements, OJ. EU from 29 November 2008, L320/5.

behind the initiative was the necessity to coordinate national regulations valid in the Member States and a register development of a minimum scope of disclosed non-financial data across the European Union. Such actions seem to be particularly important, taking into account the fact that in the era of globalisation, many companies operate in more than one Member State.

Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, is a result of the European Commission work. It should be noticed that the Commission's clear intention was preparation of a legal act which would impose on companies an obligation to disclose non-financial information, though would allow for a considerable range of flexibility. In this way, a nature of social business responsibility in the strategy of modern enterprises was supposed to be emphasised. On the other hand, the European authorities wanted new legal regulations to ensure comparability and easy access to non-financial data for investors and consumers. One could ask whether there was a chance for concurrent realisation of two objectives. Whether an increase of information resource transmitted to report's recipients and possibility of their comparability would be possible, being flexible at the same time concerning the disclosure of non-financial data by companies. While trying to find answers to these questions, it should be pointed out that the Directive isolated areas, for which the Member States have freedom of use. Practically it means, that in the appointed areas, based on public consultations, the Member States may have a wide margin of discretion for introduced regulations. It may lead to a situation where in the Member States of the European Union, despite the Directive implementation, other standards will be applicable as far as non-financial data disclosure is concerned. The objective of increased transparency and first of all reports comparability amongst the European Union countries becomes questionable.

The Directive's entry imposes on the Member States enforcement of obligations within the disclosures of non-financial data and assurance to access procedures for all natural or legal persons. They should be complying with the Directive's regulations. The Member States had time until 6 of December 2016 to implement the Directive. The first reporting year to accept the introduced regulations is the year 2017.
3. Draft amendments introduced to the Accounting Act

As an answer to Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU, a project of 7 April 2016 amending the Accounting Act was developed. The project constitutes changes inter alia in Articles 49 and 55, which will be extended according to the Directive's assumptions.

The Directive imposes the obligation to publish non-financial information by the largest public interest units, as well as the biggest capital groups, where the dominant entity is a public interest unit. In practice the following entities are classified to this unit directory: entities operating on financial markets such as banks, social insurance institutions, and issuers of securities. In the amended bill of the Accountancy Act, in Article 49b, paragraph 1 apart from legal form companies obliged to disclose non-financial data, also additional criteria connected with employment and total balance sheet assets, were introduced, and the net revenue from the sale of goods and materials. Companies listed in Article 49b, paragraph 1, which in a financial year a financial statement is made for, and in a previous year, exceeded the following amounts:

- 500 people - in case of annual average employment expressed in full time equivalents and
- 85,000,000 PLN - in case of total balance sheet assets at the end of the accounting year or 17,000,000 PLN - in case of the net revenue from the sale of goods and materials in the financial year are obliged to disclose non-financial information in the activity report.

The scope of disclosed non-financial information in accordance with the assumptions of draft amendments of the Accounting Act was presented in Figure 1.

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16 The bill of the Accounting Act amendment of 7 April 2016 issued by the Law Department of Ministry of Finance.
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Figure 1. The scope of non-financial information of the amended Accounting Act.

Source: Own description based on the bill of the Accounting Act amendment of 7 April 2016.

The analysis of the above figures and records of the bill amendments of the Accounting Act results in a register of five basic areas which will have an obligation to disclose information. Though the areas have not been characterised or explained it may be beneficial for units preparing a non-financial data statement because they will have more freedom within content of disclosed data, however, lack of regulation may result in 'information chaos'. The absence of clear guidelines is often a huge challenge for people responsible for preparing financial reports, as they have to make their own decisions regarding the scope of disclosed information. The author claims that a wide margin of discretion concerning information disclosed, may lead to a failure in reaching the Directive's objective, which is increased transparency and comparability of data shared by companies addressed to reports' recipients.

EU Institutions introduced three areas, where the Member States have flexibility in terms of solutions employed, covered by the Directive, namely:

- in exceptional cases, a permission to omit information regarding expected events or subjects of negotiation, if their disclosure would have harmful effect on the situation of a unit;
- permission to present information by an entity in the form of a separate report;
- requirements for the published non-financial information would have become a subject of investigation by the statutory auditor or other body providing assurance services.
The above issues became an area of investigation within public consultations conducted by the Ministry of Finance. Questions concerning the areas mentioned were addressed to both, investors and non-financial information users, as well as companies which will be obliged to comply with the regulations of the amended Act. The following entities were participants of the consultations: the Ministry of Economy, the Ministry of State Treasury, the National Chamber of Statutory Auditors, the Financial Supervision Authority. The issue of publication form of non-financial data was the first area investigated.

Chart 1. Should Poland transpose an option allowing companies for a presentation of non-financial information in a form of a separate report?

![Chart 1](chart.png)

Source: own description based on data made available by the Ministry of Finance [www 1]

As Chart 1 shows, replies to the question on publication of non-financial information in a form of a separate report, were mostly 'yes'. In such situation, entities which currently prepare reports concerning non-financial data, in compliance with assumptions of the amended Accounting Act, will be able to continue such form of reports. One should pay attention to the answers to this question given by reports' addressees. The majority also advocated for non-financial data publication as a separate report. However, 39% of the respondents were against such possibility. It demonstrates a lack of precise expectations in terms of form of non-financial data presentation. The bill of the amended Accountancy Act gives units freedom of choice. Companies will have a possibility to publish non-financial information in a form of a statement
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within activity report or as a separate report. Such decision is undoubtedly beneficial from a corporate point of view, reporting non-financial data, which de facto will not be burdened with any new report obligations. Companies which have not disclosed such information, will be able to decide to issue a statement attached to activity report. This solution is definitely less time consuming and it is cheaper than a preparation of separate reports. However, one should ask about advantages for financial statements' recipients. Will the increase of transparency and data comparability assumed by the Directive be able to be implemented in case of any form of reporting? The author claims that it will be undoubtedly very difficult for individual reports' recipients, who may have a problem with a comparison of data amongst companies. The difficulties will be additionally compounded by the fact that Directive 2014/95/EU defines that a unit while disclosing non-financial data may use any standards, both domestic or EU, or international ones. Such solution certainly will not influence transparency positively, nor data comparability provided to financial reports' recipients. Therefore, it should not be expected that the publication obligation of non-financial data by public interest companies will contribute to substantial minimising of informative loopholes.

The next area within conducted social consultations was the possibility not to publish the non-financial data by companies in exceptional situations. The data involved included the information whose disclosure could have harmful effect on trade situation of a unit. Chart 2 presents opinions of entities obliged to publish information as well as data recipients.
Chart 2. Should Poland transpose an option allowing companies for omission of some non-financial information due to harmful effect on a unit trade situation?

Source: own description based on data made available by the Ministry of Finance [www 1].

The option concerning the possibility of omitting some non-financial data was positively evaluated by both companies and reports' recipients. It was generally agreed if information disclosure would have harmful effect on a unit trade situation, publication may be waived. As far as publication of non-financial information is concerned, the Directive assumption is based on the rule 'comply or explain'. It means that in case of omitting in a statement non-financial data resulting from the Directive's regulations, an entity is obliged to inform about such situation. On one hand, this solution will ensure subjects' security against the effects of data publication, which could affect its market standing, on the other hand the reports' recipients will receive a clear signal that there are areas left with undisclosed information.

The last area, where the Directive's regulations left the Member States an option is the issue of non-financial information verification. Chart 3 demonstrates public consultation results within this issue.
Chart 3. Should Poland transpose an option imposing on companies the obligation to provide non-financial information to be verified by bodies providing assurance services?

Source: own description based on data made available by the Ministry of Finance [www 1]

The analysis of replies to the question regarding an obligation to verify published non-financial data points out a conflict amongst companies expectations and reports' addressees. 73% of the investigated subjects which were imposed on with the obligation to publish non-financial information, favours the rejection of verification by the assurance bodies. It is mostly connected with financial issues. As the data concerning CSR (Corporate Social Responsibility) report verification shows, the costs of such examination varies between 25 to even 70 thousand zlotys\(^\text{17}\). Therefore similar amounts should have to be calculated in the event of a compulsory non-financial data investigation. Undoubtedly, it would have been a considerable burden on companies. On the other hand, an objective research of data published by an entity carried out by an assurance service, gives the reports' recipients a high degree of certainty. Hence, 83% of examined users of non-financial information voted in favour of an obligation of non-financial data verification by eligible bodies. In the amendment bill of the Accounting Act, the legislator adopted a solution beneficial for companies. The

option enabling the obligation of non-financial information verification was not used. This decision was supported by an argument that this type of non-financial reporting should be developed on a voluntary basis through market trends. The draft of amendments of the Act, is supposed to introduce additional requirements for companies, apart from the ones required by the Directive. Such position is certainly an advantageous conclusion for companies, however again the interest of the reports' recipients was not the most important. From their point of view, an independent non-financial information verification is fully justified. The acceptance of such outcome is another negative reply to the questions posed at the beginning of the paper. Taking into account the discretionary approach to the issue of non-financial information disclosure, it will not be possible to meet two of the objectives set in the Directive at the same time.

Summing up the bill of amendment of the Accounting Act, it should also be noticed that consequences of data non-disclosure have not been clearly defined. In order to achieve the Directive's objectives, appropriate verification means ensuring compliance with its assumptions should be introduced.

Conclusions

Contemporary financial reporting is a subject to constant changes. They are a result of evolving expectations concerning information they are suppose to provide. In recent years, non-financial information is becoming more and more popular. Market trends appearing in this area, contributed to many companies preparing various financial reports for a long time. So far they have been optional. From 6 December 2016 the obligation to publish non-financial data for public interest units is a result of The Accounting Act. It was a date by which Poland must have implemented Directive's 2014/95/EU regulations, regarding the obligation of non-financial data disclosure. The purpose of the EU bodies was to increase access to the data for the recipients and possibility of their comparison in the Member States. At the same time, considering the nature of changes introduced, the European Union left the Member States an option of form in several areas. Poland took advantage of this possibility, introducing public consultations. The result of the analysis was presented in Chapter 3, and shows that it will be impossible to reach all of the Directive's objectives. The information loophole between
reports' recipients and companies will not be eliminated because of a wide margin of discretion regarding accepted forms and standards while preparing reports, as well as the possibility of resignation from some non-financial data disclosure, and also a lack of verification obligation by assurance service authorities. Moreover, one should be aware that the entities which since December 2016 are obliged to disclose non-financial information, mostly have been doing so. It is essential though to define more detailed guidelines referring to a form and scope of disclosures, as only they will allow for data comparability and may contribute to increase quality reports to recipients. The changes introduced to the accounting law connected with non-financial information prove that it is more important subject. Though, it should be pointed out that ensuring the right quality of disclosed data will require an effort of both theoretical and practical side of accountancy.

Legal Acts


[3.] The bill of the Accounting Act amendment of 7 April 2016 issued by the Law Department of Ministry of Finance.

[4.] Regulation of the Minister of Finance of 9 February 2009 on current and periodic information provided by issuers of securities and the conditions for the recognition of equivalent to the information required by the law of the Member State, which is not a Member State (Journal of Laws from 2014, item 133).


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Leon PODKAMINER*  

FURTHER EVIDENCE ON THE VALIDITY OF THIRLWALL’S LAW

Summary
A simple equation is considered whose empirical analysis could confirm – or reject – the validity of Thirlwall’s Law. Autoregressive Distributed Lags (Bounds) approach is used to establish the empirical adequacy of the Law. The analysis, working with data for 58 countries and covering the years 1960-2012, suggests that the Law may not hold for the decisive majority of countries considered.

JEL classification: F43, F15, F62, F32, O41, O49

Key words: Thirlwall’s Law, trade elasticities, balanced growth, co-integration, ARDL

Introduction

Thirlwall’s Law¹ is a conceptually simple approach to international macroeconomic analysis (see for example Thirlwall², and Soukiazis and Cerqueira³, for relatively recent reviews of the Law’s extensions and applications). Section 2 briefly restates the original Law. One of its underlying assumptions is that long-term growth in small open economies must respect the balance-of-payments constraint. The constraint, taking the form of an equation phrased in terms of conventional trade elasticities, is to reflect the existence of a balance-of-payments (or rather balance-of-trade) limit on the growth rate of output.

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Podkaminer noticed that Thirlwall’s Law analytically rests on an equation that represented a necessary condition for externally balanced growth. A modification of the underlying equation was proposed. Section 3 briefly restates the case for the modification. The modified equation whose satisfaction is sufficient (as well as necessary) for growth to be externally balanced (and at the same time to be consistent with additional assumptions on the functional form of import and export functions) is restated in Section 4. In Podkaminer an econometric co-integration analysis based on the modified equation, using the Dynamic Ordinary Least Squares (DOLS) method applied to data for 59 countries covering the years 1960-2012, suggested that Thirlwall’s Law might not have held for the decisive majority of countries. Section 5 reports the outcomes of the Autoregressive Distributed Lag (ARDL) ‘Bounds’ approach being applied to the same set of data. The findings are similarly negative regarding the empirical adequacy of Thirlwall’s Law. Section 6 concludes.

1. The original Law

The assumptions behind the original Law are quite straightforward. In the spirit of the age-old traditions (‘absorption and elasticity approaches’) it is postulated that a small open economy’s foreign trade can be properly described by two conventional ‘demand equations’, one for its exports (X), the other for its imports (M), both in real terms.

The equations are defined as follows

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5 Ibidem
6 Aricioglu, Ucan and Sarac (2013) provide a review of recent studies concerned with econometric testing of the conventional versions of the model (i.e. the versions based on the necessary, but not sufficient, condition for externally balanced long-term growth). In the majority of multi-country studies listed therein the Law is found invalid in one third to one half of the cases.
8 The ARDL approach has a number of advantages over the older approaches to co-integration. Its major disadvantage has been the necessity to conduct a very large amount of auxiliary calculations (for example in order to be able to select the optimal lags for the variables considered). The EViews 9 econometric package, currently available, allows fast (automated) conduct of the most labour-intensive auxiliary calculations.
Further evidence on the validity of Thirlwall’s Law

\[ X = A_x(P/EP^*)-\varepsilon_x Y^* \eta_x \]  
\[ M = A_m(EP^*/P)-\varepsilon_m Y^* \eta_m \]  

where \( P \) and \( Y \) are the ‘home’ country’s price and real GDP levels; \( P^* \) and \( Y^* \) are price and real GDP levels of the ‘foreign’ country (it is assumed that the ‘home’ and ‘foreign’ countries trade exclusively with each other); \( E \) is the home country’s exchange rate (its currency per unit of the foreign country’s currency); \( A_x \) and \( A_m \) are non-negative constants and \( P/EP^* \) is the real exchange rate. All constant elasticity parameters (\( \varepsilon \) and \( \eta \)) are assumed to be positive (\( -\varepsilon_x, -\varepsilon_m \) are price elasticities of exports and imports respectively; \( \eta_x \) and \( \eta_m \) are income elasticities of exports and imports respectively). The Marshall-Lerner condition (\( \varepsilon_x + \varepsilon_m > 1 \)) is (usually) assumed (or expected) to hold.

From the postulate that trade must be balanced ‘in the long run’ (i.e. the value of exports must be equal to the value, in foreign currency terms, of imports: \( PX = EP^*M \)), it is then tacitly concluded that in the long run the rates of growth of values of exports and imports must be equal to each other.

This conclusion gives rise to the following equation

\[(\varepsilon_x + \varepsilon_m - 1)(p - p^* - e) = \eta_x Y^* - \eta_m y \]  

where the lower-case symbols (\( p, p^*, e, y, y^* \)) represent growth rates of the variables \( P, P^*, E, Y, Y^* \) respectively.

Equation (3) is equivalent to the following one

\[ y = [(1-\varepsilon_x-\varepsilon_m)(p-p^*-e)+\eta_x Y^*]/\eta_m \]  

Various conclusions are customarily drawn from (3) and/or (4). For example, suppose that there is one currency shared by both countries so that \( e=0 \) and, in addition, \( p > p^* \) (there is no substantial inflation differential).

Then

\[ \eta_x Y^* = \eta_m y \]  

or

\[ y = (\eta_x/\eta_m)y^* \]
Equations (5) and (6) are valid also when \((\varepsilon_x + \varepsilon_m - 1) = 0\) or under ‘elasticity pessimism’ extensively discussed in the literature. Equation (6) is commonly referred to as Thirlwall’s Law. It relates the rate of growth of a country’s GDP to the rate of growth of GDP of its foreign partners combined (or of the rest of the world). According to (6), the lower the country’s elasticity of demand for imports \(\eta_m\) and the higher the world’s elasticity of demand for its exports \(\eta_x\), the faster its (externally balanced) GDP growth. Observe that (5) implies the equality of the real rates of growth of exports and imports – but not the equality of (changing) volumes of exports and imports.

2. The satisfaction of the Law is necessary but not sufficient for growth to be externally balanced

Balanced trade, i.e. the satisfaction of

\[ PX = EP^*M \]

implies the satisfaction of equation (3) – and of the equations eventually derived from (3). But the satisfaction of (3) does not per se imply the satisfaction of the equation \(PX = EP^*M\), i.e. of trade being balanced. Equation (3) is a reduced form derived from equations (1)-(2) under the additional assumption of trade being balanced. The condition that is both sufficient and necessary for growth to be balanced is, of course, \(PX = EP^*M\). By plugging (1) and (2) into it one obtains the following expression

\[ PA_x(P/EP^*) - \varepsilon_x Y^* \eta_x = EP^* A_m(EP^*/P) - \varepsilon_m Y \eta_m \]  

(7)

Taking logarithms of the expressions on both sides of (7) and rearranging the result, one obtains an equation relating \(\log(Y)\) to \(\log(Y^*)\):

\[ \log(Y) = \frac{1}{\eta_m} \log(A_x/A_m) - \left((\varepsilon_x + \varepsilon_m - 1)/\eta_m\right) \log(P/EP^*) + (\eta_x/\eta_m) \log Y^* \]  

(8)

Assuming that equations (1)-(2) hold (for some concrete values of the parameters), equation (8) describes \(\log(Y)\) as a function of \(\log(Y^*)\). Notice that unlike equation (3), equation (8) guarantees the satisfaction of the balanced-trade requirement, all along.

The assumption on trade being balanced is of course violated for practically all countries, and most of the time too. But common sense dictates that trade cannot go imbalanced (either way) indefinitely. From this fact it follows that (8) is interpreted as a kind of locus of balanced positions.
Further evidence on the validity of Thirlwall’s Law

for the variables (Y, Y* and P/EP*) in question. The observed values of the variables in question may lie off the curve given by (8), reflecting imbalanced trades. But there should be a tendency for such imbalances to diminish sooner or later. It is in this sense that one can talk of the long-run tendency to balanced trade - and of real output growth being consistent with such a trade. If the assumptions underlying equations (1) and (2) (plus the notion that there is a tendency for imbalances to correct themselves) are empirically correct then the logarithms of Y, Y* and (P/EP*) ought to stand in a long-run relationship, or to be co-integrated. The presence of co-integration of Y, Y* and (P/EP*) means that the parameters of (8) are such that the trade imbalances represented by

\[ \log(Y) - (1/\eta_m)\log(A_x/A_m) + ((\epsilon_x + \epsilon_m - 1)/\eta_m)\log(P/EP*) - (\eta_x/\eta_m)\log(Y*) \]

show the tendency to diminish following occasional ‘disturbances’. The tendency of the above difference to diminish would then also lend credence to equation (3) – and to equations derived from it (such as (4) or (6)).

To avoid misunderstanding, the failure to confirm the existence of co-integration between log(Y) and log(Y*) does not necessarily mean that the actual output growth has not respected the external balance constraint. The ‘normal’ countries have to respect the external trade-balance constraint in the longer run – no matter how their export and import functions are functionally defined. The failure to confirm the existence of co-integration may mean that the basic forms of the demand equations (1) and (2) – from which (8) is derived – are incorrect.

3. Testing for co-integration

Assuming the presence of co-integration of the logarithms of Y, Y* and P/EP*, one is able to say something about the parameter estimates – without engaging into separate estimations of export and import functions which is usually based on the logarithmic) forms of (1)-(2).\(^9\)

Observe that if co-integration of the logarithms of Y, Y* and P/EP* is confirmed (following the application of some specific econometric tests) and log(Y) is assumed to be determined by log(Y*) (and eventually in

\(^9\) Equation (8) does not require information on (or estimates of) separate trade elasticities featuring in (1) and (2). This must be considered an important advantage. The calculation of trade volumes – needed for separate estimations of these elasticities – is a cumbersome business as it requires application of reliable price deflators for exports and imports.
addition also by \( \log(P/EP^*) \)), and not the other way round, then there are parameters (call them \( c_1, c_2, c_3 \)) to estimate from the following regression:

\[
\log(Y) = c_1 + c_2 \log(P/EP^*) + c_3 \log(Y^*)
\]  

(9)

It follows that if the equations (1)-(2) are the correct formulae for the export and import functions \textit{and} trade has had the tendency to be balanced then the parameters in (9) may be given specific meanings. The \( c_1 \) parameter would then correspond to \( (1/\eta_m) \log(A_x/A_m) \) in (8); \( c_2 \) to \( (\varepsilon_x + \varepsilon_m - 1)/\eta_m \); and \( c_3 \) to \( (\eta_x/\eta_m) \).

If co-integration is not confirmed, there is really no point in trying to estimate the specific elasticities and parameters in equation (8) (and in (9)), by \textit{any} method. Absence of co-integration would mean that the basic model (1)-(2) is inappropriate – and/or that the assumption is not confirmed that there has been a tendency for imbalances to correct themselves, or both. Consequently, in such situations (3)-(6) are also irrelevant.

Of course even if co-integration between the logarithms of \( Y, Y^* \) and \( (P/EP^*) \) is not rejected, the empirical results will not always make sense. For example, the eventual parameters of the ‘co-integration equation’ (9) may have apparently ‘wrong’ signs (e.g. the estimated ratio of income elasticities \( c_3 \)) may turn out to be negative or the estimate of \( c_2 \) (equal \( -(\varepsilon_x + \varepsilon_m - 1)/\eta_m \)) may turn out to be positive, contradicting the Marshall-Lerner condition).

4. Co-integration of the logarithms of \( Y, Y^* \) and \( P/EP^* \) seems to be quite rare

This Note reports the main findings of co-integration tests conducted, by means of the Autoregressive Distributed Lags ‘Bounds’ method, for a sample of countries for which reasonably long time series of data on \( Y, Y^* \) and \( P/EP^* \) are available. The sample of countries under examination consists of Argentina, Australia, Austria, Bangladesh, Belgium, Bolivia, Brazil, Canada, Chile, China P.R., Colombia, Cyprus, Denmark, Egypt, Ecuador, Finland, France, Greece, Germany, Iceland, India, Indonesia, Iran, Israel, Italy, Japan, Kenya, Korea, Madagascar, Malaysia, Mexico, Namibia, Netherlands, New Zealand, Nigeria, Norway, Pakistan, Panama, Paraguay, Peru, Philippines, Portugal, Senegal, South Africa, Spain, Sweden, Switzerland, Tanzania, Togo, Tunisia, Turkey, Uganda, UK, USA, Venezuela, Vietam, Zambia and Zimbabwe: 58 countries in total. (Ireland, which was considered in Podkaminer, 2015 is excluded this time round because the time series for that country is too short for a meaningful
Further evidence on the validity of Thirlwall’s Law

application of ARDL). The data, extending (for most countries) from 1960 through 2012, come from the World Development Indicators (WDI), which are accessible on the World Bank web page. A country’s GDP (Y) is measured at constant 2005 USD. GDP of a country’s ‘rest of the world’ (Y*) is measured as the difference between global GDP (again measured at constant 2005 USD) and Y. The Real Effective Exchange Rate Index (REER) series reported by WDI are substantially shorter than the Y and Y* series. They do not start before 1975, while for some countries they start later and for some other countries they are not reported at all. The P/EP* measure used instead of REER is calculated from the WDI series of real and nominal GDP (the former expressed at constant 2005 USD, the latter at current USD). This measure (called Π henceforth) is actually closer to the original P/EP* concept.10

It is assumed that log(Y) is the dependent variable, potentially determined by log(Y*) (and, additionally, possibly by log(Π)). This is justified by the fact that any country’s GDP is a more or less small fraction of the GDP of the rest of the world. Testing for co-integration between log(Y) and log(Y*) and log(Π) reported below was conducted by means of the ARDL method. The ARDL approach requires that the variables considered are not I(2). That requirement is easily satisfied as evidence (following the application of ADF unit root tests) is strong that all log(Y) and log(Y*) series are I(1) while log(Π) series are either I(1) or possibly even I(0). The second essential requirement is that the residuals to the eventual ARDL models are free from autocorrelation. That requirement is safely satisfied for all countries - whether or not the analysis rejects the existence of co-integration11.

ARDL was first applied to the equation abstracting from the exchange rate term (log(Π)):

log(Y) = c1 + c3logY*

The F-statistics alone, calculated as prescribed by Pesaran et al (2001), rejects (at the conventional significance levels) the null of ‘no long-term relationship’ for 27 countries. But for 6 of these countries the estimates for c3 turn out to be negative – which does not seem to make sense. For some

10 Let Y_nom and Y*_nom be nominal GDP levels (at current USD) of a country and its ‘rest of the world’. Π is then defined as (Y_nom/Y)(Y*_nom/Y*). Observe that Π_2005=100 in each case. In most cases the Π and REER series turn out to be quite strongly correlated.
11 Similarly, the customary stability tests (such as CUSUM) do not suggest instability of the estimated parameters.
other countries (including China, India, Italy, USA) the estimate for the so-called error-correction (EC) term turns out to be positive – thus indicating the non-existence of long-term co-integration. According to the t-statistics (which is the second ‘bounds’ testing statistics associated with ARDL) only 10 countries (out of the 27 passing the F-statistics test) qualify. Estimated $c_3$ for these countries are positive and significant at 0.01% level while the estimated error-correction terms are all negative (as should be expected) and also significant at 0.01% level (see Table 1).  

<table>
<thead>
<tr>
<th></th>
<th>Observations included</th>
<th>F-statistics</th>
<th>t-statistics</th>
<th>EC term</th>
<th>$c_3$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>45</td>
<td>4.83**</td>
<td>-3.000*</td>
<td>-0.3239</td>
<td>0.6299</td>
</tr>
<tr>
<td>Colombia</td>
<td>49</td>
<td>4.28*</td>
<td>-3.494**</td>
<td>-0.255</td>
<td>1.1986</td>
</tr>
<tr>
<td>Finland</td>
<td>51</td>
<td>5.94**</td>
<td>-2.950*</td>
<td>-0.2179</td>
<td>0.9513</td>
</tr>
<tr>
<td>Indonesia</td>
<td>51</td>
<td>10.5***</td>
<td>-3.470**</td>
<td>-0.1305</td>
<td>1.825</td>
</tr>
<tr>
<td>Israel</td>
<td>51</td>
<td>10.50***</td>
<td>-3.110*</td>
<td>-0.240</td>
<td>1.4486</td>
</tr>
<tr>
<td>Kenya</td>
<td>52</td>
<td>23.9***</td>
<td>-2.990**</td>
<td>-0.1655</td>
<td>1.283</td>
</tr>
<tr>
<td>Malaysia</td>
<td>51</td>
<td>4.3**</td>
<td>-3.190**</td>
<td>-0.1945</td>
<td>2.048</td>
</tr>
<tr>
<td>Tunisia</td>
<td>51</td>
<td>8.715***</td>
<td>-3.240**</td>
<td>-0.2596</td>
<td>1.406</td>
</tr>
<tr>
<td>Uganda</td>
<td>29</td>
<td>11.44***</td>
<td>-4.490***</td>
<td>-0.2245</td>
<td>2.423</td>
</tr>
<tr>
<td>Venezuela</td>
<td>51</td>
<td>6.36**</td>
<td>-3.075**</td>
<td>-0.241</td>
<td>0.6739</td>
</tr>
</tbody>
</table>

F-statistic values for testing Ho: ‘no long-term relationship exists’. *** implies rejection of Ho at 1% significance; **: rejection at 5%; *: rejection at 10%. The critical bounds for the F-statistics are taken from Narayan\(^\text{12}\). Appendix Tables A1-A3. t-statistics values for testing the same hypothesis: *** implies rejection of Ho at 1% significance; ** at 5%, * at 10%. The critical bounds for t-statistics are taken from Pesaran et al.\(^\text{13}\), Table CII(iii)).

The tests (for the same set of countries and the same time periods) based on DOLS reported in Podkaminer (2015, Table 1) suggested the

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Further evidence on the validity of Thirlwall’s Law

presence of co-integration between \( \log(Y) \) and \( \log(Y^*) \) in 6 cases.\(^{14}\) Interestingly, 4 of these cases also appear in Table 1 above. (These are Finland, Indonesia, Israel and Malaysia. Reassuringly, the DOLS estimates for \( c_1 \) and \( c_3 \) for these four countries are very close to their ARDL counterparts).

According to the ARDL analysis, allowing for \( \log(\Pi) \) as an additional explanatory variable, the F-statistics rejects the null of non-existence of long-term relationship in 31 cases. However, most of these cases are highly problematic anyway. In two cases the estimated EC term is positive and in 12 cases it is negative but very close to zero. In 8 cases the estimated \( c_3 \) is negative (though generally insignificant). The estimated \( c_2 \) has a ‘wrong’ (i.e. positive) sign in 19 cases. Finally, only 4 countries pass the second ‘bounds’ testing statistics (see Table 2). The estimates for \( c_2 \) are all ‘wrongly signed’ (in violation of the Marshall-Lerner condition) but – in two cases – statistically insignificant (see the last column in Table 2). The estimated EC terms and \( c_3 \) parameters for these cases are correctly signed and significant at 0.01% level. (However, the estimated EC term for Namibia is greater than 1 in absolute terms. This suggests instability of the ARDL model for that country.)

Table 2. The 4 cases of non-rejected co-integration between \( \log(Y) \), \( \log(Y^*) \) and \( \log(\Pi) \)

<table>
<thead>
<tr>
<th>Observations included</th>
<th>F-statistics</th>
<th>t-statistics</th>
<th>EC term</th>
<th>( C_3 )</th>
<th>( C_2 )</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ecuador</td>
<td>49</td>
<td>4.13*</td>
<td>-4.02***</td>
<td>-0.267</td>
<td>1.082</td>
<td>0.0855</td>
</tr>
<tr>
<td>Namibia</td>
<td>29</td>
<td>7.07***</td>
<td>-4.58***</td>
<td>-1.014</td>
<td>1.433</td>
<td>0.2976</td>
</tr>
<tr>
<td>Tunisia</td>
<td>51</td>
<td>7.73***</td>
<td>-3.27*</td>
<td>-0.282</td>
<td>1.55</td>
<td>0.3605</td>
</tr>
<tr>
<td>Venezuela</td>
<td>51</td>
<td>5.25**</td>
<td>-3.22*</td>
<td>-0.285</td>
<td>0.670</td>
<td>0.0361</td>
</tr>
</tbody>
</table>

F-statistic values for testing Ho: ‘no long-term relationship exists’. *** implies rejection of Ho at 1% significance; **: rejection at 5%; *: rejection at 10%. The critical bounds for the F-statistics are taken from Narayan\(^{15} \), Appendix Tables A1-A3. t-statistics values for testing the same hypothesis: *** implies rejection of Ho at 1% significance; ** at

\(^{14}\) DOLS did not reject integration in 7 further cases with linear (or quadratic) trends included as additional variables in the long-run relationship between \( \log(Y) \) and \( \log(Y^*) \).

The tests based on DOLS reported in Podkaminer (2015, Table 2) suggested the presence of co-integration between log(Y) and log(Y*) and log(Π) in only 2 cases (Ireland and Japan). In both cases the estimates for $c_2$ were also positive (i.e. ‘wrongly’) signed.

The findings reported in Tables 1-2 provide some support to Thirlwall’s original idea that corrections of trade imbalances primarily involve quantity (GDP) and not the relative price (i.e. exchange rate) adjustments. In the cases reported in Table 1 the cointegration obtains with the exchange rate variable being ignored. When that variable is taken into consideration (Table 2) it proves to be ‘wrongly’ signed. In any case the elimination of trade imbalances in the cases from Tables 1-2 cannot be expected to proceed through exchange rate adjustments. However, our estimates do not allow any judgement on the relative roles of the quantity and price adjustments for the remaining countries.

Concluding remarks

An earlier analysis applying the Dynamic Ordinary Least Squares approach to the model given by (9) suggested that Thirlwall’s Law did not hold for a decisive majority of countries considered. The same conclusion follows the analysis using the ARDL Bounds approach. The latter approach appears slightly more ‘liberal’ than DOLS. This may have something to do with the fact that the critical values for the upper bounds of the t-statistics (taken from Pesaran et al., 2001) are asymptotic – while the series considered are not very long. The exact critical bounds values for the t-statistic for the time series considered may have been more restrictive.

The unimportance of the real exchange rate as a factor co-determining long-term growth, revealed earlier, has now been confirmed. Evidence is strong that the Marshall-Lerner condition does not hold, at least in the longer-run perspective. Of course this is not quite a novel finding as many authors have also found violation of the Marshall-Lerner condition in studies...
concerned with the estimation of trade elasticities (e.g. Imbs and Mejean, 2010; Crane et al., 2007; Wu, 2011). Imperfect data may have been one reason for the generally negative verdict on the empirical validity of the Law. The ‘fault’ may also lie with the functional form of the underlying equations (1)-(2). Some parsimonious modifications of the functional form of equations (1)-(2) may perhaps need to be developed. With such modifications the Law may ‘fit the data’ satisfactorily without losing the power to provide simple insights into the role external imbalances play in determining long-term growth of small open economies. In any case it is vital that the eventual testing applies to models that are capable of reflecting sufficient (and not merely necessary) conditions for long-term balanced growth.

Literature


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18 Recent contributions (such as Tharnpanich and McCombie (2013), Ibara and Blecker (2016) and Razmi (2015) among others) introduce variously defined structural changes (and ‘structural breaks’) into the original Thirlwall’s framework. One trouble with these innovations is that they introduce additions making the basic insight of Thirlwall’s Law no more appealingly transparent. Besides, the innovations rendering the elasticity parameters dependent on exogenous developments (e.g. the supply-side ones, or relating to the advances in globalisation) implicitly reject the underlying model (1-2) which assumes constant parameters. Moreover, the recent contributions go on with the direct – necessarily problematic - estimation of the elasticity parameters for the export and import functions. Last, but not least, the estimates they provide are derived from the formulae reflecting necessary – but not necessarily sufficient conditions for long-term balanced growth.


[14.] Wu, Y. 2011 Growth, expansion of markets, and income elasticities in world trade. IMF working paper no. 05/11.
ACCOUNTANCY ENTANGLED BY FINANCIAL CAPITAL

Summary
This paper aims at presenting some contradictions that can be found in the contemporary theoretical approach to the issue of accounting. Accounting has changed the systemic perception of economic phenomena into the process related one. This may be manifested in using current value to assess fixed asset component, which results in distortions in the informative system of accounting, thus encouraging application of creative accounting. Partial contradictions demonstrated in this paper are deeply rooted in the theoretical background of accounting and they have one common foundation – seeing productive capital through the prism of financial capital. This approach results from financial capital related tendencies to search for new forms of capital returns. New accounting allows for following such tendencies on the microeconomic level. New subjective interests of accounting deepen the dichotomy between theory and practice.

Key words: production capital, financial capital, historical cost, fair value, creative accounting

Introduction

The author of the paper points to theoretical drawbacks of contemporary accounting resulting from the key dichotomy – seeing productive capital through the prism of financial capital. Making money on production capital is a domain of business activity conducted by investors, this domain is conditioned by progressing globalisation processes. Activation of financial capital is forced by the objective barriers and obstacles to generate profit on production capital. The pressure from investors looking for attractive returns on financial capital had a considerable impact on the accounting measurement system.

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Conceptual transformation of the accounting system was based mainly on creating opportunities to use volatility of the value of money.

Theoretical justification for activation of the role of money through impacting the economy is proposed by monetarists. The concept of monetarism, rooted in the current trend of neoliberal economy, forced the necessity of process approach to creation of informative system of accounting. With globalisation came the international accounting which had to redefine its systemic approach in order to open international flows of financial capital, the opening was achieved by introducing a number of changes. The most important changes referred to a new outlook on the role of a business unit and replacing historic cost by current value to price the assets and to change the economic content of capital. In view of the author of the present paper, introduction of the changes aimed at activating the accounting system triggered serious discrepancies rooted in current theoretical layer of accounting.

1. Macroeconomic thought in monetarist version of neoliberalism

The title of the paper which emphasizes the entanglement of accounting by financial capital requires a brief profile of neoliberalism enhanced by a monetarist outlook on the role of money. The development of economic thought abounded in many theories explaining the essence of wealth of a given society. The easiest way to understand the process of wealth accumulation lies in the very logic of rational thinking of societies, who through their labour use the earth’s natural resources to satisfy their needs and the kind and scope of the needs correspond to the level of cultural and social development of each respective society. Identification of objectives is rudimentary, it gives sense to social processes of manufacture. Simultaneously, the very same society is aware that in order to fuel their productive force, they have to capitalize on their existing technological, cultural and social developments. In this way, conditions for involvement of new generations in the process of accumulating wealth are created. Reproducing of existing and creating new wealth is a continuum of each society in economic and civilisation spectrum.

Societies functioning in the conditions of market economy require money, a currency. Money serves an ancillary role in the process of accumulating wealth, it is a mean of tangible expression of value, a mean of circulation facilitating the exchange of goods. This basic truth is
expressed by the theory of value, which shows in a synthetic way how labour is applied to satisfy the needs of a society in market economy conditions. According to this theory, the structure of value is expressed by the ratio of capitalized labour to new value manufactured as the result of current labour of the society. Thus, value denotes the creative force of a given society. Of course, the theory of value is far from being perfect as it does not take into account the capital in the form of natural resources. Excessive labour leads to overexploitation of the natural environment and effects of this exploitation are clearly visible.

The development of economic thought was not channelled towards building up on this particular theory which was rejected by neoliberalism as it seemed to undermine the role of labour as the main source of wealth. Contemporary neoliberalism adapted the point of view of monetarists who claim that only money may be the source of wealth. Monetarists are convinced that money is a fundamental and original factor that triggers economic change. For monetarists variables such as: global production, employment and prices are shaped and determined by money which seems to be, in their view, the only meaningful asset.¹

Classic economy, quite rightly, believed that money is a neutral intermediary mean of exchange. The primary reason behind the increase in the volume of money in circulation was the increase of value of goods and services. Money seems to have been the result. This regularity is reflected in the principle of money circulation. Monetarism infringes the principle of money circulation and turns the cause into effect claiming that demand for money is a demiurge determining economic growth.

Assigning an excessive role to money secures economic interests of the banking sector. In this regard the most harmful is issuance of money by the Central Bank to cover public debt. Banks discovered long ago this particular nature of money. Banks can freely increase and decrease the money supply.² Funds generated in this way may not only be utilised as investments but they can also be spent on reckless consumption. Nowadays such phenomena are, unfortunately, quite common. Banks exceed their mandate to create money and generate profit of their own, mainly in the form of interest rates. When it comes to money, scientifically formulated theories seem to be of lesser importance than real life institutions and experiences”.³

At this point an observation must be made that banks while manipulating the money supply impact price volatility as well as changeability of interest and exchange rates. These three volatilities detached from the real value of provided goods and services create perfect opportunities to make money from the mere changeability of money. The answer to the question why manipulating the changeability of money has become so desired lies in the key contradiction of capitalism. The right to accumulate capital and the related right of maximising profit encounters obstacles. Increased output of goods and services requires increased consumption which, in turn, is limited by the division of added value which is subdued to the principle of maximising profit. Extended consumption is possible through supplying a considerable amount of credit money or increasing the volume of cheap money in circulation. This contributes to increased inflation, which as the result of rising prices leads to unjustified transfers of added value. A similar role in the transfer of the added value is played by changeability of interest and exchange rates.

Expansion of financial capital benefiting from this ‘changeability’ becomes obvious. No wonder then, that nowadays it is more and more difficult to generate profits from value created in reality, it is so much easier to make profit by manipulating the value of money. In recent years there has been considerable intensification of financial capital looking for easy money, which triggers unjustified redistribution of added value on global scale and poses the threat of crisis occurrences. Contemporary economists do not even try to conduct a thorough reliable analysis because proving that neoliberal model is unrealistic is pointless, as this model does not describe the world as it is but as it should be. Neoliberalism is not trying to build the system that is well-matched to the real world; instead it is trying to build a world which would match the system. Monetaristic outlook on the expansive role of money in economic processes has become deeply rooted in the system of international accounting developed for the purposes of advancing globalisation processes.

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2. Contemporary accountancy versus financial capital

In recent years accountancy has reorganised its measurement system. It has been done with the intention to extend the range of information for the needs of investors who want to earn profit on changeable values of money. But what theoretical thought inspired these changes? What are the consequences for the economic life from the new offer of informative accountancy? It is not easy to answer these questions without revisiting the basics of accountancy, without understanding its theoretical side and grasping the relations between processes underlying a given theory and the accounting measurement system. For the sake of theoretical considerations the author concentrated on three key aspects which have a critical significance in the process of rebuilding the information system of accounting. Namely, a new outlook on the role of a business unit for which this information system is being built, rejecting the principle of historical cost for valuation of assets and replacing this principle by the current value and adopting to accountancy a new concept of capital. The order of the issues listed above marks the sequence of the author’s deliberations.

Traditionally accountancy was defined as: information system which identifies, records and informs about economic occurrences of an organisation.\(^5\) Accounting through its measurement system explained the behaviour of business entities who used limited resources to achieve their economic objectives. The governing rule here was the rule of a business entity. Various social groups are included in activities of business entities, establishing certain relations of social labour participating in the process of creating value. The quality of informative system of accountancy which, at the same time, reflects its theoretical value could be seen in the extent of implementation of proper measures and relations between those labours. The foundation of systemic approach of the development of accounting measures was the theory of creation and distribution of value. Accountancy allows for tracking the circular movement of capital in the process of creating and distributing of value. In its registration system accountancy pointed to internal allocation of capital, waste of capital in different phases of circulation and driving forces participating in accumulation of capital. Financial reporting as the end product of accountancy served a number of various end-users.

In the current development stages this approach was rejected. A company is treated as a certain set of contracts between external parties e.g. moneylenders and investors, between internal parties: managers and employees. The reason behind formally written down contracts is the conflict of interests between the contracting parties which results from their respective economic interests. It is assumed that contract participants are aware of the economic assumptions of occurrences and formulate contracts in a rational manner. Business activity of an organisation with contractual balance of economic forces should find reflection in accounting. In the most current approach accountancy introduced new categories and measures of relations, whose aim is to support decision taking processes of a business unit. From this angle accountancy is nothing more than a kind of language in which the contract is written down. Contractual outlook on a business organisation exposed interests of investors, with a tacit assumption that it also meets the interests of other groups of users. This approach, obviously, cannot be agreed with. The interests of investors and interests of other groups of users of the information provided by accountancy are completely divergent. The level of generalisation thanks to which interactions of various interests would be more or less balanced, has not been found. Accountancy in response to challenges coming from globalisation processes has rebuilt its informative system having in mind the interests of investors eager to make money on financial capital.

Another key problem to be addressed here is the rejection of historic cost principle by contemporary accountancy. In accordance with this principle assets of a business unit should be recorded in their purchase price, i.e. the cost that a business unit must bear. Historical cost represents the value transferred in the process of creating value. Application of historic cost to valuate assets has objective character, the value of purchased assets was confirmed in business transactions and in the melting pot of social hieroglyphics exposed in trade exchange in a given society. Each society devotes a portion of their income to purchase capitalized wealth – assets. In this way division forms of value were incorporated in yet another process of value creation. Purchase of assets is a prerequisite for creating production force of capital. Capitalized value of assets is nothing more than savings transformed into investments. The degree to which a given business unit will combine

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added value to transferred value (represented by historic cost) shows the production force of the capital involved in a given business unit. Application of historical cost for valuation of assets allows for cumulative expression of wealth. Exchange value represents the purchasing price. Historical cost emerges in a given moment from the very same share relations of value which referred to the members of the same society, relationships established in given economic conditions. Application of historical cost reveals the process of shaping value on the level of microeconomic capital allocation. Historical cost allows to show capital flows in input-output system, and most of all, enables the structural approach to value.

Historical cost is under strong criticism in the circles of the so called academic accountancy due to the static nature of value written down on its basis. It was assumed that accounting, by using different measurement methods should not just describe reality. It was argued that the role of accounting is also assistance in decision taking processes, useful most of all for investors who are interested in future returns on their capital. Thus the investors are in need of information about the future. Pressure from investors forced accountancy to become interested in economic processes described by means of variables of value conditioned by changeability of money. A great emphasis was put on the category of fair value which was introduced into the accounting system, this category is of predictable nature. It is in line with the opinion that the aim of accounting theory is to provide the set of principles and relation which would explain what can be observed and foresee what cannot be observed. Foreseeing of what cannot be observed should refer mainly to future cash flows based on the volume of wealth which is understood as the sum of assets valued in accordance with fair value principle. The fair value is a kind of current price shaped on an active market or predicted current value in a situation when active market, regulated by the principle of demand and supply, does not exist. Thus the accounting system was enriched by measures of future occurrences which operate on the basis of predictable changes in the value of money. The ancillary role with this respect was given to the notion of fair value. However, fair value contrary to what its supporters

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claim, does not assure the process approach to economic occurrences in the measurement system of accounting.

The experience up to the present shows that using fair value in the process of asset valuation opens space for creative accounting, which, as it is already known, contributes to crisis occurrences. Creative accounting consists of a selection of accounting principles and such interpretation of transactions and occurrences to allow for manipulation aimed at improving or very often just smoothing the financial result. The term is also used with respect to instances of fraudulent financial reporting.\(^9\) It is worth recalling the famous Enron scandal of 2001. Mass media all over the world reported on fraudulent ‘creative accounting’, which made it possible to generate non-existent profits. In a nutshell, negative occurrences at the energy giant were connected with forging financial reports and other frauds, committed by accountants with consent from auditors. Financial results were manipulated and the company value was artificially created in order to satisfy demands of owners and other stakeholders.

Such situations are connected with the development of financial markets attracting investors eager to make money from their cash. The possibility to conduct transactions on the Internet makes the whole thing so much easier. Demand for profits generated by financial transactions triggers reaction from companies. Searching for capital on stock markets businesses try to publish as positive financial results as possible. Using fair value to evaluate assets they fall into temptation to overprice assets which results in overestimation of profits. In some cases these activities go so far that they rich a climax and end in a scandal which then reverberates all over the world. Each scandal means excessive losses for investors. Creative accounting often uses a range of methods of manipulation which mostly refer to revenues and costs.

It wouldn’t be possible, if the creators of the new approach did not regard creative accounting as something positive. Creative accounting is the way of keeping track and register of economic occurrences in accordance with regulations in force and appropriately interpreted accounting principles but the method of interpretation is not directly prescribed by the principles and is the result of imaginative and unusual

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application of these regulations and principles. The volume of this paper does not allow for a full polemic with such reasoning. It should be noted however, that reliable recognition of economic assumptions in which a business unit operates is not possible in order to apply creative accounting. It should also be mentioned that creative accounting opens space for using derivatives, contractual options for evaluation of which changeability of exchange and interest rates is applied. Creative handling of derivatives, more than once brought considerable losses for business units.

The possibility of practical application of fair value for evaluation of assets and implementation of volatility into the measurement system of accounting required redefinition of some basic categories such as: capital, revenues and costs. Capital is conceived in residual way as net assets (assets less liabilities), revenues is the growth of net assets value, costs, by contrast, the fall in net assets value. Such understanding of capital has absolutely nothing in common with its essence as the notion of capital has always meant transformation of savings into capital resources. The way of expression of capital in contemporary accounting completely rejects the theory of value i.e. the capital stands next to value. From theoretical perspective of the theory of value, capital represented capitalized values which when incorporated into the processes of accumulating wealth conditioned growth of production force of the functioning capital. Capital conceived in residual way consists not only of capitalised volumes but also of volumes foreseen for the future. It is assumed that net assets which represent equity capital are the basis for predicting future cash flows. This kind of information should come in handy for potential investors as it may project potential profits from invested capital. Moreover, maximisation of net assets should trigger increase in demand for stocks and shares of a given business unit. This kind of reasoning motivates managers towards maximisation of net assets. No wonder than, the status of a business unit has been changed. In order to maximise net assets a priority has been given to value management. It cannot escape unnoticed that the volume of net assets does not offer any grounds for foreseeing future cash flows. Such

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situation could take place if assets were purchased in order to be re-sold at profit. But then there would be only particles of financial capital incorporated in various assets, nothing more. In a manufacturing business unit assets are not purchased to be resold but to participate in the process of value creation in an organised way. Capital conceived in residual way represents demandingness with respect to distribution of added value but says nothing about input of this capital in the process of creating this value. Such approach is ideologically confrontational and gives rise to unfounded ripping off of equity capital from the capital of function. The accounting assumption on a business unit has not been officially waived but it may not be based solely on the function of equity capital. This function is characterized by the division of value not by its creation process.

3. Contradictions in contemporary accountancy

Development of informative system of accountancy although it serves the needs of practice and is rooted in real life business experience, may not be independent beyond the understanding of economic content of the same observations of real life. Today’s globalised economic world is full of intensified activities of financial capital. Accountancy is not neutral towards this reality which is proved by its proposal of an alternative system which is in opposition to reality. This alternative system introduces a series of serious contradictions, some of these contradictions are presented below:

- accountancy assumed the supreme goal of investors and applied measure procedures for the benefit of this particular group of users, at the same time causing a shift of criteria for rational conduct of managers. Reasonableness in resource management no longer is the most important thing for managers, it was replaced by reasonableness of creating the value of the company, the capital volumes of a business unit. That explains why managers every so often turn to creative accounting in order to fulfil the criteria;

- creative accounting was meant to serve a worthy goal – economising on accounting profit. This assumption is, inherently, false. The managers may be aware of economic assumptions for internal allocation of capital in the business units under their jurisdiction, but they cannot know the assumptions for capital allocation on macroeconomic scale;
Accountancy entangled by financial capital

- theoretical accountancy rejects the value principle because it comes from the abundance of occurrences in the business practice, occurrences provoked by the expansion of financial capital. There is no evidence that the value principle contradicts the practice of business life. Current trends in economy do not offer an alternative theory which would consistently contradict the value principle. It does not mean, however, that the value theory cannot be improved and better adjusted to rapidly changing times. Attempts of partial theoretical corrections made by narrow specialists will not be sufficient. What is really needed is a macroeconomic theory with a fresh outlook on the new market reality, a theory synthetically expressed in the value principle. In contemporary accounting, interests of investors are excessively glorified and the theoretical aspect of accounting is being ripped off the necessary objectivism. Theory must not be a direct transformation of empirical experiences. If a theory concerns social processes of wealth accumulation in which various social groups participate, it must take into account usefulness for all participating groups not just one. Otherwise, the theory ceased to be scientific and becomes a part of utilitarian knowledge.

In the contemporary accounting system one may point to many other, more detailed, contradictions, however, it is impossible to discuss them all in a study of this volume. But it must be emphasized that detailed contradictions in contemporary accountancy stem from one elementary contradiction i.e. looking at production capital through the prism of financial capital.

Conclusions

The author of this paper points to deficiencies of contemporary accounting measurement system. The main reason behind these deficiencies is the absence of solid theoretical background. Looking at production capital from the angle of financial capital poses a serious ontological error which deforms the nature of the research object of accountancy. It must have resulted in misshaping of the category of capital, revenues and costs. These categories are not of transactional nature, they do not emerge from social character of market relations. The measurement model of profit is based on the concept of nominal capital behaviour and application of current prices together with predicted value; it reveals the impact of the changing value of money regardless of real
content of economic processes. Theoretical error of contemporary economy which sees money as a commodity and monetaristic assumption about superior role of money in economic processes was fortified by contemporary accounting which loosened its assumptions making space for creative accounting and its tools related to changeability of money. The concept of contemporary monetarism overtook the intellectual, political and economic awareness of establishments as well as those who create the information system of accounting.

**Literature**


THE IMPORTANCE OF REPUTATION OF A COUNTRY IN THE PROCESS OF BUILDING ITS COMPETITIVE ADVANTAGE ON THE GLOBAL MARKET

Summary
In the contemporary information era countries compete with one another on many levels and almost in every field of life. Governments prepare comprehensive development strategies, thanks to which they hope to improve their country’s competitiveness and gain better competitive advantage on the global market. Methods and tools which are becoming more and more popular in preparing these strategies are similar or identical to those traditionally used in business management. The sources of competitive advantage are more and more frequently found in the domain of immaterial assets. Currently one of the most valuable merit which helps build the worth and competitive advantage of a country is its reputation. This paper attempts at explaining the importance of reputation of a country in building its competitive position on the global market and explaining its main determinants which are the basis for assessment of their reputation. To achieve these goals the author used methods of literature research and analysis of a reputation study conducted by the Reputation Institute.

Key words: country reputation, country image, national brand, reputation indicators, reputation ratios

Introduction
In light of increasing competitiveness between countries not only on continental but also on local scale, governments and public institutions undertake steps to raise the level of competitiveness of their country’s economy, to improve its innovativeness and macroeconomic results. Such efforts aim at attracting new external investments, finding new sources of financing for projects, tempting skilled workers, tourists and
new residents. To achieve these aims various management methods and tools traditionally used in the world of business are applied. An extremely useful instrument here is the instrument of international marketing by means of which various unique virtues of a given place such as: local products, unique natural resources, convenient investment environment, attractive sights, beautiful landscapes, hospitable locals are promoted.1

In the contemporary, knowledge based, information and economy era, one of the most basic resource which guarantees strategic advantage and development prospects is reputation. Its significance is systematically rising due to a large number of dynamic changes occurring in the social, political, cultural and technological environment. The most vital changes are: increase in the impact of stakeholders (especially media, NGOs, law and regulatory institutions that make laws of international reach), technological advancement in the area of media and communication which allows access to information in real time, as well as deepening globalisation processes which generate the need to respect generally applicable ethical principles, as well as unification and standardisation of activities within global supply chains2. Therefore, good reputation has become important not only for businesses but also for non-profit institutions, individuals (politicians, actors, artists, scientists, athletes etc.), as well as countries and international organisations.

The aim of the paper is to highlight arguments justifying the significance of reputation of a country in building its competitive position on the global market and to identify main attributes that underlay the evaluation of reputation of nation states. The research methods used by the author included the analysis of literature on the topic as well as analysis of results of studies on reputation conducted by the Reputation Institute.

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1. Reputation versus image and identity of a country

According to a very general definition reputation is an opinion people have on a given person, organisation, company or product. Reputation may thus refer to a person, character, place, organisation, animal or object. In literature there is a greater number of definitions of reputation used with respect to organisations (businesses). One of the most popular definition was formulated by Ch. Fombrun and C. van Riel, according to this definition reputation is an aggregated evaluation of past, present and planned activities of a business based on perception of different groups of stakeholders; it is a subjective and collective evaluation of everything that makes an organisation credible and trustworthy. The elementary groups of stakeholders are: customers, employees, investors, business partners, public administration, media, local communities and the society as a whole. These groups formulate their opinions about a company not only on the basis of the information the company sends to the outside world by means of for example its advertising campaigns but also on their own personal experiences and opinions of other entities who came in contact with the company, its products, services and employees. Own experience and observations of people have a crucial meaning because they allow for verification of actions with words, it is on this basis that the trust of stakeholders is formed and trust is the foundation of reputation.

With respect to what was said above, the reputation of a company is not equal to its image, which is defined as a way of perception of a given object, and to be more precise, constituents of its identity formed during processing of information coming from different sources. Image is the picture people have in their minds of themselves, other people or objects; it is the picture of a company’s identity in the consciousness of recipients. Therefore, the image of a company can be defined as a certain picture or visualisation created in the minds of recipients, this picture may be "artificially" shaped by commercials, advertisements or

PR activities. Image results from perception, reception and interpretation of identity elements, which make it possible to identify a given company and differentiate it from the rest, especially its direct competitors. Identity of an organisation embraces visual constituents, such as its name, logo, symbols, colours, architecture, decor of buildings, staff uniforms etc., and elements such as attitudes and behaviour patterns of members of this organisation with special emphasis on communication with the outside world. Identity is born within, image and reputation, on the other hand, are born outside of the organisation.

The concepts of reputation, image and identity may analogically be used with respect to countries:

- reputation of a country is a relatively well-established opinion various groups of internal and external stakeholders hold about this country on the basis of evaluation of its natural merits and activities of its residents;
- image of a country is a way of perception of its identity by internal and external observers on the basis of information coming from different sources;
- identity of a country is a system of visual elements i.e. name, national emblem, colours of the flag, cultural monuments, works of art, landscapes, architecture as well as traditions, customs, attitudes, patterns of behaviour especially with respect to foreigners. Relations between these categories are shown in Image 1.

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Image 1. Reputation versus image and identity of a country.

Source: Own work.

Image of a country results from the perception of its identity by different groups of observers (stakeholders). Reputation is an assessment of a country made on the basis of notions and associations people have about it i.e. on the basis of the image created in consciousness of recipients of the image. In this way, image is one of the instruments of shaping reputation. Besides, reputation is built by means of experiences stakeholders have due to contacts with a given country and, in consequence, the reinforced image may be updated in plus or in minus for a given country. Thus, reputation may also have an impact on image – these two are interrelated.

The entities which take part in reputation evaluation process i.e. stakeholders may be divided into external and internal. External stakeholders include: institutions of public administration (the parliament, the government, ministries etc.), tourists, media (traditional and modern), investors, businesses (local and international), business partners and contractors, international institutions of control and supervision (the so called regulators), NGOs, opinion shapers (politicians and economists), public opinion, international community. Internal stakeholders include residents as natural persons (citizens, customers, consumers, patients etc.) as well as members of various organisations (businesses, offices, institutions, NGOs). Reputation of a country as an
outcome of perception of various groups of stakeholders is influenced by the following factors:

- direct experiences of stakeholders, their personal contacts with representatives of a given country on different levels: international, interorganisational and interpersonal,
- communication activities and initiatives of representatives of the state: parliaments, governments, organisations, businesses, individual persons
- influence of third parties i.e. opinions, reports, ratings etc. developed by various international bodies, stereotypes i.e. widely held believes reinforced by the media and other opinion shaping centres with respect to particular countries and their residents.

Reputation and image of a country are related to the notion of the national brand. The national brand is defined as a comprehensive composition of image and reputation which constitutes a sum of functional and emotional values transmitted by a country to the outside world, the values are well-known, appreciated and desired by stakeholders of the brand i.e. organisations, groups and individuals which exert influence on the country and vice versa. The national brand is a sum of generalised experiences of its stakeholders. Thus, the image of a country as well as its reputation are treated as key constituents in building the national brand which represents relevant, unique values and attributes of a given country and its society.

2. Instruments and factors building a country’s reputation

Reputation of a country is shaped as a result of conscious, intended activities of its representatives (governments, public institutions, NGOs and the like) but also of objective events and actions of entities which are impossible to control - businesses, organisations, institutions as well as ordinary citizens. According to S. Anholt countries are building their reputation through exchange of material and immaterial values through the following six communication channels.

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The importance of reputation of a country...

- brand export – it refers to offering products from well-known brands which are the showcase of the country of origin and clearly exposing this fact (made in Poland);
- internal and external policy – political decisions and steps which impact the process of shaping the image of the country among its own citizens as well as abroad;
- foreign investment and immigration – ways of acquiring foreign investors, entrepreneurs, skilled workers, scientists, students etc.;
- culture and national heritage – cultural exchange with other countries as well as export of a country’s national culture (works of literature, film, music, sport achievements, honourable representatives of the country);
- people – residents of a given country, well-known and respected representatives of the world of science, politics, sport, media etc., as well as ordinary residents who, by their behaviour and attitudes towards foreigners, give evidence about the place;
- tourism – promotional activities of professional tourist organisations, agencies and institutions, as well as own experiences of foreign tourists visiting a given country in an organised or individual way.

In the author’s view these channels complement each other and make up a kind of a hexagon (Image 2).

**Image 2. Communication channels building reputation of a country.**

Source: Own work based on Anholt, 2007.
It should be noted that scope of utilisation of a particular channel depends on objective (i.e. geography, natural resources, history etc.) and subjective factors (i.e. political system, culture, traditions, customs etc.).

One of the key groups of stakeholders consists of consumers who evaluate a given country from the perspective of the quality of products and services manufactured and delivered by this country’s businesses\(^{10}\). Product is the factor most easily associated with a given country. Tourism, human potential or housing conditions are not as powerful as the possibility to consume products available for everyone everywhere\(^{11}\). Buyers who do not dispose of full information about a product, take their purchasing decision on the basis of the country of origin of the product or brand taking into account its image and reputation. It is the so called country-of-origin effect, or made in...\(^{12}\). M. Hereźniak\(^{13}\) points out that globalisation processes trigger creation of the so called hybrid products whose country of origin is difficult to determine. Therefore, the country of origin effect could be explained as association of a given product or brand with one particular country which is the source of the product regardless of the fact where exactly the product was manufactured. In consequence, the country of origin concept can be replaced by the country of origin of the brand concept. For instance, Toyota which has its plants in Europe e.g. in Turkey, is still perceived as a reliable Japanese brand.

3. Indicators of a country’s reputation

Reputation of a business or a country is an aggregated assessment of an entity carried out by different groups of stakeholders from the perspective of their various expectations, demands and criteria. Reputation is then the effect of evaluation of many different aspects and areas of activity which can be called attributes of reputation. These areas are subject to evaluation within procedures of reputation assessment worked out by various institutions, research centres or consulting

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\(^{10}\) Caputa W., Kapitał klienta w budowaniu wartości przedsiębiorstwa, CeDeWu, Warszawa 2015, pp. 216-222.

\(^{11}\) http://szapiro.pl/produkty-kluczem-do-budowania-silnej-reputacji-krajow/


\(^{13}\) Hereźniak M., Marka narodowa: jak skutecznie budować wizerunek i reputację kraju, PWE, Warszawa 2011.
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agencies. One of the most popular methodologies of assessment of corporate reputation is a procedure used by Fortune magazine which since 1983 has been conducting annual opinion polls among executives and management specialists from various industries. The respondents evaluate businesses in the following areas: products/services quality, innovation, quality of management, long-term investment, social responsibility, people management, financial soundness, use of corporate assets, global competitiveness. For each area 11-point-scale is used. The obtained data when averaged produce Overall Reputation Score – ORS for each business.\(^{14}\)

As far as countries are concerned, Reputation Institute has been measuring their reputations rigorously since 1999. Indicators of countries’ reputation (so called Country RepTrak® Pulse) are calculated on the basis of 16 attributes within three groups (Image 3):

- effective government: safe place, ethical country, responsible participant in the global community, progressive social and economic policies, operates efficiently, favourable environment for business,
- appealing environment: friendly and welcoming, beautiful country, appealing lifestyle, enjoyable country,
- advanced economy: contributor to global culture, high quality products & services, well-educated and reliable workforce, well-known brands, values education, technologically advanced.

Evaluation of these attributes is conducted by residents of G8 group countries (France, Japan, Canada, Germany, Great Britain, Italy, the USA and Russia) who fill in an online questionnaire (CAWI). In 2016 58,000 respondents took part in the study.

Reputation indicators of a country are placed on the scoring scale from 0 to 100 and may be divided into the following categories:

- **Excellent** (score above 80),
- **Strong** (score 70-79),
- **Average** (score 60-69),
- **Weak** (score 40-59),
- **Poor** (score below 40).
Table 1. Reputation indicators for 10 best countries in the world in 2016 (according to Reputation Institute).

<table>
<thead>
<tr>
<th>2016 Country RepTrak®/Pulse</th>
<th>Effective Government</th>
<th>Appealing Environment</th>
<th>Advanced Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>78.34</td>
<td>Sweden 76.8</td>
<td>Canada 80.2</td>
</tr>
<tr>
<td>Canada</td>
<td>77.82</td>
<td>Switzerland 75.6</td>
<td>Sweden 79.4</td>
</tr>
<tr>
<td>Switzerland</td>
<td>77.00</td>
<td>Norway 75.1</td>
<td>Italy 79.1</td>
</tr>
<tr>
<td>Australia</td>
<td>76.84</td>
<td>Finland 74.6</td>
<td>Australia 78.5</td>
</tr>
<tr>
<td>Norway</td>
<td>76.18</td>
<td>Canada 74.4</td>
<td>Norway 78.2</td>
</tr>
<tr>
<td>Finland</td>
<td>75.16</td>
<td>Denmark 73.6</td>
<td>Switzerland 78.1</td>
</tr>
<tr>
<td>New Zealand</td>
<td>74.68</td>
<td>Netherlands 72.7</td>
<td>Ireland 77.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>74.25</td>
<td>Australia 71.6</td>
<td>Finland 77.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>74.11</td>
<td>Austria 71.2</td>
<td>New Zealand 77.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>73.90</td>
<td>New Zealand 70.7</td>
<td>Netherlands 76.0</td>
</tr>
</tbody>
</table>


As it can be seen, top positions are occupied by Scandinavian and island countries, these countries are well known for their neutrality and legal order. Countries with highest reputation scores are respected, above all, for lack of corruption, clean natural environment, high level of prosperity, well-being and friendly locals. Poland, with score 56.71, occupies 27th place which is between the USA (56.32) and Thailand (57.00). The United States achieve high scores in areas which are referred to as ‘rational’ i.e. advanced technology or strong brands made in America, but when it comes to ‘emotional’ categories such as trust, respect and admiration the score is rather weak. Out of all countries on the list as many as 71% received reputation score below average.

It is worth mentioning that countries with biggest population (China, India, the USA, Indonesia or Brazil) or these with the highest GDP (such as the USA, China, Japan, Germany or Great Britain) do not enjoy good reputation (Table 2). The 10 top countries are the least corrupted, most peace-loving countries and their people are the happiest in the world.
Table 2. Countries according to population, GDP, happiness, peace and corruption.

<table>
<thead>
<tr>
<th>No.</th>
<th>POPULATION</th>
<th>GDP</th>
<th>HAPPINESS</th>
<th>PEACE INDEX</th>
<th>LEAST CORRUPT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>China</td>
<td>USA</td>
<td>Denmark</td>
<td>Iceland</td>
<td>Denmark</td>
</tr>
<tr>
<td>2.</td>
<td>India</td>
<td>China</td>
<td>Switzerland</td>
<td>Denmark</td>
<td>Finland</td>
</tr>
<tr>
<td>3.</td>
<td>USA</td>
<td>Japan</td>
<td>Iceland</td>
<td>Austria</td>
<td>Sweden</td>
</tr>
<tr>
<td>4.</td>
<td>Indonesia</td>
<td>Germany</td>
<td>Norway</td>
<td>New Zealand</td>
<td>New Zealand</td>
</tr>
<tr>
<td>5.</td>
<td>Brazil</td>
<td>UK</td>
<td>Finland</td>
<td>Switzerland</td>
<td>Netherlands</td>
</tr>
<tr>
<td>6.</td>
<td>Pakistan</td>
<td>France</td>
<td>Canada</td>
<td>Finland</td>
<td>Norway</td>
</tr>
<tr>
<td>7.</td>
<td>Nigeria</td>
<td>India</td>
<td>Netherlands</td>
<td>Canada</td>
<td>Switzerland</td>
</tr>
<tr>
<td>8.</td>
<td>Bangladesh</td>
<td>Italy</td>
<td>New Zealand</td>
<td>Japan</td>
<td>Singapore</td>
</tr>
<tr>
<td>9.</td>
<td>Russia</td>
<td>Brazil</td>
<td>Australia</td>
<td>Australia</td>
<td>Canada</td>
</tr>
<tr>
<td>10.</td>
<td>Mexico</td>
<td>Canada</td>
<td>Sweden</td>
<td>Czech Republic</td>
<td>Germany</td>
</tr>
</tbody>
</table>


Due to strong dynamics of changes occurring both globally as well as locally, the reputation levels of countries fluctuate year to year. Some countries improve their reputation, others show a negative trend. In 2016, as compared to 2015, the following countries improved their reputation: France, Russia, Peru, Bolivia, Italy, Czech Republic, Portugal, Paraguay, Ireland, Iraq. The following countries, however, observed a fall in their level of reputation: Turkey, Saudi Arabia, Belgium, Greece, Nicaragua, Egypt, India, Ecuador, Morocco, the United Arab Emirates and Germany.

4. Benefits coming from good reputation

In case of businesses good reputation generates a number of tangible benefits such as: increase of revenues from sales, lower cost of capital, availability of the best workforce, smaller risk of conducting business activity etc. Companies with strong positive reputation achieve much better financial results\textsuperscript{15}.

\textsuperscript{15}Burke R. J., Martin G., Cooper C. L., Corporate Reputation. Managing Opportunities and Threats, Gower Press, London 2011, pp. 4-5.
The importance of reputation of a country...

In case of countries, their good reputation translates in many positive results in the area of economy, politics, society and culture. These benefits are reflected in activities and behaviour patterns of representatives of other countries both on the level of organisation (businesses, institutions, public administration organs), as well as natural persons (buyers, tourists, workers, students, residents). Consequently, friendly business environment attracts investors and entrepreneurs whose activities contribute to the development of regions and the whole country. New enterprises create new work places, fuel the national budget with taxes they pay, build infrastructure, pass on know how, disseminate new technological developments, come into cooperation with local suppliers etc. Attractive natural environment, traditions, cultural heritage, scientific centres, well-known products tempt tourists to visiting, consumers to buying national products, young people to studying, workers to looking for employment and settling down on long-term basis. Efficient management assuring peace, security, legal order, respect for the code of ethics, credibility of authorities and public institutions facilitates establishing diplomatic contacts and cooperation in many aspects and on many levels which may result in attracting international organisations to the country, hosting important international events etc. Benefits generated by key groups of stakeholders with respect to a country are shown in Table 3.

Table 3. Good reputation benefits generated by key groups of stakeholders.

<table>
<thead>
<tr>
<th>Stakeholders</th>
<th>Main benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors</td>
<td>• Invest in the region</td>
</tr>
<tr>
<td></td>
<td>• Recommend as investment</td>
</tr>
<tr>
<td></td>
<td>• Benefit of the doubt</td>
</tr>
<tr>
<td>Companies</td>
<td>• Invest in the region</td>
</tr>
<tr>
<td></td>
<td>• Do business in the region</td>
</tr>
<tr>
<td></td>
<td>• Recommend to others</td>
</tr>
</tbody>
</table>
### Stakeholders

<table>
<thead>
<tr>
<th>Stakeholders</th>
<th>Main benefits</th>
</tr>
</thead>
</table>
| People          | • Work in the city/country  
                  • Live in the region  
                  • Study in the city/country |
| Tourists        | • Visit the country/city  
                  • Recommend  
                  • Benefit of the doubt |
| Regulators      | • Recommend  
                  • Benefit of doubt  
                  • Support our activities |
| Media           | • Consult before writing  
                  • Use as case story  
                  • Benefit of the doubt |
| Opinion makers  | • Engage in dialogue  
                  • Recommend  
                  • Benefit of the doubt |


As it can be clearly seen, the benefits resulting from good reputation are not only the effect of activities of particular groups of stakeholders but come from attitudes towards others and dissemination of positive opinion about a country, recommending its merits and values. The foundation of these behaviour patterns is trust the stakeholders put in a given country, its authorities and citizens.

### Conclusions

Dynamic changes in economic, social, political and cultural life trigger growth of importance in the process of building a competitive position not only of businesses or other organisations or persons but also of nation states. The reputation of a country is a multi-faceted assessment made by internal and external stakeholders on the basis of their own experiences and opinions as well as experiences of others. The reputation determines behaviour patterns, attitudes and activities of particular groups of stakeholders with respect to a given country. Good reputation
The importance of reputation of a country...

attracts investors, talented workers, tourists, consumers, scientists, artists etc., what in turn contributes to development and improves competitive advantage on the international arena. As a consequence, governments and representatives put in every effort to facilitate positive perception of their country through emphasizing its merits and values. International organisations such as the Reputation Institute, measure reputation of countries taking into account various factors and attributes which are pertinent to three crucial areas: efficiency of the government policy, attractiveness of natural environment and cultural heritage as well as the level of the national economy and its contribution to the development of the global economy.

Literature

[17.] Szwajca D., Ryzyko reputacji jako wyzwanie dla menedżerów w erze globalizacji, ‘Organizacja i Kierowanie’ no 14/2014 (164).
FACTORS DETERMINING RATING BASIS OF LOCAL GOVERNMENT UNITS

Summary
The need to obtain information regarding credit rating of entities, both public and private was the reason for rating agencies development. A worldwide rating market is characterised by a dominance of the largest international agencies, including: Standard & Poor’s, Moody’s and Fitch. Rating is one of the tools increasing the competitiveness of a local government unit. The purpose of this study is to present the nature of rating as well as rating criteria of local government units employed by rating agencies.

Key words: rating, rating agency, local government units
JEL Classification: G24, H74

Introduction
The scope of tasks imposed on local government units as well as limited financial resources of entities, resulted in the necessity to seek external financing. So—acquired capital is most often allocated to investments financing, primarily the long-term ones. Information regarding a local government unit condition enabling use of the tools are ratings – assessments made by rating agencies.

The basic task of rating agencies is to collect, analyse and evaluate information concerning credit rating, thus solvency. A rating agency is an investment consulting company, defined as legal entity, whose main area
of activity refers to issuing credit ratings, that is creditworthiness of an investigated entity.\(^1\) The purpose of agency development was to enhance transparency in a market and facilitate investors an access to an independent evaluation.

A credit rating system is employed in different sectors of the economy due to versatility and various types of methodology including the specific nature of entities or issue of securities. Rating may be applied to:\(^2\):

- countries,
- local government units,
- insurance companies,
- financial institutions (e.g. banks and investment funds),
- industries,
- enterprises,
- mortgage bonds,
- bonds, including income bonds.

A research literature defines rating as an assessment and investment risk classification system\(^3\). Other definition refers to rating as comprehensive creditworthiness of an issuer or an assessment of the issuing, considering specificity and accuracy of an issuer in compliance with past commitments as well as a projection of future financial standing, and an analysis of all types of risk connected with the investment\(^4\). Simplifying the second definition, it may be stated that rating refers to an opinion concerning a possibility of debt repayment by a particular entity. The essence of rating relates to the fact that a study includes historical data, however rating itself refers to debt service made by an issuer, or a lender in future, thus it is targeted at future events\(^5\).

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1. Rating agencies and applicable rating scales

Rating background dates back to the first half of the nineteenth century, with the introduction of rating in 1909, when John Moody published the first bond rating using a proprietary method of issuers credit rating in a form of the universal letter code, which has become a global standard over the years. Such way of a synthetic view presentation was positively accepted by market participants, since it was based on the assumptions that a quality and accuracy of the analyses are the result of high competence level of entities (specialists) involved in analyses preparation as well as their independence and objectivity.

A worldwide rating market is characterised by a clear dominance of the largest international agencies\(^6\), including:

- Standard & Poor's Rating Services (Standard & Poor’s or S&P)\(^7\),
- Moody's Investors Service Inc. (Moody’s)\(^8\),
- Fitch Ratings Ltd. (Fitch)\(^9\).

It is estimated that the three largest agencies so called 'the Big Three' hold over 90% of a global market regarding the service: S&P – 40%, likewise Moody’s and Fitch about 15%.\(^10\) Total revenues of all the above agencies approached USD 6 000 billion in 2014 (Figure 1 illustrates global market share of rating agencies in 2015).

Polish rating agencies hold a short history. CERA S.A. (the Centre of Analyses and Rating) was established as first in Poland and Central and Eastern Europe in 1996 acting on the Polish Bank Association initiative. The Agency was responsible for businesses, local government units, and financial institutions assessments. However, the demand for services performed by a local agency appeared to be lower than it was expected at

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\(^6\) Rating agencies operating on an international market include, inter alia: A.M. Best Company Inc., Japan Credit Rating Agency Ltd., Dominion Bond Rating Service Ltd. of Canada, Rating and Investment Information Inc. of Japan, Egan-Jones Ratings Company, LACE Financial Corp., Realpoint LLC.

\(^7\) The company Standard & Poor's started activity in 1860 with a publication of financial statistics - currently it belongs to McGraw Hill Companies.

\(^8\) Moody's Investors Service was created in 1900 as John Moody & Company - currently it is a part of Moody's Corporation.

\(^9\) Fitch Ratings was founded in 1913 as Fitch Publishing Company - currently it is a part of Fitch Group Company.

\(^10\) I. Bobrek, Działalność agencji ratingowych na przykładzie sektora publicznego w Polsce, Scientific Journal ZPSB Firma i Rynek 2016/1, p. 44.
the moment of establishing; within five years of activity the agency published 15 ratings. In 1998 an American agency Thomson Financial BankWatch (TFBW) became the company's strategic investor, which in 2000 was taken over by Fitch Ratings Ltd. In 2001, due to global market takeovers, CERA SA. lost its sole local nature and became a part of an international concern Fitch Ratings Ltd. Whereas since 2007 the EuroRating, Rating Agency has worked, responsible for enterprises and financial institutions credit ratings, including banks operating in the area of Central and Eastern Europe.

**Figure 1. A share in a rating market of selected agencies in 2015**

![Pie chart showing percentage of rating agencies](image)


Credit rating issued by rating agencies - is regarded as a primary cause of their success. Categories prepared by agencies provide fast information concerning a condition of a given enterprise or country, thus

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12 The Agency does not deal with credit rating of local government units, but publishes credit rating of entities subsidiary, leading a guarantee activity. [http://www.eurorating.com/](http://www.eurorating.com/)
saving investors time it would have to be spent for in-depth analysis of International Monetary Fund reports. A rating scale employed by most agencies relies on letters (where A refers to the highest grade, and D respectively to the lowest)\footnote{A. Sarnik-Sawicka, \\Wpływ działalności międzynarodowych agencji ratingowych na stabilność systemu finansowego [in:] Rola międzynarodowej współpracy finansowej w tworzeniu norm i regulacji ostrożnościowych zabezpieczających stabilność systemu finansowego, J. Zabińska (ed.), AE, Katowice 2010, p. 79.}. Additionally, a grade is completed by modifiers – numbers (1,2,3 e.g. Mood’s) or signs (+) and (-) (e.g., Fitch and Standard & Poor’s) - to further fine-tune the rating. Moreover, a forecast of changes for upcoming years is presented. A favourable rating outlook indicates the possibility of rating upgrading, negative rating – rating downgrading, whereas stable – upgrading or downgrading.

While rating, securities symbols are diversified. In bonds rating system there are two levels: investment and speculative, however four groups of rating are used, from AAA to D (it was necessary to extend rating scale due to a financial market development). In both classifications, of Moody's Investors Service, and Standard & Poor's, a definition of 'high grade' means lower credit risk, thus a high probability of obligation repayment. The first four levels: AAA, AA, A and BBB are regarded as investment securities, where debts, interest and additional benefits are to be regulated on time. Securities classified as BB are regarded as speculative; a C category is perceived as income bonds, however payment of interest depends on a possible corporation profit. Bonds verified as D are extremely risky, and reclaiming of the capital invested may be possible in case of an enterprise liquidation\footnote{C. A. Frost, \\Credit rating agencies in capital markets: a review of research evidence on selected criticisms of the agencies, State University of New York at Buffalo, June 2006, p. 25.}. A rating system used by leading rating agencies has been presented in Table 1.

Initially, it was presumed that rating agencies would act as independent, objective guardians of investors' money, but over time and due to outbreaks of further crises and bankruptcies\footnote{An interest in rating agencies activity and ratings issued particularly intensified after the financial crisis outbreak in 2008. Findings after the crisis cause analyses were used to implement new law regulations both in EU, as well as outside EU. In 2011 EU established an organisation European Securities and Markets Authority (ESMA), which since July 2015 has directly supervised registered rating agencies.} resulting from...
creative accountancy and weaknesses of legal solutions, serious doubts have been raised concerning the functioning of rating agencies.\(^{16}\)

<table>
<thead>
<tr>
<th>Level</th>
<th>RATING AGENCIES</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fitch</td>
<td>Mood’s</td>
</tr>
</tbody>
</table>
| Investment | AAA | Aaa | AAA | • prime bonds rating,  
|          |     |     |     | • zero default risk, |
|          | AA  | Aa  | AA  | • prime bonds rating,  
|          |     |     |     | • obligor’s capacity to meet financial  
|          |     |     |     | commitments, instalments and  
|          |     |     |     | interests is extremely strong, |
|          | A   | A   | A   | • high repayment credibility,  
|          |     |     |     | • risk of lowering beneficial features  
|          |     |     |     | of investment, |
| Speculative | BBB | Baa | BBB | • medium bonds rating,  
|          |     |     |     | • deficient grade of some issuance  
|          |     |     |     | components, |
|          | BB  | Ba  | BB  | • medium debt protection,  
|          | B   | B   | B   | • insufficient guarantee of financial  
|          |     |     |     | commitments, instalments and interests, |
|          | CCC | Caa | CCC | • low issuance grade,  
|          | C   | Ca  | C   | • extremely speculative issuance,  
|          |     |     |     | • substantial repayment risk |
|          | DDD | C   | DDD | • extremely risky bonds (junk bonds)  
|          | DD  | DD  |     | • default imminent |
|          | D   | D   |     |     |


2. Rating of local government units and rating characteristics

Local governments' entrance to a capital market was possible due to records enclosed inter alia in the European Charter of Local Self-Government. Two basic elements determine a rating issuance of local government units. Firstly, a lack of possibility of bankruptcy by local government bodies - a special character of tasks provided by the organs requires a guarantee of constant and uninterrupted activity within a field of public utility; entities operate regardless of their financial condition and a potential insolvency of the entities may not result in their liquidation. Secondly, there is a rule stating that a financial credibility of a unit cannot be higher than credibility granted to a country thus country rating influences a unit rating. However, there are possible exceptions from the rule – for example the Fitch agency allows a situation when a local government unit of high legal and fiscal autonomy, may receive higher rating than national one. Though regarding Poland, the agency definitely emphasises that a decentralisation process causes a frequent changes of tasks performed by local governments, which results in unfavourable influence on their budgets, as usually resources transferred to fund new tasks are insufficient. A fast growth of payroll expenses, primarily due to government decisions concerning the increase of salaries in education without proper funding results in a pressure on local government budgets and an increase in fixed expenditures in their budgets.

The first rating for a local government unit was issued in 1997 by Standard & Poor's agency – it was granted to Łódź, and in the same year to Kraków. In 1998 Wrocław and Szczecin were rated, in 2000: Gdańsk and Bydgoszcz. The first ratings obtained by large towns reached

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19 Otoczenie prawne samorządów w Polsce, Special Report, www.fitchratings.com
investment grade, meaning the ability to regulate long-term commitments, however a negative outlook indicated a possibility of rating downgrading due to economic or political changes.

For almost ten years, Poland ratings have been maintained at a relatively constant or increasing level. However, in January 2016 rating downgrading took place by Standard&Poor’s agency, from a previous 'A-' 'BBB+'\(^{20}\). Consequently, in case of Kraków a creditworthiness dropped from 'A-' to 'BBB+' (Standard & Poor's), additionally the outlook was changed to negative.\(^ {21}\) Table 2 presents rating for selected towns in 2016.

<table>
<thead>
<tr>
<th>Town</th>
<th>Grade</th>
<th>Rating outlook</th>
<th>Rating agency</th>
<th>Date of rating confirmation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bydgoszcz</td>
<td>BBB+</td>
<td>stable</td>
<td>Fitch</td>
<td>09.09.2016</td>
</tr>
<tr>
<td>Chorzów</td>
<td>BB+</td>
<td>stable</td>
<td>Fitch</td>
<td>30.07.2016</td>
</tr>
<tr>
<td>Kraków</td>
<td>BBB+</td>
<td>negative</td>
<td>Standard&amp;Poor’s</td>
<td>21.01.2016</td>
</tr>
<tr>
<td>Łódź</td>
<td>BBB+</td>
<td>negative</td>
<td>Standard&amp;Poor’s</td>
<td>22.01.2016</td>
</tr>
<tr>
<td>Szczecin</td>
<td>BBB+</td>
<td>stable</td>
<td>Fitch</td>
<td>15.07.2016</td>
</tr>
<tr>
<td>Warszawa</td>
<td>A2</td>
<td>negative</td>
<td>Moody’s</td>
<td>17.05.2016</td>
</tr>
</tbody>
</table>


In a presented ranking, Warszawa, Katowice and Gdańsk have the best rating. Warszawa, like Katowice, owe favourable financial results to companies that pay income tax where there is the main headquarter. CIT (Corporate Income Tax) constitutes a very large part of local governments income in big towns. Due to this fact, Warszawa possesses a relatively low debt, moreover Warszawa's authorities rationally


Factors determining rating basis of local government units

determine the investment tasks. In case of Gdańsk, high rating was guaranteed by positive operating results and strong operation and debt repayment ratios in the medium term. Gdańsk rating also illustrates proper strategic and financial management, together with right operation results ensure a town a high ability to fund investments of own resources.

3. Rating criteria of local government units employed by rating agencies

Local government rating is formed as a result of detailed analysis, based on extensive sets of micro- and macroeconomic information. While evaluating the economic condition of an examined subject, rating agencies primarily analyse five basic factors which constitute a basis for credit rating of local government unit. The following elements are examined (Chart 2): institutional, administrative, social, economic and budget factors, an organisational structure and management, as well as a financial analysis and subject debt are executed.

Chart 2. Basic rating areas of local government units

Source: own description

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22 Warszawa with a negative rating outlook. It was first time rated so low by Moody’s, 17.05.2016, http://businessinsider.com.pl/finanse/rynek/moodys-obnizyl-perspektywe-ratingowa-dla-warszawy-i-poznania/lzync8p

An analysis of presented areas requires a detailed study which includes inter alia elements listed in Table 3.

### Table 3. A detailed analysis of rating areas of local government units

<table>
<thead>
<tr>
<th>Institutional and administrative factors (Standard &amp; Poor’s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- a presentation of main objectives of state and local policy,</td>
</tr>
<tr>
<td>- a development of employee relations in a public sector, a number of employees, personnel costs,</td>
</tr>
<tr>
<td>- an influence of public administration reforms on a town, particularly relations with the remaining levels of state and local government</td>
</tr>
<tr>
<td>- a state budget influence on a town budget, particularly an amount of state subsidies</td>
</tr>
<tr>
<td>- a state government policy relative to a local government policy</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Social and economic factors (Standard &amp; Poor’s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- all economic aspects including comparison to other big towns in Poland</td>
</tr>
<tr>
<td>- value added, investments and an employment by economic sectors</td>
</tr>
<tr>
<td>- restructuring and privatisation of local economic activity</td>
</tr>
<tr>
<td>- listing of the biggest employers in a town, including average salaries</td>
</tr>
<tr>
<td>- infrastructure projects (local transport, schools, hospitals, public nursing homes, sewage treatment plants, etc)</td>
</tr>
<tr>
<td>- external trade relations</td>
</tr>
<tr>
<td>- EU accession influence on local economy</td>
</tr>
<tr>
<td>- GDP in the last 3 years, and the future prospects, GDP per capita</td>
</tr>
<tr>
<td>- economic growth including sectors</td>
</tr>
<tr>
<td>- unemployment rate and future developments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Organisational structure and management:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Town organisational structure and distribution of competences</td>
</tr>
<tr>
<td>- employment structure</td>
</tr>
<tr>
<td>- changes in the composition of the City Council over the last 2 years including political parties</td>
</tr>
<tr>
<td>- the main disputable issues between the present authorities and the opposition</td>
</tr>
<tr>
<td>- relations with central authorities and other levels of government and local authority (political environment description)</td>
</tr>
<tr>
<td>- a division of authority amongst political and administrative parties</td>
</tr>
</tbody>
</table>
Factors determining rating basis of local government units

<table>
<thead>
<tr>
<th>Budget factors and financial analysis:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• a budget implementation, revenues and expenses analysis in the last years</td>
</tr>
<tr>
<td>• budget objectives for the next year and current budget execution</td>
</tr>
<tr>
<td>• income flexibility: tax policy, state subsidies</td>
</tr>
<tr>
<td>• the main expenses areas: education, health, social care, investments, the influence of new financing of health care system on town financial condition</td>
</tr>
<tr>
<td>• major investment projects and opportunities to obtain funding</td>
</tr>
<tr>
<td>• changes in the Accountancy principles and their impact on a budget and financial situation</td>
</tr>
<tr>
<td>• expenses flexibility over the short- and long- term</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subject debt analysis:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• management of budget provisions</td>
</tr>
<tr>
<td>• liquidity policy and funds management</td>
</tr>
<tr>
<td>• an analysis of a current and future credit and loans demand</td>
</tr>
<tr>
<td>• a current level of gross debt and future plans</td>
</tr>
<tr>
<td>• present and future debt structure (credits, loans, bonds,)</td>
</tr>
<tr>
<td>• debt service (interest rate and depreciation)</td>
</tr>
<tr>
<td>• urban companies debt</td>
</tr>
<tr>
<td>• an analysis of changes in shareholding and entity debt</td>
</tr>
<tr>
<td>• General measures of credit risk (Fitch):</td>
</tr>
<tr>
<td>• the main amount of debt compared to local GDP of an entity</td>
</tr>
<tr>
<td>• the main amount of debt per capita</td>
</tr>
<tr>
<td>• the main amount of debt compared to market value of the assets , subject to taxation</td>
</tr>
<tr>
<td>• the percentage share of debt service costs concerning current income and annual operational expenditure</td>
</tr>
<tr>
<td>• the percentage share of pension liabilities in current operational expenditure</td>
</tr>
<tr>
<td>• debt ratio to fixed assets</td>
</tr>
</tbody>
</table>


While conducting a detailed analysis concerning institutional and administrative factors, the importance in relations: state- self- governance assigned by rating agencies can be observed. Investigation of such issues as an influence of public administration reforms on a town, or the Government policy relative to Self- Government, indicates that Self-Government is perceived as an element of a whole system of public institutions. Consequently, following the idea that a rating of a subordinate institution cannot be higher than the one of a superior's institution – in this case Poland.
Analysing social and economic aspects, the qualitative factors influencing the income level (a list of the major employers, investments and employment, external trade relations) and costs (infrastructural needs, unemployment rate) are investigated among other things. Comparison of these factors with data concerning other Polish towns is also essential as it illustrates changes and indicates a development direction.

A significant element of an assessment is the organisational structure of the rated entity as well as its management, at this point relations State-Self- Governance, political surroundings, changes in the composition of the City Council, including political parties, or disputes taking place between the present authorities and the opposition are analysed among other things. A local government undertakes tasks of an important social significance, designed to meet expectations and needs of a local community. The activity should be reasonable and logical because the local government has the best understanding of the needs and expectations of the local community.

Another rating area refers to budget factors and financial analysis - the study includes an analysis of variables such as:

- budget results,
- self-financing capacity of assets expenditures,
- operational results.

The data obtained are a starting point for the most crucial part of a research, that is an analysis of an entity debt. A debt management concerning a local government unit can be defined as all of the activities connected with an acquisition, service and repayment of debt. The main objectives of a debt management are24:

- tasks funding, which lack of financial resources within a local government unit income,
- minimisation of financial risk ,
- minimisation of costs connected with debt use by a local government,
- minimisation of liquidity risk and a local government unit insolvency.

A long-term investment programme and a long-term financial planning are instruments to facilitate the management of assets. Guidelines enclosed in the programmes should be a result of a strategy employed by a local government unit - a long-term action plan. A weight

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Factors determining rating basis of local government units

of rating debt analysis is significant as far as a local government financial management is concerned, because development prospects are far more essential than a properly designed annual budget.

Issuing of reliable rating requires a detailed analysis of the following: institutional and administrative aspects, social and economic factors, budget, debt structure and dynamics. The above factors - supplemented by analysis of an institutional and administrative surroundings - are mutually interactive thus rating considerably is far beyond the ranks of traditional financial analysis. The most essential rating element is debt analysis – it is due to the fact that debt ratios have definitely the largest impact on determining the development prospects and unit capacity to repay the financial obligations on due dates.

Conclusions

While preparing rating, rating agencies analyse qualitative and quantitative results, thus try to examine and evaluate future development of a given entity. Rating criteria employed by rating agencies are commonly well known and differ only slightly. However, rating agencies do not reveal accepted weight of particular factors, therefore the clarity of rating is clearly limited. Obtaining rating gives measurable benefits, however is not without disadvantage. The following elements are regarded as beneficial due to credit rating:

- an effective and objective comparative instrument,
- a clarity of rating grade due to standardised scale,
- an assessment and projection of financial situation,
- a risk management tool and risk communication functions,
- building an image and the investment credibility,
- a factor motivating local government bodies,
- an incentive for potential investors – increased interest in local governances,
- a possibility to obtain a competitive advantage,
- an instrument to improve a negotiation situation of a local government unit with a credit institution (bank) – an opportunity to obtain a capital at lower costs,
- an objective evaluation of entity's capacity to meet obligations.

In turn, the disadvantages include:

- a high price,
- a complexity and time-consuming of a rating process,
- a lack of guarantee for investors concerning refund of contribution and obtaining expected profit,
- ex post analysis,
- a schematic evaluation, not taking into account local governments characteristics.

Despite numerous advantages, rating of local government units in Poland loses its meaning. In 2011 31\(^{25}\) towns held it, and in 2014 just 19\(^{26}\), it means that in practice rating is neither commonly regarded as a method to success nor a way to introduce local governments into area of international standards of finance management. External rating is taken into account by banks issuing credits (e.g. the European Investment Bank), or dealing with organisation of municipal bonds issuance. Rating assesses a capacity of a given local government unit to meet obligations, such as loans, or bonds, therefore high rating grade also enables negotiating for more favourable interest rates. It should be noticed that if a local government is a subject to external, independent rating, it proves its credibility, and clarity of financial situation, thus increases potential customers' trust.

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[1.] Bobrek I., Działalność agencji ratingowych na przykładzie sektora publicznego w Polsce, Scientific Journal ZPSB Firma i Rynek 2016/1.
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\(^{25}\) https://www.obserwatorfinansowy.pl/forma/rotator/rating-miasto-kryteria-samorzad-kryteria-koszty/

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Tomasz GRZEGORCZYK*

QLUALIFICATION OF COMPUTER GAMES
IN COPYRIGHT LAW

Summary
The aim of the paper is to discuss different options for qualification of computer games into appropriate category of copyright. The qualification is essential due to considerable differences between various protection regimes which emphasizes practical aspect of the issue. Difficulty in classification of computer games results from their specific structure which consists of software (computer programme) and audiovisual presentations. Some of the possible options include qualification of computer games as software or audiovisual work but other solutions are also taken into account such as: unnamed work, multimedia work or a completely new category of work. Due to the absence of Polish jurisdiction in this matter and insufficient research body it was necessary for the author to reach for foreign experiences and doctrine.

Key words: copyright law, computer games, multimedia works

Introduction
Back in 1981 a single computer game Pacman generated over a billion of dollars of revenue. In 2014 the market of computer games in Poland, according to a survey conducted by PwC, amounted to nearly 1.5 billion PLN; it is forecasted that by 2019 it will grow to 2 billion PLN. The Polish computer games sector consists of 150 businesses and 6000 employees, and Polish games are among very few products made in Poland to be found on the shelves of retail outlets all over the globe. It can be assumed, that in the turnover there is a large number of contracts

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2 M. Gawrychowski, Kowalski mocno trzyma się komputera, Puls Biznesu (02 July 2015), p. 6.
3 M. Gawrychowski, Polskie gry okrzepły, Puls Biznesu (30 September 2015), p. 4.
relating to computer games, and it is just a matter of time when lawsuits with respect to them will commence. Moreover, the existing uncertainty with respect to the scope of protection of computer games hinders development of this sector in Poland.

The difficulty of classifying computer games into appropriate category results from their peculiar structure. On one hand computer games are based on a computer programme which is the *engine* of the game, on the other, the key role is played by audiovisual presentations displayed to the gamer in the course of the game. What is more, the multi-layer structure of games and multiplicity of creative inputs inclines some representatives of the doctrine to classify them as multimedia works\(^4\). Due to the absence of Polish judicature on the topic and scarce body of research it was necessary to reach for foreign experiences and doctrine.

The paper attempts at classifying computer games into appropriate copyright category. Correct classification is vital due to considerable differences between particular protection regimes such as: permissible use, copyright holder, author’s moral rights, fields of exploitation or co-authors rights. The paper also touches upon the issues of individuality and originality prerequisite with respect to computer games as well as objective scope of protection.

1. **The notion of computer game**

There is no legal definition of a computer game. The dictionary of Polish language defines it as: ‘a game played on the computer screen’\(^5\). A game, in turn, is defined as: ‘a parlour entertainment conducted in accordance with certain rules’\(^6\). Thus, it may be assumed that computer games are different from other kinds of games (such as board games or card games) because they rely on software, which assures their functioning on a computer\(^7\). Computer games unlike computer programmes, which serve utilitarian aim, have educational and amusing character. Audiovisual images are displayed in real time as the result of

\(^4\) If it is not possible to classify them into any existing category, D. Flisak, *Utwór multimedialny w prawie autorskim*, Wolters Kluwer SA, Warszawa 2008, pp. 135-144.

\(^5\) The Polish Language Dictionary PWN, sjp.pwn.pl (as of 28 March 2015).

\(^6\) Ibidem.

commands issued by the player. There are many kinds of computer games, this fact however, does not influence their copyright protection in any way. What is only emphasized, is that the genre of the game may impact creative freedom of the process of its development\textsuperscript{8}.

2. Computer game as a work of authorship

Pursuant to Article 1 of the Act on copyright and related laws\textsuperscript{9} in order for a creation of intellect to become a work of authorship the following premises must be fulfilled: it must be the manifestation of creative activity of a human being (originality prerequisite) of individual nature and it must be established. A computer game, undoubtedly is a creation of a human being even though it takes a number of computer programmes to develop. The computer programmes are nothing more than tools in the hands of the creator and as such do not impact the rights of a copyright holder contrary to works generated by computer\textsuperscript{10}.

The individuality and originality prerequisite should be considered in a similar manner as other types of work. The characteristics determining individuality of a work can be found in the context of differences with respect to other similar works, in accordance with the individuality prerequisite in an objectified manner\textsuperscript{11}. The originality prerequisite, on the other hand, will be fulfilled when a subjectively new creation of intellect is born\textsuperscript{12}. On top of that I. Matusiak claims that individuality prerequisite can be found in differences between the way of expression of computer games, taking into consideration the category (e.g. strategic game, simulation game) to which a given game belongs. The main differences for that matter would be the presentation of visual and aural effects\textsuperscript{13}. Furthermore, one can look for signs of creative activity in the way of combining individual creative outputs. Due to a large number of

\textsuperscript{8} Ibidem, p. 52.
\textsuperscript{13} I. Matusiak, op. cit., pp. 176-189.
many kinds of creative outputs (visual representations, images, music, written word) and multiplicity of possibilities of their combinations, fulfilling the individuality prerequisite by a computer game understood as a whole should be fairly easy. It can be assumed that vast majority of computer games are works of authorship. It should also be noted that integrity and inseparability of constituents of a game is justified by the statement that computer games can be considered as a whole, not just a set of individual constituents.\textsuperscript{14}

3. Possible protection variants

The analysis of multimedia works presented above showed that it is necessary to determine such a protection regime that would be appropriate for a very unique creation of human intellect whose process of development is complicated and takes an army of representatives of different walks of life, producers, editors etc. This unique creation is, of course, a computer game.

It must be emphasized that for each respective creative output different regulations may be applied.\textsuperscript{15} There are some categories of works, however, which require an extraordinary regime; in these cases the copyright to the programme as a whole must be determined. It is especially important in determination of rights that can be attributed to the entities taking part in the process of development of computer games and with respect to the issue of permissible use. J. Barta and R. Markiewicz propose that in case of computers games the following may apply:

- general legal provisions of copyright or
- provisions applying to a category of work of the biggest similarity to a computer game (be it a computer programme or audiovisual work) or
- jointly all provisions for various categories of works that are included in a given computer game or
- apart from general provisions also detailed regulations concerning an element of a work inextricably linked to a game e.g. software.\textsuperscript{16}

\textsuperscript{14} Ibidem.
\textsuperscript{15} J. Barta, R. Markiewicz, Prawo autorskie, p. 302.
\textsuperscript{16} Ibidem, p. 301.
Polish judicature is rather poor when it comes to court decisions with respect to computer games, therefore the experiences of other countries will be cited therein. In Germany, for example the EU law was harmonized by the Software Directive\textsuperscript{17} and Directive 2001/29\textsuperscript{18} and it is based on legislation in force similar as in Poland. The American judicature, despite major differences between civil and common law, was the first to adjudicate in precedent cases. It also offers the most extensive material whose elaboration helps to understand the reasoning of courts in such cases.

4. Classification of computer games in American judicature

In the USA computer games can be classified into two categories: audiovisual works or computer programmes protected as literary works. It is recognised that for respective constituents of computer games separate provisions of copyright law may be applied and that these constituents may be protected separately; this was already proved by the very first court decisions with respect to computer games back in 1980s\textsuperscript{19}. The more recent outlook of American courts on the matter in question is reflected in the decision issued in 2012 regarding a famous computer game Tetris, in the case Tetris Holding, LLC v. Xio Interactive, Inc\textsuperscript{20}. The defendant had created a clone of Tetris, copying almost all of its audiovisual representations generated by the game which make up graphic user interface. However, the code of the game had not been copied. Xio explained that only such elements of the game were copied which were not covered by the copyright i.e. rules, functions and


expressions indispensable for the interface for a game of this kind. Their arguments invoking the doctrines of merger and scènes à faire did not convince the court\(^\text{21}\) who observed that audiovisual representations generated by the game Tetris and its clone are indistinguishable for an average user. In order to develop a game based on the same concept as Tetris, Xio could have created its visual representations in several different ways each one consistently different from its original. As the consequence, the court ruled infringement of copyright and stated that graphic user interface of the game is subject to protection under copyright in the same manner as audiovisual works\(^\text{22}\) and such an interpretation must be considered predominant all over the United States.

5. Classification of computer games in German judicature

German judicature emphasizes differences in the protection of the programming layer and audiovisual layer of representations\(^\text{23}\). The first layer is subject to protection pursuant to regulations relevant for computer programmes. While representations of a game on the screen may be protected as a film work which is the German equivalent to Polish audiovisual work (\textit{Filmwerk}, §2 subparagraph 1 point 6 \textit{Urheberrechtsgesetz}\(^\text{24}\)). Furthermore, the category \textit{Laufbild} (moving pictures) is also taken into account pursuant to §95 UrhG. It is a very important classification in German law, it refers to a work similar to audiovisual work but with lesser requirements with respect to fulfilment of the creativity prerequisite and narrower scope of protection. As regards a single frame of a computer game it may be covered by protection under \textit{Lichtbildwerk} i.e. photographic work\(^\text{25}\). Another option

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\(^{21}\)In accordance with doctrines \textit{merger} and \textit{scènes à faire}\(^\text{21}\) elements of computer games are not protected in case of ideas which are too tightly merged with the form of expression or due to the fact that a given idea may only be presented in one way (\textit{scènes à faire} – an obligatory scene). It results from the fact that copyright does not protect ideas and thoughts because their monopolisation would mean unjustified intervention in competitiveness and would hinder innovativeness.


\(^{24}\)Gesetz über Urheberrecht und verwandte Schutzrechte of 9 September 1965 as amended; gesetze-im-internet.de/urhg/; as of 28 March 2016.

\(^{25}\)§2 item 2 point 5 UrhG.
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is *Lichtbild*\(^{26}\) which refers to photographs of more technical nature\(^{27}\). German literature also emphasizes difficulties in separating software and audiovisual layers and considerable differences in their respective protection\(^{28}\).

Initially, German judicature rejected the possibility of classification of computer games as film works. In cases of *Donkey Kong Junior I* and *Parodius* it was being argued that such protection only applies to a sequence of moving pictures which is uniform and unchanged\(^{29}\). Whereas in a computer game the changeability of presented visualisations is indispensable for maintaining interactivity; these visualisations are generated on the screen individually for each player as the result of their activity.

With time the initial approach changed (decisions with respect to *Puckman*, *Donkey Kong Junior III* and *Amiga-Club*). The new starting point for copyright protection became exclusively visual representations regardless of the fact whether they are just a reproduction of a previously made sequence of picture or these pictures are generated by a computer programme\(^{30}\). Moreover, the number of possible sequences which can be displayed to the player is limited by the creators of the game. Thus, it can be assumed that in German law computer games have dual nature; they may be treated as either film work or a computer programme depending on the layer of the work under evaluation.

6. **Computer game as an unnamed work**

American and German doctrine and judicature by focusing on separate creative outputs in computer games do not offer a uniform answer to the question regarding the status of a game a whole. As the

\(^{26}\) §72 UrhG.


consequence, it is necessary to analyse possible classification in the Polish copyright law.

One of the supporters of classification of multimedia works, including computer games as unnamed works is D. Flisak. Such qualification means that computer games are not assigned to any category of work listed in Article 1 of the Act on copyright and related laws. It is possible because Polish copyright law includes an open catalogue of works which assumes protection for all established works created by a human being which are a manifestation of creative activity of individual nature. The benefit of such a solution is that extensive multiplicity and variety of multimedia works could be covered by copyright protection in the most optimal way.

Exclusion of computer games understood as a complete entirety from special protection regimes reserved for audiovisual works and computer programmes, could have far-reaching consequences. Resignation from the regime of audiovisual works would be contrary to the interests of producers of computer games as it rejects the specificity of computer game development process which is very similar to the process of creation of multimedia works. On the other hand, allowing for permissible personal use to be excluded in case of computer programmes (Article 77 of the Act on copyright and related laws), because of the ease of dissemination of computer games by their users due to their digital character, would generate considerable losses for their producers because production of games would become practically unprofitable. Certainly, such a solution would find advocates among many users of computer games. Although copyright ought not to focus only on the interests of creators, trying to satisfy the users’ interests here would be unreasonable. Therefore, such classification does not take into account specifics of computer games and for this reason it must be rejected.

7. A computer game as a computer program

A computer program is undoubtedly a basis for a computer game and its integral component. I. Matusiak points out that in technical terms a program is a dominant game element. However, it is not true for

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31 If they cannot be assigned to one of the existing categories. D. Flisak, *Utwór multimedialny w prawie autorskim*, Wolers Kluwer SA, Warszawa 2008, pp. 135-144.
32 Ibidem, p. 142.
a game user who comes in contact with audiovisual layer. Besides, the whole work cannot be qualified only on the basis of its part.

One should also take into account that computer programs are protected in accordance with Article 74 paragraph 1 of the Act on copyright and related rights, as literary works and are included in works expressed in text, mathematical symbols, pictures and graphics, what actually means that only code elements are protected. Therefore, in accordance with provisions concerning special protection regime of computer programs, only a part of a code describing game visual presentations and enabling a code operation would have been protected, but not just the visual, graphic presentations.

Graphical user interfaces are visual presentations generated by a program, enabling an interaction with a program user (the so-called look&feel). It should be noticed that computer games visual layer could have been recognized as a type of a graphical user interface. Against the qualification considered, is the judgement of the Court of Justice of the European Union (TSUE) in case C-393/09, where it was found that graphical user interfaces are not a form of expression of a computer program and do not use the special protection regime.

The Court of Appeals in Paris also considered the classification of computer games as programs, in case Sesam v. Cryo. It was rejected due to classification of computer games as multimedia works. However, it does not prevent from employing a special regime provided for computer programs directly to a game software layer.

8. A computer game as audiovisual work

J. Barta and R. Markiewicz define audiovisual works as works which constitute series of images causing impression of movement. It is quite easy to notice that generated images in computer games meet this

34 A. Nowicka, op. cit., p. 28.
35 The Judgement of TSUE of 22 December 2010 in case C-393/09, curia.europa.eu (access 28 March 2016).
36 droit-technologie.org (access 28 March 2016).
37 J. Barta, R. Markiewicz, Prawo autorskie, p. 302.
definition. Moreover, according to Article 1 paragraph 2 subparagraph 9 of the Act on copyright and related laws audiovisual works, including films, are subject to copyright, hence it is an open category. It is questionable whether one could use this term referring to the whole multimedia work, ipso facto computer games.

J. Bleszyński claims that the most essential criterion distinguishing multimedia works is the application of filmic technique or audiovisual convention while creating multimedia works. It means creation of work based on a script, including action and plot expressed via video and audio carriers.39 Most of computer games would comply with the criteria. In turn, A. Wojciechowska assigns computer games to a group of audiovisual works, due to the movement criterion, which may also include images secondary set in motion – by a player by means of a computer program40. Supporters of qualifying games as audiovisual works emphasise similarities in the construction of these works, manifesting itself in a deep integration of individual components41.

One should also consider the nature of audiovisual works regime, regulated in Articles 69 – 73 the Act on copyright and related laws. Regulations with Article 69 (mentioning audiovisual work co-authors) and Article 70 of the Act on copyright and related laws are particularly significant. As far as Article 70 paragraph 1 is concerned, there is the presumption that a producer of an audiovisual work by force of a contract to create the work or contract to use an existing work, acquires exclusive copyright to exploit the works within an audiovisual work as a whole. This issue is addressed to some extent in a model of computer games creation, where individuals of various professions are involved, as well as subcontractors, and the creation process itself is organised and supervised by a producer.

Nonetheless, computer games qualification as audiovisual works should be rejected, due to practical reasons. It does not take into account the relevance of a computer program, being the 'engine' of a game in a creation and development process. Such classification, as in a case of unnamed works, would allow for non-special use of computer program

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regime, including regulations concerning exclusions of permitted personal use or decompile.

I. Matusiak shares a similar opinion, but due to other reasons – he claims that because of games interactivity 'a participant's role is dominant over visual sphere'. The author of the paper does not subscribe to this point of view. As it was pointed out, images displayed on the monitor screen meet the criterion of 'images series causing impression of movement'. The interactivity of computer games has its boundaries precisely in an audiovisual layer developed earlier by creators, hence it cannot be 'dominated' by a player.

Similarly to the programming part, there is a possibility of applying a special audiovisual works regime for a graphical layer of computer games. Moreover, this point of view is shared by already described case law and American and German doctrine, as well as by the representatives of Polish doctrine.43

9. A computer game as a comprehensive multimedia work

Bearing in mind what was said above, it seems clear that none of the proposed solutions of computer games qualifications as a whole is relevant. However, the classification as unnamed works would have been a financial failure of their creators, inter alia, due to regulations concerning permitted use.

Therefore, following the Italian judgement of the Supreme Court of 3 September 2007 it seems to be the only right solution.44 It denotes that computer games are fundamentally different from computer programs, as they are more complex, and a program is used only to play a game content. They also cannot be compared to media, which include movable images. Hence, the Court found that comprehensive multimedia works, called hybrid, sui generis works45 constitute computer games. The questions that need to be answered here are: what regulations should be applied, considering current law? Are there any legal changes necessary?

44 The judgement of the Italian Supreme Court of 3 September 2007, No. 33768, IIC 2009, No. 1, pp. 107-114.
45 J. Barta, R. Markiewicz, Prawo autorskie, p. 302.
The solution is proposed by J. Barta and R. Markiewicz, however, as they admit themselves, it is 'unclear'\(^{46}\). If computer games are neither a program, nor audiovisual work, to evaluate a subject to whom the copyrights belong, in case of employee works, a general regulation of Article 12 of the Act on copyright and related laws can be applied. It is more beneficial for employees, co-founders, as in case *lex specialis* of Article 74 paragraph 3 of the Act on copyright and related laws there is a primary acquisition to the employer. Consequently, the mentioned authors reject the application of regulation of Article 72 paragraph 2\(^1\) of the Act on copyright and related laws. Moreover, they allow for provisions regulating prohibition of any use, and decompile prohibition to the programming part. It is due to admissibility of the same application of regulations concerning the protection of audiovisual works and computer programs to computer games, in a case of well-founded objective of the regulations\(^{47}\). It is a proper solution, though in case of a court process more likely is the application of adequate *lex specialis* to separate works parts; only when it would be impossible to achieve it, the use of a functional interpretation, while defining possible law regimes as more adequate ones, will be applied.

Yet another solution is the inclusion of computer games into a directory of works mentioned in the Act on copyright and related and application of a special regime or a category of multimedia works, or *stricto sensu* computer games. This solution has both its supporters and opponents\(^{48}\). The apprehension concerning that the subsequent Act on copyright and related laws amendments could cause the excessive directory extension of intellectual property protected by copyright law, is unjustified. This way, copyright law may react to changes resulting from technological development. It would also be a clearer solution than the one proposed above. However, the solution is unnecessary when computer games are substantially similar in structure and in the way of creation to existing categories. It would be contrary to the legislator's intention\(^{49}\). Also in a foreign legislative systems computer games are not particularly isolated. Finally, it seems, that it would be a rare situation to raise the necessity to employ provisions to a game as a whole – and in

\(^{46}\) Ibidem.
\(^{47}\) Ibidem, p. 303.
\(^{49}\) D. Flisak, *Utwór multimedialny*..., p. 140.
these cases the interpretation described by J. Barta and R. Markiewicz can be successfully applied.

Conclusions

Due to the diversity of creative efforts, in a vast majority of cases computer games may be classified as a work. The American judicature may help in defining the subject scope of computer games protection, particularly in distinguishing a protected way of expression from unprotected concept. Moreover, the analysis of German and American judiciary clearly indicates the necessity to employ adequate copyright regimes to the individual parts of the work. Hence, the computer program regime should be used to a programming layer, and to visual images generated by a game – an audiovisual work regime should be applied. In case of necessary qualification of a computer game as a whole, the most convincing is the view of J. Barta and R. Markiewicz who recognise them as comprehensive multimedia works. In such situation, to computer games, as a whole, selected provisions concerning specific computer programs or audiovisual works should be applied, based on a functional interpretation. Accepting the above position, it should be assumed that interference of legislator and development of a new category of work is unnecessary.

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Mieczysław HANDZEL

THE PRINCIPLE OF EQUALITY BEFORE THE LAW AND REAL PROPERTY SALES LIABLE TO PERSONAL INCOME TAX

Summary
Under the Constitution of Poland, everyone shall be equal before the law. It means that each citizen shall have the right to be treated equally by the public authorities and no one can be discriminated against for any reason whatsoever. Moreover, in accordance with the Constitution of Poland everyone shall comply with his responsibilities and public duties, including the payment of taxes, as specified by statute. The obligation of taxation of the revenue (income) from a real property transfer by natural persons results from the Personal Income Tax Act. Therefore, in this paper there has been discussed a constitutional principle of equality before the law and also there have been outlined the issues related to taxation of real property sales by natural persons over the last ten years against the background of sometimes contradictory judgements and thereby unequal and inconsistent approach of tax authorities and administrative courts to this issue.

Key words: principle of equality before the law, taxation of real property sales, personal income tax

Introduction

In the Polish society, there is a belief that everyone is equal before the law, each citizen has the right to be treated equally by the public authorities, and no one can be discriminated against for any reason whatsoever. This belief is so strong that it was reflected in the Constitution of the Republic of Poland passed on 2 April 1997 and thereby it became one of the chief constitutional principles. This legal act of the highest priority grants not only rights but also responsibilities.

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1 Journals of Laws of 1997 No. 78, item 483, as amended, hereinafter referred to as: the Polish Constitution or the Constitution.
According to Article 84 of the Polish Constitution, one of the responsibilities is that everyone shall comply with his responsibilities and public duties, including the payment of taxes, as specified by statute. Article 84 of the Polish Constitution is closely related to Article 217 of the same act, according to which the imposition of taxes, as well as other public imposts, the specification of those subject to the tax and the rates of taxation, as well as the principles for granting tax reliefs and remissions, along with categories of taxpayers exempt from taxation, shall be by means of statute.\(^2\) When defining the sources of taxation in the Act of 26 July 1991 on the personal income tax\(^3\), the Polish legislator decided that one of the numerous sources of tax revenue (income) should be the real property sales by natural persons. The principles and methods of taxation of such a legal action have been changing significantly over the last decade. The application of regulations in that regard has caused a lot of doubts and controversy. Therefore, the presentation of selected issues regarding the real property sales liable to personal income tax for private individuals not involved in business activities seems legitimate, illustrated by court judgements in the context of the constitutional principle of equality before the law, taking into account the practice of tax authorities and court judgements given in that regard.

1. The constitutional principle of equality before the law

The principle of equality was included in the Polish Constitution of 1997 in Chapter II The Freedoms, Rights and Obligations of Persons and Citizens, in Article 32, which in Section 1 states that All persons shall be equal before the law. All persons shall have the right to equal treatment by public authorities, and in Section 2 that No one shall be discriminated against in political, social or economic life for any reason whatsoever. In this way, Article 32 of the Polish Constitution regulates the principle that orders the comprehending and obeying all the rights – the principle of equality.\(^4\) According to B. Banaszek, this Article clearly defines the addressee of the principle of equality. These are public authorities, which

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\(^3\) Journals of Law of 2016, item 2032 as amended.

mean the legislator, executive bodies (including local government bodies) and courts.\textsuperscript{5} As the above author states, equality should be referred to the legislative process and non-discrimination to the application of the law.\textsuperscript{6} Nevertheless, the phrase equality does not mean absolute equality, according to which the same rules of law shall be applicable to everyone.\textsuperscript{7} As B. Gronowska states, equality means equal rights, equality before the law (including equality of legal protection) and equal treatment by public authorities. Such an understanding of equality cannot mean identity.\textsuperscript{8} According to the author mentioned above, there is a close relationship between the principle of equality and prohibition of discrimination\textsuperscript{9}, whereas discrimination is understood as a differential treatment of persons who are objectively in the same (or essentially similar) situation, and this treatment has no reasonable (objectively justified) grounds.\textsuperscript{10}

Equality in law may be understood as formal or substantive equality. Formal equality means equal treatment by the law to all the addressees of the standard. There is no differentiation.\textsuperscript{11} Nevertheless, such an understanding of the principle of equality brings significant restrictions, which cause that the principle cannot constitute the basis of the whole legal system in force due to the fact that this principle does not include the complex nature of legal relations as well as the fact that legal standards are frequently addressed only to some groups of citizens.\textsuperscript{12} On the grounds of the Constitution equality in the law, which means equal rights, should be understood as substantive equality.\textsuperscript{13} The Constitutional Tribunal, at the very beginning of its judicial activity, determined the essence of the formal equality, which states that all public law entities distinguished equally by a given essential feature (relevant), shall be

\textsuperscript{7} Ibidem, p. 71.
\textsuperscript{9} Ibidem, p. 159.
\textsuperscript{10} Ibidem, p. 160.
\textsuperscript{12} Ibidem, p. 159.
\textsuperscript{13} Ibidem, p.159.
treated equally. Therefore, they shall by treated without any differentiations, neither discriminative nor favouring.\textsuperscript{14}

In case law of the Constitutional Tribunal, the principle of equality is not equated with the prohibition of differentiation. The Tribunal does not preclude the preference to some groups (positive discrimination, equalizing favouring) when necessary to achieve real equality.\textsuperscript{15} In the name of equality, the law should individualize the situation of the citizens in view of some essential features (relevant). The main concern is to set the criteria allowing the differentiation of principles that refer only to some persons, which do not infringe the principle of equality before the law at the same time, from the principles distinguishing the groups of addressees in a favouring or discriminative manner.\textsuperscript{16} It is emphasized in the doctrine that the criteria must be:

- relevant, therefore they should be related directly to the purpose and content of the provisions, which include the controlled standard, as well as they should serve the purpose and content, which means that the implemented differentiations have to be reasonably justified,

- proportional, therefore the interest that the differentiation of the standard addressees’ situation should be beneficial to must be adequate to the interest that shall be infringed due to the unequal treatment of the entities,

- must be related to other values, principles or constitutional standards that justify a different treatment of similar entities.\textsuperscript{17}

The principle of equality by public authorities refers to the application of the law. According to this principle, the body that gives the judgement based on the law in force should give identical judgements in the same cases.\textsuperscript{18} The principle of equality should be somewhat considered in conjunction with the principle of justice. The principle of equality corrects the principle of justice, and even concretizes it. In a manner of speaking, the principle of equality and the principle of


\textsuperscript{16} See: J. Falski, Ewolucja wykładni zasady równości w orzecznictwie Trybunału Konstytucyjnego, Państwo i Prawo 2000, no 1, p. 49.

\textsuperscript{17} Ibidem, B. Banaszak, op cit., p. 184-185.

\textsuperscript{18} See: P. Sarnecki, op cit., p. 162.
justice are complementary.\textsuperscript{19} Whereas the principle of equality includes equal treatment of all entities distinguished according to the relevant feature in a given social field, the principle of justice reveals if the choice of a certain criterion of differentiation was right and adequate to the situation of a given person.\textsuperscript{20} According to the Constitutional Tribunal, if there occur unjustified differences in granting rights, then it is a problem of inequality. \textit{Justice requires that legal differentiation of entities (their category) remains appropriately related to the differences in their actual situation as addressees of the given legal standards. Such distributive justice means that the equals should be treated equally and the similar – similarly. Therefore, the principle of justice can be expressed as the principle, according to which there cannot be established a law that would differentiate the legal situation of the entities, whose actual circumstances are the same. Such an understanding of equality means acceptance of different treatment of different entities by the law. However, this different treatment should be justified.}\textsuperscript{21}

Summing up, it should be emphasized that the Constitutional Tribunal repeatedly accentuated in its judgements that the principle of equality is not strictly mandatory in the sense that it equalizes the situations of all entities on the grounds of their distinguishing features. The principle of equality requires that entities are treated equally if a certain feature distinguishes them. Therefore, according to the Tribunal, equality also means acceptance of different treatment of different entities by the law. It results from the fact that equal treatment of the same entities by the law in certain respects usually means different treatment of the same entities otherwise.\textsuperscript{22} The essence of the principle of equality before the law is not equal treatment to everyone, but equal treatment only of a certain group of citizens, distinguished due to the legally relevant feature.\textsuperscript{23} A basic issue for the assessment of retaining the principle of equality is to define the essential feature, because of which the provisions of the law differentiated the legal situation of their

\begin{itemize}
\item \textsuperscript{19} See more: W. Sokolewicz, \textit{Konstytucja Rzeczypospolitej Polskiej – Komentarz}, 2007 r., p. 59.
\item \textsuperscript{20} Ibidem, p. 59, and also the judgement of the CT of 24 May 2006, file no. K 5/05.
\item \textsuperscript{21} See: the judgement of the CT of 7 June 2004 (file no. P 4/03).
\item \textsuperscript{22} See: the judgement of the CT of 11 April 1994 (file no. K 10/93).
\item \textsuperscript{23} See: the judgement of the CT of 6 February 2002 (file no. SK 11/01); the judgement of 7 June 2004 (file no. P 4/03) and the judgement of 10 April 2002 (file no. K 26/00).
\end{itemize}
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Differentiation of the legal situation of citizens is then contradictory to the Constitution if similar entities or situations are treated differently, and those differences in treatment cannot be properly justified according to the Constitution.

As a result of the above, derogation from the principle of equality is not identical to infringement of Article 32 of the Constitution. To resolve the issue it is necessary to assess the accepted criterion of differentiation of legal entities.

Moreover, it should be noticed that in the doctrine and case law of the Tribunal there is a conflict on whether Article 32 Section 1 of the Constitution includes the legal right. At this point, the author of the paper would like to notice that if the doctrine inclines to adopt the law resulting directly from the linguistic interpretation of Article 32 Section 1 of the Constitution, the judgements of the Constitutional Tribunal do not include this law directly based on the content of Article 32. According to A. Łabno, defining the right to equal treatment is a controversial issue in the judicature practice of the Constitutional Tribunal. The Constitutional Tribunal determines it as the legal right of special nature, somewhat the “secondary right” or “meta-right”. As A. Łabno and B. Banaszak claim, Article 32 Section 1 of the Constitution establishes the legal right according to the linguistic interpretation, but the Constitutional Tribunal draws a different conclusion. The Constitutional Tribunal restricts the interpretation of Article 32 to the constitutional principle and therefore there occur doubts, regarding both the theoretical grounds for the settlements and practice for the application of the standard of Article 32 Section 1 of the Constitution. According to A. Łabno, the position in favour of the right to equal treatment considered as the legal right seems appropriate, because it is enforced by the drafting of Article 32 Section 1

28 To obtain more information on the problem with the recognition of Article 32 Section 1 of the Constitution as the legal right, see: A. Łabno, ibidem, p. 38-42; B. Banaszak, op cit, p. 186-187; the judgement of the CT of 24 October 2001 (file no. SK 10/01) and the dissenting opinions.
of the Constitution, where the legislator applied the term *all*, which should be understood as *everybody*.\(^{30}\)

While speaking about the principle of equality, in terms of this article, it seems reasonable to refer to the principle of the democratic rule of law\(^{31}\) regulated in Article 2 of the Constitution, and to be more specific, to the rules\(^{32}\) interpreted out of its wording, which specify the principle: the rule of the citizen’s trust in the state, thereby also in the law, which this state establishes, the rule of the protection of acquired rights, the rule of determinacy related to legal regulations, the rule of legal certainty, and also the rule of decent legislation.

The recognition that the clause of Article 2 constitutes *an extremely important directive in terms of the legislation and law application according to the standards of the rule of law* led to the conclusion of the Constitutional Tribunal that it may also constitute the grounds for attributing constitutional principles related to the action of those bodies, which were not directly disclosed in the Constitution.\(^{33}\)

Taking into account the case-law of the Constitutional Tribunal and the acquis of the doctrine, there may be briefly outlined the proper understanding in accordance with the principles mentioned above, which influence also the law application in terms of taxation of real property sales by natural persons.

The principle of trust (loyalty) refers not only to the procedure and form of the established law, but also to the application of law in general, including its legal interpretation.\(^{34}\) Despite its uncertainty, the principle of trust results from the general principle of the democratic rule of law.\(^{35}\)

The principle of the protection of legitimate expectations requires that the state body (including the legislator) treats the citizens with respect to


\(^{33}\) See: W. Sokolewicz, op cit., p. 17; the judgement of the CT of 17 February 2006 (file noTs 183/05).

\(^{34}\) See: the judgement of the CT of 27 November 1997 (file no. U 11/97).

minimum rules on integrity. Therefore, legal provisions cannot be traps, empty promises or break the established rules of the procedure, as well as they cannot provide the state bodies with opportunities to abuse their position towards the citizen.\textsuperscript{36} As the Constitutional Tribunal states, the principle of the protection of legitimate expectations: \textit{(\ldots) is based on legal certainty, therefore it is based on such a group of legal features, which provide the entity with legal safety, enable the entity to decide on their own actions on the basis of the full awareness of prerequisites of the state bodies’ actions and legal consequences (\ldots) particular conduct and incidents.}\textsuperscript{37} According to the Constitutional Tribunal, if new provisions refer to e.g. taxes, then two weeks of \textit{vacatio legis} may be too short and the legislator is obliged to set a longer (appropriate) period of \textit{vacatio legis}.\textsuperscript{38} Next, it should be noticed that legal provisions must be formulated clearly enough so that the addressee can easily define legal consequences of their actions.\textsuperscript{39} Establishing unclear and ambiguous provisions shall be considered an abuse of the principle of the rule of law. Therefore, according to L. Garlicki, establishing a law that includes mutually contradictory terms or allows free interpretation, abuses this principle.\textsuperscript{40}

The legal certainty must guarantee the stable legal order in the state, and on the other hand, it must ensure the citizens that based on the current law they can freely take care of their lives. In other words, the principle of legal certainty provides the citizens with conditions favourable to accurate predicting the actions of the state authorities, which provides predictability of the rule of law in the legislative sector, but also in terms of the application of law, which gains a particular practical meaning in the levy issues.\textsuperscript{41} It should be noticed that the Constitutional Tribunal in its case law emphasized repeatedly the meaning of the infringement of Article 2 of the Constitution in the context of the tax law. The Tribunal pointed out that the requirement of precision and equivalence of the wording and legislative correctness derived from those principles has a special meaning in the tax law, particularly where it obliges to self-calculation of

\textsuperscript{37} After; ibidem, see: the judgement of the CT of 25 June 2002 (file no. K 45/01).
\textsuperscript{38} See: for example: the judgement of the CT of 23 March 2006 (file no. K 31/06).
\textsuperscript{40} See: L. Garlicki, op cit., p. 64.
\textsuperscript{41} See: W. Sokolewicz, op cit., p. 36.
the tax, which means the calculation and payment of the tax. Only the payment of the due tax causes the termination of the tax liability. Otherwise, the taxpayer is exposed to tax arrears, and even penal-fiscal liability. A significant lack of the precision of legal provisions, which causes their vagueness, leads often to the lack of specificity of those provisions, because it is impossible to establish precise legal standards based on them. Vagueness of the provisions and imprecision of the legal standards infringe the citizens’ trust towards the state and the state law. The Constitutional Tribunal in its judgement of 20 November 2002 decided that theoretically distinguished and named principles on the grounds of the existing factual situations are linked: in practice, vagueness of the provision means uncertainty of the legal situation of the addressee of the standard and leaving its shaping to the bodies applying the law.

The principle of trust, otherwise referred to as the principle of loyalty of the state towards the addressee of the legal standards, has an established position in case–law of the Constitutional Tribunal. In the justifications of numerous judgements, the Constitutional Tribunal emphasized that in a democratic rule of law establishing and applying the law cannot be a trap for the citizens.

In the judgement of 22 May 2002, the Constitutional Tribunal pointed out that establishing vague, ambiguous provisions, which do not allow the citizens to predict the legal consequences of their conduct, constitutes an infringement of the Constitution. In the justification of the judgement of 2 April 2007, the Constitutional Tribunal emphasized that the principle of the protection of legitimate expectations and the law established by the state is a constitutive element of the rule of law defined in Article 2 of the Constitution. From the point of view of the

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42 Ibidem, the judgement of the CT of 27 November 2007 (file no. SK 39/06).
43 See: J. Bauta-Szostak, B. Bogdański, Nieruchomości sprzedaż najem dzierżawa 2010 skutki w PIT, CIT i VAT, p. 46.
44 The judgement of the Constitutional Tribunal of 20 November 2002 (file no. K 41/02).
47 See: the judgement of the Constitutional Tribunal of 22 May 2002 (file no. K 06/02).
48 See: M. Handzel, ibidem, p. 83.
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...protection of legitimate expectations and the law established by the state, in the field of public levies Article 84 of the Constitution is also essential. According to this provision, everyone shall comply with his responsibilities and public duties, including the payment of taxes, as specified by statute. In this article there is used the quantifier “everyone”, which should be expresses the prevalence of obligation to maintain the state and support its functioning by all persons who benefit from its care.  

49 Mentioning taxes in this article is not only an example of public duties, which the entity should bear, but it also has a wider meaning, because in the tax law it is insufficient when taxation is shaped formally by a legal act, but it should also be formed in a material sense, so this act should include a certain content. Therefore, Article 84 of the Constitution stipulates precise defining of essential elements of the levy proportion in the act, so that the entity can predict the fiscal consequences of their actions. It should be therefore noticed that the principle of the protection of legitimate expectations and the law established in the sector of public levies is based on Article 2 in connection with Article 84 of the Constitution. According to the Constitutional Tribunal, the analysed principle requires particularly that the person concerned knows the exact content and the amount of the due levies at the moment of taxable events.  

Therefore, the legislator, when regulating real property sales liable to personal income tax, and also law enforcement should take into consideration the constitutional principle of equality before the law, because a different attitude towards the same circumstances may cause a sense of infringement of this principle among taxpayers. How to explain a taxpayer that the same circumstances of a real property sale within five years from the date of its acquisition, for the same period, may be taxed differently?  

2. Taxation of real property sales – general notes  

In case of a real property sale by natural persons, who are not involved in a business activity, such a disposal should be liable to income tax if it took place within five years from the end of the calendar year, in which the real property was acquired.  

At the beginning, it should be noticed that in the provisions of the Personal Income Tax Act there is no definition of real property. In this

49 See M. Handzel, ibidem, p. 83.  
50 Ibidem, p. 83.
regard, the most appropriate is to refer to the provisions of the act of 23 April 1964 – the Civil Code\textsuperscript{51}, which states in Article 46 that real property is an area being the separate ownership unit, and also buildings permanently fixed to the ground or their parts if under the specific provisions they are separate ownership units.

It should also be noticed that paid disposals are disposals based on: a sales agreement, exchange agreement and any other agreement, which provides for a payment in any form. The term “acquisition”\textsuperscript{52} should be widely understood; it includes not only an acquisition by purchase but also by exchange, inheritance, donation, dissolution of joint property or any other paid form.\textsuperscript{53} It is worth noting that a preliminary agreement regarding an acquisition or a disposal is exclusively binding and does not transfer the ownership, therefore it does not influence the calculation of the five-year period. The principle is taxation of the sales within five years, starting from the end of the calendar year, in which the acquisition took place. For example, if a taxpayer constructed a building on a land, the five-year period is calculated form the date of the acquisition of the land, because the building is not a separate object of the property right.\textsuperscript{54}

Taking into consideration the amendments to the provisions of the Personal Income Tax Act over the last ten years in terms of the regulations regarding a paid disposal of the real property and the transitional provisions in force, such a sale of real property may be taxed in three ways. The criterion that determines the tax system to be applied shall be the year, in which the real property is acquired. Therefore, despite the fact that since 2009 the rules of real property taxation have not changed and the expiration of tax liability shall take place after a period of five years, the provisions of 2006 or 2007-2008 in this regard may apply, having regard the provisions of the Tax Order Act on the limitation of tax liabilities. For example, if a taxpayer purchased real property in 2006 and sold it 28 December 2011, in this situation the provisions of the Income Tax Act in force in 2011 were not applicable,

\textsuperscript{51} Journal of Laws of 2016, item 380 as amended.
\textsuperscript{53} See: I. Kocemba; Opodatkowanie dochodów (przychodów) z tytułu odpłatnego zbycia nieruchomości i praw majątkowych, Biuletyn Skarbowy nr 1/2009; p. 13.
\textsuperscript{54} See: J. Bauta-Szostak, B. Bogdański, Nieruchomości sprzedaż najem dzierżawa 2010 skutki w PIT, CIT i VAT, p. 19.
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but the provisions of 2006, because according to Article 7 of the act of 16 November 2006 on the amendment to the Personal Income Tax Act and the amendments to some other acts, for the revenue (income) from a paid disposal of real property and other ownership rights, acquired or constructed until 31 December 2006, the provisions in force before 1 January 2007 are applicable. Moreover, taking into consideration the regulations regarding the limitation of tax liabilities and their interruption regulated in the act of 29 August 1997 – the Tax Order Act\(^{55}\), it should be noted that if a taxpayer on 28 December 2011 sold the real property acquired in 2006, the deadline for the tax payment was 11 January 2012, and such a liability (if it was not interrupted) is barred by limitation within five years, starting from the end of the year, in which the tax liability arose, therefore it is actually barred by limitation on 31 December 2017. This means, the tax authority in the tax proceedings in this regard may apply those provisions in practice.

According to Article 8 Section 1 of the act of 6 November 2008 on the amendments to the Personal Income Tax Act, the Corporate Income Tax Act and some other acts\(^{56}\), for the revenue (income) from a paid disposal of real property and the rights defined in Article 10 Section 1 Subsection 8 a)-c) of the act amended in Article 1, acquired or constructed (put into use) between 1 January 2007 and 31 December 2008, the provisions of the act amended in Article 1 are applicable, the wording effective on 31 December 2008. With reference to the above, there should be three legal conditions distinguished:

- taxation of the real property sold within five years, whereas its acquisition took place before 1 January 2007;
- taxation of the real property sold within five years, whereas its acquisition took place between 1 January 2007 and 31 December 2008;
- taxation of the real property sold within five years, whereas its acquisition took place after 1 January 2009.

\(^{55}\) Journal of Laws of 2017, item 201 as amended.
3. The rules of taxation of the real property sales, acquired before 1 January 2007

The Personal Income Tax Act in Article 10 Section 1 Subsection 8 a)-c), the wording effective until the end of 2006, stated that the source of the revenue was a paid disposal of: real property or its part and an interest on real property; the cooperative ownership right to residential or commercial property and the right to a single-family house from a housing cooperative; the land perpetual usufruct right, provided that such a paid disposal does not take place, but was completed within five years, starting from the end of the calendar year, in which the acquisition or construction took place.

The legislator anticipated also exceptions from the general rule of taxation of real property sales within five years, in which the legislator determined the real property that is not liable to this tax, regardless of the fact that the period of five years has not expired yet. These exceptions were included in Article 21 Section 1 Subsection 28-30, 32-32a of the Personal Income Tax Act. Moreover, according to Article 21 Section 1 Subsection 32 d) of the above-mentioned act, the revenue from the real property and ownership rights sales defined in Article 10 Section 1 Subsection 8 a)-c) is tax-free if their acquisition was by donation or inheritance.57

The sale of real property or ownership rights acquired before 1 January 2007 (provided that the disposal took place within five years, starting from the end of the calendar year, in which the acquisition or construction took place) was liable to a 10% tax assessed on the basis of the revenue, i.e. regardless of the value of the costs spent on the construction or acquisition of the property.58 This means that the taxpayer could not reduce the tax base by the cost of acquisition, but only by the cost related to the sale of the property. Taxation of the revenue without

57 It should be emphasized that the acquisition by inheritance means both the acquisition based on the decision regarding the confirmation of the inheritance acquisition and the acquisition of the property or ownership right by the division of inheritance (See: the judgement of the Supreme Administrative Court in Warsaw of 8 February 2007, file no. II FSK 187/06). Until the issue was not solved by the SAC, some tax authorities presented different position by misinterpreting Article 21 Section 1 Subsection 32 d).

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reducing it by the tax-deductible costs is commonly known as flat-rate taxation.\textsuperscript{59}

The revenue from a paid disposal of the real property or ownership rights was their value expressed in the price defined in the agreement, reduced by the costs of the paid disposal.\textsuperscript{60} However, if for no reason the price differed significantly from the market value of those objects or rights, the revenue was defined by a tax authority or tax inspection authority as the market value. However, those authorities were obliged to call on the parties of the agreement to change the value or indicate the reasons for the price that differed significantly from the market value. If no reply is received, no changes to the value took place or no reasons for the lower value were indicated, the tax authorities defined the value including expert witnesses.

The tax was paid without a call, within 14 days from the date of the paid disposal (signing the notarial deed transferring the ownership rights) into the account of the Tax Office, managed by the head of the Tax Office competent for the taxpayer’s place of residence.\textsuperscript{61} The obligation to pay the flat-rate tax from the paid disposal was connected with the obligation to submit a relevant tax statement. The tax statement had to be submitted within the period of the tax payment. The tax statement relevant to the flat-rate tax settlement from real property sales was PIT-23.

The legislator, by the regulation included in Article 21 Section 1 Subsection 32 a) and e) of the Personal Income Tax Act, enabled the taxpayers the exemption from the tax payment from the paid disposal of real property if the revenue is spent within 2 years on the purposes

\textsuperscript{59} See: J. Bauta-Szostak, B. Bogdański; op cit. p. 31.

\textsuperscript{60} It is worth emphasizing in the context of this paper that the content of Article 19 Section 1 of the Personal Income Tax Act, the wording effective until 31 December 2000, was recognised by the Constitutional Tribunal in the judgement of 27 November 2007 (file no. SK 39/06) to the extent, in which it omits the element of the standard defining that the value expressed in the price determined in the sales agreement, which constitutes the revenue from the sales of the property and ownership rights and other objects is reduced by the due goods and services tax as incompatible with Article 2 in relation to Article 84, Article 217 and Article 64 Section 1 and 3 of the Polish Constitution Then the provision included the wording “selling costs”.

defined in this article. Then the taxpayer within 14 days from the date of the disposal should submit an appropriate statement to the relevant Tax Office competent for the taxpayer’s place of residence and submit PIT-23. However, taking into account the court judgements and the practice of tax authorities, when the taxpayer did not submit the statement, it did not deprive them of the right to the exemption, although right after the implementation of this regulation, tax authorities made this tax relief contingent on submitting such a statement, but they departed from this practice rapidly.  

According to Article 21 Section 1 Subsection 32 a) and e) of the Personal Income Tax Act, the tax-free revenue was the revenue from real property and ownership rights sales:

a.) in the expenditures made within two years from the date of the sale for the purpose of:

– an acquisition of a residential building on the territory of the Republic of Poland or its part or a share in this property, a residential unit which is a separate property or a share in this property, and also an acquisition of a land or a share in the land or the perpetual usufruct of land or a share in this right related to this building or the housing unit,

– an acquisition of the cooperative ownership right to a housing unit on the territory of the Republic of Poland or a share in this right, the right to a single-family house in the housing cooperative or a share in this right,

– an acquisition of a land on the territory of the Republic of Poland or a share in this land, the perpetual usufruct of land or a share in this right related to the construction of the residential building, including a land or a share in the land or the perpetual usufruct of land or a share in this right related to the construction of the residential building in progress,

62 See: the judgement of the Supreme Court of 6 June 2002 (file no. III RN 90/01), which decided that if the statement was not submitted by the taxpayer, defined in Article 28; Section 2 of the Personal Income Tax Act, it causes the loss of entitlement to the flat-rate tax deferral, but it does not exclude the exemption form it in case of meeting the conditions in Article 21 Section 1 Subsection 32 a) of the Personal Income Tax Act. The Supreme Court agreed also that it is the deadline of the substantive law and is not subject to restoration.
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- a construction, development, superstructure, reconstruction, renovation or modernization of the owned residential building, its part or the owned residential unit, located on the territory of the Republic of Poland,

- a development, superstructure, reconstruction or adaptation of the owned non-residential building or its part, non-residential unit or non-residential room for residential purposes, located on the territory of the Republic of Poland,

b.) in the expenditures made within two years form the date of the sale for the purposes of the credit or loan repayment, and also the interest on the credit or loan taken for the purposes defined in a), from a bank or credit union, located on the territory of the Republic of Poland, including the repayment of the a credit or loan and the interest on this credit or loan taken before the date of obtaining this revenue.

It should be noted that the taxpayers who benefited from so called interest exemption regulated in Article 26b (the wording effective until the end of 2006) could not benefit from the exemption defined in Article 21 Section 1 Subsection 32 e) of the Personal Income Tax Act.63

The revenue from real property sales was exempt from the income tax, which was spent on the purposes mentioned above within two years from the date of the sale. This gave reasons for frequent doubts if the new property can be acquired before the conclusion of the real property sales agreement, based on which the income was liable to exemption be exempt from taxation. The discussed provision introduced only the deadline for the expenditure of the funds obtained from the paid disposal of the property. It did not refer to the earlier period of time when the funds could be spent. Therefore, it had to be stated that the conclusion of the real property sales agreement related to an acquisition of a new property by a taxpayer before the conclusion of the sales agreement related to the “old” property should not cause the loss of the right to exemption from taxation.64 It is worth mentioning that in practice of tax authorities and in court judgements once an expenditure within two years

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63 It should be noticed that in this case the taxpayer could benefit from such an exemption but they had to submit the adjustments to the annual statement, in which they would not benefit from so called interest exemption. The taxpayer would have to analyse which exemption would be more profitable.

64 See: J. Bauta-Szostak, B. Bogdański; op cit. p. 59-62, including numerous examples of the judgements by administrative courts, given by the authors.
was allowed if it was made as an advance and then this advance was included in a notarial deed related to the ownership transfer even after two years from the date of the sale\textsuperscript{65}, and another time the expenditure was not allowed, because it was stated that an acquisition within two years means transferring the ownership to the acquirer during this period\textsuperscript{66}.

The next dispute solved in two ways in practice was the problem if the expenditure made on the repayment of the mortgage credit taken for the repayment of the property that has just been sold was in accordance with the exemption based on Article 21 Section 1 Subsection 32 e). Therefore, the position of some courts was that the catalogue included does not provide for an exemption when the funds obtained from the sales for the purpose of the repayment of a loan taken for an acquisition of a property, which the taxpayer disposed of.\textsuperscript{67} Similarly, an administrative court decided that a taxpayer who spends the funds from the property sales on the repayment of the credit taken for its acquisition has no right to exemption, defined in Article 21 Section 1 Subsection 32 e) of the Personal Income Tax Act unless this repayment is made for the purpose of an acquisition of another property.\textsuperscript{68} Another court gave a completely different opinion on this issue and stated in the justification of the judgement that it does not have to be an acquisition of a new right but also a repayment of a mortgage credit taken for the acquisition of the right, the sales of which provided the revenue.\textsuperscript{69}

Another dispute was if the repayment of a refinance credit is liable to the exemption from Article 21 Section 1 Subsection 32 e) of the Personal Income Tax Act. On one hand, the courts admit that such a credit may be a refinance credit, provided that it is used for the residential purposes\textsuperscript{70} and that there cannot be made a conclusion on the basis of the provision of Article 21 Section 1 Subsection 32 e) of the act mentioned above that a refinance credit taken before obtaining the revenue for the repayment of

\textsuperscript{65} Ibidem, e.g. the judgement of the SAC of 9 April 1997 (file no. SA/Ka 1920/95).
\textsuperscript{66} Ibidem, e.g. the judgement of the SAC of 8 April 1999 (file no. III SA 5249/98).
\textsuperscript{67} See: the judgement of the Province Administrative Court in Warsaw of 9 November 2007 (file no. III SA/Wa 1074/07).
\textsuperscript{68} See: the judgements of the PAC in Łódź of 5 March 2008 (file no. I SA/Ld 1135/07) and a similar judgement of the SAC of 5 November 2009 (file no. II FSK 863/08).
\textsuperscript{69} See: the judgement of the SAC of 6 April 2007 (file no. II FSK 509/06) and a similar judgement of the PAC in Wrocław of 7 December 2007 (file no. I SA/Wr 1420/07).
\textsuperscript{70} Ibidem, the judgement of PAC in Kielce of 12 November 2009 (file no. I SA/Ke 393/09).
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a construction and mortgage credit lost the status of a credit, which is defined in the provision mentioned above. On the other hand, the courts claimed that the catalogue included in Article 21 Section 1 Subsection 32 e) of the act mentioned above did not allow in this regulation the credit to be a repayment of another credit even if it financed directly or indirectly the residential needs of the taxpayers.

As J. Bauta-Szostak and B. Bogdański emphasize, all the previously discussed purposes related to an acquisition, construction or development of the properties located on the territory of Poland. Such a condition is yet contradictory to the basic principles of the European Union – a principle of a free movement of persons and the principle of free movement of capital. Therefore, the legislator in 2009 implemented changes in this regard. However, the taxpayers in this regard could rely on the incompatibility of the Polish regulation with the EU law from the moment of the Poland’s accession (i.e. 1 May 2004) until the implementation of amendments in 2009. The judgement favourable to taxpayers was issued by ECJ in a similar case on the grounds of Portuguese legislation. The Polish courts gave also a similar opinion, claiming that restricting the exemption of the expenditures of the funds coming from the sales on acquiring the properties located in the territory of Poland is incompatible with the Community law.

If the conditions defined in Article 21 Section 1 Subsection 32 e) of the Personal Income Tax Act were not met, the tax was payable at the latest on the next day after the two-year period, starting from the date of the sales, including the interest calculated:

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71 Ibidem, the judgement of the PAC in Reszów of 5 listopada 2009 (file no. I SA/Rz 703/09) and a similar judgement of the PAC in Kielce of 29 October 2009 (file no. I SA/Ke 365/09).
72 Idem, the judgement of the PAC in Wrocław of 30 November 2010 (file no. I SA/Wr 1151/10) and the judgement of the SAC of 24 September 2009 (file no. II FSK 650/08).
74 It concerns the regulation of the income tax, the wording effective until 31 December 2006, provided that on the basis of acquired rights, in case of using the revenue for the purposes defined in Article 21 Section 1 Subsection 32 a), the period of spending is passed to the years 2007-2008.
76 See: the judgement of the PAC in Warsaw of 4 November 2009 (file no. III SA/Wa 832/09) and the judgement of PAC in Warsaw of 14 September 2009 (file no. III SA/Wa 942/09).
• from the 15th day after the date of the property sales until the date on which the two-year period expired, starting from the date of sales – in the amount of half the interest on tax arrears,
• on the next day after the two-year period expired, starting from the date of the sales until the date of payment – full interest on tax arrears.

4. The rules of taxation of real property sales acquired between 1 January 2007 and 31 December 2008

By the Act of 16 November 2006, amending the Personal Income Tax Act and some other acts there were implemented changes in terms of taxation of the paid disposal of a property and the ownership rights by natural persons. Those principles related to the properties, which were acquired, constructed after 31 December 2006 and before 1 January 2009.

The basic principle, according to which after five years, starting from the end of the year, in which the property was acquired or constructed, the sales of the property is not liable to income tax, did not change.

Taxation principles applicable to the properties acquired in the period mentioned above resulted from Article 30e of the Personal Income Tax Act, in terms of which the seller paid the income tax in the amount of 19% of the income. The base for calculating the tax was the income (not the revenue as up to 2006), which was the difference between the revenue from the paid disposal of the property or ownership rights and deductible expenses established in accordance with Article 22 Section 6c and 6d of the act mentioned above, increased by the depreciation write-offs made on the disposed properties or rights. Tax-deductible expenses from the paid disposal of the property were:

• documented costs of acquisition or
• documented costs of manufacturing,
• increased by documented expenditures, which increased the value of the properties, made by the taxpayer during the ownership.77

If the property was acquired by inheritance, donation or in any other unpaid way, the deductible expenses were:

• documented expenditures, which increased the value of the properties, made during the ownership and

77 Ibidem, Article 22 Section 6c of the Personal Income Tax Act.
the amount of the paid inheritance and donation of such a proportion, in which the value of the property disposed of, accepted to be liable to inheritance and donation tax, is equal to the total value of the property accepted to be liable to inheritance and donation tax.\footnote{78}

The acquisition or manufacturing costs could include, for example: the price, tax on civil law transactions paid on the acquisition of the property, notary and court fees paid on the acquisition of the property, real property agent’s fees paid on the acquisition of the property, credit or loan interest, taken for the purpose of the acquisition or construction of the property, construction costs, renovation costs.

The costs of the acquisition or manufacturing of the property, defined in Article 6c of the Personal Income Tax Act were increased annually, starting from the year after the one, in which the disposed properties were acquired or manufactured, until the year preceding the tax year, in which the properties were disposed of, at the level compatible with the consumer price index in the first three quarter period of the tax year in relations to the same period of the previous year, announced by the President of the Central Statistical Office in the Official Journal of the Republic of Poland “Monitor Polski”.

The income tax on the paid disposal of the property was payable at the submission of the annual tax return for the tax year, in which the disposal took place. The tax should be declared in the annual tax return PIT-36, PIT-36L or PIT-38. The tax return included only the due tax, not the revenue and deductible expenditures.

For the revenue from the paid disposal of the property acquired in 2007-2008, the legislator did not provide any relief in the form of spending the revenue for the residential purposes, as it was in the previous regulation, but provided the exemption regulated in Article 21 Section 1 Subsection 126 of the Personal Income Tax Act, i.e. residency relief. According to this article, the tax-free revenues were the revenues from the paid disposal of:

- a residential building, its part or a share in ownership of this building,
- a residential unit being a separate property or a share in the ownership of this property,
- a cooperative ownership right to the residential unit or a share in this right,

\footnote{78 Art 22 item 6d of the Act on personal income tax.}
• a right to a single-family house in a housing cooperative or a share in this right if the taxpayer was registered in this building or unit mentioned in a)-d) for a permanent stay for a period of time not shorter than 12 months before the date of the disposal, subject to Article 21 Section 21 and 22 of the act mentioned above.

The exemption was applicable to the revenues of the taxpayer, who submitted a statement that they meet the requirements of the exemption in the relevant Tax Office within the time of submitting the annual tax return\textsuperscript{79}, defined in Article 45 Section 1 of the Personal Income Tax Act for the tax year, in which the paid disposal of the property took place. The exemption, defined in Article 21 Section 21 of the act mentioned above was applicable to both spouses.\textsuperscript{80}

The exemption caused numerous problems with its interpretation and applying by tax authorities, and because of appeals from the tax decisions – by administrative courts. One of the disputes was the following issue: if in a given residential units, one of the spouses was registered and the other not, was the exemption applicable to both of them? In this case, tax authorities presented the position unfavourable to taxpayers, claiming that both spouses had to be registered for at least 12 months before the disposal, so that they could benefit from the exemption based on Article 21 Section 1 Subsection 126 of the Personal Income Tax Act.\textsuperscript{81} However, most of administrative courts presented an opposite position, claiming that the residency relief was applicable to both spouses, despite the fact that only one of them met the requirement of registration.\textsuperscript{82} Such an interpretation that regards some expression as unnecessary cannot be considered correct (…) every word used in the legal text is necessary for

\textsuperscript{79} It should be emphasized that originally the legislator gave the taxpayers 14 days for submitting the statement, starting from the date of the property disposal. However, later in the amendment to the Personal Income Tax Act the deadline was changed for the date of the annual tax statement submission, i.e. no later that 30 April of the following year in relation to the year, in which the property sales took place.

\textsuperscript{80} Ibidem, Article 21 Section 22 of the Act on personal income tax.

\textsuperscript{81} See: the judgement of the PAC in Warsaw of 14 November 2007 (file no. III SA/Wa 1387/07); the judgement of the PAC in Warsaw of 21 December 2009 (file no. III SA/Wa 1224/09).

\textsuperscript{82} See: the judgement of PAC in Łódź of 17 December 2009 (file no. I SA/Ld 757/09), a similar judgement of the PAC in Gliwice of 25 March 2010 (file no. I SA/Gl 858/09); the PAC in Lublin of 21 January 2009 (file no. I SA/Lu 622/08); the PAC in Poznań of 2 September 2010 (file no. I SA/Po 384/10).
the reconstruction of the tax standard of the proceedings. In addition, the Constitutional Tribunal claimed in one of its acts that the interpretation, which leads to the conclusion that some part of the provision should be considered unnecessary, could not be allowed.

The next dispute on the grounds of this provision was the issue regarding the date from which the registration should be counted. In the justification of one of the judgements, the court rightly decided that there were no grounds for the statement that the registration started from the date of the acquisition of the property. Article 21 Section 1 Subsection 126 of the Personal Income Tax Act neither determined the initial date of the registration, nor required its continuity before the date of acquisition, therefore there were no normative bases to accept that the registration for a permanent stay in a given place started for the seller on the date of acquisition disposed of. Therefore, the significant fact was the registration of the taxpayer for a permanent stay in a unit disposed of, or a building, for at least 12 months before the date of disposal, without the requirement of the continuity of registration. On the contrary, another administrative court decided that the period of registration should be counted from the date of acquisition.

Another disputable issue solved in many ways in practice was if the residency relief covered the land under the building. According to one opinion, the residency relief should relate to the whole property sold, which means the land and the residential building constructed on it, which did not result from the content of the Personal Income Tax Act, but from the provisions of the Civil Code, which state that the land and the buildings constructed on it constitute the whole property and cannot be subject to a separate disposal. In this case, the residential building is

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84 See: the Act of the CT of 14 June 1995 (file no. W 19/94).
87 The SAC in the judgement of 14.05.2001 decided that the registration regarding the permanent stay in a given residential unit means residing in a certain place at an indicated address with an intention of a permanent or long-term stay, concentrating the life in a given place, including setting a centre of personal and material interest.
not traded, but the land property built-up with this building.\(^{89}\) If the ownership right to a residential unit, the ownership right to a residential building and the land perpetual usufruct, where the building is located, cannot be subject to a legal trade, then the subject of the sales cannot be divided into certain elements only because of the tax law.\(^{90}\)

According to the second opinion, the exemption was applicable only to a part of the income obtained from the whole property by the taxpayer, to the extend in which the exemption related the revenue from the residential building disposed of. Article 21 Section 1 Subsection 126 a) of the Personal Income Tax Act constituted \textit{lex specialis} in relation to the regulation of Article 10 Section 1 Subsection 8 a) of the act mentioned above, making an exception from the rule that the property sales is subject to the income tax. On the grounds of the definition of “property” included in Article 46-48 of the Civil Code, it was obvious to the court that the term “building”, being a part of the whole property, has a narrower connotation (the meaning of the word) and therefore there arises a situation when the disposal of the building is subject to the exemption, not the whole property, where it is located.\(^{91}\) Using by the legislator in Article 21 Section 1 Subsection 126 of the Personal Income Tax Act the expression \textit{the disposal of the residential building, its part or a share in it}, according to another court, did not constitute a deviation from a civil understanding of the term “property” and did not contradict the building being its part. The civil law and tax law belong to two different areas of law, which means that the same event actually could be judged differently and different legal effects could be assigned to it. On the grounds of the civil law, a disposal of the whole property took place, but on the grounds of the tax law, this action caused the fiscal obligation only with reference to a part of the income from the land sales.\(^{92}\)

In the doctrine of the tax law, significant differences are in order to regulate the tax and civil law, because the civil law concerns private interest, and the tax law – the general interest. It means that the civil law concentrates on the maintenance of legal order and legal certainty, and the tax law is based on the principle of equality and universality of

\(^{89}\) See: the judgement of the PAC in Warsaw of 22.04.2010 (file no. III SA/Wa 2040/09).
\(^{90}\) See: the judgement of the PAC in Olsztyn of 23.09.2010 (file no. I SA/Ol 576/10).
\(^{91}\) See: the judgement of the PAC in Wrocław of 30.10.2009 (file no. I SA/Wr 1100/09).
\(^{92}\) See: the judgement of the PAC in Poznań of 19.05.2010 (file no. I SA/Po 116/10).
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taxation. Tax law and other fiscal issues are a part of new legal complexes and gain special features, necessary to reach the purposes of taxation set by the legislator.

5. The taxation rules real property sales acquired after 31 December 2008

By the amendment to the Personal Income Tax Act of 6 November 2008, the Polish legislator partly changed the method of real property taxation effective in the years 2007 - 2008. The basic principle was not changed, according to which the property sales by a natural person, apart from the business activity, is not subject to taxation if it takes place after 5 years from the end of the tax year, in which the property was acquired or constructed. In addition, the general rules of taxation of the property paid disposal were not changed, as well as regulations regarding the rules of establishing the income to be taxed and the tax rate. A significant change was the liquidation of so-called residency relief and the possibility of spending the obtained revenue on private residential purposes.

The new exemption was included in Article 21 Section 1 Subsection 131 of the Personal Income Tax Act, according to which the revenue from the paid disposal of the property and ownership rights is tax-free, which are determined in Article 30e of the act mentioned above, in the amount, which is equal to the product of this income and the share of expenditures on private residential purposes in the revenue from the paid property disposal and ownership rights if starting from the date of the paid disposal and no later than within two years from the end of the calendar year, in which the paid disposal took place, the revenue obtained from the disposal of this property or the ownership right was spent on private residential purposes; documented expenditures on those purposes are included in the revenue from the paid disposal of the property and ownership rights.

According to Article 21 Section 25 of the Personal Income Tax the expenditures on the purposes defined in Section 1 Subsection 131 of this act are:

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94 See: M. Zirk-Sadowski, Problem autonomii prawa podatkowego w orzecnictwie NSA, Przegląd Orzecznictwa Podatkowego 2004, no. 2, p. 113-123.
expenditures on:

- acquisition of a residential building, its part, or a share in this building, a residential unit being a separate property, or a share in this unit, and also an acquisition of a land, or a share in this land, or a land perpetual usufruct, or a share in this right, related to this building or unit,
- acquisition of a cooperative ownership right to the residential unit, or a share in this right, a right to a single-family house in a housing cooperative, or a share in this right,
- acquisition of a land for a residential building construction, or a share in this land, a land perpetual usufruct, or a share in this right, including also a construction of a residential building in progress, and acquisition of another land, or a share in this land, a land perpetual usufruct, or a share in this right if within the period defined in Section 1 Subsection 131, the land changes into the land for a construction of a residential building,
- construction, development, superstructure, reconstruction, or renovation of the owned residential unit,
- development, superstructure, reconstruction, or adaptation to residential purposes of the owned non-residential building or unit,
- located in a member state of the European Union or in other state within the European Economic Area, or in the Swiss Confederation;

expenditures on:

- repayment of a credit (loan) and the interest on this credit (loan) taken by the taxpayer before the date of obtaining the revenue from the paid disposal, defined in Article 10 Section 1 Subsection 8 a)-c), for the purposes defined in Subsection 1,
- repayment of a credit (loan) and the interest on this credit (loan) taken by the taxpayer before the date of obtaining the revenue from the paid disposal, defined in Article 10 Section 1 Subsection 8 a)-c), for the repayment of the credit (loan) defined in a),
- repayment of any other credit (loan) and the interest on this credit (loan) taken by the taxpayer before the date of obtaining the revenue from the paid disposal, defined in Article 10 Section 1 Subsection 8 a)-c), for the repayment of the credit (loan), defined in a) or b)
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- in a bank or credit unit, seated in a member state of the European Union or other state within the European Economic Area, or in the Swiss Confederation, in a bank or credit unit, seated in a member state of the European Union, or other state within the European Economic Area, or the Swiss Confederation, subject to Section 29 and 30;

- the value of the obtained from a paid disposal, by exchange, located in a member state of the European Union or other state within the European Economic Area or the Swiss Confederation:
  - a residential building, its part or a share in this building, a residential unit being a separate property, or a share in this unit, or
  - a cooperative ownership right to a residential unit, a right to a single-family house in a housing cooperative, or a share in those rights, or
  - a land or a share in a land, a land perpetual usufruct, or a share in this right, assigned to a construction of a residential building, including a land, or a share in a land, or a land perpetual usufruct or a share in this right, with a construction of a residential building on this land, or
  - a land, or a share in a land, or a land perpetual usufruct, or a share in this right, related to a building or unit defined in a).

According to Article 25 Section 26 of the Personal Income Tax Act, the owned private building, unit or room, defined in Section 25 Subsection 1 d) and e) of the act mentioned above, is a building, unit, or room being a property or co-property of the taxpayer, or to which the taxpayer has a cooperative right to a unit, single-family house in a housing cooperative, or a share in those rights.

Article 21 Section 27 of the act mentioned above states that in case of expenditures on residential purposes in a member state of the EU other than the Republic of Poland, or other state within the European Economic Area, or the Swiss Confederation, the exemption defined in Section 1 Subsection 131 is applicable, provided that there are legal grounds resulting from the agreement on avoidance of double taxation or other ratified international agreements, in which the party is the Republic of Poland, to obtain by a tax authority the tax information form the tax authority of the state, on the territory of which the taxpayer makes expenditures for the residential purposes. The legislator in Article 21
Section 28 of this act does not consider the expenditures defined in Section 25 if they are spent on:

- acquisition of a land, or a share in this land, a land perpetual usufruct, or a share in this right, a building, its part, or a share in this building, or
- construction, development, superstructure, reconstruction and adaptation, or renovation of a building, or its part

– for recreational purposes.

Income tax is declared in a separate annual statement PIT-39. The taxpayer declares the income exempt from taxation, regardless of whether the expenditures for residential purposes were already made or not yet. In case when the conditions of the exemption from the tax in relation to the use of the revenue for the private residential purposes are not met, the taxpayer is obliged to submit an adjustment to the annual statement PIT-39 and pay the tax, including the interest on the delay.

It seems that in the light of the regulation effective since 2009, the disputable issues are reduced, but in practice of the interpretation and law application, they exist. For example, they relate to some expenditures declared as the deductible cost, or the expenditures on private residential purposes.

Conclusions

A vague wording of a provision causes that there arises a possibility of a different interpretation of its content and therefore, its different application in analogical situations. The above examples prove that application of some provisions of the Personal Income Tax Act in terms of taxation of real property sales brought many difficulties to both tax authorities and administrative courts. In practice, depending on the Tax Chamber or administrative court, to which the taxpayer was assigned, the identical situation of the real property sales could be taxed differently. Such actions have caused a sense of injustice and unequal treatment of taxpayers by tax authorities and administrative courts. Therefore, it so crucial those legal standards effective in this regard are precise enough so that there is no misinterpretation, and as a result – different taxation of the same legal action subject to taxation. If a casuistic regulation of a given issue is impossible or difficult, it seems that at least tax
authorities and administrative courts should treat this issue fairly and try to eliminate the cases of different attitude in the same matter.

Legal acts

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