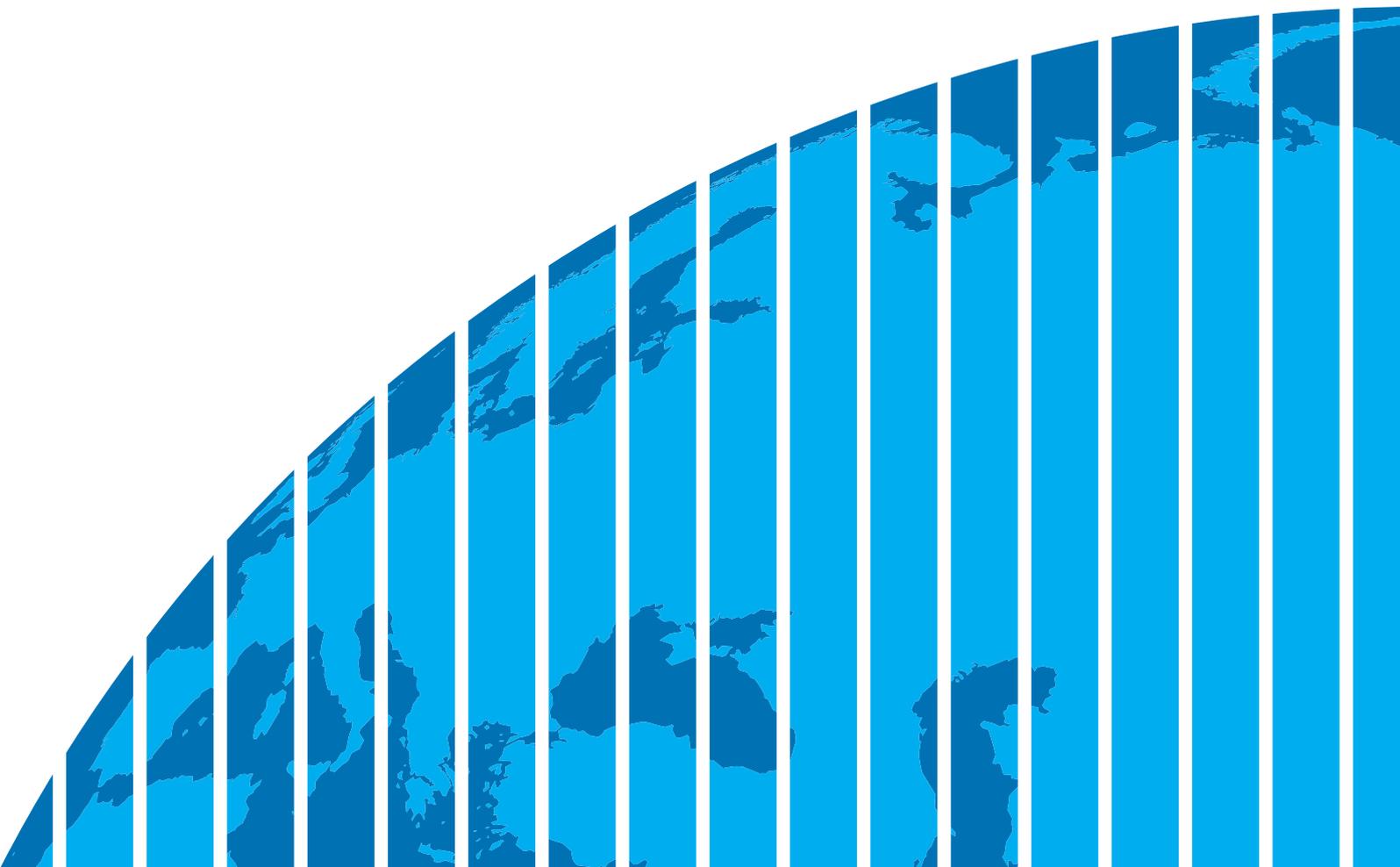


6th INTERNATIONAL CONFERENCE *ECONOMIC DEVELOPMENT,
TAX SYSTEM AND INCOME DISTRIBUTION
IN THE COUNTRIES OF SOUTHERN AND EASTERN EUROPE
OF ASECU*

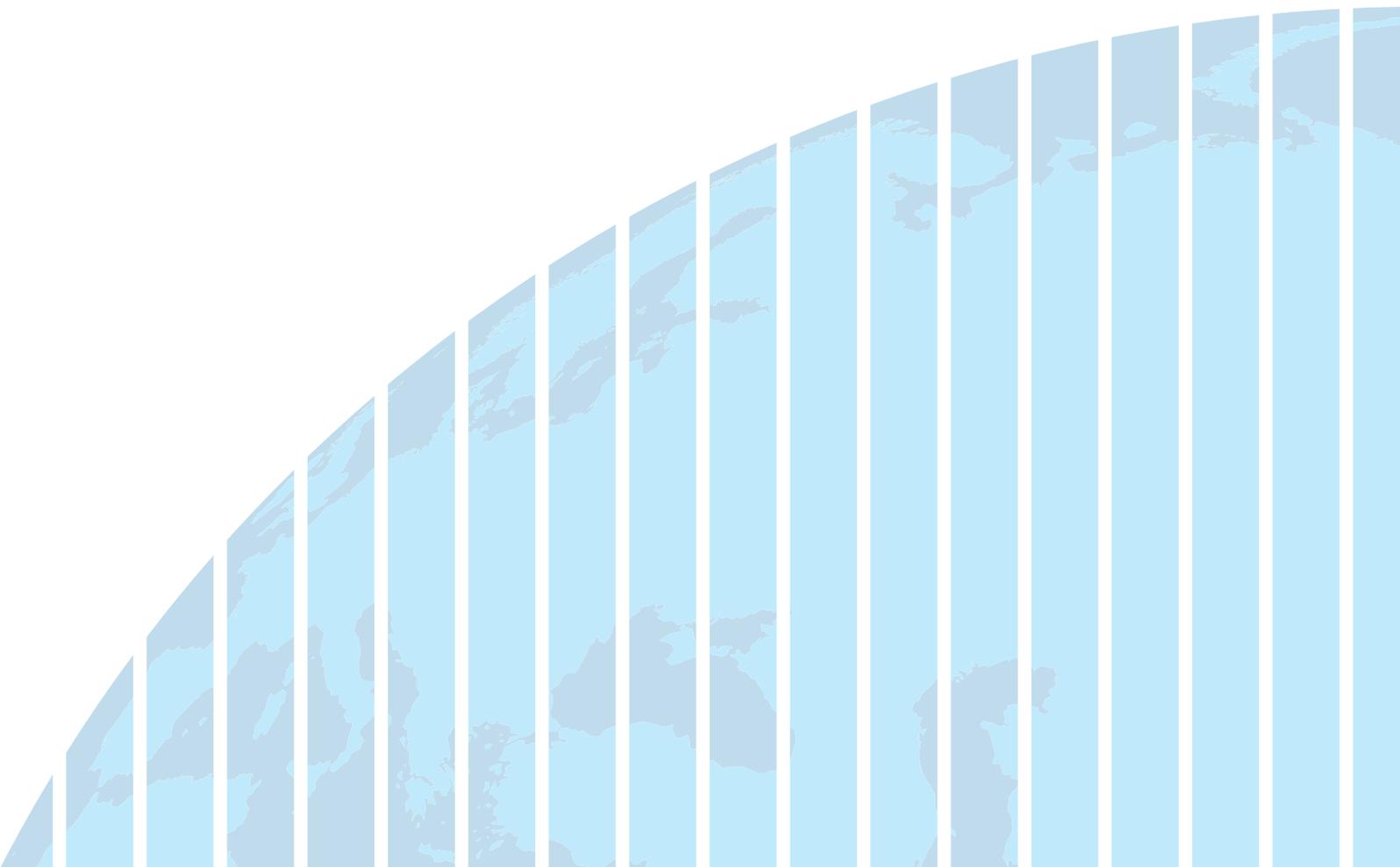


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6th INTERNATIONAL CONFERENCE *ECONOMIC DEVELOPMENT,
TAX SYSTEM AND INCOME DISTRIBUTION*
OF ASECU *IN THE COUNTRIES OF SOUTHERN AND EASTERN EUROPE*



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FOREWORD

The proceedings named „Economic development, tax system and income distribution in the countries of South and Eastern Europe“ include papers presented at the 6th International Conference of ASECU, held in Podgorica, Montenegro, on May 20-22, 2010.

In recent years, efforts for economic and social development in South East Europe have been dominated by reform agendas supporting strong economic growth and EU integration. In spite of progress made, the economies remain frail and social fabric weak. The economic downturn triggered by the global financial crisis has had a profound negative impact on South East European economies, magnifying structural deficiencies and revealing a strong need for accelerated structural reform. These were the main topics of the 43 papers presented at the Conference.

The Conference was characterized by constructive and inspiring dialogue in which the following remarks were emphasized:

- The small size and fragmentation of regional economies provides strong justification for regional trade and economic integration, in parallel with the growing integration with the EU and global economy. Regional free trade area and its deepening as well as joint efforts to attract foreign investment are domains where the value added of regional cooperation is evident. Historical and present affinities between the economies of the region often justify a regional approach in disseminating policy analysis, spreading best practices and exchanging national experiences, in close collaboration with EU and other international actors.
- Building human capital through development of education, science, culture and research is fundamental, not least for strengthening administrative capacities, increasing long-term competitiveness and fostering a regional identity. It is also key for successful European integration, taking into account the objectives of Lisbon Strategy and Europe 2020. While human capital development is a national priority throughout South East Europe, current investment levels in the region in this field are far below what is needed.
- In South East Europe and Western Balkans in particular, the common background and similarities between the education systems justify enhanced regional cooperation in education and research. Regional projects foster knowledge transfer, exchange of best practices, and can lower project realization costs. Regional university cooperation and development of a comparable system for evaluation of education are good examples. Such cooperation can lead to improved transparency of qualifications and allow greater mobility of workers, students and academics within the region.
- Promoting Information Society will help better integration of SEE Countries into the global knowledge base economy. The application of digital technology is the key factor of economic growth, employment rise and unique vehicle for seamless integration into EU.

The main objectives of the conference were obtained and dissemination of the core empirical results will be of great use for further analysis of the economic development, tax system and income distribution in the countries of South and Eastern Europe.

REGIONAL STRATEGY OF REINDUSTRIALIZATION AND REVITALIZATION THE ROLE OF INDUSTRIAL DISTRICTS - THE CASE STUDY OF VOJVODINA

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ABSTRACT

The main thesis in this paper is that key to Vojvodina's exit from the developmental blockade (that exists as a consequence of transition crisis in Serbia and Vojvodina) is enabling manufacture enterprises and agriculture farms in open market economy following European concept of endogenous and sustainable development, creative society and innovative economy. Derivative analysis, to point out an the revitalization of development functions the industrial districts, should be an instrument in solving the problems of large unemployment, revitalization, modernization and construction of needed physical infrastructure, the implementation of sustainable development concept, as well of creating the condition for internal and external cooperation an sub regional and local level. Elaborated methods and results of research is structured in three parts. In the first part are presented synthetic results of analysis the current characteristics of regional producing-organizational system. In the second part is to prepare the phenomena stimulating i.e. blocking the generation and implementation of technological and business innovation. In the three part is elaborated the basic elements of the project of revitalization the role of model the industrial district in regional strategy of reindustrialization.

Key words

Vojvodina, Regional strategy of reindustrialization, European concept of endogenous and sustainable development, Industrial district

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INTRODUCTION

Vojvodina (which as NUTS 2 Region to have in frame of Serbia has got a long tradition of high level of political and administrative autonomy), after the restoration of capitalism and transfer to the development of market social-economic system, are covered by a specific form of long-term social-economic crisis. Vojvodina is after 20th year from the restoration of capitalism, and four investment cycles, only 0.64 of GDP from pre-transitional maximum achieved in 1986. To designate this type of (long-term) social-economic crisis, the notion of *transitionism* is used in the national economic literature (Djuričin, 2008). Without dealing with the explanations in detail here, transitionism is a complex and multidimensional phenomenon which, besides economic, also covers geopolitical, historical, anthropological, and culture aspects. The economic aspects are marked by the problems resulting from the failure to complete four characteristic processes of the (post) socialist transition – privatization, macroeconomic stabilization, institutional reforms and reindustrialization. It appears as the post-transitional stagflation, characterized by – the disharmony between the real and financial sector (dominated by the banking system oriented to retail crediting and the crediting of current business activities, primarily within the sector of non-exchanged goods), impotent (in developmental sense – the author’s note) real sector, vulnerable macroeconomic stability, lack of institution development, and high regulatory risk.

The most visible result of the transitionism is devastated industry. Many old, especially (which used to be) export industries have disappeared, and none new one has been created. The deindustrialization process from 1990 to 2000 in Vojvodina has been survived by only each fourth industrial system and from 4 out of 5 employees at large industrial enterprises have lost their job. The production volume and employment in the industry of Vojvodina in 2000 amount to only around 45% of the pre-transition maximum achieved in 1986/87 (Adžić, 2009b).

There are various views of the basic causes of the occurrence of the transitionism in Serbia and Vojvodina (Djuričin, 2008; Adžić, 2009b; Madžar, 2008). There is the predominant position that its causes should be sought in the geopolitical cataclysm caused by the disintegration of the SFR Yugoslavia and the incapability of Serbia to, in this context be included in the process of integration with European Union (Djuričin, 2008). Without negating this factor, in the author’s opinion, the major cause of the transitional stagflation is the fact that neither capital restoration (1990/91) nor transfer to democratic political system (in late 2000) have eliminated the key social-economic barriers immobilizing production entrepreneurship and blocking the generation, implementation, and economic evaluation of technological and business innovations.

On other side, the process of tertialization of internal economic structure, as a main development model from 2000. years, has depleted its development potentials in Serbia, and Vojvodina, because it has generated the fall of internal and external competitiveness, intensiveness of economic-social asymmetry without appropriate results of development of (national, regional, sub regional and local) producing entrepreneurs and effective public and corporative management, high and growing foreign trading deficit, dynamic growth of external and internal debt of economic subjects and population and similar. The question of open economy has opened again, apropos of systems of criteria and instruments that should have been taken by the state on several levels of governance (in this case an regional, sub regional and local levels) in order to develop organizational and market structures and to review resource priorities and main properties of entrepreneurship and labor culture. This brings us to more questions – Which of existing producing-organizational models would be the most efficient for realization of the reindustrialization due to circumstances in Vojvodina: Clusters, Industrial districts or Poles of generic growth based on development of strong and internationally competent research and academic institutions? Official (implicite) versions of national, and regional industrial policy insist an devolpment model to base a clustering and industrial and technological

parks (zones), primarily to engage of the foreign factors However, this policies doesn't have a real analytic and professional elaboration and, as a consequence, there is a low degree of social-economic coordination and poor maintenance of individual and group development attempts, mainly, in the manner of creating the conditions for privatization of development of the real sector and authentic (national) producing entrepreneurship. Because of that, the solution should be found in adequate combination of all three variants. Industrial clusters should be an instrument for realization of basic regional (and, national - author's remark) goals, mainly in the domain of competitiveness enhancement of total (regional) production structure. Revitalization the development function of Industrial districts should be an instrument for realization of regional (sub regional, and local) goals of development, mainly in solving the problems of unemployment, revitalization, modernatization and construction of needed physical infrastructure, the implementation of sustainable development concept, as well of creating the condition for internal and external interregional and international cooperation an sub regional and local levels. The model of Poles of generic growth should be an instrument for connecting research and academic institutions with the project of regional reindustrialization, mainly in the manner of enhancing the producing entrepreneurship and the quality of human capital to the international level of competitiveness. The layout of realization of the whole project should be represented as a suitable regional policy for reindustrialization (with premises of total social-economic development in order of overcoming the consequences of, so called, transitional crises in Vojvodina, and Serbia) in the function of development of good regional business environment for producing entrepreneurship, and private investments for only in that context, it is possible to develop an adequate producing-organizational configurations in regional economy.

The main focus in this paper is a problem the revitalization of the development functions the industrial districts in frame the project of regional reindustrialization. Elaborated methods and results of research is structured in three parts. In the first part are presented synthetic results of analysis the current characteristics of regional producing-organizational system. In the second part is to prepare the phenomena stimulating i.e. blocking the generation and implementation of technological and business innovation. In the three part is elaborated the basic elements of the project of revitalization the role of model the industrial district in regional strategy of reindustrialization.

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THE BASIC CHARACTERISTICS OF PRODUCING-ORGANIZATIONAL SYSTEM IN VOJVODINA

The current characteristics of regional producing-organizational system must to analysis in the contest of historical estate Industrialization of Vojvodina in the period from 1947 to 1989 was developing in line with the model of industrial districts (Bandin, 1975; Adžić, 2009b). Until the end of 60s of the last century, were formed 7 industrial districts in line with the principle of vertical capacity consolidation into sub-regional business units on reproduction principle which formally had the role of the sub-regional micro-clusters (Table 1). Thereof, only one industrial concept was based in line with the socialist concept of heavy industry development - Pančevo with three micro-clusters (in the form of vertically integrated enterprises) for the production of artificial fertilizers, oil refining and petroleum derivatives production, and manufacturing of petrochemical products. The basis of the development of other industrial districts and micro-clusters mostly included the industries and enterprises set up in the period from 1890 to 1940. Creation of industrial districts was followed by, beside logically rounded production capacity structures, development of adequate logistic capacities (roads, railroads, river-channel networks, ports, warehouses, trading enterprises) and educational capacities (above all, secondary education for industrial and other production occupations in line with specific structure of production of every particular industrial county).

Table 1: Overview of Industrial Districts and Structure of Key Sub-regional Clusters in Vojvodina in 1989

Name of industrial district	Structure of key (formal) sub-regional clusters					
	Agro-industrial cluster	Electro-metal cluster	Oil and gas production and refining	Manufacturing of chemical and pharmaceutical products	Textile and footwear production	Construction and production of buildings materials
Novi Sad	+	+	+		+	+
Subotica	+	+			+	+
Pančevo	+		+	+	+	+
Zrenjanin	+	+				+
Sombor	+	+				
Sremska Mitrovica	+					
Vrbas	+					

The basic characteristic of the regional industrialization within the observed period is that the regional producing-organizational system were developed within the frameworks of mass energy, material and work intensive production based on the imitation of foreign technologies (above all, by importing equipment and buying licenses) and predominant role of political elite within their structural development. The consequences of such approach felt up to date include: (1) poorly accumulated experiences *from the best industrial practice*, mostly because of tolerating high irrationality in using the resources, (2) well rooted habit (especially within business structures) regarding high protection and non-competitive efficiency and (3) value system and social relations blocking in cite generation and implementation of technological and business information. The goods market was not transmitting the signal indicating the production and business system actors – What and under which conditions should be produced to be competitive? The basic signals were coming from the offer side, and then mostly the already present things, without searching for some new ones, were offered. Therefore, the key actors of the production and business system behaved as the typical groups of special interest (distribution oriented coalitions). And where such groups rule, there are no technological and business innovations, but all the efforts are concentrated to maintain the position (Adžić, and Popović, 2005).

INNOVATIONS AND MACROECONOMIC ENVIRONMENT AS FACTORS OF REVITALIZATION OF DEVELOPING FUNCTIONS OF INDUSTRIAL DISTRICTS IN VOJVODINA -

In this point, the emphasis is on macroeconomic phenomena instigating and blocking generation and implementation of technological and business innovations as factors of revitalization of development functions of industrial districts in Vojvodina. Basic criterion is determination of their content in line with European concept of regional endogenous and sustainable business, social, and environmental development, creative society and innovative commerce (according to the basic paradigms presented in the modified version of the Lisbon Agenda from March 2000 – Europe Agenda 2020 from March 3rd 2010 – as noted by the author).

Let us begin, first, from the results of national and regional commercial and public institutions reforms and changes in contents of goals and actions of economic and regional policy. After 2000, the following was realized:

First – Banking system reform according to the recommendations of international economic and political organizations. A new, profitable banking system was created in which, more or less, the principles of hard budgetary limitations and evasion of moral hazard was respected. However, one does get an impression that this reform was carried out, primarily, according to desires of foreign factor, that is, foreign banks which used the vacuum, created by liquidation of four largest national banks, and took over a large portion of the market. This thesis was indirectly confirmed with the beginning of the World economic crisis which showed that the international protagonists, whose interests were represented by these organizations, did not apply this model when some of their key financial organizations were on the brink of collapse. On the other hand, public factor in 2009 led to pushing off the market the private sector through their activities in the securities market.

Second – Rigorous monetary control. However, only a partial success was achieved in fighting inflationary pressures in Serbia, above all, because of the manner in which the privatization income was used (putting it into current consumption and not in realization of infrastructural projects and advancement of human capital performances) and tardiness in preparation and execution of reindustrialization projects.

Third – Privatization of inherited enterprises in competition sector according to the model of sale to external investors. Overflowing of global economic crisis effects to Serbia showed that the privatization was executed at the price of total developmental blockade of these enterprises.

Fourth – Partial prices and products liberalization of monopolistic enterprises and enterprises for public goods production. In this case as well, key changes were left out in the sector of public consumption and restructuring of public enterprises which operated in the regime of natural or administrative monopoly.

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On the other hand, in the last 20 years, numerous limiting factors for realization of national and regional reindustrialization project were created:

First – Existing industrial districts and their clusters are practically gone. In the analysis of this phenomenon one must take into consideration the fact that most of them lost their function around 1980s. What is worrying is the fact that in the last ten years, practically nothing was done to replace them.

Second - The spirit of entrepreneurship is missing both at the group and individual level, as well as the whole social-economic system. The majority of the demonstrated entrepreneurship initiatives have ended in the sphere of non-exchangeable goods (retail, real estate, construction) and very few within the real sector and export industry. This is especially distinctive within the domain of high tech where there are only few successful entrepreneurial attempts (Adžić, 2008; Matejić, 2002). The key issue is that the total situation of the entrepreneurial spirit in Vojvodina is characterized by low capacity for accepting the initiatives which could result from the generic growth polarities.

Third – The absence of development policy market and public institutions is almost completely obvious based on generation and implementation of business and technical innovations. Internal investment potential is missing, there is no venture capital, none of the banks has financing of enterprises created on innovation in their portfolio, public programs for transfer of technologies from research system to new production initiatives are insufficient and with vague and inconclusive results.

Fourth - Strategic coordinating mechanisms are very underdeveloped even besides numerous attempts of the reforms of market infrastructure and infrastructure for public regulation of economy and economic development (Adžić, 2006). This is reflected in the following: (1) very short time horizon of decision making (short term authority), (2) very high subjective discount rate (tactics prevails over strategy), (3) market incentives do not stimulate collaboration, co-operation, confidence, dedication, and cautiousness and (4) public intervention does not stimulate co-operation since it is based on the unconditional co-operation with predominant political option (Matejić, 2002).

Fifth – There is no demand on the part of leading users on the market, as long as interactions between producers and users are weakening and becoming sporadic. The military ceased demand of new technological solutions, Power enterprises presents demands with a warning that payments are not secure, telecommunications are not counting on participation of domestic technologies, while large public communal and production systems are completely taken by sustaining themselves.

Sixth - STIEOT (Science–Technology–Information–Education–Organization–Telecommunication) infrastructure (system) is in decent situation and it is more quality that in many regions of similar development level. However, the structure of the STIEOT infrastructure is non-effective in production sense (Adžić, 2006). All performed STIEOT infrastructure reconstructions (privatization, rationalization, applying European standards in education and science, modernization, association and programming) the task of which was to change the relation to economic innovation evaluation and its contribution to the social-economic development, have failed. The key issue is that the internal relations among the participants of the STIEOT infrastructure are very poor, thus, there is no capacity to exert higher technological pressure to the real economy by actual offer of relevant human resources and new technology.

.....14 Within the presented context, regional, production, business and institutional system, and their environment are not capable of performing the function of the mechanism of the strategy of reindustrialization realization in line with the European concept of endogenous regional development. The analysis demonstrates that the basic human, physical, and normative parts (components) of such systems are mostly correct, in consideration of the situation of the circumstances that determine them. However, complete structure is inadequate therefore they may not express their (development) potentials. Nevertheless, economic analyses are inexorable and they show that Serbia, and Vojvodina undergo, without exaggeration, economic crisis, indicating that they are (now at) permanent basis faced with a kind of development crisis – which could be designated as ***paradox of institutional and technological changes without (real) changes*** (numerous institutional, technological, and human resources and efforts for their improvement are widely seen, but the (new) promised technologies (in the form of new industries), or the efficiency increase of those available to us (in the form of the radical improvement of the performances of the existing enterprises and agricultural farms) are not seen). The current structure is the consequence of the dominance of the interests of the non-competitive and the lack of understanding the essence of the contemporary development problem. Thus, the production, business, and institutional system in Serbia, and Vojvodina have been set within the structure which has been overcome, and which is marked by the paradox stated at the beginning of this paper, i.e. it is in position to maintain itself.

BASIC DETERMINANTS REVITALIZATION PROJECT OF INDUSTRIAL DISTRICTS IN VOJVODINA

Expose in the previous text points out that creation of good macroeconomic environment for revitalization of development functions of industrial districts in Vojvodina is a complex and evolutionary process which includes overcoming numerous barriers in political, economic and social sphere and redistribution of social and economic power, but which has no alternative if one wishes to renew commercial development and bettering of living and work conditions on the basis of synergetic effects of inclusion in the process of European integration. In this context, one can determine the contents of scientifically valid approach of in determining the role of the regions in public regulation of commerce and commercial development in function of creating macroeconomic conditions for the realization of industrial districts revitalization model on the basis of reindustrialization and implementation of key European principles of endogenous and sustainable commercial, social and environmental development. It is precise identification of (regional, sub-regional and local) comparative advantages, ways and problems of their transformation to real (competitive) advantages and in line with that, defining adequate strategies, goals and instruments of regional (sub-regional and local) policies and institutional reforms which would secure, on subsidiary principle, execution of the following set of demands:

First – Thoroughly respecting the principle that modern development is based on differentiated processes which are simultaneously realized in different (sub-regional and local) frames, respecting natural, cultural, social, economic and historical differences. In connection with that, it is necessary to view concrete (sub-regional and local) territories as poles of development, and their population and commerce as a set of potential resources which has to be used efficiently. Because of this, development initiatives must have clear sub-regional and local content and present a realistic response to concrete problems and goals, for which, initiatives are instigated by sub regional and local actors.

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Second – The focus of public factor activities should lie on qualitative, wide and structural development and abilities of every sub-regional and local community to create new activities in production sector on the principles of sustainable commercial, social and environmental development, on its own, and not on quantitative development with very expensive investments in elimination of inherited social and environmental problem.

Third – Reorientation of development approach should be done from *top to bottom* to *bottom to top*. In this way, endogenous characteristics of contemporary commercial development are emphasized, on the basis of public, corporate and individual entrepreneurship and more rational utilization of available regional, sub-regional and local human capital. With the development of the awareness that endogenous development is justified, belief that there is a need to connect every developmental project with the possibilities created by the process of European integration and implementation of the sustainable commercial, social and environmental development possibilities. Accordingly, it is necessary to realize to the letter programs of public regulation decentralization understood in the context of continual process of competences division and responsibility for development from regional to sub-regional and local level, but also, based on respecting the process of subsidiary principle and realistic possibilities in realization of complex and contradictory (public) activity.

Fourth – For the purpose of creating institutional conditions for development privatization on the basis of implementing key standards of sustainable commercial, social and environmental development, it is necessary to create a wide spectrum of different sub-regional and local actors (institutions, organizations and individuals) which create, develop and apply different policies and strategies and their integration in harmonious and functional operative structures. In this context, it is necessary

to provide conditions for partner approach, cooperation and participation in creation of every sub-regional and local sector-oriented and spatial development strategy and their implementation. Only in this manner it is possible to provide consensus of different actors of development, promote strategic approach and avoid (if possible) overlapping of development efforts and negative social and environmental effects and consequences for future generations.

Fifth – It is necessary persistently and consistently to work on creation of social and economic conditions for sustainable economic, social and environmental development on the basis of reindustrialization, understood as wellbeing maximizing factor and securing adequate economic, social and natural foundations for present, as well as future, generations on particular sub-regional or local territory. Critical elements of sustainability on every level are: (1) development of diversified and flexible economic foundation, (2) improving the quality of work and living, (3) protection and advancement of environment (4) providing good natural resources management.

Sixth – It is necessary to create conditions for holistic approach to the problem of sub-regional and local development, respecting strategic aspect, operational structures aspect and activity aspect. Development strategies should provide a framework for programs and activities which are being undertaken. Thus, they have to be based on realistic assessment of the nature of economic, social and environmental problems which occur in a region, as well as they have to be based on ways in which these problems can be overcome. In the implementation of the chosen strategy one should use numerous operational structures, among which the key role is that of the local, sub-regional, regional, as well as national organs of government, enterprises, business associations, development agencies and agricultural farms.

Seventh – Activities on which every sub-regional and local development should be based in function of reindustrialization on the basis of sustainable economic, social and environmental development are: (1) inciting of creation of regional multi-national enterprises, business networks and alliances, (2) inciting development of agricultural farms, small and medium sized enterprises on the basis of export clusters, (3) inciting creation of new enterprises in export industries, (4) promotion of foreign and domestic investments in production sector, (5) development of physical infrastructure, with the emphasis on local level activities – construction and reparation of access roads, reconstruction of industrial railroads, construction and reconstruction of business facilities, communal infrastructure, (6) development of STIEOT infrastructure – providing education and training, support to research and development, providing business consulting, construction and reconstruction of IT infrastructure, (7) strengthening business infrastructure, above all, improving access to financial assets (with strict respect to hard budgetary limitation principle and individual responsibility for fraud and embezzlement) and (8) strategies for improvement of the quality of life, increase of personal safety, reduction of criminal, etc.

Suggested concept of good macroeconomic environment development for production entrepreneurship on sub-regional and local level as social and economic foundations for realization of the project of revitalization of development functions of industrial districts point to following key moments:

First – Measures and instruments of regional strategies of industrial districts development function revitalization overlap with the content of key sector and spatial regional (development) policies, before all, industrial policy, development strategy of agro-industrial complex, trade and educational policy, entrepreneurship policy, “small” business, small SMEs, housing-communal infrastructure, strategy of technological development, spatial strategy and environmental policy strategy. Because of this, there is no need to define explicit versions of this strategy, but its goals, measures and instruments should be built in all key sector and spatial policies (sub-regional and local), with the emphasis on activities that instigate diffusion of organizational innovations and development of

business culture and work culture oriented towards the global market (above all for agro-industrial sector which has resources which are larger than those of EU's inner market) and inner EU market (for other types of processing industry) in direction of satisfying the needs of consumers and developing cooperation in which everyone is the winner, as a source of existence of every commercial subject and business venture.

Second – Strengthening the awareness about realistic range of measures and instruments for realization of regional revitalization of development functions of industrial districts. It means that in the goals of this awareness limitations must be included which are consequence of: (1) underdeveloped system of automatic incentives, that is, various forms of adequate market and non-market motivation, (2) general economic climate, that is, general economic structure which significantly shortens the time horizon of key business decisions, and (3) fact that gain from introducing business innovation, respecting basic principles of sustainable economic, social and environmental development and intensifying international cooperation is marginal compared to other possibilities of acquiring economic and other status gains. In this case, as the results of regional clusterization projects and local business incubators projects, industrial and technological parks, show, the measures based on financial instruments usually did not result in real change on the level of increasing performances of entrepreneurs, managers, agricultural farms and enterprises, according to criteria of open market economy and principles of sustainable social and environmental development, because they were used, predominantly, as a compensation for operating under conditions of non-stimulative business environment, including various occurrences of misuse of funds..

Third – Executing development strategy of good macroeconomic environment for realization of regional revitalization of development functions of industrial districts must be based on sensible scenarios. Every project must be adapted to the condition of the resource and social and economic particularity of the industrial district in question. However, their joint outcome is rehabilitation of the culture of trust in the context of interest of private factor for creation of inciting social and economic framework for restructuring and development of export industries and export trade on the basis of joining together sub-regional and local (private) resources in adequate reproduction wholes. Initial condition is such that, practically, in neither of industrial districts in Vojvodina there are no significant private initiatives for revitalization and development of new export industries, or creation of trade capital circles oriented to export of industrial products on the basis of improving competitiveness and implementation of (European) principles of sustainable economic, social and environmental development. Why are there no private initiatives for development of export industries in sub-regions of Vojvodina? The answer, According to the author, should be sought in domination of distribution oriented coalitions interests and poor quality of public and corporate management (main reason for blocking development of culture of trust lies in avoidance of fiscal obligations, irregular servicing of wages and late payments for obtained agricultural products, unregistered workers, grey economy, poor health protection, long hours, etc.). Of course, in these conditions it is not realistic to expect consensus about redistribution of social and economic power in favor of those who will painstakingly work on development and advancement of competitiveness of any social and economic whole – from business to public function, through agricultural farms, enterprises, regions, state, as the basis for even and decentralized spatial development.

CONCLUSION

The key to coming out of this state of developmental blockade of Vojvodina is enabling enterprises and agricultural farms to do business in conditions of open market economy according to (European) concept of endogenous and sustainable economic, social and environmental development. One of the solutions is to create creative and work potentials in the framework of inherited infrastructure relying on *in cite* resources for their complete valorization through allocating in enterprises, farms, and business ventures which have greatest chance in global and European division of work. To realize this it is necessary that the public factor concentrates on support to local and sub-regional initiatives to achieve excellence, through coordinated efforts of production, educational system and research sector, which contributes to advancement of competitiveness and development of production of local industries oriented towards external markets. Crucial importance for realization is to a smaller degree of material, that is, economic nature (low inflation, exchange rate based on real parameters – area of national economic policy), and to a larger degree determined by cultural nature (trust, accuracy, giving importance to future) and mostly determined by regional macroeconomic environment (in function of support to local and sub-regional development initiatives, diminishing power of distribution coalitions and replacing them with development-oriented coalitions and neutralizing mechanisms of corruption in public regulation) and state of knowledge and entrepreneurial performances of regional population. Because of this, entrepreneurs and managers with their expert teams, in cooperation with the regional state and local communities must set very ambitious (regional, sub-regional, local and business) goals and find original ways to realize them.

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POLITICAL TRANSITION, CORRUPTION AND INCOME INEQUALITY IN NEW DEMOCRACIES. SPECIAL CASE ALBANIA.

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ABSTRACT

This paper examines the effect of democratization on income inequality in new democracies country, using data from the World Income Inequality database. We attempt to explain why income inequality rises at much faster in developing nations than in developed ones. Briefly summarized, high and rising corruption increases income inequality and poverty by reducing economic growth ; increase elite political polarization, induce political instability and even threaten the survival of democracy. The paper argue that the key to solving this puzzle lies in a better understanding of the patterns of democratization and the consequences of corruption in new democracies. While democratization ideally takes place after the construction of a solid institutional foundation of rule of law, realistically most developing countries democratize by introducing elections before they have structured a system of accountability. This type of electoral democracy, despite of legitimizing the government, does not hold the ruling elites accountable through an effective system of checks and balances. As a result, corruption becomes rampant at every level. Most importantly, the emergent corruption attenuates the social demands for redistribution during democratization,since corruption leads to tax evasion particularly among the rich and well connected. This evasion in turn reduces tax progressiveness and offsets the welfare implications of the tax system. Additionally, corruption misallocates social welfare and education program spending by redirecting that spending from those who are truly in need to those who are inside the patronage network. In short, corruption enriches a small part of population at the cost of whole society and therefore leads to greater income inequality.

Key Words

Corruption, Poverty, Income inequality, Democratization.

INTRODUCTION

Income inequality, or more generally the distribution of wealth among citizens in a society, has been a central topic of concern and discussion for several disciplines. Income inequality is found to reduce economic growth (Alesina and Rodrik 1991) ; increase elite political polarization (McCarty et al.2003), induce political instability (Londregan and Poole 1990) and even threaten the survival of democracy.(Przeworski et al.2000).

That democratization in new democracies results in greater income inequality is not only empirically distinctive but also theoretically puzzling. Particularly, many studies have documented a more equal income distribution in democratic countries than in authoritarian regimes.(Muller 1988;Reuveny and Li 2003).This empirical fact alone may not be surprising since various channels exist for responding to social demands in democracies,whereas such demands are easily ignored or even suppressed in authoritarian countries. Thus, in theory, one should intuitively expect a reduction in inequality when a country moves from an authoritarian regime to a democratic system. But why, in reality, do we find that democratization in every new democracy leads to greater income inequality? Put differently, why does this cross-national empirical regularity between income equality and democracy fail to manifest itself inter temporally? Obviously, the key mechanism identified by the conventional wisdom –social demands for redistribution –falls short of answering this question, as the democratic transition also unleashes strong social demands for redistribution –falls short of answering this question, as the democratic transition also unleashes strong social demands for redistribution and yet these social demands for redistribution and yet these social demands are attenuated and not translated into improved equality.

I argue that the key to solving this puzzle lies in a better understanding of the patterns of democratization and the consequences of corruption in new democracies. While democratization

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Ideally takes place after the construction of a solid institutional foundation of rule of law, realistically most developing countries democratize by introducing elections before they have structured a system of accountability. This type of electoral democracy, despite legitimizing the government, does not hold the ruling elites accountable through an effective system of checks and balances. As a result, corruption becomes rampant at every level. Most importantly, the emergent corruption attenuates the social demands for redistribution during democratization, since corruption leads to tax evasion particularly among the rich and well connected. This evasion in turn reduces tax progressiveness and offsets the welfare and implications of the the tax system. Additionally, corruption misallocates social welfare and education program spending by redirecting that spending from those who are truly in need to those who are inside the patronage network. In short, corruption disproportionately enriches a small part of the population at the cost of the whole society and therefore leads to greater income inequality.

In this paper we seek to understand why democratization results in greater income inequality in new democracies, using survey data from the World Income Inequality Database for the world's 30-old countries experiencing democratic transitions during the early part of the 1990s comparing with the new democracies countries, just like my country Albania with a back ground of 20-years fragile democracy,if i can call it democracy.

Why is democracy believed to reduce inequality.

While early investigations of income inequality focused mainly on economic factors, a growing consensus in the literature is that income inequality is jointly determined by both economic and

political factors. One particularly intuitive proposition is that democracy, characterized by a more equal distribution of political power, should be more likely to generate a more equal distribution of economic wealth than its authoritarian counterpart. What leads to this difference between democracy and non-democracy with regard to income inequality is the availability of popular and competitive elections. In societies with no or few democratic rights, the state machinery is controlled by a few political elites who can easily increase and retain their wealth through predatory and repressive means. By contrast, as political participation broadens, democracy takes both political power and economic privilege from the few and places it in the hands of a majority, hence contributing to an egalitarian distribution of income. (Hewitt 1997; Muller 1988; Simpson 1990; Reuveny and Li 2003; Lee 2005). According to this view, social demand for redistribution unleashed by popular suffrage are the key mechanism through which democracy is argued to reduce the income disparity among citizens. The lower and other socio-economically disadvantaged classes, that previously were excluded from political arenas now have a chance to call for redistribution at the ballot box. Redistribution policy transfers wealth from the rich to the poor, which in turn leads to a more egalitarian distribution of income in a society. First, the poor benefit from redistributive policies, whose costs are mostly borne by the rich. Therefore, the poor will demand redistribution, whereas the rich will oppose it. Second, the median voter is located below the average income voter in the income distribution, since empirically the income distribution is typically right skewed. Lastly, using Downsian logic, government adopt the policy that is preferred by the median voter. Taken together these assumptions brings us the following theoretical prediction: democratic governments respond to social demands for redistribution, which are generated by the gap between the median and the average income voters, through progressive taxes and social transfers. The redistribution demands in democracies provide the rich with a disincentive to invest domestically, so they are more likely to flee with capital to other countries with lower taxes, hence reducing economic growth in the home country, (Franzese 2002a, Chapter 2) further shows that government responsiveness to redistribution demands are greater in countries with higher voting turnout rates.

Social demands for redistribution do not simply manifest themselves in elections and then fade away thereafter. The key is that democracy grants and protects the freedom of association, enabling the poor to form labor unions and social democratic parties to represent their economic interests. Various studies demonstrate the egalitarian consequences of union density. Golden and Wallerstein (2006), for instance argue that unions reduce fairness, and most importantly, empower low-pay workers against employers during the wage-setting bargaining process. On the other hand, empirical studies derived from partisan theory (Hibbs 1977) have consistently shown that social democratic governments are associated with higher welfare –state expenditure (Hicks and Swank 1992), lower unemployment (Alvarez et al. 1991), and greater investment in human capital (Boix 1997). In short, unions and social democratic parties jointly protect both the market and political power of the poor, thereby institutionalizing social demands for redistribution. Through these organized bodies, the poor are more likely to succeed in tilting the income distribution in their favour.

In sum, according to the conventional view the poor's social demands for redistribution are unleashed through multiple channels and are answered by democratic governments. Taking this democracy –equality argument to its logical conclusion, one should intuitively expect a reduction in income inequality when a country moves from an authoritarian regime to a democratic system. Muller (1998), for instance, finds that income inequality gradually reduces as a country gains more years of democratic experience. Similarly, Robinson (2000) attributes the egalitarian trends in Europe in the past century to the democratization of these countries. Nevertheless, as figure 1 shows, this intuitive proposition does not fare well in the context of the new democracies, for which we find the exact opposite pattern. This makes us wonder what went wrong in these nascent democracies. Why do social demands for redistribution unleashed during the democratization process fail to result in a more egalitarian income distribution?

Political Accountability.

I argue that the key to solving this intriguing puzzle lies in more fully understanding the dynamics by which democratic governments process redistribution demands and translate them into policy outputs. I think that to assure the proper translation from social demands to better distributional outcomes lies in political accountability. In my country, still nowadays, that we are a new democracy, (20 years) country, is happening the same thing and the problem is the political accountability. When democratization brings political accountability to the hands of citizens in new democracies, citizens are empowered to evaluate incumbents' performances and decide whether or not to throw the rascals out. Consequently, accountability creates a channel for citizens to exert their influence and to make elected officials act in the interests of citizens (Ferejohn 1986). Specially when new democracies are equipped with institutional check-and-balance structures, citizens are able to take advantage of the conflicts of interest among political elites and elicit information that is otherwise unavailable to them (Persson et al 1997). Hence, democratic accountability mechanisms help to constrain the ruling elites from abusing their powers and ensure that social demands for redistributions will be fully addressed in the policymaking process. Without proper accountability mechanisms, redistribution demands are vulnerable to electoral considerations and political manipulation and hence become attenuated in new democracies.

The theory of accountability is well supported in several empirical studies. Muller (1988) argues that the lack of fully institutionalized political structures in new democracies is the main reason for a non-finding concerning the relationship between the level of democracy and inequality. Is the level of institutionalization and accountability, not the level of democracy, that leads to the reduction of inequality. Specifically, (Lee, 2005) argues that the public sector expansion only reduces inequality in fully institutionalized democracies in which the working classes can channel their organized interests "through an efficient and sound bureaucracy capable of implementing progressive tax and transfer policies". While all these studies emphasize the importance of political accountability in the democratization process, accountability is unfortunately a rare commodity in new democracies. By sharp contrast, most citizens in new democracies find themselves poorly governed. As Keefer (2005, p.1) forcefully puts it, "Many democracies fall short of many autocracies in the provision of public services or the protection of human and economic rights." Keefer finds overall that nascent democracies suffer from more corruption, lower provision of rule of law, inferior bureaucratic quality, and lower school enrollment.

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DEMOCRATIZATION AND ITS DISTRIBUTIONAL CONSEQUENCES

In this section, first, I highlight differences in the modes by which and the conditions under which democratization takes place. Second, I discuss how democratization without institutionalization, the dominant type of new democratization, may lead to an outbreak of corruption. Finally, I examine the mechanisms by which corruption leads to inequality in new democracies.

The Modes of Democratization:

I argue that much of the debate over political and economic performance in young democracies results from overlooking the ways and the conditions under which democratic transition initially takes place. An influential tradition in the democratization literature posits that the outcome of democratization is path and history dependent. In their seminal book, O'Donnell and Schmitter (1986) hold that the mode of transition, shaped by the strategic interaction between state and society, critically determines both the path and the destination of democratic transitions. These authors identify four critical actors in the early phase of democratic movements, using the side of affiliation (democratic challengers or authoritarian incumbents) and the strength of ideology (hardliners or

moderates) as guides. Importantly, they argue that a democratic transition is most likely to succeed when both moderate incumbents and challengers ally with each other but is doomed to fail in the absence of such an alliance. In particular, a new democracy is more likely to survive using the mode of pacted transition because pacts that enhance trust and sharing among actors become institutionalized as a set of checks and balances in the new democracy (McFaul 2002). Meanwhile, Przeworski (1991) emphasizes the importance of the initial condition: democracy enhancing pacts are most likely to appear when the distribution of power is roughly equal between both sides. Under such circumstances, political actors have higher uncertainty regarding their own strength and the odds of success if they switch to using force, and they hence have greater incentives to reach a compromise. Importantly, Cervellati et al (2006) shows that new consensus-based democracies produce growth-enhancing environments and implement larger fiscal redistribution programs, since consensual democracy serves as a signaling device to coordinate the society's expectations about the rule of law and to secure property right protections. By contrast, democracies that were born in a conflictual environment do not necessarily perform better than authoritarian regimes. In short, Cervellati conclude that democratization does not guarantee the emergence of efficient economic systems; what is more important is the process by which countries democratize. Kaplan and Converse (2006) endorse this view and argue that the variance among democracies in terms of constitutional arrangements and institutional maturity matters more than the level of democracy itself with regard to delivering preferred economic outcomes.

The above discussion on the patterns of democratization and their economic consequences sheds light on the lack of accountability in new democracies. Specifically, it is important to emphasize the distinction between democratic transition and democratic institutionalization; the former refers to a process that transfers political power from a few elites to the popular masses, whereas the latter denotes the process of engraving democratic principles into the society. Huntington (1971) is one of the pioneers warning us of the potential incompatibility between these two concepts. He argues that democracies vary significantly in degree of institutionalization. More important are the political consequences when democratic transition and democratic institutionalization fail to occur in the right order during the democratization process. Concretely, Huntington posits that political systems will become unstable when political participation advances more rapidly than institutionalization.

Rose and Shin (2001) elevate Huntington's view to a higher level by comparing the democratization processes observed in the first and third waves of democratization. They argue that the first wave of democratization took place in a "forward" manner. That is, before universal suffrage and competitive elections were introduced in these advanced democracies, these countries had already developed a state structure buttressed by a solid institutional foundation of rule of law, a vibrant civil society, and checks and balances among political actors. By contrast, new democracies introduced free elections before these countries even had a chance to build and secure an institutional foundation. As a result, "The governors of these new democracies thus face a double challenge: completing the construction of the modern state while competing with their critics in free elections" (Shin and Rose 2001, p. 336). Due to the absence of fundamental institutions, Rose and Shin (2001) hold that most new democratizations remain incomplete. As other scholars have also posited, a functioning and consolidated democracy needs to be buttressed by behavioral, attitudinal, and constitutional foundations. While new democracies enfranchise citizens and legitimize the government through elections, these democracies fall into the trap of electoralism by only fulfilling the electoral criteria of democracy without supplying an effective system of checks and balances to hold the ruling elites accountable (Diamond 1999; Bratton et al. 2005). A live example is still nowadays, my country, Albania. We have the same problem, we had our last elections in July 2009 and we still have a political crisis, because the opposite doesn't agree with the results of the elections and is still out of the parliament, as it doesn't believe in the government institutionalization.

DEMOCRATIZATION, CORRUPTION AND ITS CONSEQUENCES IN INEQUALITY.

The combination of competitive elections and a lack of accountability in new democracies can be explosive in several consequential ways. First, the pressure to stay in office may encourage opportunistic incumbents to engage in electoral fraud or economic manipulation. Since Nordhaus' (1975) early contributions, a standing literature commonly known as the political business cycles (PBC) literature has emphasized that the desire for reelection leads incumbents to stimulate the economy just before elections, with subsequent adverse effects.

Political parties in new democracies are in general institutionally underdeveloped. For instance, Kim (2000) argues that parties in South Korea, just like in Albania are ideologically indistinctive and are organizationally detached from civil society. Put even more bluntly, politicians have turned political parties into their own personal instruments. The accountability consequences of ill-developed parties are non-trivial. Literature on personal voting has long posited that when candidates' personal reputations electorally outweigh party reputations, candidates will seek to build their own patronage networks and pursue personal votes. However, personal votes are costly to candidates, and the more personal votes a candidate needs to secure victory, the more incentive he has to seek illegal funds from special interest groups to finance the campaign, thereby engaging in corruption (Cain et al. 1987; Carey and Shugart 1995). Paradoxically, while democracy theorists consider electoral competition conducive to accountability, stiff competition under this personal vote scenario can actually serve exactly the opposite purpose. In fact, a candidate's dependence on personal votes increases with his perceived electoral uncertainty. Competitive elections will magnify a candidate's belief that he will lose in his reelection bid, and he therefore will try to collect more personal votes (and hence more illegal bribes) in order to win (Chang 2005). In short, a lack of institutionalized party politics leads to the prevalence of personalistic elections in new democracies. In turn, these personalistic elections increase candidates' dependence on unlawful resources and result in higher levels of corruption and economic outcomes (e.g. tariffs, contracts, or subsidies) that are dominated by or favorable to various special interests at the expense of ordinary citizens. Hellman (1998) vividly illustrates how organized interest groups effectively hijacked the economic reform process in post-Communist Russia, reaped the benefits, and stonewalled other reform policies intended to create transparency, competition, and openness.

Finally, democratization without institutional foundations may simply present a golden opportunity for self-enrichment and power abuse in new democracies. Moran (2001) demonstrates that bribes, kickbacks, and various forms of corruption are supplied in return for government favors and special treatment in Latin American countries when democratization is associated with privatization. I think that the point is that "although democracy has in many ways opened up Albanian politics and brought people liberty, it has also produced a degree of chaos and instability that has actually made corruption and lawlessness worse in many cities ." Several scholars hold the same view in the context of East European country and African country. Quan (2004) argues that the third wave of democratization has been accompanied by an eruption of corruption in both the Philippines and South Korea. Chu and Lin (1996) suggest that with the expansion of electoral avenues in Taiwan, local factions and business sectors were presented with new and greater opportunities for political investment, and as a result the money politics and corruption that used to dominate the local level elections quickly seeped into national level elections. In short, as Moran (2001) argues, the conventional view that democratization necessarily reduces corruption is subject to fallacy. While limitations of the currently available cross-national data on corruption prevent us from drawing a definite inference concerning the effect of democratization on corruption, all our discussions so far lead us to the same conclusion: democratization by itself is not an adequate deterrent against corruption. To the contrary, when countries democratize without institutionalization, election-winning incentives and pressures, underdeveloped

party structures and ill defined policy platforms, and the lack of credible accountability mechanisms jointly provide a breeding ground for corruption in new democracies. Worth noting is the mutually reinforcing process between state building and democratic consolidation discussed in Bratton and Chang's study (2005).

Why Corruption Worsens Inequality.

Corruption is now recognized as a cancer of a polity. Commonly referred to as the abuse of public office for private gain, political corruption is found to harm economic growth, lower levels of investment, foster underground economies, and distort the composition of governmental expenditures (Mauro 1995; Jain 1998). Furthermore, recent empirical studies have started to systematically explore the channels through which corruption may affect income inequality. Corruption may affect income inequality and poverty through various channels, including overall growth, biased tax system, and poor targeting of social programs as well as through its impact on asset ownership, human capital formation, education inequalities, and uncertainty in factor accumulation.

1. Growth.

High corruption can lead to high poverty for two reasons. First, evidence suggests that a higher growth rate is associated with a higher rate of poverty reduction (Ravallion and Chen, 1997), and that corruption slows the rate of poverty reduction by reducing growth. Second, income inequality has been shown to be harmful to growth (Alesina and Rodrick, 1994; Person and Tabellini, 1994) and if corruption increases income inequality, it will also reduce growth and thereby limit poverty reduction. (Ravallion, 1997).

2. Biased tax systems.

Corruption can lead to tax evasion, poor tax administration, and exemptions that disproportionately favor the well-connected and wealthy population groups. This can reduce the tax base and the progressivity of the tax system, possibly leading to increased income inequality.

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3. Poor targeting of social programs.

Corruption can affect the targeting of social programs to the truly needy. The use of government – funded programs to extend benefits to relatively wealthy population groups, or the siphoning of funds from poverty-alleviation programs by well-connected individuals, will diminish the impact of social programs on income distribution and poverty.

4. Asset ownership.

High concentration of asset ownership can influence public policy and increase income inequality. In a society where asset ownership is concentrated in a small elite, asset owners can use their wealth to lobby the government for favorable trade policies, including exchange rate, spending programs, and preferential tax treatment of their assets. These policies will result in higher returns to the assets owned by the less well-to-do, thereby increasing income inequality. Furthermore, assets can be used as collateral to borrow and invest; therefore, inequality in ownership of assets will limit the ability of the poor to borrow and increase their lifetime income and will perpetuate poverty and income inequality. (Li, Squire, and Zou 1996; Birdsall and Londono, 1997).

5. Human capital formation, education inequalities, and social spending.

Corruption can affect income distribution and poverty via its impact on human capital formation and the distribution of human capital. First, corruption weakens tax administration and leads to tax evasion and improper tax exemptions, as discussed above. Therefore, for a given tax system, the higher the level of corruption, the lower the tax revenue and the lower the resources available for funding public provision of certain services, including education.

Second, corruption increases the operating cost of government, and therefore reduces the resources available for other uses, including the financing of social spending that is crucial to the formation of human capital. In fact, higher corruption is found to be associated with lower education and health spending (Mauro, 1997).

Third, wealthy urban elites can lobby the government to bias social expenditure toward higher education and tertiary health, which tend to benefit high-income groups. Corruption can also increase expenditure on tertiary health because bribes can be more easily extracted from the building of hospitals and purchasing of state-of-the-art medical equipment than from expenditure on vaccinations.

Finally, corruption can increase the share of recurrent expenditure devoted to wages as opposed to operations and maintenance. (Tanzi and Davoodi, 1997). This lowers the quality of education and health services and affects the ability of the state to improve educational attainment levels.

6. Uncertainty and factor accumulation.

If the “rules of the game” in a corrupt country are unclear and biased toward the well-connected, the poor and the less-well-connected face added risk premium in their investment decisions. This unequally distributed risk increases

expected returns to any investment for the well-connected relative to the less-well-connected. Therefore, low income and poor groups—the less-well-connected will be discouraged from investing in any resource—human, physical capital, or land—and income inequality and poverty will be perpetuated or accentuated.

.....28 In a pioneering contribution, Gupta et al. (2002) argue that corruption increases income inequality through the following mechanisms.

First, corruption distorts income distribution in a direct and self-explanatory way, since illegal benefits derived from corruption by definition accrue disproportionately to those who control and/or have access to political power, while the costs are externalized to ordinary citizens. Second, corruption distorts the tax system in several ways (e.g. tax evasion) that favor the rich and well-connected. This in turn reduces tax progressiveness and offsets the welfare implications of the tax system. Additionally, corruption misallocates social welfare and education program spending by redirecting that spending from those who are truly in need to those who are inside the patronage network.

Alternatively, corrupt politicians may auction off the provision of public goods, and under such circumstances delivery of social services will give priority to the rich (who can afford to pay higher prices) rather than the poor (who are the assumed beneficiaries of social programs) (Lui 1985). In either case, corruption will cause under-provision of social and education programs, which consequently prevents the formation of human capital, the upgrade of job skills, and the potential for social mobility for the poor. Therefore, corruption inevitably nullifies the egalitarian effects of social programs on income inequality. Finally, Gupta et al. (2002) note that the corrosive effects of corruption and income inequality can be mutually reinforcing through two parallel mechanisms. In systems that are penetrated by and permeated with special interests, corruption disproportionately enriches the wealthy and thereby leads to a high concentration of wealth. Meanwhile, beneficiaries whose assets are obtained from non-market profits have incentives to bribe the government for favorable policies and information so as to maintain their market advantages. The favorable policies and information in turn yield higher returns to the assets owned by the rich, while extra uncertainty and risks in the investment environment bear down only on the shoulders of the poor. Under this vicious circle, inequality raises corruption, and corruption in turn strengthens inequality.

Alesina and Angeletos (2005) mirror the above view and argue that the vicious circle of inequality and corruption operates through government spending programs. The notion is that when wealth resulting from corruption is deemed unfair by the society or when the ability to seek illegal rents lies most in the hand of the rich, the poor will demand redistribution programs to compensate for the inequality induced by corruption. However, when the size of government increases, more opportunities for corruption also emerge, which again contributes back to a higher level of inequality and stronger support for redistribution. Alesina and Angeletos suggest that this vicious circle accounts for the political economy in Latin American populist regimes, which are characterized by a paradoxical coalition that includes both the poor who benefit from redistribution and the rich ruling elites who gain from corruption. Similarly, You and Khagram (2005) argue for a self-reinforcing relationship between corruption and inequality, with an emphasis on how inequality might turn corruption into an acceptable norm and practice for both the poor and the rich. To sum up, the above discussion warrants several empirical inquiries, including (1) whether different modes of democratization affect the quality of new democratic regimes, (2) more specifically whether backwards democratization leads to greater levels of corruption, and (3) whether corruption in new democracies attenuates social demands for redistribution and hence leads to greater income inequality.

Empirical Analysis.

I attribute rising income inequality in new democracies to corruption, and I empirically test the hypothesized corruption-inequality link at two levels. At the cross-national level, I build upon data compiled by Reuveny and Lee (2003), and I focus on the world's 30-odd countries experiencing democratic transitions during the early part of the 1990s. (Figure .1). At the individual level, I use survey data from both the Afrobarometer and the Albanian Statistics (IDRA; Institution of Researches and Development Alternatives), country that span more than 20 new democracies .

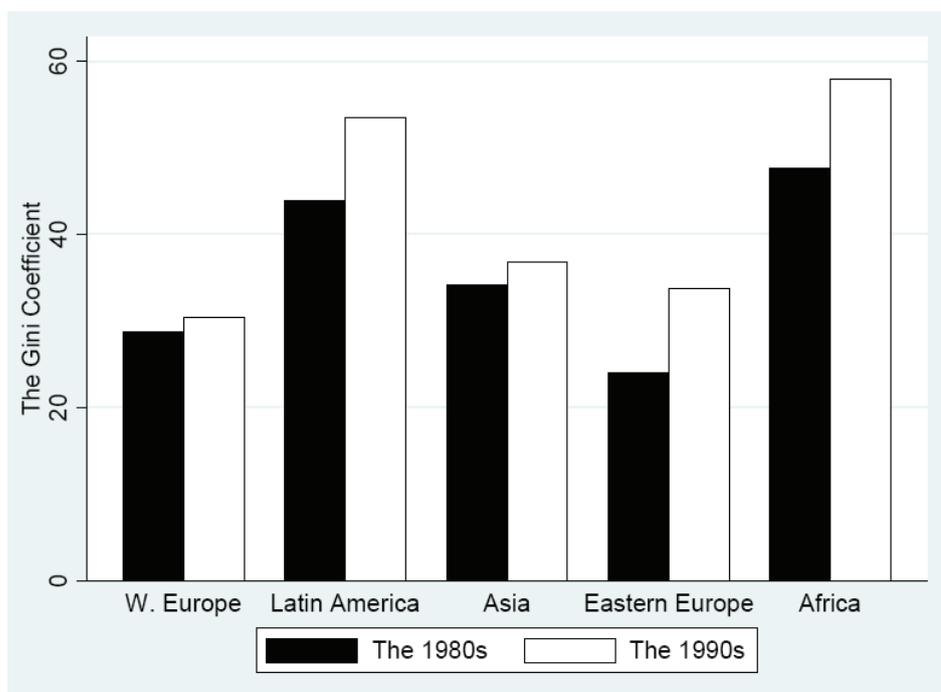


Figure 1: Inequality Before and After Third-Wave Democratization

Aggregate-Level Analysis

Reuveny and Li's recent contribution (2003) is the first systematic empirical study to examine both the international economic and domestic political determinants of income inequality. In terms of domestic political factors, these two authors, following the conventional view regarding social demands for redistribution, argue that higher levels of democracy should be associated with lower income inequality. With respect to international factors, they argue that trade openness increases income inequality in developed countries but reduces it in developing countries. This differential effect of trade on inequality is guided by the Heckscher-Olin model and the Stolper-Samuelson theorem, which posit that the winners from international trade between developed and developing economies are the unskilled workers in developing countries and the skilled workers and capital owners in developed countries. Additionally, drawing from various insights, they argue that both foreign direct investment and exposure to foreign financial capital should reduce inequality.

Reuveny and Li test their hypotheses against cross-national time series data that cover 69 countries during the period from the 1960s to the 1990s. Their dependent variable is the decade average Gini coefficient. Controlling for the effect of domestic economic growth (i.e., the Kuznets curve), they find that both democracy and trade reduce the level of income inequality, that foreign direct investment increases inequality, and that foreign financial capital has no effect on inequality in either developed or developing countries. From the graphics above we can see that only the new democracies country, like Latin America, East Europe who included Albania, Africa, have worsen the Gini coefficient, also income inequality.

Individual-Level Analysis

While the results from the previous aggregate-level analysis seem encouraging, additional analysis on individual-level data is useful for both theoretical and empirical reasons. First, despite the proliferation of aggregate-level studies of income inequality, individual-level analysis on income inequality is grossly under-developed. While income inequality is by construction an aggregate-level phenomenon, this unbalance is still unfortunate given the fact that citizens' perceptions concerning income inequality and corruption may strongly affect their behavior. Thus, it is informative to examine whether the influence from the country level inequality might have dipped into the individual level. Milanovic (2003) forcefully argues that citizens' perceptions of inequality, and corruption provoke their sense of injustice, since it is human nature for people to compare themselves to their peers. Their self-placed positions in the income distribution become a surrogate of how they think the society values them. In this sense, the perceived level of inequality is "a social expression of their own worth". Additionally, citing the fact that participants commonly turn down an unfair (yet Pareto-enhancing) offer in the dividing-a-dollar ultimatum game, Milanovic argues that rational individuals have implicitly embedded inequality into their utility functions. Hence, it is of great importance that we enrich our understanding of income inequality at the individual level. Second, while the previous aggregate-level analysis is informative, the model is static in nature, meaning that its inferences are drawn from cross-national variation. As a result, it inadequately captures the dynamic between corruption and inequality implied by the theory. As I shall elaborate on below, turning to individual-level survey data provides at least a partial solution to this problem of dynamism.

The individual-level data come from two parallel cross-national survey projects: the Afrobarometer and IDRA. The Afrobarometer is a collaborative survey project that studies citizens' social, political, and economic attitudes in more than a dozen African countries. IDRA (Institution of Researches and Development Alternatives) conducts similar research in Albanian, sponsored by USAID.

As discussed above, one empirical advantage of using survey data is the ability to measure the dynamics of income inequality. Specifically, the Afrobarometer asks respondents the following question: "Please tell me whether the gap between the rich and the poor in this country is better or

worse than it was a few years ago, or whether it has remained the same.” The answer scores on a metric of 1-5, where 1 represents “much worse” and 5 “much better.” Table 1 summarizes citizens’ perceptions concerning past changes in inequality in Africa. At first glance, we can quickly see that rising income inequality is indeed a common concern: a great majority of the African respondents believe that the gap between the rich and the poor has increased over the past few years, while only slightly more than 10 % think the opposite. More than 50% of respondents say that income inequality has gotten much worse. While Albanian cities present a less extreme picture, overall more respondents still report that inequality has become worse than better.

While the information that I have taken about Albania from IDRA, tell us that the Albanian people (60 % of the interviewers) have still the same perception that corruption is very high in our country and it is going worse, and it is the main factor why things doesn’t go better for the Albanian, although we have 20 years of democratization. Table.2 and the graphics below summarizes citizens’ perception of inequality and corruption in Albania, told by IDRA, 2009. The tables below, Fig.4; Fig.5 ; Fig.38; Fig.10.(taken off the IDRA opinion –poll, 2009) tell us about the perception of the Albanian people in relation with corruption, under four years, 2005 ;2006; 2008; 2009, and we can see clearly that the most corrupted in our country are the customs officers, tax force, ministers,deputies, the doctors, public officials (average. 70%- 80% think the same.), and that from 2005 (a electoral year in Albania), still now the corruption seems that it is increased with 13 % .

Four years later, another electoral year for albanian, other four years of democratization, and we are still more corrupt and more unequal, and of course, still out of European Community... and I think that Albania is a live example of 20 years of democratization without before institutionalization, political accountability and when the pure democratization is still a dream...

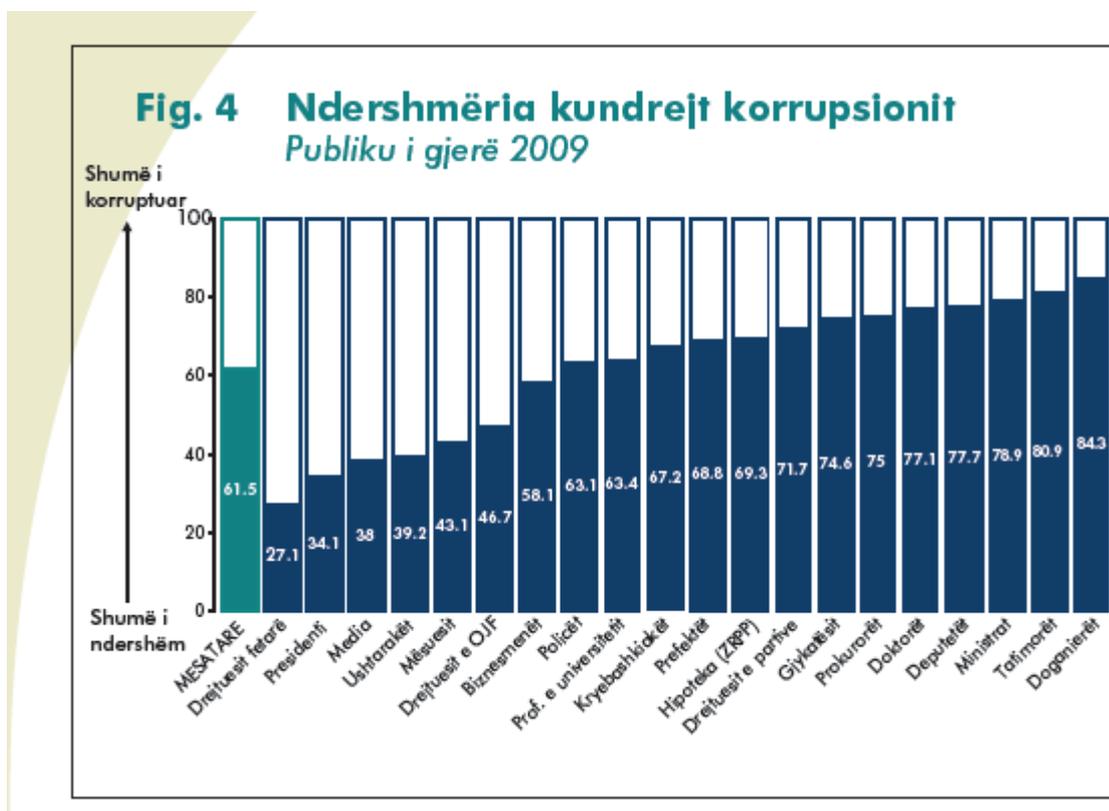


Fig.4 The honesty by % (percent) of corruption.

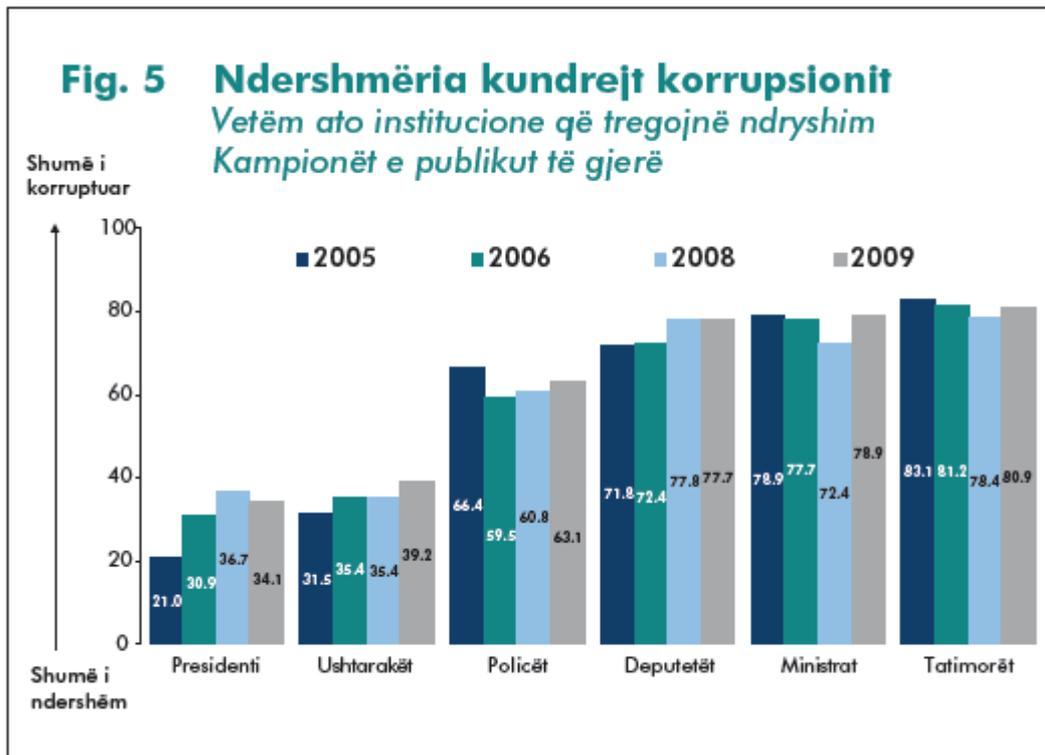


Fig.5 The honesty by %(percent) of corruption, under 4 years, (2005;2006;2008;2009).

Source of data : IDRA.(2009)

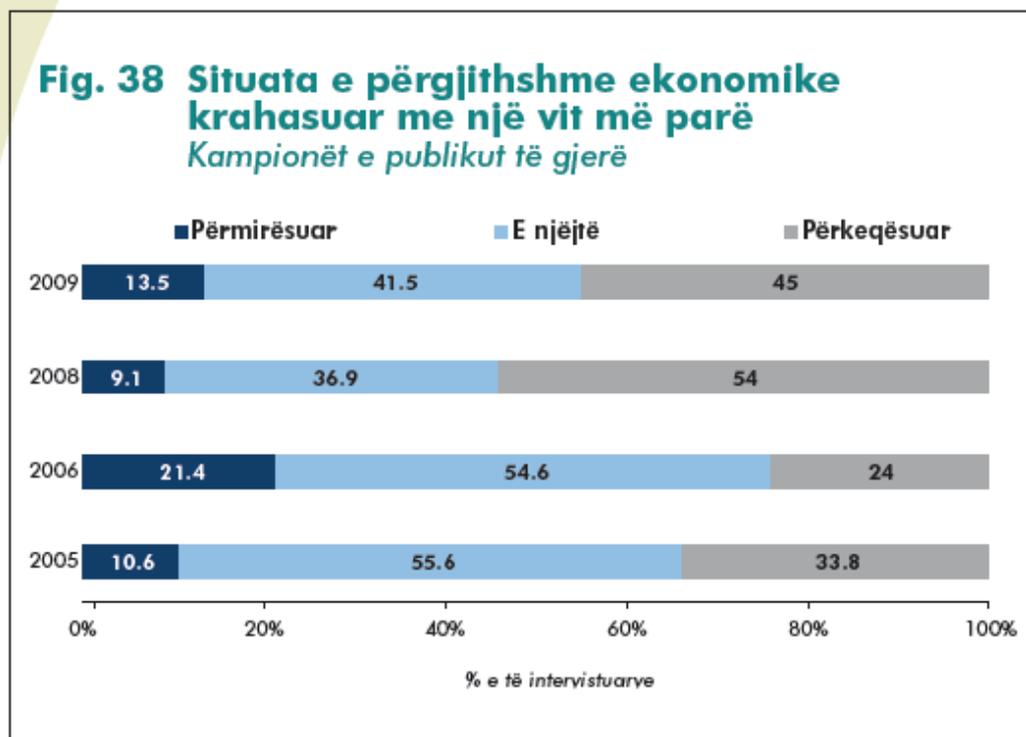


Fig.38 Economic situation in Albania compared with a year ago.

Fig. 10 Korrupsioni ndërmjet zyrtarëve publikë krahasuar me vitin e kaluar
Kampionët 2009

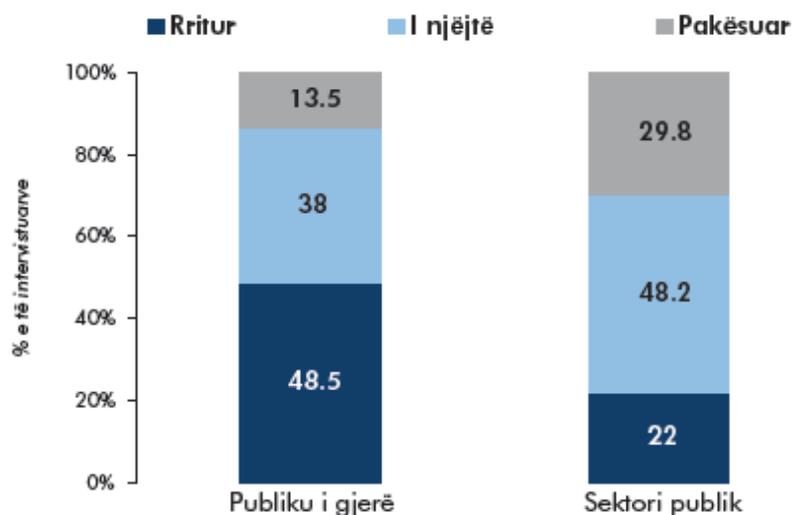


Fig.10 Corruption of Public officials compared with a year ago.

Source of data : IDRA, 2009.

Table.1 Citizen's perception on the past change in inequality in Africa.

Country	Much Worse	Worse	The Same	Better	Much Better
Benin	37.8	42.5	10.9	6.8	4
Botswana	32.5	30.6	20.6	13.7	.8
Cape Verde	17.9	34.2	25.6	10.3	1
Ghana	32.7	26.5	19.4	14.1	1.8
Kenya	43.3	25.7	15.0	11.1	.9
Lesotho	56.8	21.4	9.0	10.5	.3
Madagascar	18.6	38.6	22.6	15.2	.2
Malawi	67.8	15.9	6.9	5.3	2.4
Mali	30.0	33.3	17.3	16.0	1.6
Mozambique	19.9	30.8	23.2	14.9	1.6
Namibia	18.0	24.6	30.9	19.9	3.9
Nigeria	52.9	27.6	11.7	6.4	.6
Senegal	13.8	40.2	14.7	19.6	2.1
South Africa	27.6	24.5	24.6	17.1	3.4
Tanzania	34.4	23.3	12.7	11.7	4.6
Uganda	37.8	31.3	14.3	14.0	.7
Zambia	55.8	25.7	14.7	1.8	.7
All African Countries	35.2	29.2	17.3	12.0	1.6

Source: Afrobarometer,2008

Table.2 Citizens perception on the past change in inequality in Albania.

City	Much Worse	Worse	The Same	Better	Much Better
Fier	17.5	43.5	30.9	7.8	0.3
Elbasan	35.2	36.8	13.7	10.6	3.8
Durres	10.2	15.6	47.7	21.5	5.0
Vlore	18.9	21.0	33.4	23.5	3.2
Tirane	1.6	7.7	41.4	40.2	9.1
All Albanian cities	15.4	24.8	32.9	20.5	4.2

Source: IDRA

CONCLUSION

This paper attempts to solve the puzzle of why democratization results in greater income inequality in new democracies. I argue that the answer lies in a better understanding of the ways countries have democratized. When third-wave countries democratize by opening up elections before they have secured a system of accountability, the resultant corruption wildly distorts the income distribution and leads to greater inequality. The corruption-inequality hypothesis is well supported by empirical analyses using both cross-national data and individual-level survey data, despite the fact that the measures of corruption and inequality, the model specifications, and the estimation strategies at the two levels are quite different. Several issues remain for future research, however. First, while this paper argues that corruption leads to higher inequality, others may rightfully argue that inequality worsens corruption (You and Khagram 2005). Therefore, it is critical to address this reciprocal relationship to ensure unbiased estimates in the empirical analysis. Additionally, examining whether a mutually-reinforcing relationship between corruption and inequality exists also contributes to our understanding of the long-term relationship between democracy and inequality. Specifically, several scholars have argued for an inverted U-shape relationship between democracy and inequality, in the hopes that the rise in inequality associated with democratization will only be temporary and that as institutionalization progresses democratization will eventually reduce inequality. Simpson (1990), for instance, argues that inequality rises with democracy up to some threshold and then starts to decline. However, I argue that this view of a “political Kuznets curve” (Chong 2004) could be overly optimistic. Rising inequality coupled with and fueled by pervasive corruption can turn into an ever-lasting nightmare for both political leaders and ordinary citizens in new democracies, unless some external shocks (such as institutional reforms) successfully break down this vicious circle. At a broader level, a greater endogeneity concern exists with regard to inequality and democratization itself. The demand for income redistribution induced by inequality has been viewed as the engine driving regime transitions in the latest political economy approach. In Acemoglu and Robinson’s (2006) study, it is indeed inequality that triggers democratization; democracy is conceptualized as a coordination solution for both the rich and poor, since democracy delivers redistribution in a credible manner to the poor while preserving the property rights of the rich. The bottom line here is that if inequality precedes and initiates democratization and also affects the ways countries democratize (as Cervellati et al. argue), then countries with higher initial levels of inequality are “doomed” and are held captive by inequality because greater initial inequality leads to conflictual democratization, which in turn furthers inequality. In this sense, we are inevitably led to a theory of predestination rather than a theory of democratization.

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KNOWLEDGE ACCUMULATION AND ECONOMIC GROWTH

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ABSTRACT

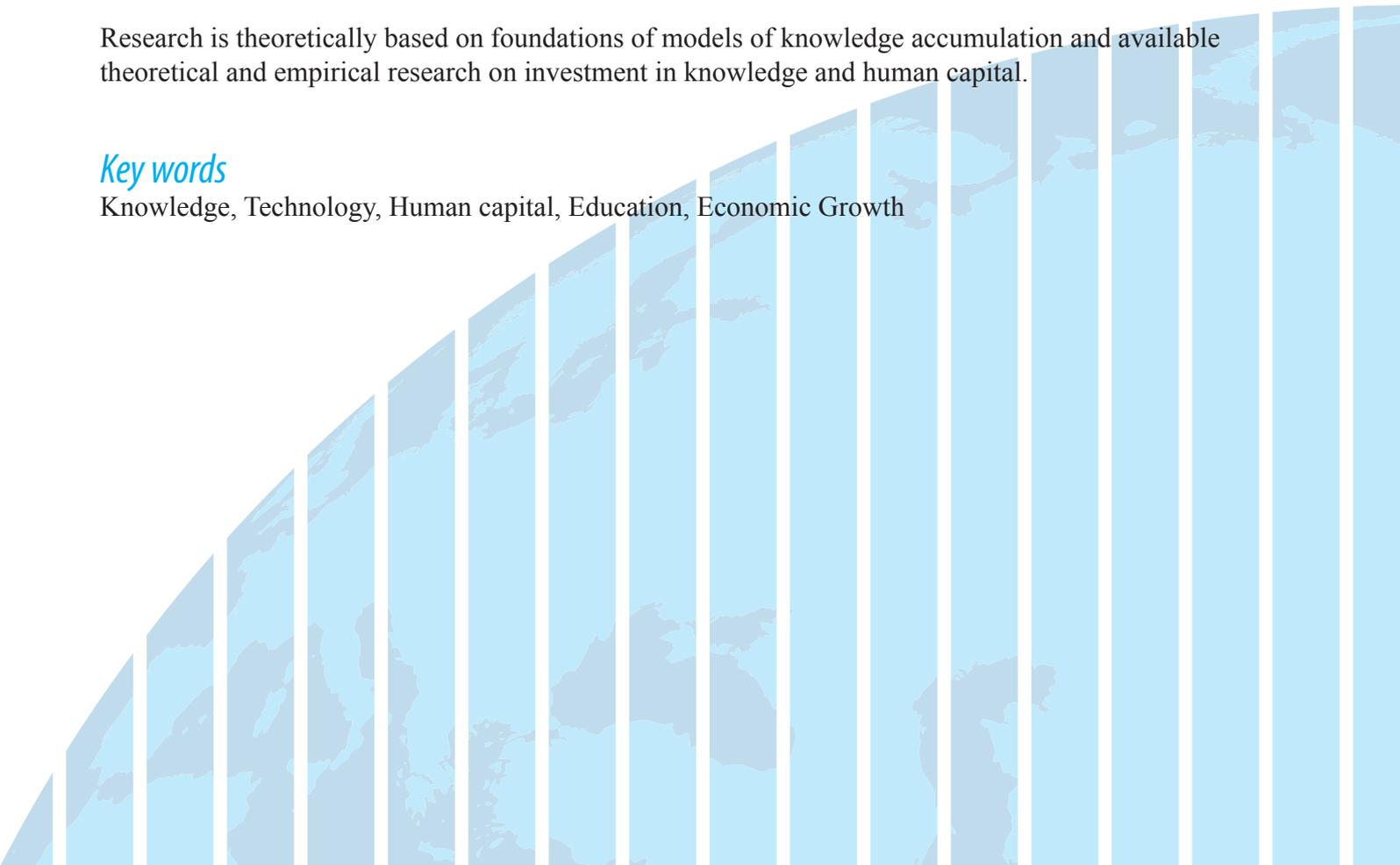
Empirical evidence shows that, in long term, economies with high level of investment in scientific and technological knowledge, education and training of labor force, achieve sustainable positive growth rates. Expansion of knowledge influence raise in productivity of labor and other production inputs. Sustainable long term growth has not been achieved in economies which development is based on expansion of physical capital and land, due to diminishing returns from additional investment.

Aim of the paper is to analyze importance of investment in education and research for long term economic development.

Research is theoretically based on foundations of models of knowledge accumulation and available theoretical and empirical research on investment in knowledge and human capital.

Key words

Knowledge, Technology, Human capital, Education, Economic Growth



KNOWLEDGE – DEFINITION

Knowledge is defined¹ as (i) expertise, and skills acquired by a person through experience or education; the theoretical or practical understanding of a subject; (ii) what is known in a particular field or in total; facts and information; or (iii) awareness or familiarity gained by experience of a fact or situation.

Knowledge acquisition involves complex cognitive processes: perception, learning, communication, association and reasoning. The term *knowledge* is also used to mean the confident understanding of a subject with the ability to use it for a specific purpose if appropriate

Knowledge in economic theory

Economic theory classifies knowledge in three main categories²:

- *Scientific knowledge*, i.e., scientific principles that can form a basis for the development of technological knowledge.
- *Technological knowledge* – implicit and explicit blueprints – in the form of inventions.
- *Entrepreneurial knowledge* that comprises business-relevant knowledge about products, organization, markets, customers, etc.

The first two definitions of knowledge are more associated with incumbents, such as firms or universities. This relates to the characteristics of knowledge described as the degree to which it is rival and excludable (Arrow 1962).

.....38 The third category, “entrepreneurial knowledge”, comprises specific knowledge tied to the market and the functioning of an economy. It actually closely connects to what is required in order to introduce an innovation, i.e. a new product, a new process, a new market, a new source of supply or a new organization (Schumpeter 1911). An innovation can be either an application of entrepreneurial knowledge or the combined result of technological and entrepreneurial knowledge.

¹ Oxford English Dictionary

² Pontus Braunerhjelm: Entrepreneurship, Knowledge and Economic Growth, CESIS, paper 102, August 2007.

KNOWLEDGE AND ECONOMIC GROWTH

G. Becker stated that economic analysis has no trouble explaining why, historically, only few countries experienced persistent growth in income per capita in long run. In his opinion, answer lies in expansion of scientific and technical knowledge that raises productivity of labor and other inputs in production. The systematic application of scientific knowledge to production of goods has greatly increased the value of education, technical schooling and on-the-job training as the growth of knowledge has become embodied in people (scientists, scholars, technicians, managers and other contributors to output).

Evidence shows that all countries which have managed persistent growth in income have also had large increase in the education and training of their labor force.

Empirical study by E. Denison (1985)³ has shown that increase in education of average worker in USA explains about one-fourth of the rise in per capital income in period from 1929-1982.

The most recent research by economists⁴ has shown importance of investment in knowledge (R&D, education and ICT), but with different strength for countries with different level of GDP per capita. Their analyses has shown that for medium income countries, investment in education and human capital are more important, while for higher income countries, innovations are key source of growth.

Accumulation of knowledge and human capital in economic theory

Analyzing economic growth, modern economists went a step further. Typical Solow's type growth model has not provided answers to growth. Such models provide conclusion that if the capital's earnings reflect its contribution to output and if its share in total income is modest, than capital accumulation cannot account for a large part of either long-term growth or cross-country income differences. And the only determinant of income in the model other than capital is the effectiveness of labor, whose exact meaning is not specified, but that behavior is taken as exogenous.

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This was incentive for economists (P.Romer (1990), Grossman and Helpman (1991) and Aghion and Howitt (1992)) to add **accumulation of knowledge** and assume it behaves endogenously. Key assumption is that effectiveness of labor represents knowledge or technology, while technological progress is the reason that more output can be produced today from a given quantity of labor and capital than a century ago.

To develop the model, it is necessary to introduce explicit research and development sector (R&D) and then model the production of new technologies. Also, allocation of resources between conventional goods production and R&D has to be modeled as well. Modeling process is rather mechanical, or, conventional production function is used to explain how combination of labor, capital and technologies are used to produce new technologies. Reasonable assumption is that more resources invested in production of new technologies will result in more technological innovation.

Model resulted with conclusion that, at an informal level, the growth of knowledge appears to be the central reason that output and standards of living are so much higher today than in previous centuries. Formal growth accounting studies attribute large portions of the increase in output per worker over extended periods to the unexplained residual component, which may reflect technological progress.

³ Source: Gary S. Becker: *Human Capital*, The University of Chicago Press, 1993

⁴ Presented in World Economic Forum report

With relevance to cross-country differences in real incomes, the relevance of the model is less clear. Even technology is nonrival good, it seems that poor countries do not use it. D.Romer explained it with lack of ability to use new technologies.

This fact motivated introduction of human capital in analysis, which consist of the acquired abilities, skills and knowledge of individual workers. Human capital has the same characteristics as conventional goods, it is rival and excludable. Key assumption regarding human capital is that amount of human capital each worker has depends only on the number of years of education he or she obtains. Model has two implications on analysis of difference among countries. First, it identifies additional sources of differences which are coming not only from differences in physical capital, but human capital as well. Second, knowing how human capital is accumulated, model concludes that adding human capital does not diminish effects of physical capital accumulation.

Furthermore, G. Becker, K. Murphy and R. Tamura (1990) developed growth model with human capital as central variable. Their key assumption is raising rate of return on human capital as the stock of human capital increases. They shown that increasing incentives to invest in human capital as the amount of human capital increases leads to »development equilibrium«, with small families and large and perhaps growing human and physical capital.

J. Dias and J. McDermott have concluded that economic growth model showed the importance of the interaction between human capital and the set of institutions present in the economy for explaining the development process. The structural institutions play a key role in setting up the initial ratio of educated to non-educated labor in the economy. However, the decision on human capital accumulation is the key to fostering technological advances, which leads to improvements in the rate of return to human capital accumulation, therefore forming a self-sustained mechanism of growth and economic development. The size of the growth of the economy and by extension the time length to becoming developed depends upon the quality of the policy institutions. These institutions are in charge of transmitting the self-sustained mechanism to the output growth. So, potential growth may differ among countries as a result of two things: the endogenous mechanism of human capital accumulation and the quality of the policy institutions. The main result is that the initial condition can only dictate the economic growth path if the human capital accumulation process is not present in the economy. Their empirical tests corroborate the model results, especially showing that human capital growth constitutes more than 60% of the average long-run growth rate of the economy. Policy institutions in general are negative for growth by lowering the growth impact of physical capital to the long-run output growth. Hence, overall policy institutions need to improve their quality in order to become contributors to economic growth.

The nature of knowledge and the Determinants of the allocation of resources to R&D

Knowledge comes in many forms, ranging from the highly abstract to highly applied. At one extreme is basic scientific knowledge with broad applicability; while at the other is knowledge about specific goods. Many of these different types of knowledge play important role in economic development.

Having in mind different types of knowledge, it is reasonable to expect that determinants of its accumulation are different. But also, as Romer (1990) emphasized, all types of knowledge share the same characteristics: they are nonrival goods, different than conventional goods which are rival. Being nonrival means that use knowledge in one application does not prevent using the same knowledge in other application. Implication of “nonrivality” is lack of market forces governing production of knowledge. Once the knowledge is produced, marginal cost to supply it to another user is zero. This leads to zero rental price of knowledge.

The other attribute of knowledge is excludability, which means that it is possible to prevent others from using it. In case of knowledge excludability depends on nature of knowledge itself and on economic institutions governing property rights. The degree of excludability has strong influence on how the development and allocation of knowledge depart from perfect competition. If knowledge is completely non-excludable, there can be no private incentives to its development. Opposite, if it is excludable, return on investment in knowledge may motivate private investors to do so.

D.Romer (2001) listed four determinants of allocation of resources to the development of knowledge: Support for basic scientific research, private incentives for R&D and innovation, alternative opportunities for talented individuals and learning by-doing process.

Incentives to invest in human capital

Even economists know that incentive to expand and improve physical resources depends on the rate of return expected, they were reluctant to interpret improvements and amount of human resources in the same way, as systematic response or investment resulting in good part from the returns expected.

G.Becker (1993) presented analysis explaining determinants of returns on investment in human capital, as well as variables which make difficult to precisely estimate returns (risk, liquidity, difficulties to obtain funds in capital market...).

But, basically, incentives to invest in human capital come from three main sources: individuals, companies and government.

Incentives of individuals, as presented by Murphy, Shleifer and Vishny (1991) are determined by:

1. Size of relevant market: larger markets leads to higher returns
2. Marginal income rate – more developed market will influence slower decline in marginal income rate
3. Excludability of knowledge – protection of property rights

Key benefits of individuals to invest in human knowledge are wage or income they make at the labor market. Also, higher education level leads to lower risk on unemployment.

Companies benefits from investment in human capital directly, as those increase productivity and therefore profitability.

On macro level, effects are higher tax returns, lower expenditures on social policy and overall human development of the society.

R&D, INNOVATION AND PRODUCTIVITY

R&D investment is an important driver of productivity gains. C.Criscuolo, M.Squicciarini, O.Lehtoranta (2010) presented the model, similar to its predecessors in the economics literature, depicts the link from R&D investment to productivity as a relationship consisting of three steps.

The first step encompasses firms' decisions about whether and how much to invest in R&D. The second step formalizes the link between the investment in R&D and the innovative output that can be obtained. The third step mirrors the relationship between innovative output and productivity.

The estimates show that receiving financial support and having (relatively more intense) collaborations are strongly and significantly correlated with a higher probability of engaging in R&D activities. The amount invested in R&D is positively related to the size of the firm (in terms of number of employees) and to the intensity of the obstacles faced.

For innovative output, investing in R&D is positively related to higher sales from innovative goods. Another element that emerges is the positive relationship between product and process innovations: process innovation seems to be complement product innovation and is positively correlated to higher innovative sales. Conversely, innovative output is significantly and negatively affected by the problems firms may have encountered while innovating. Both innovative output and productivity are shown to be positively related to belonging to a group, and to firm size. Finally, and very importantly, innovative sales are positively correlated to productivity.

Their analysis supports the hypothesis of a positive link between investing in R&D, innovation output and productivity, and has several interesting policy implications. Firstly, they observe a positive correlation between the fact that firms collaborate and the size of their investments in R&D. Secondly, obtaining subsidies indeed eases firms' budget constraint and increases the likelihood that firms will invest in R&D.

Nevertheless, firms still do encounter problems in their innovative activities, and these are negatively correlated to sales from innovative products. This latter result, coupled with the evidence that belonging to a group correlates positively with both innovative sales and productivity, seems to suggest that innovating is difficult for firms, because of the cost, knowledge and market problems involved. This seems to be especially true for individual firms, i.e. firms that do not belong to a group. Hence, purposeful, well formulated policies could ease the hampering factors firms encounter by supporting their innovation activities from invention to the marketing of innovation. Policy support should not stop once an innovation output is obtained; it needs to continue to enable firms to transform innovative output into market success.

Thirdly, their results suggest that product and process innovations are complementary. This somehow questions those policy programmers in which subsidies go preferably to those firms whose innovative activities are expected to result in a product innovation (normally protected by a patent).

D.A.Higon, M.M. Antolin (2010) investigated whether degree of internationalization may increase a firm returns to R&D. The reason is it increases both a firm's innovative capacity and its ability to exploit and appropriate the innovation outcomes. First, the availability of a broader range of global resources may provide MNCs with a higher capacity to innovate (Kobrin 1991). Second, the geographical expansion that characterizes MNCs may improve their appropriability regime (Teece 1986). However, internationalization is not devoid of problems that may have a detrimental effect on the returns obtained from R&D activities. Among these, several authors point out the possibility of knowledge leakages to competitors (Fish 2003; SannaRandaccio and Veugelers 2007) and the high coordination and control costs of a global network of R&D departments (von Zedwitz and Gassman 2002; Gersbach and Schmutzler 2006).

Therefore, their results suggest that the effect of multinationality is not constant but varies over the distribution and is particularly important within the most inefficient firms.

EMPIRICAL ANALYSIS

To investigate importance of knowledge accumulation for economic growth, we did empirical research in two phases.

First, we investigated trends in investment in knowledge using available statistics⁵, and then, in second phase, tried to estimate impact on several variables to GDP per capita and employment.

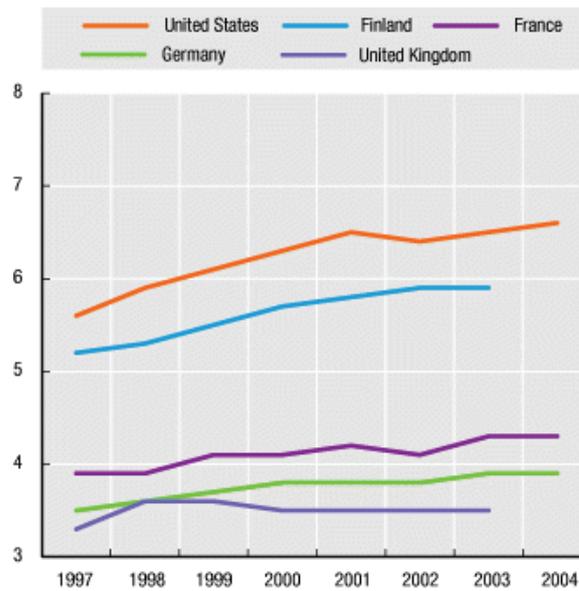
Trends in Investment in Knowledge and Economic Growth

Investment in knowledge is defined as the sum of expenditures on R&D, on total higher education (private and public) and on software⁶.

Analysis of investment in knowledge and GDP growth has shown that leaders in investment achieve the highest productivity and therefore, high GDP growth.

The most recent OECD statistics has shown that the most developed countries have achieved growth in investment in knowledge (picture 1.), while at the same time have been leaders in this field (picture 2.).

Picture 1. Investment in knowledge for selected countries as a percentage of GDP



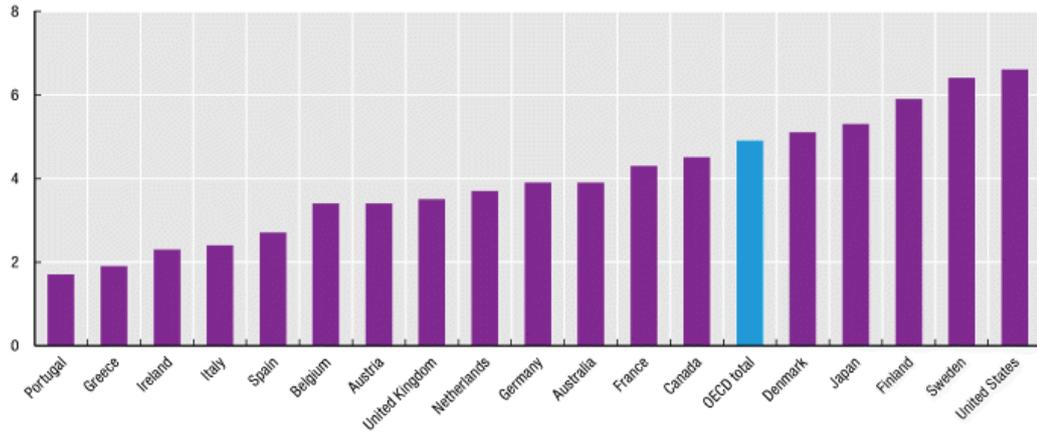
Source: OECD factbook 2009.

The highest growth was evidenced in USA and Finland, which, as we will see later, are leaders in productivity.

Less developed countries invest significantly lower share of GDP in knowledge (picture 2)

⁵ OECD research
⁶ OECD definition

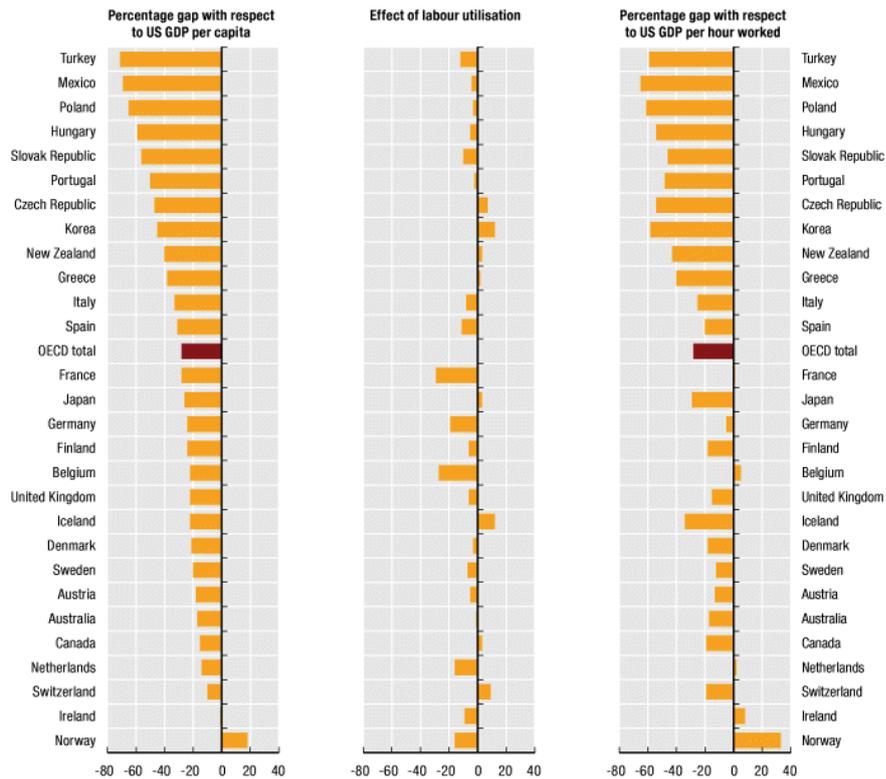
Picture 2. Investment in knowledge as a percentage of GDP, 2004 or latest available year



Source: OECD factbook 2009.

Comparison of GDP per capita and productivity in United States with same indicators in other countries confirm the importance of investment in knowledge as source of economic growth (picture 3).

Picture 3: Income and productivity levels, Percentage point differences with respect to the United States, 2007



Source: OECD factbook 2009.

As picture 3. shows, economies with the greatest gap in productivity have the same in GDP per capita. If we know that investment in knowledge influence growth trough increase in productivity, than is obvious why knowledge accumulation is important for sustainable economic growth.

Statistical analysis and fixed effect model

The starting point of the analysis was to try to evaluate how each of three components of investments in knowledge (expenditures on R&D, expenditures on higher education and investments in software) influence main economic indicators (especially economic growth and employment).

Struggling with missing data problem, we had to exclude investments in software and concentrate on the first two components of the investments in knowledge. We took the data from 29 countries (EU-27 together with USA and Japan as one of leaders in investments in knowledge) and examined the effects of expenditures in research and development (R&D, measured as percentage of GDP) and public expenditures on higher education (PEE, measured as percentage of GDP). For the purpose of this analysis several indicators were used: GDP growth rate (RGDP), GDP per capita (GDPPC, EUR current prices), employment rate (EMPLR) and unemployment rate (UNEMPLR)⁷.

In the first phase of preliminary analysis, we estimated several correlation coefficients for above-mentioned variables that describe relationships between the variables we are interested in. The results are presented in Table 1.

Table 1: The correlation matrix of variables from the sample

	GDPPC	PEE	R&D	RGDP	UNEMPLR	EMPLR
GDPPC	1.000	0.313	0.560	-0.304	-0.584	0.519
PEE	0.313	1.000	0.356	-0.211	-0.167	0.303
R&D	0.560	0.356	1.000	0.381	-0.392	0.688
RGDP	-0.304	-0.211	0.381	1.000	0.221	-0.289
UNEMPLR	-0.584	-0.167	-0.392	0.221	1.000	-0.699
EMPLR	0.519	0.303	0.688	-0.289	-0.699	1.000

The analysis of correlation coefficients shows a significant positive correlation between the level of GDP per capita and research and development expenditures as percentage of GDP. Not as strong relationship exists between public expenditures and GDP per capita, but it still has a positive sign.

Also, the share of R&D in GDP and employment rate is in direct relationship. The same is with public expenditures on education and employment rate.

One strange remark in correlation coefficient within GDP growth rate and our variables of interests is present. This is illustrated with the values of correlation coefficients between GDP growth rate and public expenditures on higher education having negative sign (-0.21). Results of a preliminary analysis motivated us to take a level of GDP per capita rather than GDP growth as measurement of economic development. We have to stress that this result is not unexpected, as it might seem. It is well known that the investments in knowledge impact on economic growth could have a lagged effect, i.e. its positive influence is more usually observed in future.

⁷ All results in this paper were computed in econometric software Eviews 6;

Following previous results, we estimated fixed effect model⁸ using panel data from 2000-2006, for above-mentioned 29 countries. The data for all countries in the sample are built from the Eurostat database⁹. This database has the advantage of presenting standardized information across countries, providing the measurement error as minimized as possible.

Our dependent variables of interest were both GDP pc and employment rate. After detailed analysis we found positive effects between the components of investment in knowledge and GDP pc. Unfortunately, instead of very high correlation coefficient with employment/unemployment rate we could not get a statistically correct specification. That is why we present only the equation with GDP pc as dependent variable¹⁰.

Table 2: The estimated fixed effect model

Dependent Variable: <i>GDPPC</i>				
	Coefficient	Std. Error	t-Statistic	Prob.
<i>PEE</i>	0.105223	0.038687	2.719778	0.0074
<i>R&D</i>	0.138798	0.038593	3.596437	0.0004
<i>Const</i>	0.013208	0.002136	6.183721	0.0000
Effects specification				
Cross-section fixed				
R-squared	0.586463			
Adjusted R-squared	0.355267	Mean dependent var		-0.01211
S.E. of regression	0.098437	S.D. dependent var		0.12259
Sum squared resid	1.327515	Akaike info criterion		-1.61592
Log likelihood	175.7772	Schwarz criterion		-0.95974
F-statistic	3.707917	Hannan-Quinn criter.		-1.34971
Prob (F-statistic)	0.000000	Durbin-Watson stat		1.87824

The results in Table 2. confirm our hypothesis that increase of investments in scientific and technological knowledge and education – measured in this case with public expenditures in higher education, and expenditures on research and development – have positive effects on level of GDP in the countries covered by sample. This is confirmed with all coefficients being highly significant and with their positive signs.

⁸ For more details on fixed effect models: Baltagi, B.H., 2001, *Econometric Analysis of Panel Data*. John Wiley & Sons, London;

⁹ Data available on http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database

¹⁰ It is important to note that all variables in the model are previously transformed by taking the first difference of the natural logarithm. The transformation is done in order to eliminate the heteroscedasticity and autocorrelation problems observed in residuals.

With Hausman's test of specification¹¹ we examine if individual effects should be treated as fixed parameters or random variables. According to results presented in Table 3 we conclude, with 5% significance level, that we cannot reject null hypothesis, which confirms that there is no statistically significant difference between fixed and random effect model. This gives a support for fixed effect estimator.

Table 3: Results of Hausman's specification test

Correlated Random Effects - Hausman Test				
Test cross-section random effects				
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.	
Cross-section random	5.704713	2	0.1577	
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var (Diff.)	Prob.
PEE	0.103616	0.1056166	0.003155	0.7958
R&D	0.125338	0.1380342	0.000027	0.4038

Based on data from OECD database¹² we also conducted a correlation analysis between GDP per capita (US dollars, current prices) and two science and technology indicators available in this database, such as shares of ICT investment in non-residential gross fixed capital formation (ICT) and gross domestic expenditure on R&D as percentage of GDP (R&D). We estimated correlation coefficients for some of countries leaders in investments in knowledge for which data were available. Time period differ from one country to another, and it is described in Table 4 together with correlation coefficients.

Table 4: The correlation coefficients between GDP pc and science and technology indicators (R&D and ICT)

Country	Time period	R&D, GDPpc	ICT, GDPpc
Austria	1994-2007	0.988	0.350
Belgium	1983-2007	0.853	0.692
Canada	1981-2007	0.922	0.792
Finland	1981-2007	0.963	0.875
France	1981-2007	0.298	0.853
Germany	1991-2007	0.836	0.377
Great Britain	1986-2006	0.915	0.883
Ireland	1981-2006	0.781	0.493
Japan	1990-2006	0.917	0.853
Sweden	1981-2007	0.890	0.813
USA	1981-2007	0.278	0.895

¹¹ Hausman, J. A. 1978. *Specification tests in econometrics*, Econometrica 46 (6);

¹² <http://www.sourceoecd.org/database/OECDStat>;

We found particularly interesting the correlation between ICT and GDPpc. On the level of individual countries, interrelations are mainly highly significant between this pairs of variables, confirming the existence of very strong relationship between this science and technology indicator, as well as between R&D and GDPpc.

Our main findings in this analysis are as follows: First, as hypothesized, coefficient estimates are both statistically significant and positive, confirming that a relationship between GDP and the investment in education exists over time in the countries from the sample. Precisely, the coefficient 0.138 is interpreted as an average percentage change in GDPpc from period to period caused by one additional percentage point of R&D share in GDP. Also, the contribution of increase of public expenditures in education to average percentage change in GDPpc from period to period is about 0.105.

Second, the value of R^2 (0.586) shows that there are many other important variables influencing the increase of GDP per capita.

Third, the results might not be too convincing because, as theory suggests, the effects which investments in knowledge and its components have on economic development, is something that has long term effects, rather than short term effects. It means that they could be more clearly observed in future period.

All these results leave enough curiosity for the authors to verify them in the future period, with intention to introduce question of simultaneity that might be important for deeper analysis of this problem, because level of GDP could be very important factor of investments in knowledge.

CONCLUSION

Both theory and empirical research confirmed our hypothesis on importance of knowledge accumulation for economic growth.

We saw that the most developed countries, therefore leaders in productivity and GDP per capita, are the biggest investors in knowledge. Investing in knowledge, these economies provided sustainable long run growth rates.

For less developed economies, as we saw, the most important variable is investment in higher education and skills which will provide use of advanced technologies already developed in the world.

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THE ROLE OF FOREIGN DIRECT INVESTMENTS AND INTERNATIONAL OUTSOURCING IN DEVELOPMENT OF TECHNOLOGY AND INNOVATION SECTORS IN SOUTH AND EAST EUROPEAN COUNTRIES

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ABSTRACT

Creation and development of scientific and technological sectors of Southern and Eastern Europe (SEE) economies is a crucial condition of their sustainable development and further integration into world economy as its full-fledged members. Foreign direct investments (FDI) and international outsourcing (offshoring) can become sustainable factors in this process as they can enable creation of cluster economy and increase national economies' competitiveness.

In this paper the main emphasize is laid on the influence which FDI and international outsourcing processes can have on development of science intensive and innovative sectors in SEE states; current place of SEE countries in the world outsourcing and foreign investment markets; analysis of main institutional factors that define attractiveness of SEE countries for FDI and international outsourcing purposes.

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Key words

International Outsourcing, Research and Development, Foreign Direct Investment, Economic Development, South and East European Countries.



INTRODUCTION

In recent years there have been numerous speculations in Russia and some other East European countries on how to modernize national economy by implementing the best sources of growth in directions of product improvement and cost reduction, with focus on efficiency of R&D investment, both state and private. As time and experience show, outsourcing and offshoring within last decades became a widely used practice in this field for not only multinationals, but also for SME's and governmental structures and an essential part of FDI policy for all the parties.

In this paper will focus on the main tendencies of the world outsourcing market, which development has gradually led to creation of specific form of international business – in the way that we understand it (both as a part of direct trade and foreign investment) with specific interest on the East European region. We will also determine main factors that make SEE countries stand among emerging and the most promising outsourcing destinations, and explain why exploiting this status can be beneficial for them.

CONCEPTUAL ISSUES OF OUTSOURCING

Present-day world situation can be described as “a grid of potential locations for value-adding activities, connected by flows of information and products” [Buckley and Hashai (2004, p. 33)]. The changes that happened almost in all countries of the world during the last 25 years “reflect political, economic and technological changes that have together encouraged more international trade and foreign investment, altered the structure of trade, and changed the relation between trade and foreign direct investment. Expansion of trade during this period has occurred increasingly through sophisticated global value chains, as companies in industrialized countries went offshore to perform both manufacturing and services” (table 1) [Milberg W., Schöller D. Globalization, Offshoring and Economic Insecurity in Industrialized Countries / U.N. Department of Economic and Social Affairs, 2008. P. 22].

It is widely known that international outsourcing (especially on the highest levels of its development when it becomes inseparably linked with foreign direct investment (FDI)) enables the companies who use it to gain organizational effects due to possibility of concentration on the main activity, distribution of risks between partners, flexibility of peopleware, acceleration of projects' realization, etc. In addition to that, for majority of developed countries who face problems of shrinking and aging population, international outsourcing can be very attractive due to the fact that it gives access to the vast talented labor pool of developing countries.

Tendencies of the last years show that international outsourcing (offshoring) can be realized within not only direct trade but also within foreign direct investment¹. Indeed, production of goods and services can be organized in different ways: companies can produce final goods using all the necessary resources from in-house or outsource production of intermediate inputs to off-side suppliers located at home or in a foreign country. An FDI way of realization of outsourcing cooperation happens mostly on the highest levels of outsourcing strategy maturity when companies establish joint company with an outsourcing provider abroad, acquire a specialized center (an operating provider of outsourcing services) or, which is more typical for TNC's, create its own affiliated outsourcing company (captive center).

Unfortunately, meanwhile the terms of FDI are widely presented in economic literature [Bartels

¹ In this case we are talking about vertical FDI that are viewed as a complement to trade rather than about horizontal FDI which are considered to be a substitute for trade.

(2004); Buckley and Casson (2002); Dunning (2000); Buckley (1999) and others], “the use of the term outsourcing has not been standardized” [Amiti and Wei (2004, p.4)].

Majority of definitions that can be met simply regard outsourcing as “acquiring services from an outside company”. Moreover, they mainly focus on domestic outsourcing, meanwhile international outsourcing / offshoring is concerned to be just one of the options of FDI outsourcing strategy and all the description is about discussion of its advantages and disadvantages for home countries and, rarely, for enterprises.

We have the following understanding of international outsourcing: it is a form of international business that supposes using in the activity of companies-producers of the final goods and services the competitive advantages of foreign outsourcing providers. This definition allows to:

- emphasis twofold nature of offshoring as both a form of international business and a way of competitiveness improvement;
- indicate that buyers of outsourcing services involve competitive advantages of outsourcing providers into the process of creation of value of final goods and services;
- stresses the long-term nature of parties’ interaction and a possibility of prompt control and adjustment of outsourcing contract by the customer.

SEE COUNTRIES IN R&D WORLD OFFSHORING

Over the last years an R&D offshoring was steadily growing within developed countries. More and more firms from North America and Western Europe started to relocate conduction of their research to foreign firms, laboratories and universities (both public and private) of developing countries. One of the main reasons that makes companies from developed countries to outsource R&D is the rising costs and complexity of innovation (calling for more diverse skills, knowledge and equipment) and intensifying competitive pressure to bring out new products more quickly [Howells 1997, Roberts 2001, Engardio and Einhorn 2005].

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The growing number of R&D providers also facilitates outsourcing.

Thus, transformational processes of the last 20 years on the territory of the former USSR, growth of economic collaboration of all the members of the Council for Mutual Economic Assistance, intensification of integration processes into the world economy in the region of Southern and Eastern Europe (SEE) led to considerable expansion of trade area.

These new markets due to their geo-political location almost instantly became treated as promising and advantageous object for investment. And by the beginning of 2000 stable growth of economies of SEE countries in spite of all the problems, improvement of communication and transportation facilities, reduction of trade barriers, active integration with West-European countries gave an opportunity to regard this region as a promising outsourcing destination.

We should note that development of offshoring to SEE countries during last years was partly customer-driven (West-European companies who feel comfortable with the culture and language skills in this region) and partly service-provider-driven (by large international providers who have invested heavily in economies of SEE countries (e.g., Microsoft, Intel, Accenture, Nokia) and want their facilities to operate at maximum capacity.

In spite of increased competition on the world outsourcing market among service providers who often offer similar value propositions, SEE region shows good dynamics. According to the latest survey of Global Services-Tholons Study “Top 50 Emerging Outsourcing Cities” this region stands on the second place (with 26% share of the world outsourcing market) after Asia-Pacific region. Thus, the list included: Poland - Krakow (4th place), Warsaw (28th place); Czech Republic – Prague (14th place), Brno (30th place); Hungary – Budapest (22nd place), Russia – Saint Petersburg (31st place), Moscow (38th place); Romania – Bucharest (34th place); Slovakia – Bratislava (35th place); Bulgaria – Sofia (40th place); Slovenia – Ljubjana (49th place), Ukraine – Kiev (50th place) [Global Services Research Report: Top 50 emerging global outsourcing cities 2009. P. 10].

It is notable that this region is characterized by high dynamics of development not only due to presence of TNC’s but also due to growing number of big local enterprises in this field. Just in one year (end of 2008 – end of 2009) 28 outsourcing companies were established in SEE states [Everest Research Institute. Global locations insight. December 2009. P. 3].

Attraction of foreign customers by SEE providers is closely connected and somehow assisted to considerable growth of FDI inflows to this region.

Thus, analyzing the current situation on FDI and offshoring markets, it is necessary to say that global economic crises had a considerable negative impact on FDI flows. According to UNCTAD data, global FDI flows in 2009 dropped on 39% (down to \$1,0 trillion) after 14% reduction in 2008 (\$1,7 trillion). At the same time, meanwhile FDI inflows to developed economies sunk 41% and reached \$565 billion in 2009 (29% decline in 2008), inflows to developing countries who showed 17% growth in 2008 decreased only on 35% and as a result reached \$406 billion. Investments to transitional economies showed 39% decrease (down to \$69 billion).

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The greatest complicacy in this article consisted in evaluating the international outsourcing market. Meanwhile data on FDI geography and flows is widely represented in different sources, offshoring market analysis doesn’t have such statistical support. Nevertheless, according to the latest data published by Gartner Research Group, international outsourcing happened to stay among those forms of international business that suffered global crisis the less. Only 7.2% of companies declared that they will outsource less. At the same time 59.8% of companies indicated that they expect to outsource more functions, which is down from 69.3% last year. Thus, many more firms expect to outsource and spend more externally, compared with those that expect to reduce spending [Gartner Research. February 2009. Paper ID Number: G00164439. P. 3].

Many of SEE countries have great potential for expansion of their investment attractiveness and can get deserved place on the world outsourcing market and first of all in the fields of software development, IT-projects realization, programming, pharmaceutical services, engineering, construction, conduction of scientific, research and development projects.

This statement has the following substantiation:

- (i) it is generally recognized that competitive advantages of this region in comparison to North American and Western Europe regions are lower wages, big labor force pool, considerable scientific potential (including engineering and IT spheres) (tables 2-3). Among the most well-known examples of companies who have successfully outsourced some processes and functions to providers of SEE region are Boeing, Dell, Deutsche Bank, Alcatel, Reuters.
- (ii) substantial development of nonmaterial sector (whose share in GDP of these countries is more than 50%) give companies from SEE region an opportunity to compete adequately with foreign firms;

- (iii) as many of SEE states try to bring into life conversion to innovation development path, development of cluster economy and improve national competitiveness, they intensify financing of R&D sector by government sponsorship and creation of laboratory-industrial complexes on base of private-state partnership (table 4);
- (iv) the previous factor leads to creation of a friendly business environment for all companies in R&D field;
- (v) SEE region has a higher level of intellectual property protection rights in comparison to all the other developing countries;
- (vi) SEE states are more culturally adaptive to countries of North America and Western Europe;
- (vii) some countries in this region have a tendency for inner specialization within R&D sector: product development – Bucharest, St. Petersburg; scientific research and development - Bucharest, Prague, Krakow, Moscow, St. Petersburg; health-care services – Budapest, Bucharest; engineering services – Prague, Moscow [Global Services Research Report: Top 50 Emerging Global Outsourcing Cities 2009. P. 32].

CONCLUSIONS

Overview of world and regional outsourcing market and its specific R&D segment shows that development of technology and innovation sectors in SSE countries can benefit a lot from participation in offshoring collaboration (especially that one which is closely related to FDI). It may lead to structural changes in the host SEE countries due to facts that:

- (i) local provider firms who conduct R&D within outsourcing contract can gain experience and some additional knowledge and technologies from the foreign outsourcing customers;
- (ii) getting such knowledge makes this firms more linked to global innovation systems and R&D network;
- (iii) inflow of foreign customers will stimulate companies to develop innovative constituent of their business and to re-link scientific research with productive sector;
- (iv) in case of R&D conduction within a captive center, it may induce local firms to undertake more R&D to compete better. It may also show local competitors *how* to conduct R&D more effectively [World Investment Report 2005. P. 183];
- (v) conducting of rare or new projects for foreign customers can stimulate other companies of the country to carry out similar projects (which otherwise would not have been taken into consideration) and thus develop country's innovative sector.

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Table 1 – Share of outsourcing in cost of commercial goods, %

Industry	1998	2004
Automotive	3,1	14,8
Computer systems	10,9	26,6
Equipment (excl. medical)	9,8	18,3
Medical equipment	8	13,2
Military and Aerospace	5,3	9,7
Telecommunication networks	13	51
Wireless networks	18,8	38,7
All industries	9,5	25,9

Source: Novikov A. How to use external resources effectively // Comercheskiy director, № 3/4, March-April 2006. – P. 9-13

**Table 2 - Average number of employed population by economic activity
in selected countries in 2008 or latest available year
(thousand people)**

	Russia	Romania	Slovakia	Poland	Bulgaria	Czech Republic	Greece	Hungary	Croatia	Belorussia	Slovenia
Manufacturing	12727	1895,7	642,9	3259	756,7	1363,2	533,7	846,6	285,5	1215,2	258,2
Construction	2413	752,9	267,7	1267,9	351	485,3	386,8	310,7	149,6	417,4	66,1
Transportation and storage	933*	472,5	163,2	930,3	195,8	325,9	214,9	255,6	93,4	352,5	62,8
Information and communication	1379	108,1	43,8	295,5	72,2	124,8	78	99,5	35,5 (U)		30,9
Education	3692	430,8	157,9	1179,6	198,8	287,9	322,3	310,7	97,4	449,9	72,6
Human health and social work activity	2159	376,6	152,5	860,5	164,2	323,2	231	250	86	333,9	53,4
Professional, scientific and technical activities	641	132,1	80,1	431,5	87,7	198,1	244,5	140	51	31,4	39,9

Source: Eurostat official site <http://epp.eurostat.ec.europa.eu/>,
State Committee of Statistics of Russian Federation site <http://www.gks.ru/>,
National Statistical Committee of the Republic of Belarus site <http://belstat.gov.by/>,
State Committee of Statistics of Ukraine site <http://www.ukrstat.gov.ua/>

* For Russia only "Transportation" is included
U- extremely unreliable data

Table 3 - Average annual gross earnings by occupation in selected countries in 2008 or latest available year (Euro)

	Russia	Romania	Slovakia	Bulgaria	Ukraine	Slovenia	Switzerland	Belorussia	Poland
Professional, scientific and technical activities	8212	7792	13131	4682	3636,7	20424	55440	4440	14997
Business economy	6122	5462	9551	3279	N/A	15796	46113	N/A	10787
Information and telecommunication	6565	9430	16341	7150	3036	24130	62457	4164	18779
Construction	6122	5785	9197	3368	2852	16711	46423	4008	10789
Transportation and storage	7053*	6409	9080	3735	3435,9*	16594	44957	3272	10606
Education	5504	6872	7402	3560	2254,3	19911	54867	2256	10191
Human health	4301	5554	7996	3509	1832,9	18787	46491	2552	10013

Source: Eurostat official site <http://epp.eurostat.ec.europa.eu/>,
 State Committee of Statistics of Russian Federation site <http://www.gks.ru/>
 National Statistical Committee of the Republic of Belarus site <http://belstat.gov.by/>
 State Committee of Statistics of Ukraine site <http://www.ukrstat.gov.ua/>

* For Russia only "Transportation" is included

Data for Russia and all other non-euro countries is calculated on average annual euro/national currency rate.
 N/A – not available

Average nominal euro/ruble rate in 2008 = 36,41 Average nominal euro/ruble rate in 2007 = 35,01

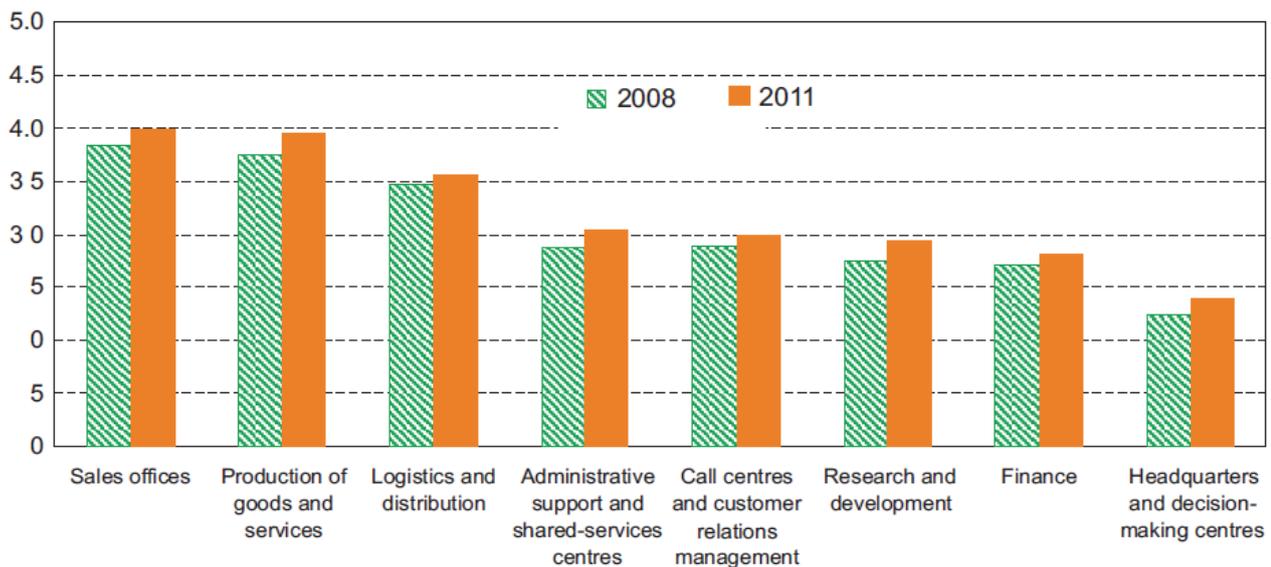
Table 4 - Total intramural R&D expenditure (GERD)
by sectors of performance in selected countries
(Percentage of GDP)

Country	2008	2007	2006
Bulgaria	0,49 (P)	0,48	0,48
Czech Republic	1,47	1,54	1,55
Greece	N/A	0,58 (E)	0,58 (E)
Hungary	1	0,97	1
Poland	0,61 (P)	0,57	0,56
Romania	0,58	0,52	0,45
Slovenia	1,66	1,45	1,56
Slovakia	0,47	0,46	0,49
Croatia	0,9	0,81	0,76
Russian Federation	1,03	1,12	1,07
Ukraine	0,9	0,93	0,98

Source: Eurostat official site <http://epp.eurostat.ec.europa.eu/>
 State Committee of Statistics of Ukraine site <http://www.ukrstat.gov.ua/>

P - provisional value
 E - estimated value
 N/A – not available

Figure 1. Proportion of various corporate functions undertaken abroad



Source: UNCTAD World Investments Prospects Survey 2009-2011.
 Note: 1- not internationalized; 5- highly internationalized.

IMPACT OF INITIAL CONDITIONS ON TRANSITION PROGRESS: THE CASE OF MONTENEGRO

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ABSTRACT

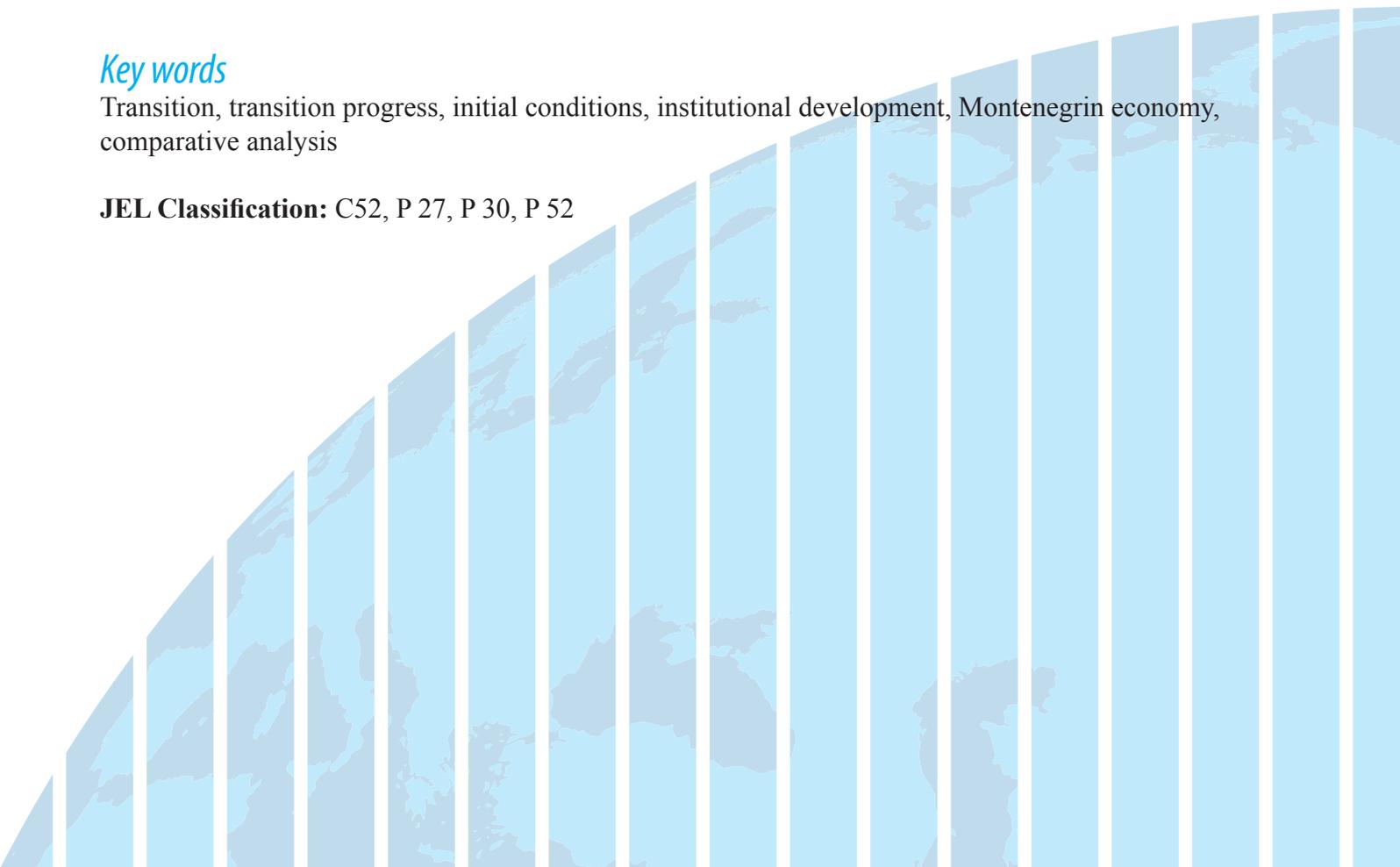
Shortly after the transition started an important debate was initiated over the length of the process and on the factors that influence advancement of a country in transition reforms. It appeared that transition progress has to be understood as an endogenous phenomenon that is affected by the initial conditions of the country in question. Moreover, economic performance also depends on inherited conditions as well as on the transition progress of a country while the latter should be also regarded as endogenous in itself. From this standpoint the case of the Montenegrin economy is analysed, since Montenegro is among transition laggards, predominantly because of a substantially delayed start of reforms. Firstly, broader assessments on transition progress are presented, mostly based on the EBRD indicators. Since the actual success of reforms conducted as well as their speed and pace of implementation, cannot be estimated correctly unless inherited conditions are taken into consideration, several models have been specified and estimated that could show how and to what extent initial conditions affect the transition progress of transition economies. The results obtained for the entire set of transition countries are subsequently applied to the case of Montenegro. The results lead to a conclusion that reforms in the country proceeded at a faster pace after the 1999 but were primarily directed to privatisation and liberalisation issues while institution building is slightly delayed and stays below an accessible level regarding initial and inherited conditions in Montenegro.

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Key words

Transition, transition progress, initial conditions, institutional development, Montenegrin economy, comparative analysis

JEL Classification: C52, P 27, P 30, P 52



INTRODUCTION

Shortly after the transition had started a huge debate began over the length of the process and the factors that influence advancement of a country in transition reforms. The first ideas suggested that initial conditions may affect transition progress but if a country is decisive in its reforming endeavours it will be rewarded by a faster recovery from expected recession while the impact of initial conditions will diminish over time (de Melo, 1996, 1997; Sachs, 1996). Further investigation has shown that this was an over-optimistic view. It appeared that transition progress has to be seen as an endogenous variable, or in other words that it is affected by the initial conditions. Hence, growth rates and economic performance could depend on inherited conditions of a country and on transition progress but the latter should be regarded as endogenous in itself (Stiglitz, 1999; Popov, 2000; Hoff and Stiglitz, 2005; Godoy and Stiglitz, 2007 and from a somewhat different angle Krueger and Ciolko, 1998; Heybey and Murrell, 1999; Fallcetti *et al.* 2005 and many others).

In a recent paper (Cerovic and Nojkovic, 2009) with a colleague of mine I have demonstrated how and why initial conditions affect both reforms and growth in transition countries even after almost two decades since the transition process started. We have also shown that many countries are still far away from a full market economy model although this cannot be attributed to the unwillingness and/or reluctance of their policy makers: the majority of the countries conducted reforms at the pace that is – more or less – the most appropriate considering their inherited circumstances. All these findings demand assessment of the progress in reforms of each country from the standpoint of their inherited conditions. In that way only, we may clarify whether a country is lagging behind a desired level of transformation for some objective reasons or through its own mistakes and/or insufficient commitment.

.....62 In this paper I shall analyse the case of the Montenegrin economy. The subject is of particular interest since it is well known that Montenegro is among transition laggards, predominantly owing to a very delayed start to the reforms. Although it started somewhat earlier when compared with Serbia – with which Montenegro was in a union during the nineties, and was suffering the same ruinous effects of the dominant political options in that period – it is nevertheless in a substantial delay if compared with other transition countries from south-eastern Europe. For that reason it is essential to assess how transition is developing now and what can be taken as realistic expectations regarding the near future. Parallel to this it is important to consider to what extent the reforms have been balanced regarding, particularly, institutional developments and what could be taken as an impact of inherited state of affairs or maybe, as an impact of improper policies.

The paper is organised in three major parts. In the first section transition progress achieved so far in the Montenegrin economy will be reviewed and analytically assessed. The second section will explore transition progress as an endogenous phenomenon and basic analytical results on the issue will be presented. Finally, in the third part the results of empirical testing will be applied to the Montenegrin case and the present transition progress of the economy will be re-assessed from the standpoint of inherited conditions and their impact on reform implementation.

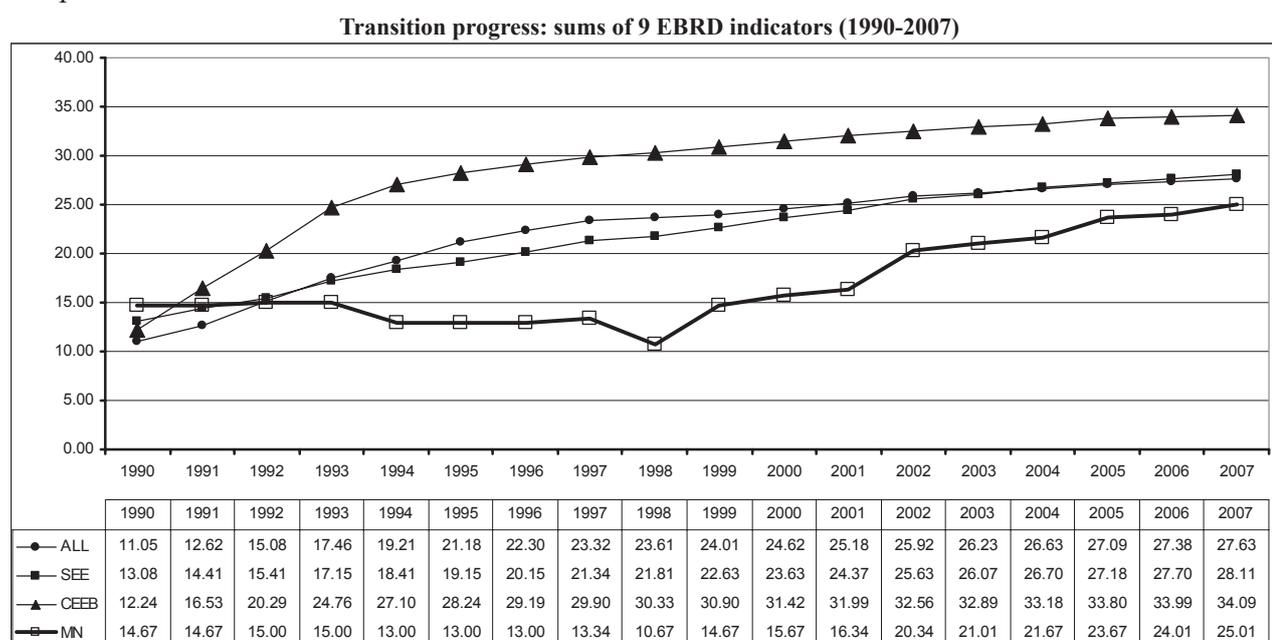
MONTENEGRO: TRANSITION PROGRESS

We may start our analysis by assessing the achieved overall progress in implementing reforms in Montenegro. A good starting point in measuring achievements of the Montenegrin economy is a set of transition indicators regularly published by the European Bank for Reconstruction and Development (EBRD). Though sometimes criticised for their theoretical and/or policy grounds, the EBRD indicators nevertheless, represent the most developed and the most comprehensive measuring tools for the reviewing reforms within transition economies (see: Appendix).

In the analysis I shall use the database for the period 1990-2007 which was previously established in conducting a project on the Montenegrin economy¹ but has never been published. However and whenever possible, the data will be renewed and will take into account the period of the two years that followed.

In Graph 1 and in the table below the path of Montenegrin transition (MN) is presented by means of the EBRD indicators (sums of nine indices ranging from 1 to 4.33) together with the data for all transition economies (ALL), Central and Eastern Europe and Baltic countries (CEEB) and for those from the Balkans or South-eastern Europe (SEE).²

Graph 1



Source: EBRD (2008)

At a glance it is evident that the graph and the table presented point to some very specific features of the Montenegrin transition. Firstly, it is remarkable that Montenegro had a relatively better starting position in terms of institutional arrangements when compared with all other groups of countries. This is due to the reforms previously taken under the self-management system as well as the initial reforms of the last Yugoslav Government in 1989 and 1990 and it shares this inherited advantage with all other ex-Yugoslav economies (see: e.g. Godoy & Stiglitz, 2007; corresponding transition indicators in EBRD, 2008).

1 The project was conducted by the consortium of three faculties of Economics (Podgorica – Montenegro, Belgrade – Serbia and Ljubljana – Slovenia) for the Government of Montenegro and was exploring the outcomes of the privatisation process until 2008. The database I refer to has been covered in the Booklet 2 that I had produced with the assistance of two younger colleagues (A. Nojkovic and B. Ristic).

2 It should be noted that in the SEE data I have included Slovenia, that is usually grouped within the CEEB. The reason for this re-arrangement comes from the fact that Slovenia has been a part of former Yugoslavia and consequently has shared some common characteristics at the initial stage of reforms with other ex-Yugoslav economies (similar institutional arrangements, similar macroeconomic indicators concerning inflation, exchange rate etc. as well as similar start of reforms as conducted by the last Yugoslav Government).

Secondly, an astonishing development occurred within the country – the favourable inherited conditions deteriorated over the nineties: the sum of the nine EBRD indicators went down from 15 in 1992 to 10.67 in 1998, which is a striking evidence of the politics and policies conducted in the remaining part of the former Yugoslavia consisting of Serbia and Montenegro. However, and also remarkable, the reforming processes in the country were re-started after 1998, in the year that marked the launching of more independent Montenegrin politics toward its Serbian counterpart. Ever since that year the value of transition indicators has increased consistently, although at a different pace and/or speed. It should be noted that this tendency continues beyond 2007 although the increase of the sum of the EBRD indicators was reduced to less than a point until 2009 (+0.66).

In comparison with the other countries we may state that the speed of reforming processes since 1998 has been sufficient to put Montenegro on the average level of all transition economies reached by 2001 that is, after more than a decade of transition endeavours. However, this is still the level which was reached (on average) by the group of the CEEB countries already around 1993-94 that is, after five years only since transition had begun in the majority of those economies.

Finally, if we draw attention to some significant groups of the EBRD indicators we may remark some other intriguing points. Namely, we may discover that in the period 1999-2007 the Montenegrin economy was assessed with relatively high marks for the results in privatisation and liberalisation. The sum-value of the two indicators for privatisation of (a) small and (b) big firms increased from 2 in 1998 to 7 in 2005 (although it slightly diminished in 2009 for slow privatisation of bigger companies in the public sector) while the sum-value of indicators for price and trade liberalisation had risen from 3.67 in 1998 to 8 already in 2007 which is a significant move since the maximum value for both categories could be 8.67.

64 It should be pointed out that fast privatisation and liberalisation characterise almost all transition economies reflecting in that way an illusion of the “big bang” theory of transition based on the idea that fostering private ownership and liberalism could *per se* secure an efficient market economy. On the other hand, privatisation and liberalisation were seen as a tool for increasing of competition but according to the market structure in many transition economies it turned out to be a dubious proposition³ while according to the EBRD assessment indicators for competition policy in the majority of cases were poor and one of the least developed aspects of the whole transition process.

So it was within the Montenegrin economy: until 2007 competition policies were assessed by *one* which is the value that depicts the initial state with no advancement or with an extremely low level of progress. A later shift to the value of 1.67 in 2007 and 2.0 in 2009 still ranks the country poorly compared with more developed transition economies. Yet, this modest move is primarily due to some formal and not very substantial changes (establishing of the competition body, adjustment of competition laws with the EU standards etc. with negligible implementation results). In conclusion it should be said that this is also due to a mistaken hyper-liberal prediction that liberalisation would produce a competitive market structure and for that reason competition policies were rather neglected in the transition reforms agenda.

The third important point concerns the entire environment that was developed under transition. Namely, if privatisation and liberalisation are fast they have to be followed by strong and viable institutions. Otherwise the results will be suboptimal and/or will be introducing a new misbalance within the economy. Among the EBRD indicators one can select at least four indices that provide certain information on institutional development, like those that reveal the state of enterprise reforms, banking and non-banking financial system as well as the reforms in infrastructure. If the

³ Thus for example, in analysing the case of Serbia I have shown that former monopolies have not been dismantled despite free and subsequently real entry of foreign companies through privatisation procedures and in some industries the market structure has even deteriorated (Cerovic, 2009).

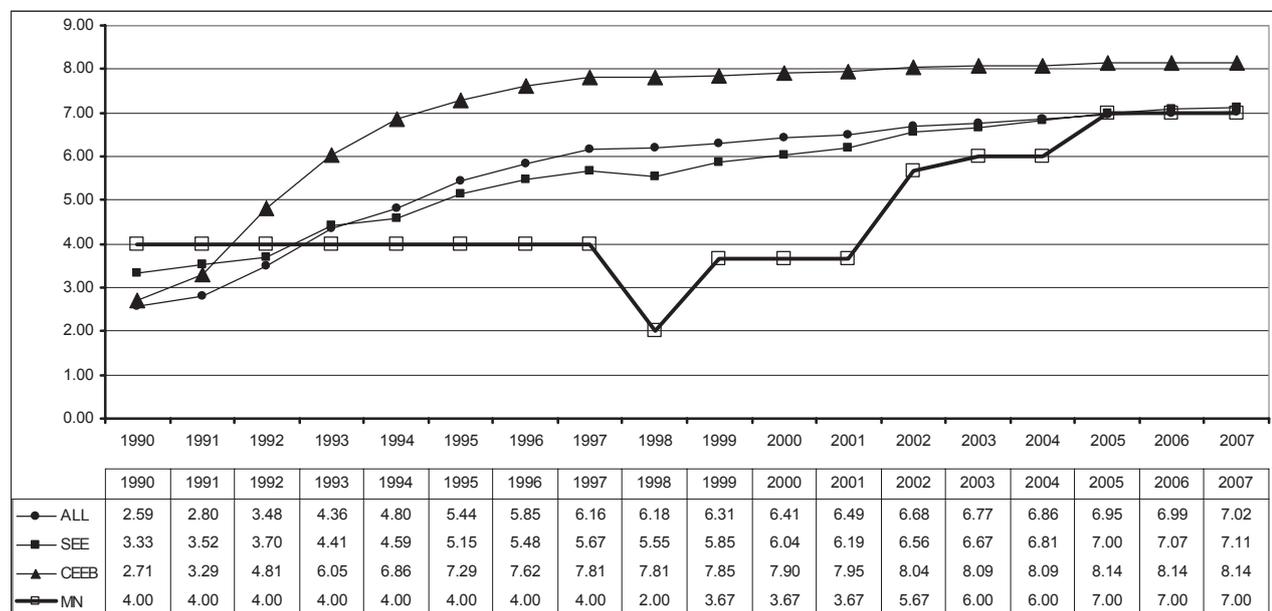
reforms were well balanced then the value of these four indicators seen as a ratio to the values of the remaining five, should produce a coefficient equal to 0.8. However, this is not the case with the Montenegrin reforms: in 2007 this ratio was 0.49 and in 2009 it reached 0.52. This is to demonstrate that deeper institutional reforms were very much lagging behind those that can be understood as “one step” reforms – like privatisation and liberalisation.

Indeed, if we use the ratio of the EBRD assessments for privatisation (small and big) to institutional development as measured by the sum of values of the four indicators mentioned above, we shall again remark an obvious lag between the two sets of reforms. Thus, in the period of 2005-07, when the privatisation indicator was valued at 7 points, this ratio for Montenegro was in the range of from 0.88 to 0.84 and in 2009 it was 0.74 (but with a decrease of the privatisation indicator to 6.67). Comparing these values with other transition economies at the time when their privatisation score was assessed by the EBRD at 7 points (as in Montenegro in 2005-07), we shall meet much lower figures that stay for more balanced reforming process. For example, in Poland this ratio ranges from 0.7 to 0.62 (1994-5), in Estonia it was 0.7 (1994), in Slovenia 0.68 (1996) in Hungary when the privatisation indicator was 6-8 the observed ratio ranged from 0.56 to 0.67 (1994-95). In general, it could be said that Montenegro enters the circle of those transition economies where privatisation was going ahead of the deeper reforms while their reforming aftermath was not very successful or that the Montenegrin approach to reforms lags behind if compared with the most successful “transitioners” from CEEB.

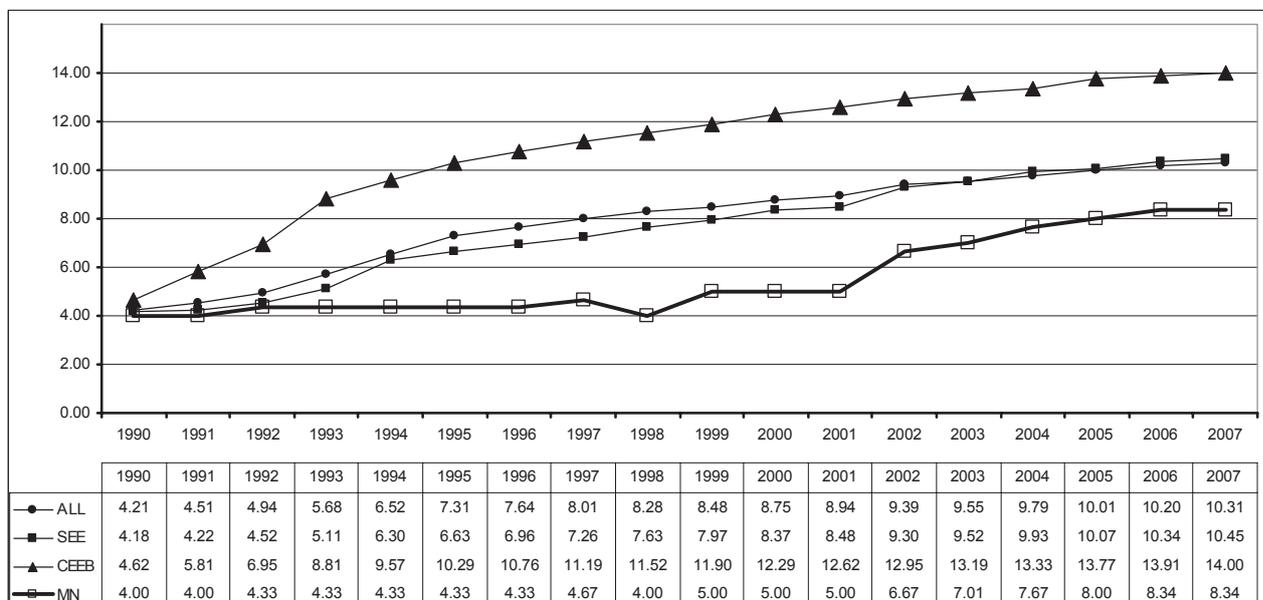
This kind of unbalanced progress in various sets of reforms recommended by transition schemes can be seen in a more transparent way in the following two graphs and tables.

Graph 2

Privatisation progress: sums of 2 EBRD indicators (1990-2007)



Source: EBRD (2008)



Looking at the data and graphs presented it is easy to conclude that privatisation was advancing at a relatively high speed, particularly after 2001. Some deeper and more institutionally oriented reforms have moved on also from 2001 but at a much slower pace. For that reason the Montenegrin economy has achieved the level of privatisation which is equal to an average of all transition economies already in 2007 despite its late start (the Montenegrin score for privatisation equals 99.7% of the one computed for all transition economies and 86% of the one for CEEB). However, Montenegro is still considerably lagging behind the average level when deeper and institutional reforms are observed (80.9% of ALL and only 56.6% of the CEEB group). The questions that are interesting concerning such a progress are whether it appears in consequence of a wrongly chosen policy and whether this could be the only explanation, or whether there were some other forces that slowed down the entire reforming process. In answering these questions we have to detect what are the main forces which govern transition advancement and the speed of reforms.

INITIAL CONDITIONS AND THE SPEED OF REFORMS

For a full assessment of transition progress in any country, as indicated at the beginning, one should look at the initial conditions and/or the inherited circumstances. The same could apply to the Montenegrin economy. We have seen that its start was late owing to purely political reasons and despite its faster accomplishment of some reforms like liberalisation and privatisation, the overall result is still relatively weak. If we re-count the EBRD indicators to a scale from 0-100% (instead from 9-39 as EBRD indicators suggest) we shall discover that Montenegro still faces a half-completed task. Namely, expressing the EBRD data in the form of percentage points we shall discover that 25.01 points in 2007 mean in fact 53.3% or 25.67 points in 2009 represent 55.6% of the desired goal which should be a developed market economy structure⁵. Is it enough or were there possibilities for faster advancement of an economy like that of Montenegro?

In answering this question we have to think about initial conditions and to weigh up how initial conditions affect reforms in a transition economy. Actually, we have to analyse transition progress

4 The four EBRD indicators being: governance and enterprise restructuring, banking reform and interest rate liberalization, securities markets and non-bank financial institutions, infrastructure.

5 The calculus is simple: one should extract nine points from the sum of EBRD indicators and relate it to 30 points that can be earned on the transition path. This way of expressing transition progress I have learned from Nuti (2008) and apply in various analyses (see: e.g. Cerovic & Nojkovic, 2008; 2009). The results are not that trivial since according to the EBRD methodology the picture could be brighter as countries were awarded nine points in advance though no reform was taken and implemented. In that way one can realise that by 2007 that is, 18 years after the start of transition reforms, there were only eight countries (28% of the 29 observed) that accomplished reforms by 75% or more, whereas among them only two countries were close to the 90% threshold (Estonia and Hungary) and one of them did just overstep the 75% line (Croatia). Thirteen countries were in the range 55%-75% in accomplishing reforms, ten of which are in the range 55%-65%. There were eight countries below 55%.

as an endogenous variable rather than to attribute the speed of reforms to the good faith and/or cleverness of policy makers.

As pointed out above there is a huge literature on the issue. However, for this analysis I shall try to present the model that I have already used together with a colleague of mine in some of our previous articles.⁶ In the table below (Table 1) I shall use three simple models that consider transition progress (TPROG) as measured by the sum of nine EBRD indicators, to be a dependent on (a) initial GDP per head in 1989, expressed in US\$ (GDP1989) according to purchasing power parity (PPP), (b) experience in market reforms (MREF), which is a dummy that assigns 1 to the countries that have conducted some market reforms during the era of socialist or communist led economy and 0 for the others⁷, (c) number of years under communist rule (INST1, a variable initially used by de Melo *et al*, 1996) and (d) black market exchange rate margin (INST5) to capture macroeconomic distortions from the pre-transition period (which is also firstly used by de Melo *et al*, 1996). I shall present here the results for 1998 since it corresponds approximately to the transition period of the Montenegrin economy in 2007 because of its late start. By means of the OLS model we get the following estimates for the three regression equations within a set of 23 transition economies, whose necessary data can be found and are reliable enough:

Table 1

Dependent variable: TPROG (1998)			
TPROG 1998			
Variable	Equation 1	Equation 2	Equation 3
Constant	19.9226 [2.4328]***	34.1089 [3.6194]**	24.0105 [2.1667]***
GDP1989	0.0008 [0.0004]***	0.0007 [0.0003]**	0.0009 [0.0003]***
MREF	4.1680 [1.9889]***		
INST1		-0.2232 [0.0501]***	
INST5			-0.0287 [0.0094]***
R ² (%)	32.7	58.8	43.8
Adj. R ² (%)	25.9	54.7	38.1
DW statistics	1.79	2.24	1.62
N	23	23	23

Note: standard errors in parentheses;*** denotes statistically significant at 1% level; ** denotes statistically significant at 5% level.

We can see that all the three equations are significant and can explain transition progress to the extent that cannot be ignored in analyses (adjusted R²-s range from 26-55%) while all their variables are also highly significant (mostly at 1% level). It should be underlined that these results are not at all surprising. In another paper (Cerovic & Nojkovic, 2008) it was demonstrated that the proposed model holds for a sequence of years (2001, 2004, 2007) confirming that initial conditions do affect

⁶ See the most developed version in: Cerovic & Nojkovic (2009).

⁷ The more profound market reforms were taken in few countries – in those that emerged from former Yugoslavia and in Hungary and Poland.

transition progress significantly and in the long run (moreover, their impact does not diminish necessarily over time, at least not beyond 2004). Hence, we can state that each model confirms the endogenous character of the variable TPROG or that this variable is indeed affected by initial conditions like development level, market experience and/or macroeconomic distortions.

Since the above analysis has shown that accomplishment of the entire set of transition reforms depends on initial conditions it would be challenging to explore whether the same could apply to those more complicated and more demanding reforms that we have called earlier the institutional ones. It could be reasonable to predict that this kind of change is even more influenced by initial conditions since they typically determine many elements that could appear important in implementing new institutions like general level of knowledge of the inner meaning of reforms, general social attitudes towards social changes, and factual understanding of the consequences provoked by certain reforming activities. Moreover, Hoff and Stiglitz (2004, 2005) have shown that institutional changes are indeed endogenous that is, dependent on the overall circumstances of an economy in question.

For all these reasons we shall try to use the same models as above but shall change the dependent variable using now only those EBRD indicators that are predominantly institutional in character that is, the four previously defined indices on enterprise restructuring, financial system development and infrastructural reforms and name this variable as INPROG. In the following table (Table 2) the results of that analysis for 1998 and for the same set of transition economies are presented:

Table 2

Dependent variable: INPROG (1998)			
INPROG 1998			
Variable	Equation 1	Equation 2	Equation 3
Constant	5.6701 [1.0496]***	12.2418 [1.6209]***	7.4526 [1.1797]***
GDP1989	0.0005 [0.0002]***	0.0004 [0.0001]***	0.0005 [0.0002]***
MREF	2.2766 [0.8581]**		
INST1		-0.1028 [0.022]***	
INST5			-0.0121 [0.0044]***
R ² (%)	46.8	64.9	47.7
Adj. R ² (%)	41.4	61.4	42.4
DW statistics	2.02	1.56	1.66
N	23	23	23

Note: standard errors in parentheses;*** denotes statistically significant at 1% level; ** denotes statistically significant at 5% level.

It is immediately evident that the models perform even better when institutional changes are explored. The explanatory power of the equations is remarkably higher (from 41.4-61.4%) and the significance

of all the variables has increased (except for MREF, but nonetheless it remains highly significant). As already remarked this is a not unexpected result since the level of development, market experience and macroeconomic stability do affect numerous additional factors that are essential in conducting reforms, particularly if they are more demanding in terms of expertise.

Here we can introduce another measure for institutional progress in order to avoid possible misinterpretation if we persist with the EBRD assessments and indices only. This new measure will be borrowed from Transparency International and is known as the Corruption Perception Index (CPI). Despite some subjectivity that may occur, since the index is based on individual estimations and perception that could be biased because of accustomed and/or learned behaviour which could prevent responders from judging the corruption level fairly, it is by no means a very frequently used indicator for the rule of law and its enforcement. It seems that it is of particular importance for transition economies since they have all been repeatedly warned about this kind of misbehaviour.⁸ For all these reasons we shall make use of our equations one more time and try to discover what would be the results when CPI becomes the dependent variable. The set of countries will remain the same but the only change will be the year of observation (1999) since this was the earliest year with available data on the Transparency International site. The results of this experiment are presented in Table 3 below.

Table 3

Dependent variable: Corruption perception index (1999)

CPI 1999			
Variable	Equation 1	Equation 2	Equation 3
Constant	0.9889 [0.4960]**	4.0833 [0.6286]***	1.9626 [0.5237]***
GDP1989	0.00035 [0.0001]***	0.00033 [0.0001]***	0.00036 [0.0001]***
MREF	1.1133 [0.4055]**		
INST1		-0.0480 [0.0085]***	
INST5			-0.0067 [0.0020]***
R ² (%)	59.4	71.9	64.8
Adj. R ² (%)	55.3	69.1	61.2
DW statistics	2.64	2.37	2.38
N	23	23	23

Note: standard errors in parentheses,*** denotes statistically significant at 1% level; ** denotes statistically significant at 5% level.

Not surprisingly, the results did not change remarkably, although the explanatory power of the models as presented by the adjusted R squared is further strengthened (55.3-69.1%) and the significance of

⁸ The appearance of corruption is not that strange under transition. Under substantial social and economic changes that characterise the transition process and which very often are not supported by correctly designed institutional surroundings, the emergence of corruption can be anticipated. Unfortunately, this is to be analysed rather from the standpoint of insufficiently designed transition policies, schemes and recommendations in particular (speeding up privatisation and some other reforms without proper benchmarks) than from the standpoint of incorrect policies and/or misbehaviour on the local grounds of a transition economy, although this cannot be ignored either.

variables remains constantly high (all at 1% level except for MREF). In other words, the level of corruption is also mainly determined by inherited conditions including GDP level, market experience and/or macroeconomic difficulties, which should not be a great surprise. This result also speaks in favour of the idea that social changes cannot be enforced at one's will nor they can be brought about through social "engineering" but have to be patiently built and improved over time⁹.

After obtaining these results we may now apply them to the case of the Montenegrin economy and try to define what is its real position concerning transition progress and whether it differs (and how much) from an expected and achievable level in conducting reforms.

INITIAL CONDITIONS AND TRANSITION IN MONTENEGRO

In analysing the economy of Montenegro one can explore observed delays in transition from two parallel standpoints. As said before and firstly, the Montenegrin economy is suffering from a delay that originated in the nineties and that appeared in consequence of the prevailing politics of that time, which were in essence hostile towards transition reforms. The other standpoint concerns the developments emerging from 1998 onwards, when analytical interest should be directed to the reforms taken during the past decade and to assessing whether they were fast and comprehensive enough.

In discussing the delay from the nineties we may use our regression models in estimating the extent of the lag. Using equations 1-3 presented in table 1 we may easily calculate what would be an expected level of transition progress expressed by means of the sum of nine EBRD indicators (TPROG). For want of fully reliable data we shall approximately estimate the 1989 level of GDP per head in terms of PPP at US\$ 4000. As explained above the variable MREF should take the value of 1 while the values of the other two variables (INST1 and INST5) will be calculated from already mentioned original source (de Melo *et al.* 1997). According to the equations 1-3 we obtain the following values for TPROG: 27.3; 26.9 and 27.5 respectively. This is to demonstrate that the Montenegrin economy should have been able to achieve the level of transition progress that equals around 27 EBRD points already in 1998 if only it had had an opportunity to conduct reforms at an average pace (compared with other transition economies) and in line with its initial conditions. However, we have remarked that an opposite process took place and that it had moved back the country to the level of 10.67 or some 16-17 points below its estimated and potential grade¹⁰.

When Montenegro took a more decisive approach regarding its reforming policies, that is since 1998, it was shown that it had a persistent advancement in implementing the reforms which led the country to a level of 25 EBRD points in 2007. Presuming that this was a real or *de facto* initiation of necessary transition policies we may use the same models from above to estimate whether these achievements could be seen as satisfactory, having in mind the initial conditions as they were in 1998. This can be done since the models are based on the same length and the same phase of transition process (initial decade) but estimated for the countries that were earlier in their reforming activities (1989-98). For that reason we have to correct our data for initial conditions i.e. to re-estimate GDP per head in terms of PPP for 1998. We let this variable take the estimated approximate value of US\$ 2600¹¹ and have done a little correction in INST5 but the latter adjustment appeared to have a negligible impact on the overall result.

9 Ironically enough, all these and similar arguments that uphold contemporary criticism of the "big bang" approach and over-accelerated reforms, including the idea of the impact of initial conditions on transition progress, have much in common with the well known, though easily neglected (both by the present-day reformers and the revolutionaries of yesterday) Marxian thesis on the relationship between "productive forces" and "relations of production". The point is that we could not change social relations and social order at our will unless the development level was high enough to provoke these changes, sustain and maintain them.

10 I have demonstrated in the project mentioned in footnote 1 that this delay may be responsible for a substantially lower level of GDP per head in the Montenegrin economy in 1998. If seen as a dependent variable of initial GDP (GDP1989), TPROG, MREF, average inflation and some other variables it appears that it could be from 2.7 to 3.0 times higher than real GDP per head in 1998 in current US\$ (or around US\$ 3400-3500).

11 In calculating this value of the GDP *per capita* in PPP terms we use the estimated level for 1989 (US\$4000) and adjust it by means of the estimated GDP *per capita* index for 1998, which is 65 (EBRD, 2008).

After modifications have been made we may estimate the new results. In compliance with the equations 1-3 in Table 1 we conclude that, according to initial conditions from 1998, the expected level of transition progress in Montenegro in 2007 (expressed by the sum of nine EBRD indicators) could be: 26.3; 25.4 and 26.3 respectively, which is somewhat above the real achievement (25.01) or approximately around 2-5% higher¹².

However, this result, which does not differ much from the progress actually attained, requires a certain amount of additional care. Despite the fact that the level of GDP had considerably diminished during the nineties it cannot be assumed that this deterioration has changed all connected factors that could affect reforms and for which the GDP variable stands. Namely, the GDP level is to represent a series of corresponding variables like knowledge, understanding of reforms and so on, which are not that changeable in such a short period of time.

For that reason, in re-thinking our calculations it would be wise to stay with the GDP per head level that was achieved shortly before, i.e. in 1989 and estimate the potential level of reforms according to that figure. In that case the result should change and we shall have the same result as for the first but lost decade of the nineties or we may state that an achievable transition progress in Montenegro in 2007 should be at the score of 27-27.5 in terms of EBRD points or around 11% higher than the attained one. Consequently, we may state that the reforms in Montenegro could have been somewhat faster and/or deeper than they actually were.

A similar procedure can be used in assessing institutional developments. Applying equations 1-3 from Table 2, we shall obtain the following values for institutional progress: 9.27; 8.45 and 8.80 respectively – if calculated with the GDP level from 1998 or 9.99; 9.22 and 9.54 – provided the GDP level from 1989 is used. However, in both cases the values obtained are higher than the achieved progress assessed by the EBRD at 8.34, confirming our previous conclusion that institutional reforms are lagging behind other transition economies with similar initial conditions. Since I have already stated why the latter version should be more realistic and more reliable it transpires that the delay in institutional reforms can be roughly considered to be in a range of from 9.5-14.4% that is, for this margin below attainable progress.

Finally, the same method of reasoning can be employed in estimating the alternative measure for institutional development used in this paper – the CPI. Using equations 1-3 from Table 3 we realise that the values of the CPI for Montenegro could be expected to be: 3.5; 3.1 and 3.4 respectively (based on the GDP level from 1989). Since the real value of CPI for Montenegro in 2007 was 3.3 and in 2008 was 3.4 (note that the model covers eleven years from the transition starting point) we may conclude that although it is low, still it is approximately at the level predetermined by the inherited conditions or is somewhat lagging but for a tiny margin¹³.

However, all data and all estimation done in this section show that despite an already long period of 10-11 years of broader transition attempts and reforming activities, the economy of Montenegro is still somewhat below the level that could be expected. Moreover, this is to confirm that there are certain possibilities and chances for further improvement, particularly in the field of institution building and institutional adjustments.

¹² It is worth noting that the *Economic Reform Network*, a non-government organisation in Podgorica, gathering experts from various fields and using allegedly the same EBRD methodology, has attributed to Montenegro 24 points as the sum of nine EBRD indicators already in 2003, obviously expressing rather its enthusiasm for reforms than neutral expert observation and analysis (ERN, 2003).

¹³ It should be noted that in 2009 the value of CPI for Montenegro came forward to the level of 3.9, ranging from 3.5 to 4.4 (Transparency International, 2009).

CONCLUSIONS

Montenegro has travelled along a very specific transition path. Its initial position was favourable for conducting reforms and was in front of all observed groups of countries including the most successful countries from CEEB. However, this encouraging position had deteriorated over the nineties and transition had to be restarted by the end of the decade. The reasons for this decline could be found in political factors, including the Montenegrin position in the union with Serbia, which is the only country that has displayed similar developments.

Since 1998-99 Montenegro has demonstrated more decisive policies in reform implementation. For that reason it has reached the average level of transition progress of the entire set of transition economies in a comparable period of time and in some activities is found in front of them. When observed from this standpoint the Montenegrin transition reforms could be assessed as successful so far. On the other hand, as in many other transition economies, reforms concerning privatisation and liberalisation were much faster and appeared easier than the ones connected with institution building and institutional improvements.

However, transition progress is an endogenous phenomenon and depends on the inherited conditions of a country. Analysed from that standpoint it could be claimed that despite its late start the Montenegrin economy has preserved some initial advantages but did not succeed in exploiting all of these potentials. According to the analyses conducted in this paper we may conclude that it is still lagging behind its estimated level of reform advancement when inherited conditions are taken into consideration. Since the present lag is not particularly remarkable the results obtained could be a useful guideline for the policies that should be taken in future.

.....72 The basic problem and the primary task in further reforms could be summarised as the need for deeper restructuring and faster institution building. Since institutional advancement should also be treated as endogenous in character we have identified the biggest delay in this set of reforms when it was analysed according to the inherited conditions. The importance of this finding is in the fact that institutional delays and lags could prevent exploitation of benefits from privatisation and liberalisation achieved so far. For that reason the most important future policies should be laid in the field of institutions and their improvements and the main efforts of local policy makers should be directed to achieving the accessible level of institution building.

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BUSINESS CYCLE SYNCHRONIZATION BETWEEN THE BULGARIAN ECONOMY AND THE EUROPEAN UNION

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ABSTRACT

This paper analyzes the level of economic convergence within the EU and in particular within EMU. The main purpose is to assess the level of business cycles synchronization between Bulgaria and the Eurozone. The research is conducted with data for the period 1995 – 2009 divided into two subsamples: 1995-2001 and 2002 – 2009. The essential findings of this paper include: lack of economic convergence within the EMU in the first sub-period and significant improvement of the business cycle synchronization in 2002 – 2009.

Key words

business cycle synchronization, EU integration, currency unions, optimum currency area, economic development, economic convergence.

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INTRODUCTION

The process of Bulgaria's accession to the European Union started in 1990 with the signing of the Convention on Trade, Business and Economic Relations and a resolution of the parliament expressing the desire of the Republic of Bulgaria to become a full member of the European Community. In 1999 the European Council decided to start accession negotiations with Bulgaria, and in January 1, 2007 Bulgaria acquired officially the status of full member of the EU. Another dimension of the Bulgarian integration into the EU is the introduction of a currency board in July 1, 1997. After several failed stabilization attempts and a period of hyperinflation, the Bulgarian currency was pegged to the Deutsche Mark at a fixed rate and in 2002 when Germany adopted the Euro, it became the anchor currency for the Bulgarian Lev.

Now 20 years after the start of this process and more than 3 years since the gaining of full member status, the Bulgarian integration in the EU economy is far from complete. Free trade and factor movement within the Union failed to provide economic convergence for Bulgaria. Despite the relatively high economic growth in the last decade Bulgaria remains one of the poorest members of the EU with the lowest income per capita, the lowest labor productivity, high unemployment, inflation and interest rates. In order to speed up the convergence The Bulgarian government declared its ambition to apply for membership into Eurozone until the end of 2010. In the same time some policymakers (including one of the prime minister's advisors) advocate the abolishment of the currency board with the argument that Bulgaria needs independent monetary policy in accordance with its own economic conditions. This paper is aimed to determine which of the two alternatives is better for Bulgaria – joining the Eurozone or maintaining monetary independence.

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THEORY OF CURRENCY UNIONS

The Maastricht treaty defines the so called **Euro convergence criteria** which are the nominal requirements for European Union member-states to enter the third stage of European Economic and Monetary Union (EMU) and adopt the Euro as a national currency. The five main criteria listed in the treaty are:

1. Inflation rate: Applicant countries should have inflation rate no more than 1.5 percentage points higher than the average of the three EU member states with the lowest inflation.
2. Long-term interest rate: The nominal long-term interest rate in the applicant countries must not be more than 2 percentage points higher than in the three lowest inflation member states.
3. Annual government deficit: The ratio of the annual government deficit to GDP must not exceed 3% at the end of the preceding fiscal year.
4. Government debt: The ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year.
5. Exchange rate: Applicant countries should have joined the exchange-rate mechanism (ERM II) under the European monetary system (EMS) for two consecutive years and should not have devalued its currency during the period.

According to the Maastricht criteria Bulgaria is eligible for applying to the ERM II (see table 1) and the Bulgarian Central Bank has been maintaining fixed exchange rate with the Euro since 2002. Therefore the adoption of the Euro from Bulgaria is a real possibility in 2013.

Table 1: Fulfillment of Maastricht convergence criteria by Bulgaria

Criteria	Bulgaria	Reference value
Inflation rate	2.4 %	3.2 %
Annual government deficit to GDP	-3.2 %	3 %
Gross government debt to GDP	14.1 %	60 %
Long-term interest rate	5.82 %	6.5 %

Source: European Central Bank data for 2008³

Nevertheless due to its normative nature, the Maastricht Treaty does not provide measures to assess if the adoption of the Euro will be beneficial for an applicant country. The benefits and costs for a country joining a currency union can be assessed within the framework of the theory of Optimum Currency Areas (OCA) developed by Robert Mundell⁴ in the 1960's. According to Mundell a Currency Area is a domain within all entities use a common currency or maintain fixed exchange rates. Usually currency areas coincide with national borders but they also can be bigger or smaller than the national territory.

Mundell analyses two extreme examples: every person has their own currency and there is only one currency in the whole world. The first case is similar to barter economy and is generally viewed as not beneficial for any economy. The more currencies that exist, the more money will have to be exchanged in order to trade with others, thus increasing transaction costs. Also, the smaller the currency areas are, the more vulnerable each area becomes to speculation with its currency. If only transaction costs and speculation issues were to be considered, the whole world should have only one currency.

In the second case – only one currency for the whole world will not be beneficial either because it suggests uniform monetary policy for all entities. Monetary policy is used by governments as an anticyclical instrument – expansionary policy is used to combat unemployment and contractionary policy is employed to control inflation. Since the world is not homogeneous in terms of unemployment and inflation therefore a worldwide common currency imply an inability to react to shocks by adjusting exchange rates. If economic stability or adjustment to shocks is the only goal considered, as many areas as possible should trade with flexible exchange rates. The best decision in respect of both minimizing transaction costs and ability to adjust to cyclical shocks is to establish monetary unions within regions regardless national borders. In order to be optimal, Currency areas must meet the following requirements (i.e. OCA properties):

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1. Labor mobility across the region – mobility of workforce equalizes the level of unemployment within the area, which allows common policy.
2. Capital mobility across the region – foreign investments reduce the inflationary pressure and equalize prices within the region.
3. Entities within the region must have synchronized business cycle dynamics – allows uniform adjustment policy.

Some authors have suggested additional requirements for the optimality of currency unions. Ronald McKinnon⁵ suggests price flexibility for goods and factors of production. Another contributor to the OCA theory is Peter Kenen⁶, who states that the participants in a currency union must have highly diversified economies (particularly external trade) because it would reduce the significance of random external shocks on exports.

³ <http://sdw.ecb.europa.eu/>

⁴ Mundell, R., A Theory of Optimum Currency Areas, *The American Economic Review*, Vol. 51, No. 4 (Sep., 1961), pp. 657-665

⁵ McKinnon, Ronald I., Optimum Currency Areas, *The American Economic Review*, Vol. 53, No. 4 (Sep., 1963), pp. 717-725

⁶ Kenen, P.B., 1969, The Theory of Optimum Currency Areas: An Eclectic View, in Mundell and Swoboda (eds.), *Monetary Problems in the International Economy*, University of Chicago Press

Fulfillment of all these requirements suggests that the participation of a country in the monetary union will be beneficial due to reduced transactional costs and increase of mutual trade among the union members. When the OCA criteria are not satisfied, idiosyncratic shocks cannot be adjusted with the instruments of monetary policy or the monetary policy itself may cause economic disturbances (inflation and unemployment).

As stated above the purpose of this paper is to assess if the joining of Bulgaria to the European Monetary Union will be beneficial or not. In order to achieve the goal of this paper, it is necessary to examine if the Bulgarian economy possesses the OCA properties.

Significant part of the fundamental European Union legislation is dedicated to the provision of factor mobility and price flexibility. Although the Rome Treaty and secondary legislation grant free movement of goods, capital and labor, in reality factor mobility within the Union is far from perfect. Capital is considered to be the more mobile factor among EU members, but its level is lower than the mobility within the US due to the different tax levels in EU countries⁷. The Rome treaty also postulates free movement of workforce but the mobility of labor is impeded by cultural and language barriers. All EU members are free market economies with negligible exclusions (in some of the members the price of electricity is regulated by the government and it is generally believed that there is no true wage flexibility⁸). Since most of the OCA properties are not country specific due to the common European legislation, this paper is focused on the main Mundell criterion – business cycle synchronization. In order to evaluate if the adoption of the Euro will be beneficial for Bulgaria it is needed to assess the level of synchronization of the Bulgarian business cycle with the cycle of the Eurozone and the individual cycles of the EMU members.

DATA AND METHODOLOGY

Measuring business cycle synchronization between the Euro zone and a specific country is not a simple task due to the composite nature of European Monetary Union – it consists of 16 separate national economies, with their own cyclic fluctuations. In order to overcome this problem and to increase the robustness of the results we apply two parallel approaches – measuring the synchronization between Bulgaria and aggregate EMU cycle and measuring the bilateral synchronization between Bulgaria and each EMU member state. The measurement of business cycle synchronization is carried out in two separate iterations: cycle identification and synchronization estimation.

We choose GDP as the most inclusive measure for economic activity and its dynamics may be considered as sufficient approximation of overall business cycle. The source of the data is the European Central Bank statistical warehouse. We use quarterly data for the GDP of the 16 EMU countries and Bulgaria. The series are seasonally adjusted, because the non-adjusted data have cyclical properties and may distort the results. The timespan of the data is from the first quarter of 1995 to the last quarter of 2009. This period provides the longest possible sample from this particular database, and includes data for most of the selected countries (Ireland is reporting data from the beginning of 1997, Greece, Malta and Cyprus are reporting from the start of 2000).

Business Cycle Identification

One of the most common methods for business cycle identification is detrending⁹ of time series.

7 Wildasin, David E., Markusen, James R. and Winters, L. Alan, Factor Mobility and Fiscal Policy in the EU: Policy Issues and Analytical Approaches, *Economic Policy*, Vol. 15, No. 31 (Oct., 2000), pp. 339-378.

8 Sanz-de-Galdeano, A., Turunen, J., The Euro Area Wage Curve, *Economic letters* Volume 92, Issue 1, July 2006, Pages 93-98, 2006 Elsevier B.V.

9 Canova, F., Detrending and Business Cycle Facts, *Journal of Monetary Economics*, 41(3), 1998, 475-512.

We apply two different from theoretical point of view filtering techniques: Band-Pass Filter and Hodrick-Prescott Filter. The Band-Pass Filter isolates the cyclical component of the time series by removing both low (which reflect the long term growth component) and high (which might be due to measurement errors and noise) frequency fluctuations from the data at a predefined level. We use the “Ideal” Band-Pass filter recommended from Baxter and King¹⁰, with low band set at 6 lags and upper band set at 32 lags; the maximum lead/lag length of the filter is 10 lags. The Baxter-King Band-Pass Filter belongs to the category of the fixed length symmetric filters which share a well known common deficiency¹¹ – they significantly reduce the length of the filtered series. Therefore we apply an alternative detrending technique, namely – Hodrick-Prescott filter.

The Hodrick-Prescott Filter¹² is a smoothing method, which isolates the long-term trend component of time series. The cyclical fluctuations of the series are calculated as a difference between the trend component and the actual data. We use smoothing parameter $\lambda = 1600$ according to the frequency power rule of Ravn and Uhlig¹³ (the number of periods per year divided by 4, raised to a power, and multiplied by 1600) which is generally accepted in the literature. The Hodrick-Prescott Filter also possesses some disadvantages, as pointed out from Baxter and King¹⁴ it is highly dependent from the sample length (samples with different length provide different results).

The Band-Pass Filter is preferable from a theoretical perspective¹⁵, but its use on small sample series is questionable. Therefore we apply both filtering techniques independently and compare the two data sets in order to increase the robustness of the results.

Estimation of Business Cycle Synchronization

Business Cycle Synchronization between Bulgaria and EMU is measured with unconditional contemporaneous correlations. We compute correlation coefficients between the filtered series for Bulgaria and the EMU aggregate (independently for Band-Pass and Hodrick-Prescott filters). As a benchmark we calculate correlation coefficients between the EMU aggregate and every EMU member-state. Additional reference is provided from the bilateral correlation coefficients between Bulgaria and individual EMU members.

In order to study the development of the business cycle synchronization over time, we divide the sample into two not-overlapping sub-periods: 1) from the first quarter of 1995 to the last quarter of 2001; and 2) from the first quarter of 2002 to the last quarter of 2009. Greece, Malta and Cyprus are omitted from the data set in the first period for both filters, and Ireland is removed from the first period sample filtered with the Band-Pass Filter¹⁶. The dividing point has been chosen for two reasons: it provides two sub-periods with almost equal length; and also on January 01, 2002 the Euro was introduced in 11 EU members as an official currency.

We are interested in the intertemporal comparison of the synchronization because it shows the development of the European economic convergence over time, but also it allows us to test the

10 Baxter, M., King, R., Measuring Business Cycles: Approximate Band-Pass Filters for Economic Time Series, *The Review of Economics and Statistics*, Vol. 81, No. 4 (Nov., 1999), pp. 575-593

11 Christiano, L., Fitzgerald, T., “The Band Pass Filter” *International Economic Review*, 2003, Department of Economics, University of Pennsylvania and Osaka University Institute of Social and Economic Research Association, vol. 44(2), pages 435-465.

12 Hodrick, R., Prescott, E., Post-war U.S. Business Cycles: An Empirical Investigation, *Journal of Money, Credit and Banking*, Vol. 29, No. 1 (Feb., 1997), pp. 1-16).

13 Ravn, M., Uhlig, H., On Adjusting the Hodrick-Prescott Filter for the Frequency of Observations, *Review of Economics and Statistics*, 2002, 84, 371-375

14 Baxter, M., King, R., op.cit.

15 Stock, H., Watson, W., 1999. Business Cycle Fluctuations in US Macroeconomic Time Series. In: Talor J.B., Woodford M. (Eds.) *Handbook of Macroeconomics 1*. Elsevier Science B.V., 3-64.

16 Due to lack of sufficient data. In the first period the series for Greece, Malta and Cyprus include only 8 lags. Ireland series include 20 lags – insufficient for computing the Band-Pass filter, but it is enough to apply Hodrick-Prescott.

assertion of Frankel and Rose¹⁷ for the endogeneity of the OCA criterion. Using regression techniques they found that the adoption of common currency itself causes synchronization of the business cycle between the participating countries.

EMPIRICAL RESULTS

The results from the described procedure are presented separately for the two periods, followed by the intertemporal comparison within the same filtering technique.

Business Cycle Synchronization within the EMU in the Period 1995 – 2001.

Not surprisingly the two filtering techniques provide quite different results. Nevertheless there are some common characteristics. In regard to the synchronization between EMU aggregate and the individual states, the results indicate definite idiosyncratic properties of the business cycle for most of the countries in the selection (see table 2 below).

Under the Band-Pass Filter only four countries show strong correlation (coefficients higher than 0.7) with the EMU aggregate: Germany, Italy, Finland and Belgium. All other countries in the selection have moderate (between 0.3 and 0.7) or weak (below 0.3) correlation. Germany has the highest coefficient (0.979), indicating almost full synchronization with the EMU Aggregate, which is easily explained– as the biggest economy in the Eurozone, the properties of the German business cycle influence directly the aggregate measure.

80 Within the observed period Bulgaria experienced severe economic problems with hyperinflation and negative economic growth, which led to the introduction of the currency board in July 1997¹⁸. The low value of the correlation coefficient (0.27) indicates the lack of synchronization between Bulgaria and EMU countries and probably an idiosyncratic nature of the shock. In comparison with the EMU members Bulgaria's level of synchronization is similar to the one Slovenia and the Netherlands. Overall the level of synchronization with the EMU Aggregate across the selection may be defined as quite low even absent.

Table 2. Synchronization Between EMU Aggregate and Individual Countries

Band-Pass Filter		Hodrick-Prescott Filter	
Portugal	-0,7862	Slovakia	-0,5949
Slovakia	-0,5916	Portugal	0,2091
Luxembourg	-0,5826	Slovenia	0,3298
Austria	-0,3584	Bulgaria	0,4773
Slovenia	0,2301	Luxembourg	0,6028
Bulgaria	0,2723	Austria	0,6211
Netherlands	0,3233	Ireland	0,7022
France	0,4604	Netherlands	0,7323
Spain	0,4871	Finland	0,7689
Belgium	0,7485	Italy	0,8237
Finland	0,8956	Spain	0,8258
Italy	0,9459	Belgium	0,8292
Germany	0,9790	France	0,9004
-	-	Germany	0,9253

17 Frankel, J., Rose, A., The Endogeneity of the Optimum Currency Area Criteria, The Economic Journal, Vol. 108, No. 449 (Jul., 1998), pp. 1009-1025 Blackwell Publishing

18 Gulde, A., The Role of the Currency Board in Bulgaria's Stabilization, in Finance and Development, September 1999 Volume 36, Number 2, Washington: IMF

Under the Hodrick-Prescott Filter the values of the correlation coefficients are radically different, but the order of synchronization level is not significantly different for most of the countries. Germany again has the highest correlation with the EMU Aggregate, followed by France, Belgium, Spain and Italy. Overall more countries have high synchronization of the business cycle with the EMU Aggregate (8 countries have coefficients higher than 0.7 against only 4 under the Band-Pass Filter). Bulgaria, Slovenia, Slovakia and Portugal have weak correlation with the EMU Aggregate under both filters, which indicates definite lack of synchronization of the business cycles of these countries and the Eurozone. In comparison with the Band-Pass more countries show high synchronization with the EMU under the Hodrick-Prescott Filter. Nevertheless the significant difference in the coefficients for Luxembourg and Austria indicate possible problems in the cycle identification process for these countries.

Our other reference measure is the bilateral synchronization of the business cycle between Bulgaria and the individual EMU member-states (see Table 3.).

Table 3. Synchronization between Bulgaria and Individual EMU Countries

Band-Pass Filter		Hodrick-Prescott Filter	
Slovenia	-0,5958	Slovenia	-0,2118
Belgium	-0,1819	Slovakia	-0,2037
Slovakia	-0,0428	Ireland	0,0391
Luxembourg	-0,0318	Portugal	0,1031
Netherlands	0,0153	Finland	0,1346
Germany	0,0859	Belgium	0,1389
Italy	0,1270	Netherlands	0,2040
Finland	0,1826	Austria	0,3351
EMU_16	0,2723	Italy	0,3483
Portugal	0,2943	Luxembourg	0,4204
Spain	0,6298	Germany	0,4456
Austria	0,6475	EMU_16	0,4773
France	0,8984	France	0,5213
-	-	Spain	0,5807

Under the Band-Pass Filter the Bulgarian business cycle has high level of synchronization only with France and moderate with Austria and Spain. As it was discussed earlier the correlation with the EMU Aggregate is weak. Business cycle identification with the Hodrick-Prescott Filter in general provides higher correlation coefficients except for France. As a result the category of moderate synchronization with Bulgaria contains 7 countries, but none of the entities in the sample is strongly correlated with the Bulgarian cyclic fluctuations.

The general conclusion for the observed period is that Bulgaria does not meet the fundamental requirement for joining a currency union with the selected countries. Nevertheless, Bulgaria de facto entered the EMU by introducing the currency board in 1997¹⁹ and fixing its national currency to the German Mark. This conclusion is not surprising, but we also found that the EMU members themselves did not meet the essential OCA criterion in the observed period.

¹⁹ According to Mundell, the fixed exchange rate and the common currency are the same, and the participating countries have to possess the same OCA properties Mundell, R., op. cit.

Business Cycle Synchronization within the EMU in the Period 2002 – 2009.

The macroeconomic setting in the second sub-period in the sample is radically different – the EMU was founded in December 1998 when 11 EU members fixed their exchange rates. In 2002 the Euro was introduced as a national currency in 12 EU members and by 2009 that number rose to 16 member-states. This should facilitate the trade and therefore the synchronization between those countries by reducing the transactional cost and due to the common monetary policy. We test this hypothesis following the same procedure from the previous paragraph. Although the results are theoretically consistent, their uniformity is astonishing (see Table 4.).

Table 4. Synchronization Between EMU Aggregate and Individual Countries

Band-Pass Filter		Hodrick-Prescott Filter	
Malta	0,8032	Bulgaria	0,8000
Cyprus	0,8244	Greece	0,8167
Greece	0,8675	Cyprus	0,8461
Bulgaria	0,8814	Slovakia	0,8785
Slovakia	0,9118	Malta	0,8813
Ireland	0,9433	Ireland	0,8935
Luxembourg	0,9509	Portugal	0,9099
Portugal	0,9675	Luxembourg	0,9178
Slovenia	0,9744	Netherlands	0,9648
Belgium	0,9797	Spain	0,9651
Finland	0,9808	Belgium	0,9709
Netherlands	0,9833	Slovenia	0,9737
Austria	0,9857	France	0,9745
Spain	0,9865	Austria	0,9765
Germany	0,9930	Finland	0,9774
France	0,9959	Germany	0,9775
Italy	0,9991	Italy	0,9816

Under the Band-Pass technique for identification of the business cycle all correlation coefficients are within the range between 0.8 (Malta) and 0.999 (Italy). This result indicates extremely high level of synchronization of the business cycle across the whole Eurozone, including the newest members and even the non-member-state Bulgaria. Actually the correlation coefficient between Bulgaria and the EMU Aggregate is higher than those of Greece, Malta and Cyprus.

In this sub-period the correlation coefficients, computed under the Hodrick-Prescott Filter provide almost the same results – the range for the whole selection is between 0.8 (Bulgaria) and 0.982 (Italy) and the individual values are very similar to the Band-Pass Filter. This confirms the conclusion derived from the Band-Pass series: that in the sub-period 2002 – 2009 there is very high level of synchronization of the business cycle across the selection.

The results for the synchronization of the Bulgarian business cycle with the EMU members are also very similar for both filters (see Table 5.).

Table 5. Synchronization Between Bulgaria and Individual Countries

Band-Pass Filter		Hodrick-Prescott Filter	
Malta	0,5044	Luxembourg	0,6160
Ireland	0,7796	Ireland	0,6329
Netherlands	0,8273	Malta	0,7016
Spain	0,8428	Greece	0,7392
Luxembourg	0,8490	France	0,7428
Germany	0,8706	Italy	0,7439
Austria	0,8788	Portugal	0,7487
Cyprus	0,8803	Germany	0,7880
EMU_16	0,8814	Belgium	0,7913
Portugal	0,8819	Spain	0,7944
France	0,8861	EMU_16	0,8000
Italy	0,8865	Cyprus	0,8101
Greece	0,8911	Slovakia	0,8111
Slovakia	0,9031	Austria	0,8154
Belgium	0,9106	Netherlands	0,8207
Slovenia	0,9140	Finland	0,8519
Finland	0,9193	Slovenia	0,8636

Under the Band-Pass filter, Bulgaria has strong correlations with all countries in the selection except Malta (0.5) and under the Hodrick-Prescott filter – except Luxembourg and Ireland. All coefficients have very close values, therefore the order of the countries differ more than the coefficients themselves. The general conclusion is that the cyclic fluctuations of the Bulgarian economy are highly synchronized with the EMU Aggregate and with every individual member state. This statement is confirmed under both techniques for business cycle identification.

Intertemporal Comparison

When we compare the results between the two sub-periods it is quite obvious that the level of economic convergence has risen dramatically across the Eurozone (Table 6.).

Table 6. Synchronization Between EMU Aggregate and Individual Countries

Band-Pass Filter				Hodrick-Prescott Filter			
1995 - 2001		2002 - 2009		1995 - 2001		2002 - 2009	
Austria	-0,36	Austria	0,99	Austria	0,62	Austria	0,98
Belgium	0,75	Belgium	0,98	Belgium	0,83	Belgium	0,97
Bulgaria	0,27	Bulgaria	0,88	Bulgaria	0,48	Bulgaria	0,80
Finland	0,90	Finland	0,98	Finland	0,77	Finland	0,98
France	0,46	France	0,99	France	0,90	France	0,97
Germany	0,98	Germany	0,99	Germany	0,93	Germany	0,98
Italy	0,95	Italy	0,99	Ireland	0,70	Ireland	0,89
Luxembourg	-0,58	Luxembourg	0,95	Italy	0,82	Italy	0,98
Netherlands	0,32	Netherlands	0,98	Luxembourg	0,60	Luxembourg	0,92
Portugal	-0,79	Portugal	0,97	Netherlands	0,73	Netherlands	0,96
Slovakia	-0,59	Slovakia	0,91	Portugal	0,21	Portugal	0,91
Slovenia	0,23	Slovenia	0,97	Slovakia	-0,59	Slovakia	0,88
Spain	0,49	Spain	0,99	Slovenia	0,33	Slovenia	0,97
-	-	-	-	Spain	0,83	Spain	0,97

All countries in the selection have improved their level of synchronization with the EMU under the both filtering techniques. These results confirm the hypothesis of Frankel and Rose that the currency union causes business cycle synchronization between the participants, even if the individual cycles are idiosyncratic prior to the adoption of the common currency. In the first sub-period the two filters provide quite different results, but in the second sub-period the coefficients are rather consistent. This dispenses any doubts that one might have towards the quality of the identification processes.

CONCLUSIONS AND FUTURE RESEARCH

The main purpose of this paper is to assess whether Bulgaria should join the EMU or it is more beneficial to have independent monetary policy. Our empirical results show that the business cycle of Bulgaria is highly synchronized with the EMU Aggregate and with every of the EMU member-states – and thus fulfils the fundamental OCA criterion. Therefore we think that it is better for Bulgaria to join the Eurozone than to maintain independent monetary policy. We plan to extend this research by studying the synchronization in EU for more macroeconomic indicators (unemployment, inflation and interest rates) and to include additional countries both from the EU and nonmember-states.

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EVALUATING FISCAL DECENTRALIZATION REFERRING TO FINANCIAL CRISES CASE OF ALBANIA

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Aida Gjika²

ABSTRACT

A last crisis happened during 2008, and still continuing, was tranquiller for Albania comparing to other countries, but it was and still remains necessary to study its behavior in the financial situation because bubbles can explode in every moment with unpredictable cost. Financial Crises and particularly the affects of an own or imported financial crises may lead us to a deeper level of overview like decentralized governance and their behavior in terms of stressed caused by this crises. If the communes/municipalities so the local government will be in front of such stress than it means that now they have higher risks for their local revenue collection and so problems in financing the expenditure, additional to the daily life problems. So in this context this paper will try to see the connection of financial crises called here a *stress* in local governance (2 tiered levels) for Albania. Under the pressure of financial crises, is always a huge debate about the politics used in this case between a monetary or fiscal politics. Debate will be focused in the decrease of taxes or growth of expenditures.

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But politics used change by economic profile of municipalities, from the scale of decentralization, from the structure of income and also from the source of financial.

To sum up this paper will have two main parts. The first one will deal on overview of the financial crises in general and than the connection to the real economy in our country, Albania. The second part will be focused in the problems, financial crisis caused in local governance, in search of the main indicators used in our elaboration. Because of not having the possibility to quantify it with a number we will try to find a proxy parameter to measure this scale of crises exported in local government function, behavior etc.

Key words

financial crisis, local governance, decentralization.

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INTRODUCTION

The increase of the financial global integration in the last two decade and further more has processed some new elements, in most of the cases unpredictable that has caused financial crises. These financial crises has its commons and diversely, but beside of the country it occurs, periods, they are becoming more and more expensive and this lead us to the necessity of study such phenomenon.

Financial Crises was the main topic and the concern of every economy in the 2007 till the nowadays (Banka e Shqipërisë:2010). But in the relation to the real economy this problem is malformed in many ways as are the channels of transforming the financial crises of the whole world in the real economy of one country. Beside of the forms or the time frame (EuroStat:2010) the problem and the concern in micro and macro level are the degrees of the affects in every country in general and specially in Albania.

The main affects of the financial crises translated in real economy are those of the unemployment, decreased of the demand, decrease of inflation, poverty, economic growth, exports, imports etc. (Dervishi-Matraku:2009). Financial Crises and particularly the affects of an own or imported financial crises may lead us to a deeper level of overview like decentralized governance and their behavior in terms of stressed caused by this crises. If the communes/municipalities so the local government will be in front of such stress than it means that now they have higher risks for their local revenue collection and so problems in financing the expenditure, additional to the daily life problems.

THE STRUCTURE AND FUNCTIONS OF LOCAL GOVERNMENT

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Institutional framework

Institutionally and legally Albania made a lot of progress especially having in mind that she have signed the European Charter for Local Government units and also laws in promoting the autonomy. Important is also that emphasizing that Albania has since 2007 a Multi Year Strategy for Local government units. (Brahimi, 2008).

Beside of the legally side, according to the institution one of the main unclear, or not well defined one is the Council of Region (Brahimi, 2008). These council are not elected by the citizens, so in democratic way.

Anyway the legal framework should be seen in the context of the permitting to the local government the tools to postpone and maintain the maneuver to minimize risks. Here it is not just the daily risk or that local units face during days but even financial crises and political cycle (Gjika:2008).

To have these analyze is useful the presentation of the structure and the way the local governance works. In Albania exist a two tier level of governance with 12 regions and 373 local governments units. From these units 65 are municipality and 308 are communes in local areas (Ministry of Finance:2009). Mayors and members of municipality/commune councils are directly elected.

Function and Revenues of Local Governments

Also in these context, it is useful to emphasize the function of the local government as it is one of the indicators that will be directly affected in time of crises. As we explained before from Malaj (2008) and also according to Duka (2009) the power of one local government is in the use of its

functions and in the volume it does such thing. In the presence of the economic crisis the amount of the money used for such functions will be reduced and so even the effectiveness of such function will be reduced. But for sure this is connected directly to the kind of functions we are taking into consideration and its importance. In general are three kind of functions. First of all are those called own function, second: are the shared functions and at the end are the delegated functions especially from central government. The law nr.8652 date 30.07.2000 determine the own functions, tools to be used the local government that are:

- Garbage, collection and cleaning
- Construction and maintaining of local roads
- Sidewalks
- Public lights
- Cemetery
- Parks and green spaces
- Urban transport (public)
- Kindergartens
- Veterinary service
- Municipal policies
- Other functions..etc

Beside of the functions determined, the institutional autonomy determine the revenue of the fulfill such functions. In case of the Albania according to LGPA (2009) the main taxes are:

- Local taxes on the small business
- Property tax
- Hotel tax
- Tax on new buildings' impact on infrastructure
- Taxes on the ownership title transfer on real estate
- Tax on the annual vehicle registration
- Tax on the use of public spaces
- Tax on billboards
- Temporary taxes

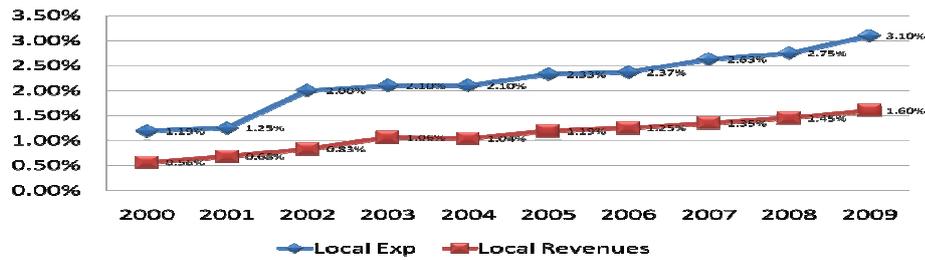
As we see from the list above, there are some taxes that addict the bulk of the revenue of the Albanian revenues of the local governments.

MEASURING ALBANIAN AUTONOMY

Expenditure Autonomy in Albania

The main problem of Albanian expenditure autonomy is that the main potion of the local budget are spend for wages, even though that they have are one of the significant voice in the budget. When we talk of the expenditure autonomy we should ask if we as a local unit have the right to spend the money according to the local needs and community or not. Obviously the remain part of the money is not sufficient and before February 2009 the local budget should have clarified before the expenditure and no over passing of the transfer from the central government.

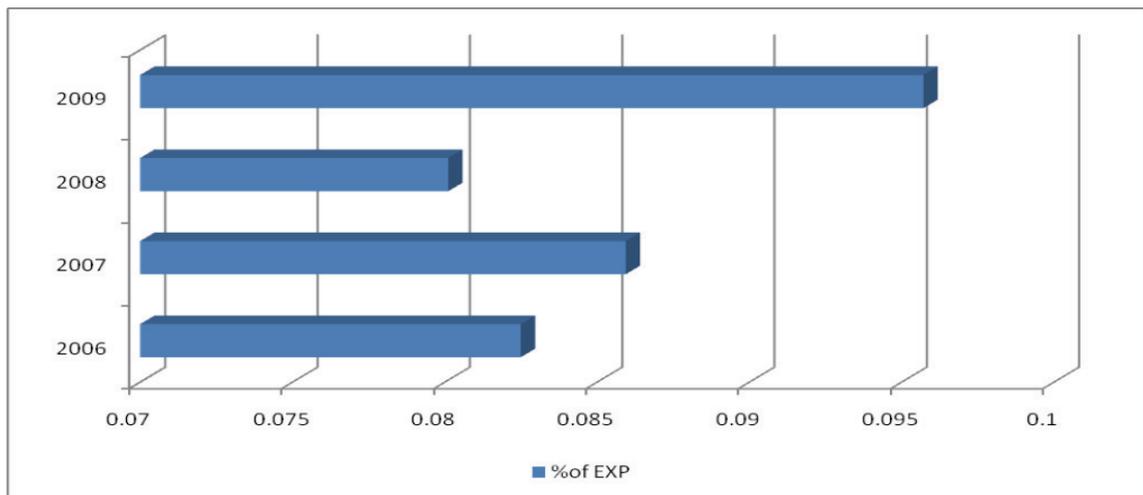
Graph nr.1 Development over time of Local expenditure in % of GDP



Source: Ministry of Finance Albania (2010)

As we see from the graph number the local expenditure of Albania is too low compared.. Anyway the problem consisting here is the function, not the delegated one, but the own function of the local government in Albania. For the shared functions according to Duka (2009) the decentralization process is not clear or is at the starting point. Even here in the expenditure side the tendency is good, with high rate of increasing, but anyway there is not a lot to do with such low pool of money, since the local unit does not have sufficient money and so cannot number the priorities of the expenditure. One of the nowadays concerns is the use of the local budget for purposes not mentioned, as priority for example for political issues and to see these things in detail we may see even the expenditure in detail for the some political year 2004-2009.

Graph nr.2 Local expenditure to Total Expenditure in Albania



Source: Ministry of Finance (2009)

As we see the year 2007³ has an increase in its expenditure, also according to level of covering of expenditure in the same year the rate has decreased, and consequently it would be needed high transfer from state, means high dependency. In this context we may see the connection that local expenditure is politically derived. But hat concerned mostly us is the year 2009, why such an increase suddenly, without specific reason. During these year were no increase of social aid, or other services delegated to people, but what may set up a hypotheses, that is our local government also drive from a central politically orientation, or is just the affect of financial crises? Anyway these remain such a doubt waiting to be clarified.

Revenue autonomy

First of all the right to change the tax rate it is not in the hand of the local unit, but to the council of region in collaboration to the central government. What local government can do is to set rate of

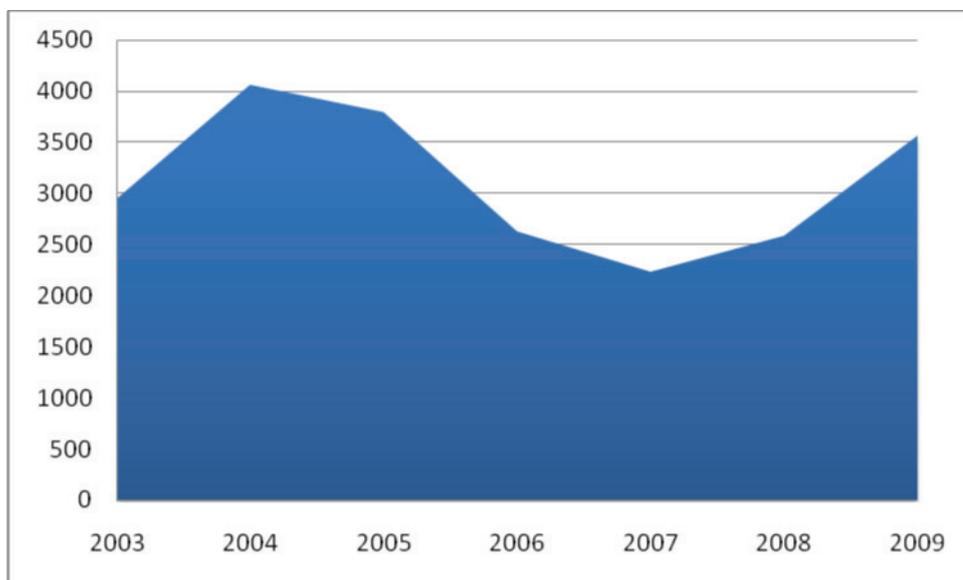
3 Election for municipality

local fees, but till now not significant taxes. Anyway to be mentioned is a progress in this context, the shift of small business tax to the local governance, but this as a share tax.

Very key in the revenue side is the tax collection. In the current legislation Law nr. 8652 of the 30.07.2000 of the structure of Major Local Taxes we may observed that the local government has the right to collect 5 taxes from 10⁴ in total. Recently there is by law another tax to be collected by local government, that of the small business taxes, but apparently produces too much difficulty for local governments, especially because of non training staff and suddenly being unprepared from this transfer of this tax to the sub national levels. Apparently this seems as good thing, and autonomy for local units, but it faces problems mentioned before like being unprepared for these.

At the moment, the largest source of local tax revenue is the small business tax with revenue over 3 billion Lek for all small businesses throughout the country.

Graph nr.3 Small business tax revenues in mln Lek 2003-2009



Source: LGPA (2009)

This tax was imposed for the first time in 2003 (in compliance with the law on local tax on small businesses) and provided for a fixed amount according to business category and administrative classification of the local units. Table 3 reflects the revenues from the small business tax (which actually composed of two parts: a small business tax based on turnover and a simplified profit tax) which is completely allocated to the appropriate local unit. In 2005 the small business tax rate was reduced by 50% and the same trend was noticed in the following years in the performance of the local unit in collecting this tax. Until the end of 2006, this tax was administered by the local units (regarding the small business tax component) and by the

Central government (regarding the simplified profit tax component as a percentage on the small business turnover), whereas since 2007, this tax was transferred completely under the administration of LGUs. The increasing trend in tax revenue of this tax has slowed down during in recent years resulting from the reduced tax rate at the end of 2005. The hoped for increased revenue has not resulted from a reduction in informality among businesses and the general economic situation does not give any clear sign of recovery as this would serve as important grounds to generate tax revenues. The transfer of full responsibility to collect this tax to the LGUs has had a negative impact on revenue in 2007.

4 Including the temporary taxes

EVALUATING THE FISCAL DECENTRALIZATION IN THE CONTEXT OF THE ECONOMIC CRISES (MICRO LEVEL)

This section is mainly based on the survey of LGPA (2009) for Albania in the frame of fiscal decentralization in the daily life of the citizens.

From the micro – level point of view, we can see the local- government services from some indicators:

Economic Problems

- Employment/lack of employment opportunities is the number one concern in all cities. The issue of unemployment is very much related with economic problems and poverty/social issues.

Satisfaction with Public Services

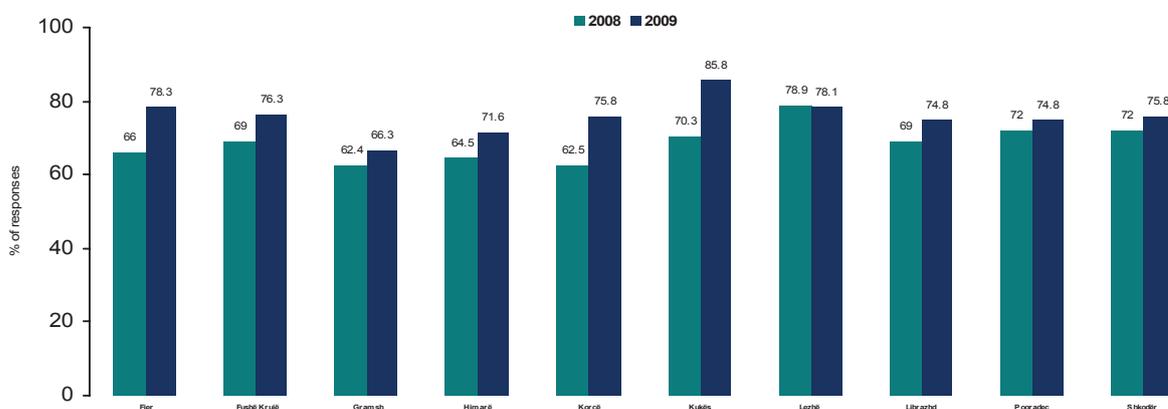
- Satisfaction from public services varies in each target municipality. Citizens are generally satisfied with drinking water supply and street lighting, while satisfaction from roads and sewage service tends to be lower.

Accountability and Responsiveness

- Aspects of municipal administrative services such as behavior of municipal employees, timely service, convenience of office hours and clear procedures were generally rated good. Rating on other aspects such as the ability to solve problems, easy access to the right person, feeling of trust and confidence varies in each municipality.

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Graph nr.4. Quality of life in 10 major cities of Albania.

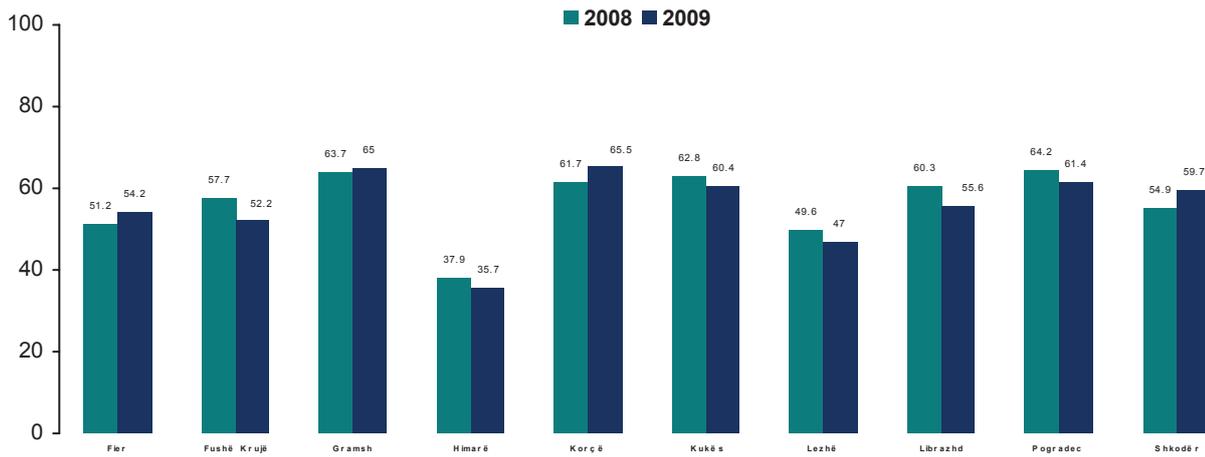


Source: LGPA (2009)

According to the graph nr.4 it is taken into consideration the quality of life of the sample of 10 municipalities, where in quite all municipality there is an increase of quality in 2009, but according to LGPA's compared to 2007 there is a decrease. So the affect it is not visible for 2009 but just for 2008.

As they mention the quality of life is improved during 2009 compared with the year 2008. The highest level of improvement is noticed in Kukës region but is there is always room for improvement.

Graph nr.5 Public Services Residents Satisfaction Index (PSRSI)

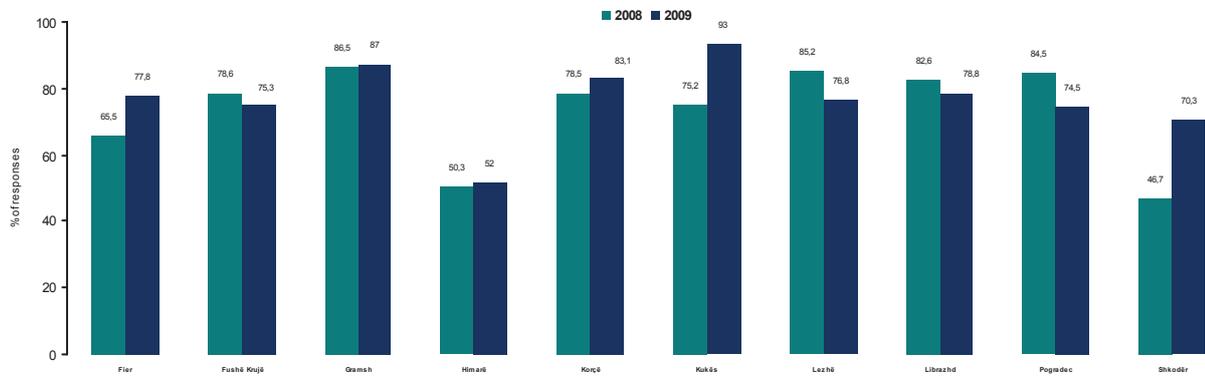


Source: LGPA (2009)

In the graph nr.5 is presented one of the chosen indexes to evaluate the life especially in time lag from one year that is way the time frame now is 2008-2009. From the households point of view there is this index of Public Services Resident Satisfaction Index comparing the two years. And as we see there is up and down of this index since is distributed in many regions. In general these indexes is increased in 2009, but decreased in 2008.

In general according to LGPA (2009) citizens declare that their life has worsened during the period taken into consideration, but according to the survey the data show a decrease just in the year 2008.

Graph nr. 6 Accountability and Responsiveness Behavior of Municipal Employees



Source: LGPA (2009)

As we see in graph nr.6 the accountability and responsiveness behavior of Municipal Employees there is also an increase, especially due to the reason of forcing the legal structure of the local government units.

CONCLUSION

There is no etalon of the fiscal decentralization and the process beside of the tendency to the increase the autonomy. Among the problems of the fiscal decentralization it is laudable to mention even the affects caused from the financial crises. As shown from the previous chapter, it emphasize the still low revenue and expenditure autonomy.

But beside of the decreasing the difference between the local revenue to the expenditure this doesn't apply automatically the increase in the fiscal decentralization autonomy. The main problem crossing these process was the sifting of the small business tax taken into consideration. The shifting of one tax, or function increase the revenue autonomy, but anyway if it is not done in the appropriate way it may harm the local governance. For this thing and also for the expenditure problem central government should do searches, training and additional supports for the local government units.

In all these context this paper tries to see the fiscal decentralization in the reference to the financial crises if it is connected and what variables is affected. From the above analyzes we may say that the most affected variable is the tax base compared to the expenditure side. Of course are also other indicator like borrowing or transfer from central government but this is not in the frame of this paper.

Also the idea was to see even the decentralization process of Albania in the micro level term, to see the sample of the municipality and to see the level of the satisfaction that individuals ha from the local government units. Anyway these doesn't imply directly the connection to the financial crises.

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CONSIDERATION OF THE PRINCIPLES OF MARKETING PHILOSOPHY IN CONCEPTION OF THE FISCAL SYSTEM OF A COUNTRY

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ABSTRACT

The use of the marketing concept, as one of the alternative ways in which companies conduct marketing activities in its orientation to the market, is an expression of company's aspirations to operate profitably by providing long-term customer satisfaction. It results from the specific relationship of supply and demand in the market, and the atmosphere of competitive relations. General outline of using marketing concepts in business enterprises can be sketched by marketing communication system analysis. There is a two-way relationship between companies and markets. Firstly, market research starts from markets to the company whose results determine the other functions of marketing in the company, as well as elements of marketing mix. Except for integrated marketing communications by which the company communicates with the market directly, the second direction from the company towards market contains the product, price and distribution through which the communication takes place indirectly.

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Common characteristics of the southeast European countries can be seen by observing the complexity of their transition experience, especially when it comes to their desire to attract foreign investment and stimulate domestic economic development. Analogue to conditions that forced companies to apply the marketing concept in their operations, there is also pronounced competition among these countries for attracting foreign investments. These investments are in turn limited by their scope and insufficient to fully satisfy the aspirations of these countries. Hence, with absolute respect of clear difference in the relationship between companies and markets, on the one hand, and the state and investors on the other hand, it is possible to find certain parallels, which will suggest the need for the use of certain elements of the marketing concept, which will be here referred to as marketing philosophy, in structuring those elements of "supply" of the overall business environment. Then, one state can present this business environment to potential foreign, and domestic investors as well.

Given the fact that the areas that states regulate, and which directly or indirectly affect investment are numerous, in this paper special attention will be paid to the elements of the fiscal system. How successful two-way communication between government and business entities, modeled on the mentioned system of marketing communications looks like, can be seen, inter alia, through the process of comprehensive reform of regulations and reduction of administrative requirements. This process is being conducted in the Republic of Serbia these months.

Keywords

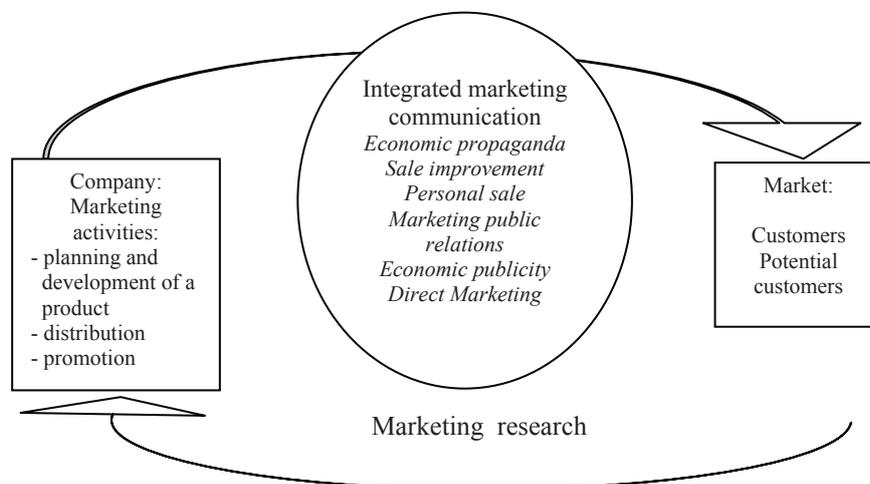
transition, foreign investment, marketing philosophy, a comprehensive reform of regulations

THE MARKETING CONCEPT IN COMPANIES' ORIENTATION TOWARD THE MARKET

Considering the various ways in which companies have undertaken marketing activities in their orientation toward the market, several competing concepts can be recognized: production concept, product concept, concept of selling, marketing concept as well as the concept of holistic marketing [1, pp. 15-24]. Using the marketing concept, instead of the former “produce and sell” philosophy, has led to a movement to the “feel and react” motto aimed at the consumer. This motto arose from the realization that the essence of achieving the companies’ goals lies in its greater efficiency in comparison with the competition when it comes to the creation, delivery and communication of value to customers in selected target markets. However, the concept of holistic understanding of marketing was added to this concept. Holistic marketing approach have arisen from the needs for a more comprehensive, cohesive approach with which it would be possible to overcome the traditional application of marketing concepts and try to accept and reconcile the scope and complexity of marketing activities.

In the standard case, application of marketing concept is brought in connection with business operations of companies that try to operate profitably by providing long-term customer satisfaction. However, marketing is characterized by ambiguity [2, pp. 18-24], so it can be also seen as an economic process, as well as a business function, as a business concept and as a scientific discipline. Previously mentioned observation suggests that considering marketing as a relation between a company and the market does not lit up all the meanings which can be attached to marketing, especially if one bears in mind all the things that are launched in today’s market [1, pp. 8]: goods, services, events, experiences, personalities, places, property, organizations, information as well as ideas. However, despite the phenomena that what is launched on the market goes beyond the capabilities of companies, significant implications for understanding the meaning of marketing in all these situations can be made by reviewing how marketing works by mediating between companies and markets.

The basic outline of the use of the marketing concepts in companies can be also sketched by the analysis of marketing communications system. Namely, in the relation between companies and markets, from the direction of the market toward the company, marketing obtains the appropriate data from the market by marketing research. Afterwards, it finds a response to the perceived market impulses relevant for their own business by specific analysis. On the other hand, in a direction from the company toward the market, marketing performs company’s communication with the market through the elements of marketing mix (4Ps concept). It is performed indirectly by product, pricing, distribution and directly through promotion, that is, integrated marketing communication.



Measuring promotion effects

Application of some other concepts which were previous to marketing concept in company's orientation toward market may be characteristic and meaningful in a given economic environment. Thus, the concept of production based on achieving high production efficiency, low costs and mass distribution, according to Kotler, is meaningful in developing countries where cheap labor can be used for gaining dominance in the market [1, pp. 15]. This thesis can be also seen in terms of one of Porter's three generic strategies: cost leadership which is counterpart to the production concept with its essential elements. Using this strategy is considered to be the most appropriate at the stage of decline, while a joint application with the differentiation strategy is thought to be the most appropriate at the stage of maturity in the life cycle of an industry [4, pp. 185].

And yet, even though the application of business-oriented marketing is linked to conditions of strong competition where supply of goods is often beyond the absorptive power of local, mostly national markets, where the "lack of markets" appears and where the business-oriented marketing is a way to meet the needs of consumers and to achieve the primary goal of enterprise's existence, business and development – that is, profit [2, pp. 11,12], one can argue that the application of business-oriented marketing, even in different conditions, gives the comparative advantage to the company. In support of this claim, we can point out to studies which examine the experience of small and medium-sized companies in relation to application of marketing. Although it is generally accepted that the basic principles of marketing are universally applicable to large and small businesses [5, pp. 40-60], in some studies it is questionable whether small businesses need to practice marketing at all in order to survive and grow [6, pp. 6-18]. The study that questioned the need to practice marketing in small businesses concluded, after all, that marketing contributed positively to small business success and the ability to think strategically. Denison and McDonald [7, pp. 54-76] have also shown that firms which were marketing orientated, or competent practitioners of marketing, performed better in terms of return-on-investment (ROI) and market share.

Additionally, placing the needs of consumers in the forefront, which is an essential feature of marketing approach, proved to be successful for the company even when it was set as a priority for top managers in a company [8, pp. 58-65]. It was shown that a common practice to put the interests of shareholders in the forefront, while managers are encouraged by getting ownership in company's shares as a reward for their work, in fact does not lead to real satisfaction of the interests of shareholders. Namely, the value of the share also depends on shareholders' expectations that often have too much enthusiasm due to good results or are too disappointed because of poor business results, so managers take such steps that lead to short-term enthusiasm of shareholders which often hurts their long-term interests. On the other hand, however, by putting the interests of consumers in the forefront, the interests of shareholders have been achieved as well. This is possible because in such an environment managers can focus on business, and compensation which they will receive is related to the time of their departure from the company, which further encourages them to hand over the company to their successors in a state which is good as well as sustainable.

TRANSITIONAL REFORM OF THE FISCAL SYSTEM IN SERBIA AND ITS CURRENT STATE

When the transition countries are in question, the tax reforms in them are not only the part of the latest trends of the tax reforms in the world, but they are also the part of the entire contents of the transition process. In addition, one of the basic conditions for accession to the EU is the harmonization of tax system with tax systems of EU member states. This process is called a "silent harmonization" [9, pp. 94].

Back in 1989, while confirming the basic concepts of fiscal reform in the former Yugoslavia [10, pp. 423-430] which was on the brink of transition at that moment, group of authors¹ noted deficiencies of the previous fiscal system of a socialist country and identified directions for reform. The biggest problems were reflected in the fragmentation and dysfunction of the fiscal system. However, the nineties of the last century, apart from the transition, brought the war events, economic isolation of the country and the flourishing of the grey economy. Parallel with the fiscal reform of the federation in the former Yugoslavia in 1990, documents on the concept of fiscal reforms were adopted in Serbia, and at the end of 1991, the first reform laws. Certain legal adjustments which occurred in the nineties by applying the principle of tax neutrality without tax exemptions and incentives, did not lead to the desired result because, as Professor Simović evaluated [11, pp. 112-115], if the economic system does not fit in the market economy, then any tax system will not have much success. Considering that the reform of economic system was not fully carried out, it was not possible to reform the fiscal system neither. Within the reform of both systems, it was stopped halfway. Followed by the aggression of NATO, and a year later the arrival of the new regime, a new fiscal reform began. Being the relatively modern concept in 1991, the fiscal system was changed for the worse during the time and entered 2001 in a very poor condition: unfair, inconsistent and without the basic philosophy, destimulative for the economic activity, often with excessive number of bad fiscal instruments, non-transparent, overly centralized, poorly administered, and the like [12, from preface]. The assessment prior to the reform of the tax system: non-transparent, unstable, inconsistent, unfair, too centralized [13, pp. 5-7] does not differ substantially from the previous description.

Observing the reform of the fiscal system during the first seven years in Serbia after 2000, Šestović [14] observed that the fiscal policy in Serbia in the first seven years of transition passed through three phases. In the first phase (2001-2003) there was a significant increase in public spending and revenues, and deficits reached a record peak. In the second phase (2004-2005) a significant reduction in public spending appeared, revenues increased slightly and Serbia recorded surpluses. In the third phase (2006-2007) the re-growth of public spending appeared again which resulted in the re-emergence of fiscal deficits.

On the other hand, while analyzing the tax system in Serbia in particular, professors Raičević and Randelović [15] were looking for the answer to the question whether taxes in Serbia are high. Analysis of the primary fiscal public revenues in Serbia (the corporate income tax, personal income tax, contributions to compulsory social insurance, value added tax, excise tax), in relation to chosen countries² and the EU as a whole, shows that Serbia has lower rates of the most important forms of public fiscal incomes. The authors concluded that Serbia must make its tax system more equitable as soon as possible and complete it by introducing the synthetic system of taxation of personal income.

As a unique, not so optimistic conclusion about the reform of fiscal systems in Serbia, one can state the opinion which professor Madžar wrote in his study, “Mechanisms of mobilization and alternatives for the allocation of public funds” [16] from 2008. According to him, the Serbia is judged as an object which is insufficiently managed and inconvenient to be directed, both in the formulation and implementation of economic and fiscal policies in particular. Difficulties in Serbia and difficulties for Serbia arose from her considerable if not over-ethnic - and with her cultural, religious, historical and other heterogeneities that results in a widely diversified and politically divided electorate. The most influential result of political differentiation is wide, unstable, multiple hampered and ineffective coalition government. Major threat to the lasting sustainability of the fiscal system and economy in general are members of political directory and their clearly expressed preference to use taxpayers’ money to strengthen as fully as possible their private, particularistically cultivated political positions.

1 The authors have drafted this analysis for the Federal Executive Council at that time.

2 The authors looked at the economic performance of countries like Serbia, which are in the advanced position in process of joining the European Union (Croatia and Bulgaria), and medium-developed country that has successfully carried out the transformation of political and economic system (Czech Republic), one of EU leaders according to its economic strength (Germany) and by its size and the population approximate to Serbia, but which achieved impressive and dynamic economic development in a short period, and at the top of the world by the degree of economic development (Ireland).

THE ROLE OF THE FISCAL SYSTEM IN ATTRACTING FOREIGN INVESTMENTS AND STIMULATING DOMESTIC ECONOMIC GROWTH

The term fiscal system is taken from the Anglo-Saxon literature, as a synonym for the tax and budget system. The fiscal system in the classical sense implies a fiscal resource mobilization by means of the tax system instruments and its redistribution by means of the mechanism of budgetary institutions for alimending public needs. The fiscal system, in that sense, is a part of (the sub-system) of the whole financial system, which consists of monetary-credit system, banking system, foreign exchange system, the system of financing of social reproduction, the system of insurance and so on [17, pp. 507]. Bearing in mind the great width that the notion fiscal system has and by specifying only a few lines of theoretical observations and results of specific studies, the authors will try to suggest the importance of the fiscal system in the context of a given theme.

Previous studies [18] often went in the direction of considering the impact of tax policy, especially tax incentives and exemptions, on attraction of foreign direct investment. These studies often drew opposing conclusions. Some of the first surveys have confirmed that if tax policy matters, it is not the most influential factor in the site selection of multinationals. The early econometric studies point out that the effect of tax policy on FDI is rather limited, at least compared to other factors such as political stability, the costs and availability of labor and basic infrastructure. However, later studies have shown that such an approach was too simplified and that there were many reasons to believe that impact of tax policy is greatly depending on the characteristics of the multinational company. Alternatives that international investors have when structuring and financing their investments, arranging their transactions between related parties located in different countries, and returning profits to investors, do have important tax implications, and there is considerable evidence that tax considerations strongly influence the choices that firms make. It is also important to mention that in recent years, the globalization process and the gradual elimination of barriers to capital movements, including FDI, across countries have led to the emergence of new topics in these studies. The first is the interaction between the home and host countries' taxation regimes and its resulting impact on FDI flows, the second is the issue of tax competition between countries and across, while the third is about the costs and not only the benefits of tax incentives.

However, despite the conflicting findings of various studies, there is no doubt that tax policy is not the only factor in attracting foreign investment. Research conducted by USAID / MEGA (Program for Boosting Municipal Economic Growth) and Strategic Marketing Research³ with foreign investors in Serbia [19], published in August 2008, offer as investment attraction factors: market size and access to other markets (through trade agreements etc.); previous experience on market; economic stability and GDP growth rate; references from local partners; living standard and purchasing power; political and social stability; level of political interference in business, monopolies, corruption, discrimination, favorizing etc; access to financing and reliability of financial institutions; incentives (tax, financial and other relieves), level of corporate profit tax; customs and tax policy; regulative and legal framework for business (laws on investment and market conduct); telecommunications infrastructure; traffic infrastructure; availability of raw materials, intermediary goods and suppliers; geographical position of country in region; availability of quality workforce; cost of labor and, finally, land ownership laws. However, the results show that all investment attraction factors of a country that were offered, had been rated quite high, with the symbolic differences of the average grades for each factor.

³ In a survey of the general investment climate in Serbia decision-makers in 106 companies that have successfully invested in Serbia (experimental group) and 13 companies who had the idea to invest in Serbia, but was not implemented (control group) answered on the questionnaire with more than 70 questions.

Mentioned research cited as the main competitors of Serbia in attracting foreign investments respectively: Bosnia and Herzegovina, Croatia, Romania, Bulgaria, Montenegro, Macedonia and Hungary. This order was slightly altered when certain economic sectors are analyzed. However, all these states are already accessing the EU or are in various stages towards the accession to the EU, and are part of the process of tax harmonization as well. This may indicate that, when it comes to the amount of the tax rate, the space for competition between the countries will lower in time to a certain degree, but that certainly opens up the space for more expressed competition in terms of other impacts of the fiscal system. Among these impacts, the simplification of administrative requirements can be particularly interesting because it can save time and money for companies.

Part of the results of the above mentioned research supports the hypothesis that has just been presented. After the 2007, these results state as the biggest obstacle for investments in Serbia regulatory barriers (48%), which were previously located in the second place, behind the instability of the political situation. Part of these obstacles is undoubtedly related to the regulations in the area of fiscal system and its application. Examining the role of institutions in making decisions about investments, more than average number of respondents, in comparison with most other institutions, mentioned the negative impressions of the Tax Administration and Customs services. When considering what could be done at the state level to improve the investment climate, the sample of investors in Serbia find that the Serbian Government should, first of all, reduce red tape (26%), achieve political and economic stability (25%), accelerate and administrative procedures (20%), while providing tax relieves and reducing taxes is pointed out by only 8% of them. On the other hand, sample of investors who were not successful in their endeavors to invest in Serbia think that the Serbian Government should primarily improve political and economic stability (60%) and then fight against corruption (40%). The removal of administrative barriers is shown, therefore, as much more important for attracting foreign investors in relation to tax incentives and exemptions.

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When it comes to the impact of the fiscal system on internal economic development, as a negative example one can state how certain poorly designed elements of it can cost business entities in the state, which certainly does not perceive the width of its influence or, in turn, challenge the usefulness of certain measures that the Serbian state undertook. Companies in Serbia, while fulfilling its obligations in accordance with the procedures in the field of fiscal legislation and in relation to certain bodies which are part of the tax policy implementation, according to calculations from 2008 [20], for only three such procedures: report or log of employees, change of company's address and issuing certificates on paid tax, spent per year, by conservative estimate, 1,839,000,000 dinars, which was at that time over 23,000,000 euros or, in turn, it was 10% of annual loans approved by the Republic of Serbia (with a minimum interest rate of 1-3%) and subsidies to support the development of small and medium enterprises, i.e. 23% more than the total amount of funds that the state was giving as a start-up loans with interest rate of 1%, i.e. 19,45% of the total amount of obligation of the company's income tax in 2007. ⁴

The following example tells also about the realization of such a complicated manner and procedure. When the taxpayer needs accurate information about the tax obligation, or more precisely, confirmation that he or she has settled all tax obligations, in order to achieve certain rights (to participate in the tender, certification of health booklets, application for credit, application for a visa, etc.), he or she must go personally to a tax service (office), take the required form, complete personally the application, pay a fee (which is different in different tax offices), and if he has certain obligations, which often exist due to records disagreements and can be in the amount of 1 dinar, he has to make settlement of tax records, pay the difference of due obligations (if any), and then goes back to take the “certificate of performed tax duties” that states the sole purpose for which the certificate can

⁴ The above estimates, made for the action “the Maze” of National Alliance for Local Economic Development (NALED), showed that the three most problematic factors for doing business in Serbia are political instability, corruption and inefficient public administration, in one word, factors that do not require capital investment but the political will to accept the principles of good governance.

be used. The problem is that there is no ability to electronically complete this job (controlling tax duties, application, taking the certificate). An additional problem is the time of up to 15 days that is given to the Tax Administration for the issuance of a certificate, which, in a situation where this certificate is most urgently needed to perform a certain task, opens space for potential corruption. This is linked to the problem that the sole purpose of the certificate is stated in this document, because if the taxpayer settled its tax liability, there can be no meaningful explanation justifying that the given certificate states it may be used only for participation a tender or just for getting loans from banks and the like.

Again it suggests the validity of the conclusion [21] that the state, in addition to restrictiveness toward business entities, which it had previously burden with many procedures whose ways of operationalisation are the edge of the meaning, acts strictly with business entities which are legal part of its system, including the fiscal system. It also suggests that the state puts little or almost no effort to direct that part of the economic activity that takes place within the framework of the so-called “grey economy” toward legalization, which would also have positive effects not only for the fiscal system, but also for the country as a whole. The data confirm the relatively poor condition. According to the Doing Business 2010 [22], which is jointly issued by the World Bank and International Finance Corporation and which compares the legal regulation of business in 183 countries, Serbia is on the 88th place, two points more than in the previous year, while the Global Competitiveness Report 2009-2010. [23], published by the World Economic Forum which compares the overall competitiveness of the 133 world economy, puts Serbia on 93rd place, 8 points lower than the previous year. At the international level, therefore, Serbia has regressed in those categories that depend on the laws brought by authorities. This certainly points out to the lack of political will to, with even relatively modest changes in regulations, make easier for entrepreneurs to conduct business.

THE POSSIBILITY OF APPLYING THE PRINCIPLES OF MARKETING PHILOSOPHY WHEN DESIGNING THE FISCAL SYSTEM OF A COUNTRY

Previous analysis has already indicated one of the problems that business entities in Serbia face when it comes to the influence of some unnecessarily complex administrative procedures in the field of regulation of the fiscal system. The fact that these problems are very well known speaks in favor of the fact that there is contact with the business subjects, that their problems and needs are considered, which may be somewhat analogous to the role of marketing research in marketing communication system. The existence of such information may be attributed to the action “The Maze” from which “The Gray Book” [24] was derived, which has experienced two editions.

Namely, in May 2008 the National Alliance for Local Economic Development launched campaign “The Maze” [25] in order to identify administrative barriers to the economy in Serbia and to assist in their removal. The main task of this activity was to define inadequate and outdated legal regulations and laws that hinder businesses and to show institutions which regulations and procedures should have been modified or terminated. In addition to concrete savings in time and money, facilitation of procedures promotes legality in the work of entrepreneurs and institutions. Large and small and medium-sized companies, municipalities, cities and non-governmental organizations gathered in the membership of NALED have joined together with the support of B92 and USAID in order to suggest the Government of Serbia how to unburden the small and medium enterprises and enable them to be more competitive in international markets.

Due to the opinion of the developed countries which supposes that public administration is a service for citizens and that its primary purpose is to serve its customers, similar actions have been carried out in the European Union for many years in order to create a system that was in the service of economy, not its burden. Also, similar types of proposals for the simplification of procedures were carried out by many countries before they started “regulatory guillotine”, i.e. radical elimination of regulations which are not in use or require modification because they burden the economy and citizens.

During the campaign of NALED in order to publish its first “Grey book” NALED collected 250 proposals for simplification of procedures which were published in it. A year later, a very small number of issues to which this book pointed were resolved, so this book is experiencing its second edition.

Of course, the authors observe that there is also room for improvement in the functioning of the fiscal system by additional actions modeled on the marketing research. It is possible to take into consideration the suggestions of employees in the Tax Administration, Customs Administration and even some ministries, who meet with the imperfections of the existing procedures in their daily work. Moreover, in addition to considering administrative obstacles, it would be desirable to consider the preferences of investors in terms of tax policy and in line with the existing available space for alternatives to the mobilization and allocation of public funds, to consider eventual changes in this regard.

On the other hand, designing the fiscal system in accordance with the obtained insights, to the extent in which it does not jeopardize the realization of its roles, it is necessary, in the direction from the country toward investors and analogous to the concept of “4Ps” within marketing communications system, to “offer” such a system to investors. It is necessary and appropriate to promote it, but in this regard, existing satisfied investors would have undoubtedly the most important role. They are according to previously mentioned study by USAID / MEGA and Strategic Marketing Research, as business contacts, the most important source of information for new investors.

At this point it should be mentioned the comprehensive reform of regulations, as well as a unit that deals with it within the Ministry of Economy and Regional Development. Namely, the Serbian government adopted a strategy of regulatory reform in the Republic of Serbia for the period from 2008. to 2011. [26], which considers the implementation of a comprehensive reform of regulations in the period from 02.02.2009. to 31.12.2009. Comprehensive reform of regulations (SRP) intends to conduct one time repeal and changes of inefficient regulations in order to improve the economic environment, reduce legal uncertainty and increase the competitiveness of the domestic economy in the world and European market. The results so far suggest the ineffectiveness of the project. That ineffectiveness essentially prevents the creation of “supply” to investors, such as described in the context of this paper. Whether the appeal of the Serbian Prime Minister, Mr. Cvetković, to accelerate the implementation of SRP, issued 10/4/2010 [27] will actually yield results, remains to be seen in the time to come.

In the end, we should not lose sight of the fact that meeting the needs of investors, even if it would not undermine the functioning of the fiscal system in any way, will inevitably bring additional costs with itself, especially when it comes to information technology and mutual informational connection of certain state services, due to which the largest part of the problem arises. However, if this is a precondition for future investment increases, there is little room for consideration of the justification of these costs.

CONCLUSION

Marketing philosophy, which places the satisfying of customer needs in the center of interest, has proven to be successful not only in conditions of outstanding competition and demand being less than the supply. Analogous to conditions that led companies to apply the marketing concept in their operations, there is outstanding competition for attracting foreign investments among transition countries, which are in turn limited in their scope and insufficient to fully satisfy the aspirations of these countries.

It is stated in this paper that successful two-way relation between the state and business entities, related to the design of certain elements of the fiscal system, could be just carried out with regard to the model of marketing communication system. Of course, one should have absolute respect of existing differences between relations of companies and market, on the one hand, and the states and investors on the other hand. Using such an approach one can come to conclusion that foreign investors already operating in Serbia, consider bureaucratic, administrative procedures as the most important disturbing factor for investment. The real removal of these obstacles “offered” to investors by Serbia (planned to be performed in comprehensive reform of regulations) would certainly become one of the important elements with which Serbia could compete to attract foreign investment. This is becoming even more important in light of the fact that the space for competing by tax policy reduces because both Serbia and its major competitors are in the process of tax harmonization with the EU.

Changes in the fiscal system, targeted, to the possible extent, to satisfy the needs of investors, would contribute not only to attracting foreign investment and domestic economic development, but could be the driver for changes in the behavior of state institutions, which would contribute to modernization and the quality of overall social environment.

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FROM EGOVERNMENT TO EDEMOCRACY – MODELS, CRITICAL KEYS AND BARRIERS FOR SUCCESS

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ABSTRACT

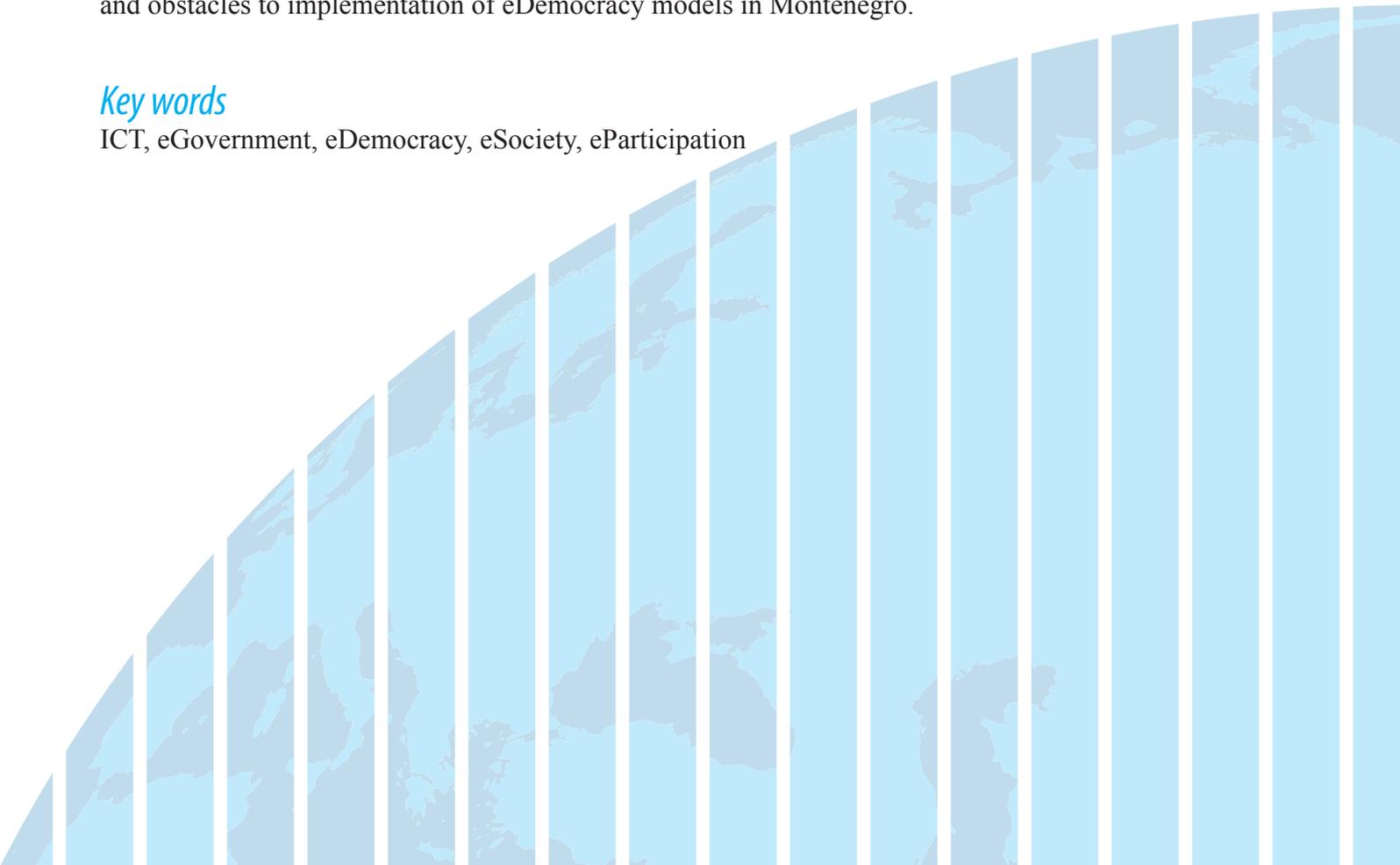
Internet and ICT are rapidly becoming key tools that allow not only access to information but also multiply communication channels that extend the capacities of the Internet far above the performance achieved so far. In this way, the question of elementary ICT (or internet) literacy of modern citizen is a precondition for engaging in any serious activity and also for living and working in digital society. Internet today has a huge impact on all aspects of life, and also in the area of the broader context of democracy, politics and politicians. If democracy is freedom of choice, there are a number of conditions that can ensure in practice the freedom to be achieved and realized. These preconditions must be achieved regardless of the manner of voting: through papers or by pressing keys on your computer, mobile phone or voting machines. The key contribution of ICT to achieve freedom of choice is that technology enables the correlation of the citizens and elected representatives on the better way than it was possible without the Internet. In this sense, we can say that the Internet and ICT are changing significantly, and potentially improving the environment in which democratic processes are taking place.

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This paper aims to describe trends in use of ICT in democratic processes, and analyzes the challenges and obstacles to implementation of eDemocracy models in Montenegro.

Key words

ICT, eGovernment, eDemocracy, eSociety, eParticipation



INTRODUCTION

Governments around the world have realized that transformation from traditional government and traditional management to electronic government is the most important public policy issue of our time. But whether the story has become a reality? Actually, what is the real story?

eGovernment doesn't include only implementation of new information and communication technologies (ICT). It refers to changing business models and processes with aim to enable different and efficient business processes. IT provides a solution, but eGovernment refers to changes in the way government agencies operate. Being "eReady" and managing the transition to eGovernment will not happen by itself. This is a very complex process and requires careful and concrete actions. Governments around the world want to set leading edge and challenges in eGovernment visions that others will follow. In response to these activities, government agencies are making many efforts to "switch" work and operations of public sector in the era of computerization. For example, a significant number of public sector representatives have set up a central web portal, which has constantly being upgraded. And at the level of agencies, many government agencies around the world have had their own web sites, which expanded over time by placing the focus on activities such as electronic services delivery (ESD)

At first, this may sound very impressive, and basically it is. But challenges and changes are so great and expectations of the governments are so large, that such steps are only the beginning of many major initiatives and activities.

For example, during the establishment of its ESD targets, agencies may be tempted to choose a service that can quickly be available online, as opposed to those that can generate the most overall benefits. Of course, there is nothing wrong with this approach, but it is often more important to start with the implementation of eGovernment solutions, and achieve results quickly. The long, slow and expensive mega-projects in general can be described as projects that help the advancement towards eGovernment.

However, the risk of reaching quick initial goals is that neither agencies nor community will be impressed with what these results are offering. Unfortunately, the greatest value lies in areas that offer much greater challenges.

In order to be present online as soon as possible, regardless of the values and needs, and functionalities, there is satiety of websites in many strategies for performing and creating eGovernment. During this process, it is often forgotten the key fact of what eGovernment has to offer, as well as to community and to agencies. Many agencies and institutions in charge clearly see that such activities only slightly »scratch on the surface" and that they need a clear reform process in order to assure all the changes that the government wants to undertake.

So, what are the next steps? What are the key factors that must be identified to lead the implementation of eGovernment?

To implement eGovernment vision and initiatives, or to make agencies "e-ready" for progress, some obstacles that must be avoided have been identified. These obstacles are divided into 8 categories, namely: (1) leadership and governance, (2) funding, (3) people, (4) legal, (5) customer readiness and accessibility; (6) privacy, (7) security; (8) technology and information management.

For many governments ESD is a priority in their eGovernment strategies. Their goal is to deliver better, faster, more reliable and cheaper services to business sector and the community. A very important

part of this strategy is the development of government agencies web sites through which government services and information may become available, at the same time enabling citizens to interact with governments. Significant efforts have been taken during creation of these websites, knowing that potential benefits of ESD will not be realized unless the web sites are not user-friendly.

Realizing previously stated the question arises: How much are government Web sites user-friendly?

- Are the services and information needed by businesses and citizens available on the site?
- Is it possible to access and find information and services easily, irrespective of whether users are in rural areas, or if they are visually impaired or have limited skills in the official language;
- Which level of technology skills are needed to access these sites;
- Which level of interactivity is required, etc.

EGOVERNMENT 2.0

Early development and breakthrough of eGovernment - use of information and communication technologies in order to provide and improve public services, transactions and interactions - has enabled government agencies to provide better service and improve efficiency and effectiveness. For example, in many countries, more than 70% of people pay taxes electronically, and many other transactions - from renewing driver's licenses and payment of the parking lot to the management of government benefits - can be implemented and carried out online.

In any case, despite continuous allocation of a large number of sources, progress in the field of eGovernment in recent years has "become straight" (appears to have plateaued), in relation to how it used to be. Many of the new eGovernment initiatives have generated expected interest among customers on one side, or allowed the clear benefits in operational efficiency, on the other. Whether it comes to unexpected fiscal constraints, or the high expectations of users based on the integration of the Internet in their daily life and work, the imperative is exactly the fact that the public sector improves their access to eGovernment in order to ensure that these initiatives will achieve the greatest impact.

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As shown in practice, three obstacles have restricted the influence of eGovernment efforts: ineffective management, lack of supported web capacity and not allowing the participation of users in the process of creating applications and content.

To reach the next level of eGovernment services, organizations must overcome each of these obstacles. First of all, they have to move it to the management model in which the eGovernment initiatives are owned "by line of business" executors and supported by respective cross-functional teams. Secondly, they must develop the capacity and capability in critical areas such as marketing, usability, Web analytics, and access into customers. Finally, government agencies must change their mindset to proactively gain citizens, businesses, and other agencies involved in providing contributions or creating applications and content.

Implementing these changes will enable public sector organizations to provide Web services that will use a large number of users much more easily, reduce development costs and management services over time, provide greater functionality and content, thus providing a higher reimbursement of spent funds.

Creating new governance models - Agencies need to understand Web development as an integral part of services provided to voters - along with initiatives such as call centres or regional units and offices. Web projects need to be managed through a consolidated portfolio with a centralized views and understandings of the costs and benefits. Clear end-to-end ownership of online experience must be established and strengthened, with responsibilities relating to the level of acceptance by users and costs.

Management of eGovernment projects must be based more on data collection and data management. Organizations must establish balance between the benefits of implementation of security decisions and cost restrictions, including the financial impact and effects of usability, comfort and acceptance. When an agency discovers that its web team, IT team and security team each have different conceptions of legal and security demands, it will clarify the requirements and enable defining specific responsibilities. The team in charge of security will be granted full responsibility for access to security, while the web team will be assigned responsibility for understanding the safety requirements that affect usability and deciding where to invest and what functions / features should be run.

Investing in Web capabilities - Effective web management does not require the formation of large teams, but must include a key group that is well informed about the requirements of business processes that are concerned with and related to customers, fact-based decisions, usability and navigation, marketing, information architecture and agile web development.

Agencies can identify the gaps in their capacity and set goals through the development of scorecards that show a category of facilities and activities to which each individual is covered. For each activity that is displayed, the agencies are supposed to specify detailed criteria for team members that they will use as the basis for evaluating their current performance and establishing targets for improvement.

Adopting “open innovation” and user participation - the process of strengthening governance and capacity will not only improve the existing content and services but will also help lay the foundation for the continuation of Web 2.0. technology. The shift from “publishing” to the sharing of experience - which includes the participation of all users - must be done in cooperation with and within government agencies. Some agencies (nationwide) are leaders in this field.

Government can use Web 2.0 technologies to move the barriers between and within organizations. How the change of ways of thinking can be achieved to enable the Web 2.0 initiatives to be divided among several government agencies? Leaders of agencies, both those who are engaged in business policy, and those who deal with IT policies, must accept innovation and participation coming from a third party. They need to talk and discuss the benefits of these efforts carry with them, to encourage the taking of risks, and to increase the capacity of their staff in implementing these initiatives.

WEB 2.0 VS. EGOVERNMENT 2.0

eGovernment is already for many years in all development policies of countries and at EU level it was a priority in development policy since the eEurope Action Plan in 1999 and until today, until the latest version of eGovernment Action Plan.

Since 2003., the new wave of web applications, which are all placed under one name web 2.0, is running with very little investment, and recorded a dramatic success in the initial stages of application operations. These applications are based on users as producers: of content (blogs, wiki, Flickr), taste/emotion (Last.fm, de.li.cious), contacts (MySpace) and reputation/feedback-a (eBay,

TripAdvisor). Web 2.0 is a term used to describe the development of the Web in a way which enables collaboration and communication in the process of service delivery, in contrast to the previous environment in which the Web is primarily used as a one-sided channel for publishing content.

Recent studies of the influence of these technologies emphasize striking effect that they already have in social life of the people, as well as industries such as advertising and media.

There are many definitions and the names of Web 2.0 (social software, participatory web, user generated content, etc.), each of which represents one dimension and excludes others (O'Reilly, 2005). One of the definitions of Web 2.0 is that it consists of a set of technologies, applications and "values." From the technological point of view, creating blocks of Web 2.0 applications are the innovations that were introduced several years ago in order to affect the increase of use/utilization, integration and reuse of Web applications.

The key question, in order to support the development of eGovernment policy, is whether these trends are relevant and whether they have any influence on the activities related to the work of government, and modernization of state administration. In order to obtain answers to this question, IPTS¹ made a report to support the development of eGovernment and contributed to the development of EU policy in this area.

Further, the following questions may be asked:

- Are web 2.0 applications relevant for the content of governments?
- If so, in which direction Web 2.0 may have an impact on governments?
- How important can be this influence?
- How are web 2.0 applications implemented in governments and how much are they relevant to their content?

There is considerable evidence to indicate that these applications are very important for the development of eGovernment services and more, in different domains of eGovernment. These applications can much more contribute to the realization of important objectives in terms of creating a better, simpler, more transparent, connected and networked governance. All this affects the creation of a positive influence of individual web 2.0 projects; of course, the full impact is not done, given that these projects are still in early stages of implementation. Also, it is well known that the evidences about the effects of ICT are usually visible only after a few years of investing.

Users can contribute to improving public services and they are already working on that. This does not mean that all citizens will participate and contribute, but some will. In any case, more people than we're used will contribute to providing better or additional services. Furthermore, even weaker forms of participation can be useful for the improvement of services.

Although there are strong elements of a different understanding of concept of Web 2.0, many emphasized socio-economic trends make us think that key features are not just a passing fashion but part of larger changes. Today's teenagers will quickly begin to work and will become part of the workforce and/or will become users of government services. In addition, long-term trends of user empowerment, creative knowledge workers, global competition, various forms of work organization, and user-oriented innovations are appropriate, and enabled with Web 2.0 applications.

This should encourage governments to start experimenting with these applications. Most applications are free or cheap, which makes the process of experimentation easier. The question is not only the acceptance of technology: creating blogs or wikis on the government's web sites will not by itself strengthen the participation of citizens. Instead, it should be moved towards more open and

¹ Institute for Prospective Technological Studies, one of the seven research institutes that make up Joint Research Center of the European Commission

transparent relationships with customers, including the value of web 2.0. As already shown, these solutions are implemented through the mechanisms of tests and errors, as well as through an iterative development through a “beta” version. This learning curve includes also the work on relevant government mechanisms that ensure that user involvement is compatible with the overall role and objectives of the governments.

This does not mean that public administration must fully accept/embrace web 2.0 in all its eGovernment activities: other methods and applications are necessary in some important areas of business such as interoperability, privacy and security. Web 2.0 is also a tool that enables the achievement of public goals; it is a complement and does not replace existing eGovernment initiatives. In addition, there are significant risks with which governments need to confront, such as destructive behaviour, interference, and low quality of services and content.

But as said before, the citizens and businesses already use this application in relation to the activities of government, and in this sense, governments are not in a position to decide whether this application should be used to provide public services. As project manager on one project said “the key is risk management, not risk avoidance.”

In this sense, experimenting and inclusion of these applications is not only a potential benefit, but probably the safest options for governments.

EDEMOCRACY

On the Forum on the Future of Democracy, held in Madrid last year, where the issue was eDemocracy, one of the key questions was what is eDemocracy. Secretary General of the Council of Europe, Mr Terry Davis, in his speech offered an answer to this question by saying: “... I do not think there is anything that can be called electronic democracy, the same way as paper democracy does not exist. There is democracy on paper, of course, but it’s another question. We can talk about e(lectronic) voting, eCampaign, eAdministration or any other eWord you can imagine, but democracy is simply a democracy “... ”

However, information and communications are now in the centre of any cultural, economic and political activities in the broadest sense. Media significantly affect the way of the adoption and implementation of political decisions at local, national or international level. In addition to radio and TV, the most widespread and influential medium is the Internet, and therefore a frequently used sentence saying that we live in an era of electronic communications and the Internet is justified.

ICT and the Internet are rapidly becoming key tools that enable not only access to information but multiply communication channels that extend the possibilities of Internet far above the performance achieved to date. So it raises the question of elementary (internet) literacy of modern man, as a precondition for any serious engagement with any activity. Today Internet has a dramatic impact on all aspects of life including the area which is within the broader context of democracy and politics and politicians. If democracy is the freedom to choose there are a number of conditions that need to be fulfilled in practice for this freedom to be achieved. These preconditions must be met regardless of the way of voting – it is not important is it done by ballot or by pressing buttons on a computer, mobile phone or „voting machines“. The key contribution of ICT to achieve freedom of choice is that the technology enables the correlation of the citizens and elected representatives in a much better way than it had been possible without the Internet. In this sense, it can be said that the Internet and ICT significantly changed and potentially improved the environment in which democratic processes are taking place.

Digital Democracy can be defined as a democracy that reflects the information age, where the ICT, especially the Internet have provided a far greater and better access to government agencies and information for citizens, allowing rapid exchange of information between large numbers of people - thus promoting non-governmental organizations, citizens' associations, etc. Digital Democracy implies the use of ICT to strengthen the power of democracy, particularly as a tool that allows citizens to directly participate in policy making. It should be able to unite the possibilities of new communication environment that has the power to increase the quality of a participation in management processes. The development of eDemocracy will have important effects, and it will facilitate the revitalization of society by enabling citizens to focus their thoughts and ideas and involve them in decision-making process.

eDemocracy includes:

- eAdministration - refers to the electronic management of state affairs management
- Information management - refers to the creation of effective communication between citizens and decision makers
- Populist model or the model of "electronic city services" - allows citizens to electronically publish their own views on certain issues.
- The model of civil society - refers to the transformation of political culture with the help of communication technology, which should affect the quality of public debates and change in interpersonal relationships
- Model of agreement democracy - this model allows the establishment of online forums for discussion between politicians and citizens
- The model combining representative and direct democracy - implies that citizens represent the values and they decide which issues require resolution through the process of representation and expertise, and which citizens are resolving immediately.

Although still not sufficiently tested, the area of eDemocracy needs to strengthen democratic and political life of the state by using ICT.

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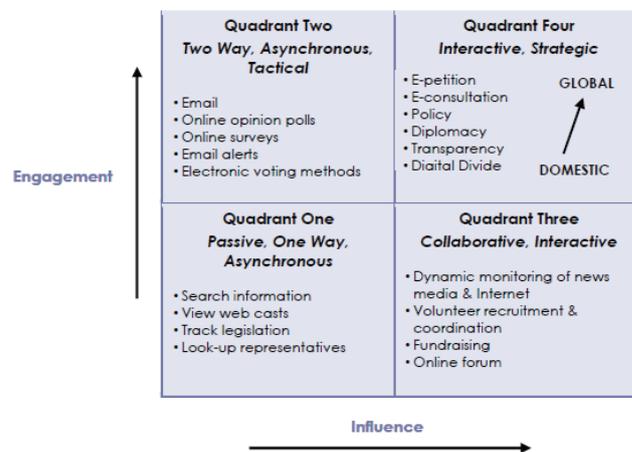
When it comes to the critical point, the total success of eDemocracy depends largely on building trust of citizens and institutions in technology, first of all having in mind terms like security, safety and confidentiality. The issue of protecting privacy rights, intellectual property, etc. will become more important, especially in countries where regulations remain inadequate or have not been enacted. Gaining trust of voters in the robustness and privacy which the technology is supposed to ensure is also one of the critical points of success of eDemocracy.

EDEMOCRACY MODELS

Representatives of the Academy and others have conducted the research about the eDemocracy models. Organization for European Cooperation and Development (OECD) has defined three types of interactions in eDemocracy - providing one-way information, two-way relationship in which citizens have the opportunity to provide feedback on certain issues, and finally, a partnership in which citizens are actively involved in decision-making process. Similarly, Coleman and Götze propose four scenarios. The first is technological support to a direct democracy. Second covers the widest layers of online social communities of interest. The third refers to the online survey and discussion groups. The fourth refers to the technology as a way to encourage and engage citizens in policy-making. Gartner Dataquest has developed a model on four levels in the area of "eDevelopment", which can be applied to services to citizens and to eDemocracy. On the first level (presence) Internet site provides information online in a static format. On the second level (interaction), the citizens search the information, download forms, or access via links to other relevant sites. The third level (transactions) facilitates the need for completing transactions by mail or by visiting the offices. The

fourth level is transformational. Some of the attributes of this level are wireless access, providing information about government operations through the web sites as well as rough CRM tools. A very important feature in this case is the redesign of working capacity and business processes.

The Institute for eGovernment (IEG) provides models of eDemocracy and go further when it comes to the definition and implementation of eDemocracy (Picture 1). IEG model is not limited to citizen-to-government point of view, marking and displaying the progression of the aspects of information and inclusion of citizens. It serves as a scorecard of digital skills - how well the government unit interprets and reacts to the environment in the digital world and how successfully they use technology in line with progressive influences. This “entity” can be either selected representative, or legislative body, local or state governments, political parties or international organizations. The model helps leaders to find a way in which they can jointly embrace and integrate tactical and strategic efforts of eDemocracy and create eGovernment strategy. With one step, governments can identify their current position with the appropriate characterization of the different levels of sophistication, and find a solution about the eInitiatives that can take them to the next level. One axis measures the level of involvement, and the second axis measures impact.



Picture 1. eDemocracy model / Institute for Electronic Government

First Quadrant - Passive, one-way, asynchronised - Most government bodies - governments, legislative bodies, international organizations, political parties - have done a very good job of making that information available online. This represents an important step in the development of eDemocracy.

Legislation bodies began to realize that it is not only the question of how to use technology to communicate with voters, but how it is done in the style of modern business, using technology.

Second quarter - two-way, asynchronised, tactical - The entities in this quadrant have made a big step forward in facilitating two-way communication. If we approach it in terms of users, the question is who is in fact the “government”? As mentioned in the movie Ghostbusters „Who are you going to call?” – is it the municipal president, the government or the parliament? Could it be the minister of health, tourism, legislation? Or is it perhaps a member of a state agency, the Secretariat, etc.

The correct answer is actually ‘all of them’! We all live in the provinces, municipalities, cities, state, and ... the world! And the challenge is reflected in this fact. Every public institution and those who work in that institution are obliged to “move” towards the adoption and increasing use of information and communication technologies and to “open” and establish two-way channels of communication in the era of digital values in which we live.

The third quadrant - collaborative, interactive - This quadrant has more interactive possibilities. Although it is still very asynchronized, communication begins to develop in collaboration/cooperation. The most visible at this stage are the political players and the electoral process with tactics such as registration and organizing volunteers online, online fundraising, campaigns, communication with the voters and the media, voter registration and voting.

The fourth quadrant - Interactive, Strategic - Management of policy-making is not nearly like product lifecycle management. Previously, in the policy-making cycles, more citizens were able to influence the results. Hansard Society in the UK is trying to develop mechanisms for the promotion of public consultation and adjustment with its constitutional processes, by demonstrating the true relationship between public input and results of policies that must be found. They identify and highlight 5 actions that governments have to do: (1) improve the quality of policies through the identification of wider sources of expertise under conditions of increased complexity, (2) prepare for greater and faster interactions at the request of the information society, (3) integration of public input/public opinions in the decision making process and creating law, (4) reaction and positive response to calls for ensuring transparency and reliability, (5) strengthening of trust in government.²

This quadrant represents the highest level of sophistication of eDemocracy, if nothing else then to predict the future and expectations - a strategic, interactive, synchronized and global in nature. Today, democratic institutions must at least actively manage the initiatives in this area. If there is any doubt that the leading governments are already using technology to gather input from citizens and businesses in order to time determine the direction of activities, what is needed is to visit only a couple of web sites and thus to identify and define trends.

CONCLUSION

There are three reasons that stand out and lead to better engagement of citizens in policy-making:

- Creating a quality policy
- Building trust and acceptance of policy
- Sharing responsibilities in the process of policy-making

Other reasons that are included but not limited to these processes are: the possibility of visualization of policy, providing opportunities for citizens to control and monitor government policy implementation process, to maintain power balance of lobbying organization, avoiding corruption, strengthening and accelerating the activities of citizens, all with long-term goal of strengthening representative democracy.

Given the comprehensive reasons, the goal of using technology to disseminate information, consultation and participation, is the enhancement of the decision-making process through the rank device designed to provide:

- Achieving wider audience and engaging it through a number of consultations and participation technologies adapted to provide a variety of technical and communication skills to individuals and to facilitate the greater participation.
- Providing relevant information in a format that is more accessible and easier to understand to the target group in order to ensure more informed participation
- Providing detailed consultation in support of significant online debates
- Management analysis of participation to support policy makers and to improve the politics
- Providing relevant and appropriate feedback to citizens in order to ensure openness and transparency in the process of policy-making
- Monitoring and evaluation processes in order to ensure continuous improvement.

² Coleman, Stephen, Nicola Hall, et. Al. "Hearing voices: the experience of online public consultations and discussion in UK governance", Nov 2002.

Additional benefits include the possibility of building "open" governments, in terms of the purpose of managing storage and retrieval, as well as ensuring the attractiveness of debate for a specific audience. It is also necessary to determine at what stage of the process of decision making, technological expansion of information, consultation and participation can be effective. Decision-making process can be understood as a series of activities involving the preparation, implementation and evaluation phase, and other phases, where the results have a counter effect in setting the agenda, i.e. defining and designing policies. Such statements provide a framework of information, consultation and participation in the life cycle of policy-making.

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IMPACT OF RECENT FINANCIAL CRISIS IN LOCAL PRODUCTION IN ALBANIA – THE CASE OF TIRANA & DURRES REGION

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ABSTRACT

The aim of the paper is to identify the most important consequences for Albanian economy, at local production level, in the context of the recent global financial crises (2008 – 2009). The authors intend to formulate as well some recommendations on how to better cope with the negative consequences of the crises, with eventual interest for governmental decision-makers and owners / managers of private businesses.

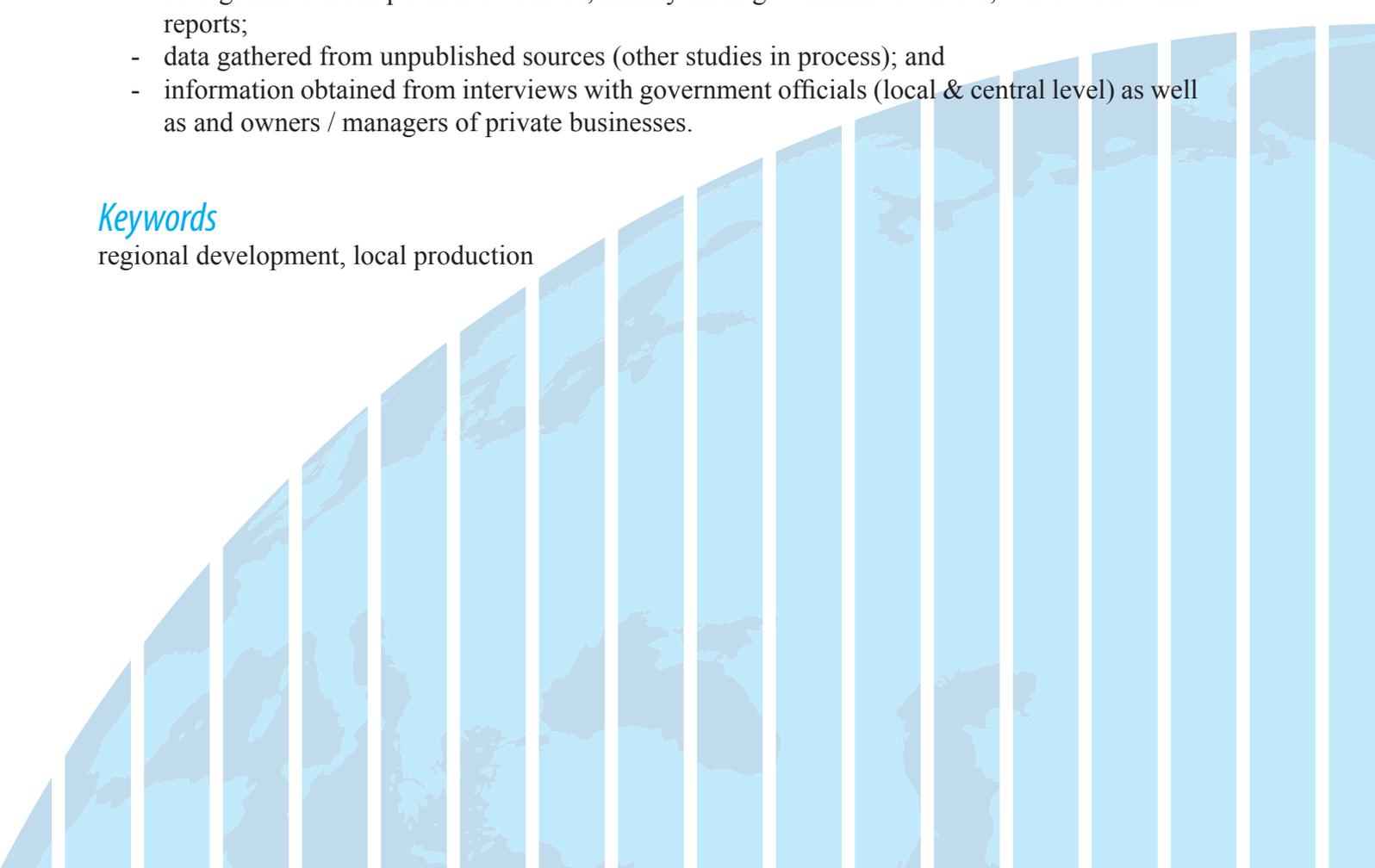
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The paper is based on:

- data gathered from published sources, mainly from government statistics, other studies and reports;
- data gathered from unpublished sources (other studies in process); and
- information obtained from interviews with government officials (local & central level) as well as and owners / managers of private businesses.

Keywords

regional development, local production



ALBANIA AND THE GLOBAL ECONOMY: TRADE AND COMPETITIVENESS

Albania is actually participating in the EU's Stabilization and Association Process (SAP), signed with the EU on 12 June 2006. The SAA provides a framework of mutual commitments on a wide range of political, trade and economic issues.

Trade-related parts of the SAA are implemented through an Interim Agreement while ratification of the SAA is being completed. The Interim Agreement entered into force on 1 December 2006. Co-operation provisions of the 1992 Trade, Commercial and Economic Cooperation Agreement (TCECA) will remain in operation until the SAA is ratified. Albania also benefits from autonomous trade measures granted by the EU. The revised European Partnership, setting out priorities that Albania should address in the short- and medium-term, was adopted in January 2005. Albania adopted a plan to implement the European Partnership priorities in July 2006.

The government is preparing a revised national plan to implement the European Partnership priorities and the SAA. This plan makes a first attempt to cost the European integration process, which is necessary for budgetary forecasting. It also broadly schedules reform and capacity-building steps and defines institutional responsibility for them. The plan will form part of a new National Strategy for Development and Integration (NSDI), which is being designed and implemented by the Department for Strategy and Donor Coordination (DSDC) which was established in November 2005. Work has begun by line ministries on the development of 23 sector strategies and 10 cross-cutting (including one on Regional Development) strategies for the NSDI. Line ministry budget allocations will be limited to actions described in the 23 sector strategies. A major aim of the DSDC is to ensure that the government's priorities and the requirements for EU and NATO integration are fully reflected in all core government policy and financial planning processes.

Albania is also actively participating in the negotiations on the establishment of a regional free trade agreement within the framework of an enlarged and amended Central European Free Trade Agreement (CEFTA), which were launched in April 2006. Albania has free trade agreements with all countries in South-East Europe. It also has a free trade agreement with Kosovo.

The Communication From The Commission To The European Parliament And The Council, "Enlargement Strategy and Main Challenges 2006-2007 (November 2006)" states "The priority now is to focus on implementation of the Interim Agreement (of the SAA), which will enter into force on 1 December 2006, and which covers trade-related issues. With EU support, Albania is tackling the challenges of political, judicial and economic reform, as well as the fight against corruption and organized crime. These themes will remain priorities in the period ahead."

The World Bank Poverty Reduction and Economic Management Unit document, "Albania: Sustaining Growth Beyond the Transition. A World Bank Country Economic Memorandum" (2004) also states that the first pillar of Albania's medium-term strategy should be the implementation of policies to boost trade. Taking advantage of its geographic location, its historical past, and the prospects of stronger trade relations with its neighbors and the EU, Albania is currently engaged in negotiations to develop regional integration in SEE countries and closer cooperation with the EU, simultaneously with compliance with the country's WTO commitments.

Three simulations undertaken by the World Bank with varying degrees of tariff liberalization indicate that Albania has a lot to gain from further integration with its neighbors. However, the benefits from regional integration can only be realized if Albania gains better access for its exports to regional markets.

The idea that Albania's growth prospects are inexorably linked to the concept of trade and competitiveness is perhaps best summarized in "The Competitiveness Environment in Albania" by Xhepa and Mancellari (2003): "The most promising trade and growth opportunity for Albania clearly involves integration with the EU. Apart from political benefits of the SAA process, such as providing the policy lock-in mechanism to pursue further reforms and the incentive to create a stable business environment that would encourage foreign investment, the elimination of the remaining barriers to trade can lead to significant expansion of trade and income. However, trade liberalization should proceed along all dimensions, as the biggest gains are to be realized when Albania lowers its barriers to trade with respect to all trading partners."

The challenge that faces Albania is therefore to how will its economy be able to withstand increased regional, European and global competition and indeed flourish in the new environment? There are clearly a number of political, sociological and economic factors here but they can all be summarised in a single idea: the growth of competitiveness of the Albanian economy.

In summary, it appears that WTO membership, preferential trading privileges granted by the EU combined with the progress in political stabilization as well as in the region following the Kosovo war have contributed to a more attractive investment environment in Albania. Yet, much progress remains to be done, as the country faces fiscal losses in the short- and medium-term and must continue improving its business environment to boost growth and attract even higher levels of FDI and remittances.

COUNTRY MACROECONOMIC PERFORMANCE

When Albania began its transition to a market economy, it had the lowest level of per capita income, trade openness, and market development in Europe. Its growth experience has been a success story among transition economies and its cumulative growth since 1990 has been impressive and is among the highest of all transition economies (after Poland and Slovenia). Since 1990 Albania's per capita income has more than doubled and the income gap with its neighbours has been steadily reduced. While these accomplishments are impressive, Albania remains one of the poorest countries in Europe (GDP per capita is still only 6.5 percent of EU-15 average) and its per capita income is among the lowest in the Balkan region. Worldwide it ranks 73rd of 177 countries on the Human Development Index (UNDP's 2008 Human Development Report).

According to the World Bank, growth patterns have evolved since 1990, and can be divided into four separate episodes. Immediately after transition real GDP contracted sharply by a cumulative 39 percent between 1990 and 1992. Recovery began in earnest in 1993 as Albania instituted a successful macroeconomic stabilization program (by bringing its budget deficit, money growth, and inflation rate under control), liberalized prices and external trade and privatized agricultural land. Between 1993 and 1996, the economy grew at a rapid annual rate of 9.3%. Most of the growth during this period was driven by agriculture, services and, to a lesser extent, construction (the latter was still a small share of GDP). In 1997, the collapse of the pyramid schemes brought widespread anarchy and a sharp contraction in real output by 7 percent. Albania was able to recover swiftly from this crisis so that growth returned in 1998. Between 1998 and 2001, the economy grew at an average annual rate of 7.4 percent, and in 1999 real GDP exceeded its level in 1990 for the first time. This growth was driven during 1998-99 by a strong performance in manufacturing and services. During 2000-01, manufacturing growth slowed significantly, the growth of services increased, and growth in construction accelerated substantially. In 2002, an energy crisis and poor weather slowed growth across the board, so that the economy grew by a mere 4.7%. In 2003, the growth rate picked up somewhat to 6%, aided by a significant increase in domestic hydropower production. Growth was similar in 2004 before falling slightly to 5½ % in 2005.

Structural transformation has taken place, as the contribution to agriculture to GDP has declined; since 1990, Albania has experienced a significant structural transformation away from industry and into services. A large part of this transformation took place during the early years of the transition: from 1990 to 1992, the share of industry in GDP fell from 39% to 20%, the share of agriculture increased from 23% to 34% and the share of services increased from 33% to 44%. Since 1992, the share of industry has stayed steady around 20%, the share of agriculture fell back to 25% in 2003 (part of this due to changes in national accounts) and the share of services rose to 54% in 2003.

Essentially, difficult initial conditions quickly changed after Albania implemented a series of successful stabilisation programmes. Each one had its own characteristics although in general their goals were similar: low inflation and stable prices, sustainable growth and lower budget deficits, improvement in the external position, and financial sector reform. According to the World Bank Poverty Reduction and Economic Management Unit, “Albania: Sustaining Growth Beyond the Transition. A World Bank Country Economic Memorandum” (June 2004), “Sound macroeconomic policies have provided a good environment for strong growth.”

According to the World Bank, three factors explain Albania’s growth performance over the last decade:

Macroeconomic stabilization and structural reforms have provided an environment conducive to economic growth over most of the past ten years. Fiscal consolidation has taken place, prudent monetary policy has been implemented and trade has been liberalized. Privatization of small and medium enterprises has been completed and only few enterprises in the services sector remain in public ownership.

.....118 **Total factor productivity:** structural reforms were also implemented in key sectors of the Government’s development strategy (education, health and energy). This has led to the re-allocation of resources from low productivity sectors like agriculture to high productivity sectors (services, construction).

Remittances from migration (of an economically active population of 1.7 million, approximately 700,000 work outside the country, mainly in Greece). These are discussed in depth in a later section.

It would be naïve to ignore the impact of illicit activities on the recent growth of Albania. The 2008 CIA World Fact-book states: “Albanian growth has been fueled by remittances and an apparently large, though difficult to quantify, injection of resources from illicit trafficking in humans and drugs” and that Albania is an “increasingly active trans-shipment point for Southwest Asian opiates, hashish and cannabis transiting the Balkan route.” The size of the informal economy in Albania has been estimated to be as much as 50% of the formal economy by donors and government.

THE ECONOMY OF TIRANA-DURRES REGION

The following section presents a discussion of the economic importance and prospects of the Tirana-Durres Region. In many ways it shows that it makes little sense to talk about the competitiveness of the region in isolation, as it composes such a high proportion of the country’s economic activity and that it is almost universally seen as the “engine of growth” Albanian economy as a whole.

Few economic data exist for the Tirana-Durres in a disaggregated form and much of the available business information relates primarily to economic activity in Tirana alone. However, some regional

data is contained in this report, derived from INSTAT, “Indicators by Prefectures” (2008). It should be a major priority to improve the supply of data on the regional economy (In the whole of Albania as well as the Tirana-Durres region, both in terms of the statistical series published and the details of the data disclosed. In particular, the International Standard Industrial Classification and the International Standard Occupational Classification should be adopted and highly disaggregated data published for each region, as should GDP and GDP per capita data disaggregated data on unemployment (who is employed, for how long, etc). Detailed data on the structure of the economy by value added and employment would allow the use of standard techniques to identify structural strengths and weaknesses such as Location Quotient Analyses - exercises which cannot even be contemplated at the moment because of a lack of numbers.

HISTORICAL REGIONAL DEVELOPMENT

The Tirana-Durres region is one of the most interesting regions in Europe in terms of the exceptional high rates of growth particularly given its starting position in 1991. The following gives an overview of the last 15 years of development in the region:

- collapse of traditional industry such as mining, mine processing, smelters, metallic, chemicals, etc (1990-1995);
- collapse of soviet type agricultural cooperative and agricultural state-owned farms (1990-1993)
- privatization of all state-owned flats with a symbolic price (1992-1993);
- closure or privatization of all services and state enterprises (1991-1994);
- increase of population of the region by more than double due to internal migration of population from the north and south to settlements in the Tirana-Durres region (1992-2007);
- establishment of huge illegal settlements in the suburbs and boundaries of Tirana-Durres region to accommodate the housing of migrants;
- boom of construction industry and services due to increased demand for homes in the region (1993-2007);
- emergence of local private firms in trade, agriculture and small manufacturing like bread production, milk, meat food processing, services, workshops, bars, restaurants, transport (approximately 40,000 in total) (1990-2007);
- establishment of foreign SMEs (car sales showrooms, Coca Cola, shoe production, shirts, Ferrero Rocher, Kinder Sorpresa, etc);
- privatization of the banking system (especially after the year 2003);
- privatization of the mobile phone industry (rising from 30,000 users in 2000 as a state enterprise to 1,200,000 in 2006 users of private businesses);
- investments in infrastructure such as the Tirana-Durres motorway, urban upgrading in main towns, water network improvements and energy network upgrading, funded by donors assistance and state budget;
- rehabilitation of numerous elementary schools; and
- emergence of private schools and private universities.

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GDP AND REGIONAL GDP GROWTH

Data are not disaggregated at sub-national levels in Albania so it is not possible to estimate accurately the GDP of the Tirana-Durres region. The best estimates must be derived from national data. It is therefore estimated that with over $\frac{1}{3}$ of Albania’s population - and growing, a higher percentage still of its workforce - and relatively low unemployment, the majority of its businesses, 60% of construction (see below) and a likelihood of higher consumption and earnings, the region must

account for at least 45% of the national economy. This amounts to over US\$3.3bn per year. Other estimates suggest that the region may comprise 50-70% of the national economy.

Similarly, with a national economy growing at above 5% a year - and some parts much slower than this, and with its economy being easily the most dynamic in Albania, with most of the country's large enterprises and foreign investments, Tirana-Durres' GDP per capita must be growing by at least 6% a year at the moment, and maybe 7-8%. It was probably growing by 1-2 percentage points faster than this in the early 2000s.

No forecasts for regional GDP change exist but it is probably safe to assume similar growth levels for the foreseeable future. The interesting issue here is that 7-8% annual GDP growth doubles prosperity in about 8 years and quadruples it in 15, producing a shift in consumption patterns from basic goods to more luxury goods and sophisticated services, especially travel and leisure, opening up further business opportunities that can create the highly desirable 'spiral' of expansion. This in turn will have big implications for upgrading labor - and management - skills and for land use and buildings for retailing and new leisure facilities.

DATA ON BUSINESS ACTIVITY IN THE TIRANA-DURRES REGION

In 2008, there were more than 26,000 large, medium and small businesses, both Albanian and foreign, operating in Tirana. The city hosts 90% of the large enterprises in Albania and more than 80% of the foreign companies and joint ventures (Unit for Economic Development of the City of Tirana, "Doing Business in Tirana", 2008). These include companies such as DHL, UPS, Deloitte & Touche, AMC, Vodafone, Coca-Cola, Aquila Liquori, Hochtief AirPort (HTA). Various American, German, Italian, Greek and Austrian banks have branches in Tirana, and have invested a large amount of capital there.

Tirana has 80% of the county's total amount of invested foreign capital and 80% of all enterprises with foreign capital, joint ventures, subsidiaries, branches and representative offices of many well-known multinational companies operate in Tirana, investing a total of 231m Euros in 2007 in Albania (source: Bank of Albania). Significant investments include the consortium of the Greek Panafone with the UK's Vodafone, resulting in Albania's second GSM operator with an initial capital of 38.1 million dollars. Hotel Rogner Europapark was built by a private Austrian construction company with an initial capital of 12 million dollars. Coca-Cola Tirana s.r.l. is a joint-venture with Busi Group Italia and has initial invested capital of US\$2.9m.

The figures from INSTAT show a considerable year-on-year variation in the values for Tirana and Durres and their proportion of the total national amounts, but one can note that in two of the last four years, the region has accounted for nearly two-thirds of the new construction in Albania.

Tirana is just 41km from Durres, which is the largest Albanian port in terms of passengers and goods, on the Adriatic Sea. The two cities are linked by a recently constructed highway, making the travel time minimal. Some estimates are quoted as saying around 75% of the 1km width of land aside of the highway is already occupied by private enterprises.

According to the UNDP "Development Strategy of Durres Region" (2005), there are about 2,308 active enterprises there (not including private agricultural activities), ranking Durres second after Tirana in the country. About a quarter of active agricultural enterprises are located here together with 13% of all industrial enterprises, 12% of construction companies, 11% of trade companies and 12% of service companies. Reflecting Durres' position as a hub for sea, railway and road, 16% of transport companies are located here.

There have been other attempts to quantify the importance of the region. For instance according to the METE report on new strategy for SMEs, (Instat originated), 50% of companies in Albania are in the Tirana-Durres region. Their turnover is 63% of the national total (35.5 billion out of 57.7 billion ALL for the first nine months of 2006 (source General Directory of Customs. Albania). This is 40.9% of national GDP. However, taking into account the concentration in the Tirana-Durres region of investments, services, internal migration, warehouses, banking system, properties, transport, infrastructure network and consumption of energy, it has been estimated by different sources that between 50 and 70% of GDP is produced in Tirana Durres region.

It is impossible to overstate, therefore, the importance of the Tirana-Durres region to the Albanian economy. Any policy measures to increase the competitiveness of the region will necessarily have a major impact on the economy as whole, and vice versa.

PRODUCTION SECTOR CHARACTERISTICS

The largest manufacturing employers in Tirana-Durres are ‘*façon*’ sub-contractors in leather footwear and apparel. The concept of ‘*façon*’ is that Albanian low wage, primarily female labour can be mobilized to perform low skilled, repetitive labor phases of the production system of companies, primarily Italian, that design and market mass consumption products in global markets. The contracting company supplies the plant located in Albania with the raw material, patterns, and technological expertise to execute routine cutting, trimming, sewing, assembly, and packaging phases of production. The Albanian plant competes with plants located in other low wage regions, particularly in Asia, to meet demanding performance standards of cost, quality and turnaround time.

EMPIRICAL DATA ON FOOTWEAR PRODUCTION

– IMPACT OF THE RECENT CRISIS

Three Albanian footwear companies achieved a daily output of 10,000 pairs of shoes, all exported, in recent years. One has since been broken up and no longer operates. A second, the 85% locally owned *Albanian Shoes Corporation*, achieved production of 10,000 pairs daily in three plants with high standards for a period of time, but has down-sized by over 40% and has found competition from Asian suppliers to its American market to be stiff. Its production line is a classic single product, mass production assembly line. In about the year 2005, an injection molding department was added to integrate leather upper with sole production. All of the technological and production expertise, as well as raw material acquisition and pattern making, was conducted by its Italian partner, *Adelchi*. The Albanian plants have not been reorganized to meet the performance standards of world-class manufacturing upon which Asian competitors are based.

The third high volume local plant, *Albaco*, is 100% foreign-owned by a two-person Italian partnership that supplies *Cofra*, founded in 1948 in Lombretto, Italy. *Cofra* became a global leader in safety shoes for working men. From the year 1993 to 2002 *Albaco* made only leather uppers, but in the year 2003 plastic sole making was added. Today, *Albaco* makes three types of rubber soles with, in all likelihood, the largest array of injection molding machines in Albania. It operates a custom, high volume production system with conveyor belts but not a moving assembly line. This gives greater flexibility and the company can make multiple products without long changeover times. It rarely does production runs of under 500 batch sizes. Competition with Chinese and Vietnamese plants has forced *Albaco* to create more variety and to move to higher quality. In fact, *Albaco* now produces an astonishing 3500 models. Nevertheless, the Albanian plant has not received sufficient orders to

operate to full capacity and is presently operating at about 80% of capacity. Nevertheless, *Albaco* works three shifts and employs 1,050 workers. Even with low wages, cost per shoe increases rapidly in such circumstances, in part because of the heavy investment in hundreds of injection moulding machines and robots.

A weakness of the *façon* model in these two cases is that all of the technical and management expertise is concentrated in the Italian partner. Some specific technical skills are transferred, but all product design, marketing, technology management, raw material acquisition skills remain hermetically sealed inside the client company. Consequently, indigenous skills and organizational capabilities are not developed as an ongoing feature of the relationship. Consequently, the local business units remain highly dependent and vulnerable to changing conditions.

CONCLUSIONS

Albania's macroeconomic environment has continued to be characterized by constant GDP growth and subdued inflation. Since 2006 the country has not been suffered severe problems with regular power supply. Such improvement gave a substantial contribution on the economic stabilization. The repercussions of the recent crisis on economic growth seem to be less than expected, up to the mid - 2009. Albania was not seriously hit by the first wave of the crisis, but export and re-export activities had to consider production reduction and restructuring. Many Albanian companies are actually seeking for more flexible organization patterns, they should adopt in order to survive in a more competitive market.

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SERVICES AS A VITAL DEVELOPMENT FACTOR OF THE MODERN ECONOMY

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ABSTRACT

The industrialised contemporary economies are dominated by employment in the service sector. This phenomenon stems from the natural evolution of economy, starting from pre-industrial, through industrial, down to post-industrial era. Economic development also leads to an increased share of service sector in the gross domestic product. In the economically developed countries, the given share may range between two-thirds and three-quarters of the total.

Rather than being industries of marginal interest, services comprise an integral part of society, essential for the functioning of economy, and situated in its very core. The service sector not only facilitates but also enables the activities necessary for production in the extractive and production sectors. Service activities are the main driving force of the current changes towards a global economy.

Although there are different views of some activities in the service sector, the prevailing one is that this sector includes the following types of services: business-related, trade, infrastructural, social and public. The fastest growth in the service sector is achieved in the areas of finance, insurance, trade, real estate, various public services (such as health, education, professional services) and retailing.

The development and growth of service industries reflect positively the cyclical movements in economy. In periods of recession, when the number of jobs in the production sector tends to be reduced, service activities either show higher employment rates, or maintain the same level. This is an indicator of consumer behaviour and their willingness to postpone the purchase of some products, but will not deprive themselves of some essential services, such as education, telephone communication, banking, health, service, public utilities etc. In practice, drawing a clear-cut line between service and production industry is often not an easy task. Some authors argue that there are, in fact, activities, i.e. industries with a higher or lower share of service in their business activities.

The economic development of a society is determined by its citizens' lifestyle, and is a measure of their living standards. The nature of the service sector can be considered through business opportunities, contribution to economic stability, and sources of economic leadership.

Key words

services, cyclical movements, employment, stability

INTRODUCTION

Defining services is neither a simple nor an easy task. Reasons should be sought in their nature, i.e. the fact that they are not easy to perceive, but they can be bought and sold. In the view of the American Marketing Association, “A service is a task or job performed for someone else and/or provision of a device, product or activity for use by someone else, rather than ownership as a result of an exchange transaction. It is intangible, and therefore cannot be stored or transported. It can be withdrawn from further use only by the introduction of an additional exchange transaction. It may also be accompanied by the sale of products.”

Starting from the above definition, one can note that services are, in fact, intangible activities resulting in certain advantages, benefits, or solutions to the user’s problem. This also implies that the given user is also willing to pay for them. Over the past decades, the core section of every society’s economic activities is definitely taken up by service industries. Last century saw a great evolution in the developed Western societies, where societies based on industrial production evolved into societies predominantly based on service activities.

Theoreticians who consider economic growth argue that the industrialisation of countries inevitably leads the movement of employment from one economic sector to another. Most of them have limited their analyses to three stages of economic activity, i.e. primary, secondary and tertiary. Some authors, however, have sub-classified services into three additional subcategories, thus obtaining the tertiary, quarternary and quintary. Most countries, however, are still in the first stage of development, as their economy is based on the exploitation of natural resources. In most of Asia and Africa, over 70% of labour force is employed in extractive industries. The dominant activity in an industrial society, i.e. the second or secondary phase, is the production of commodities. Producing as large quantities of goods as possible, at the lowest possible cost, is the companies’ principal goal. The division of labour occurs as an operative pattern generating routine tasks for semi-qualified workers.

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Unlike industrial society, which measures living standards by the amount of produced goods, post-industrial societies are more concerned with the quality of life, as perceived and assessed by medical, educational and entertainment organizations or institutions. The transformation from industrial to post-industrial society occurs in several ways. It entails a natural development of services, such as transport and communication, devised to aid industrial development. Introducing technologies that substitute direct (live) labour into production processes leads to re-employment of a larger number of workers in non-production industries, such as maintenance and repairs. Also, population growth and mass consumption of commodities makes an impact on growth in retail and wholesale services, in addition to banking, insurance, real estate trade etc. Income growth reduces the percentage of expenditure on basic personal needs, whereas the remainder tends to create demand for durable goods and then services.

Higher education levels are a prerequisite for entry into post-industrial society, requiring professional and technical knowledge from individuals. Moreover, the demand for a variety of services and a higher level of social justice leads to the growth of the government structures. Environmental concerns demand governmental intervention and demonstrate the global character of post-industrial society.

SERVICES AND ECONOMIC GROWTH

Numerous authors have considered the role of the service sector in the development of global economy. A special significance belongs to the analyses of models of economy, showing the flow of activities between its three principal sectors: extractive (agriculture and mining), production and service sector, with its five sub-groups. The final target of business activities are the final consumers. According to the given classification, the individual sub-groups include the following service activities:

- business-related services (consulting, finance, banking);
- trade services (retailing, wholesale, repairs)
- infrastructure services (communications, transport);
- social and personal services (hospitality, health care)
- public services (education, government)

Infrastructural service activities, such as transport and communications, comprise the basic links between all the sectors of economy, including the final consumers. In a complex economy, infrastructural and trade services function as intermediaries between the extractive and production sector, as well as the distribution channels leading to final consumers. The given services are a prerequisite for the industrialisation of any country, so that their development is impossible without the above mentioned service activities.

The industrialisation of economy is characterised by the fact that specialised service companies are capable of rendering various services to large corporations in a much more efficient and cost-effective manner. Very often, services such as promotion, consulting, market testing, finance etc. are performed by the service sector companies for the production sector companies. Excluding the basic needs, when individual households are self-sustaining, service activities are truly necessary for the functioning of economy and improving the quality of life. There is no special need to emphasise the importance of banks for money transfers, or transport for the distribution of food products to areas where their production is not possible. We have also witnessed the development of a large number of social and personal service activities, such as hospitality and entertainment, cleaning, childcare services etc.

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Public services play a major role, especially in terms of creating stable conditions for investment and development. Services such as education, healthcare, communication, clean air, healthy food and water, public safety etc. are vital for the survival of companies, growth in the living standards and general social welfare.

The share of services in GNP generation

In most countries, the focus of economic activities, and thus, creation of value, was long ago transferred to the service sector. In this, the leading economic powers are the leaders in performance. The given trends, however, are also evident in other countries, including the least developed ones.

The role of service sector in creating value and employment in developed countries is highly noticeable. This is obvious from the data for developed countries, OECD members (see Table 1)

Table 1.

The share of services in the economies of OECD countries						
	Service sector GDP			Employment in services		
	Share in GDP		Average growth rate	Share in total employment		Estimated growth rate
	1995	2003	1995-2003	1995	2003	1995-2003
Austria	60.2	60.4	0.8	57.8	63.2	1.6
Belgium	66.0	68.6	2.7	72.7	76.0	1.7
Finland	56.4	58.5	3.2	64.9	68.7	2.4
France	65.3	67.9	2.1	70.9	73.9	2.0
Germany	62.5	65.3	0.3	64.3	70.4	1.4
Greece	62.6	64.5	5.3	55.9	60.9	1.6
Ireland	48.6	50.0	11.4	61.1	66.8	5.4
Italy	62.8	66.4	4.4	63.0	66.6	1.9
Luxembourg	83.7	92.7	6.5	70.6	77.2	5.1
The Netherlands	63.9	67.5	3.4	74.2	77.7	2.5
Portugal	59.4	63.0	4.8	56.6	59.7	2.8
Spain	63.7	63.9	4.7	64.8	66.3	2.8
Australia	62.5	64.7	4.9	72.8	74.9	1.9
Canada	62.4	60.7	3.6	74.2	76.6	2.3
The United Kingdom	62.1	68.6	7.3	76.6	80.6	1.7
The USA	66.5	71.5	6.6	77.1	81.1	1.9
Euro region	63.2	65.6	2.4	65.5	68.3	2.2
OECD	64.8	66.4	2.0	68.1	71.4	2.1

Source: OECD Economics Department WP no.449, October 2005, p.5

The above data points to the fact that the growth in the economic development levels of individual countries is a prerequisite for the change in the economic structure in favour of service industries.

In the observed period, the highest average growth rates in the share of services in OECD member countries, which include the most developed ones in the world, were achieved in: Ireland (11.4); Great Britain (7.3); the USA (6.6); Luxembourg (6.5); Spain (4.7), Portugal (4.8), Italy (4.4), etc. The highest average employment growth rate in the service sector over the same period was achieved by Ireland (5.4), Luxembourg (5.1), Spain (2.8), Portugal (2.8) etc.

Starting from their potential in creating value, service industries have become the dominant area of foreign direct investment (FDI). The value of FDI stocks in the service sector currently exceeds 60% of the total value of directly invested and activated foreign capital in economy, compared to 46% at the end of last century (Source: Asia-Pacific Investment Review, Vol.1, No.2, November 2005.)

In terms of classical exports, service industries are subject to various limitations. Still, the growth rates for services of the most developed countries for the 2000-2006 period are very significant (see Table 2).

The average growth rates for services of the most developed countries for the 2000-2006 period.

Table 2.

Ireland	22%
Finland	14%
Sweden	11%
Greece	11%
Germany	8%
Norway	8%
Spain	8%
Great Britain	8%
Portugal	7%
Italy	5%
France	3%
The USA	3%

(Source: IMF Country Report no. 08/145, April 2008, p.72)

The highest service export growth rate in the observed period was achieved by Ireland (22%) – mostly in computer-related services; Greece (11%) – mostly in transport services; and Spain (8%) – mostly in business-related services.

The change in the economic structure from the viewpoint of the participation of individual sectors in generating GDP value occurred in individual Asian countries as follows (see Table 3):

Table 3.

Country/period	agricultural %	industrial %	services %
Singapore			
1985	1.0	34.5	68.8
1995	0.2	33.3	65.3
2001	0.1	32.0	67.7
2002	0.1	33.6	66.6
Korea			
1985	12.6	41.0	46.5
1995	6.2	43.2	50.6
2001	4.3	42.0	43.7
2002	4.0	40.9	55.1
Thailand			
1985	15.8	31.8	52.3
1995	11.0	39.3	49.7
2001	10.4	40.7	48.9
2002	9.0	42.5	48.5
Sri Lanka			
1985	24.4	26.8	48.8
1995	18.7	28.1	53.1
2001	20.1	26.8	53.1
2002	20.1	26.3	53.6
Malaysia			
1985	---	---	---
1995	12.9	41.4	47.9
2001	8.5	49.1	47.3
2002	9.1	48.3	46.4

Source: Asian Development Bank, Key Economic Indicators 2003.

The data on the share of services in the GDP of China, the country inhabited by nearly one-quarter of the human population, shows that:

- from 1978 till 2002, the share of services in GDP grew from 21.4% to 33.7%;
- in the same period, the number of the employed in service industries increased from 48.9 to 210.9 million;
- according to forecasts, service sector in India will provide 40% of total employment in the cities.

According to the 2003 data, service sector generated 51% of the GDP, while viewed from 1950 to date, the share of services in the creation of Indian GDP amounted to:

Table 4.

Year	Share of services in the GDP of India (%)
1950	28%
1980	38%
1990	41%
2000	49%
2003	51%

Source: J. Gordon, P. Gupta: Understanding India's Services Revolution, WP 04/171 International Monetary Fund, September 2004.

The above trends, as a general rule, apply to all countries so that even the developing ones can count on significant changes in the structure of value creation and providing employment in favour of the service sector in economy (see Table 5).

.....128 The global share averages of individual sectors in GDP generation depending on development levels of each country:

Table 5.

development level	agriculture	industry	services
low	24	32	45
low medium	12	40	48
high medium	7	33	60
high	2	29	70

Source: World Bank's Developments Indicators 2003, Table 4.2.

GDP structure in Serbia

When considering the share of services in the GDP of Serbia, the data points to “servicisation” of its economy, in keeping with global trends (see Table 6)

Table 6.

Year	% share of services in GDP
2002	49.7
2003	50.5
2004	49.6
2005	51.4
2006	52.9
2007	54.5
2008	55.4

Serbia's gross domestic product, as the most important economic aggregate, i.e. the indicator of total economic activities, expressed in constant prices from 2002, shows a fall of 2.9% in comparison with the previous year. However, some of service activities did show a certain level of growth, including:

- traffic, storage and logistics (excluding traffic, which showed a decline of 14.9%)
- financial mediation
- the state

However, there are also service activities that have recorded a decline, such as

- retailing (11.7%)
- wholesale (4.1%)
- hospitality (10.2)%

The highest growth rate – as much as 28.5% – in the service sector was recorded in telecommunications.

Generating value in service sector

The history of service expansion is undoubtedly based on the pre-history of value generated in the primary sector, and subsequently in the industrial sector. Contemporary service sector, however, is undoubtedly an autonomous value generator.

In addition to being dominant in the value creation processes, services significantly contribute to expanding and activating the value creation range. In the theory dealing with services, a lot of space is devoted to value creation models, which can be applied by service companies. Four such models are in circulation: value extraction, value addition, value appropriation; value creation.

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The value extraction model is based on the assumption that the revenue side is kept constant, which is not a major problem in the service processes. The expenditure side of business is impacted accordingly, in terms of its reduction. This primarily implies involving the service users in the process, which is supposed to reduce costs.

Value addition model is characterised by the fact that it is based on its impact on the revenue side of service business. This implies introducing a new feature of a product or service that the users are willing to pay for. If, in financial terms, this willingness of the user can exceed additional expenditure, the value of the service is added.

Value appropriation model is based on: the logic of retaining information related to the revenue side of service business, transaction or consumer; separating these consumers from sources or users; their transformation into value. Numerous service companies have recently been using this model in their operation, especially the so-called info-mediators.

The value creation model implies a synergetic interaction of a larger number of computerised network members, with the present input of each member. Value is created by commutation principles, and is higher than the sum of individual inputs.

The ability of service sector to be more flexible and faster than the industrial sector in using various value creation models can provide at least a part of the explanation for the relative expansion of services in all national economies. Service providers can create an entirely new service almost any time and in a relatively short period of time, and thus exceed that the users' or clients' expectations.

The employees' role in the service value creation process is entirely different than in the case of tangible products. Service is not personalised only from the user's point of view, but from the provider's as well. It is, therefore, generally easy to replace an anonymous industrial worker, but it is hard to find the right substitute for a service provider to whom the users of the given service are accustomed.

The growth in income, especially discretionary, is reflected variously on the demand for services and material products. At the higher income levels, especially discretionary, income elasticity of demand for services is high, much higher than in the case of material products, and price elasticity of demand for services is relatively low. Generally, unlike industrial sector, service sector has a wider range of available value creation methods.

Functioning of the service sector in the periods of economic crises

It is a well-known fact that great economic crises tend to be mostly crises of demand, i.e. insufficient demand in terms of absorption of the potential output of an economic system. According to crisis theoreticians, employment rate growth is only possible by stimulating effective demand, i.e. finding ways of increasing demand. In this, the inclination of those who have at their disposal sufficient discretionary revenue to save this revenue should be transformed into a tendency to invest, or into personal expenditure. In other words, to strengthen effective demand.

Starting from the above assumptions, one may ask what service sector should do. Firstly, flexibility and relatively low investment demands of the service sector enable a fast creation of new offer, which, in turn, stimulates demand on the macro level, or at least reduces its decline. A fact effectuation of demand for services contributes to employment – directly, when one speaks of the service sector as labour intensive, and indirectly, by generating additional demand through the wages and salaries of those employed in the service sector.

In addition to corporate technological flexibility, low investment demands, speed of innovation, low barriers for entering the offer, the speed of return on investment, the anti-crisis potential of the service sector should also be strengthened and promoted in order to attract investors with available discretionary revenue.

The state's fiscal intervention in times of crises can also be of such nature as to encourage effective demand on the macro level. This is important, because it can use the flexibility of the service sector, especially, the section that is fully or partly alimented from the national budget.

The development and growth of service activities reflects positively on the cyclical movements in economy. In periods of recession, when the number of jobs in the production sector is reduced, services show higher employment rates. This is an indicator of consumer behaviour and their willingness to postpone the purchase of some products, but will not give up certain services, such as education, telephone, banking, health, security, public utilities etc.

There are several factors that may explain the resistant nature of services to crises. Firstly, it is impossible to make an inventory of services, as it is done with products stored in warehouses. When it comes to services, the consumption, use, or provision itself occur simultaneously. On the other hand, demand for services tends to be more stable than for material products.

Many services continue to survive in the conditions of economic crises. So, for example, health care providers tend to have a sufficient workload in any situation and cannot lay off the employees. Profits in real estate trade decline in most cases, as well as in insurance and safety services.

Just like consumers, companies postpone large purchases in times of recession, using the existing equipment and appliances. This leads to a decline in sales in both wholesale and retail trade. However, it is such circumstances, i.e. postponed purchases, that contribute to the growth in maintenance and repair activities, creating new jobs in these activities.

CONCLUSION

Rather than being activities of marginal interest, services comprise an integral part of modern societies, essential for the functioning of economy, and situated in its centre. The service sector not only facilitates but also enables the activities necessary for the production of commodities in the extractive and industrial sectors.

For the past decades, the service sector has been the source of economic leadership. In the most developed countries, service activities account for more than 70% of the GDP structure. Their growth rate does not slow down, and a dramatic rise is recorded in services related to the elderly population (for example, health care and accommodation), as well as those that serve the needs of families with both spouses employed (such as day care centres).

Agriculture and well as industry, as the driving-wheels of global economic progress, have surrendered their primacy to services in generating value and employment.

Due to their potential in generating value, services have also become the dominant area of foreign direct investment. Value generation in the service sector includes various models. Unlike industrial sector, services have a wide range of value generation methods at their disposal. Service activities also have a substantial anti-crisis potential, manifested through their business and technological flexibility, low investment requirements, fast innovation rates, shorter return on investment period, etc.

Service operations are a characteristic of the economic structure of a rich society, but a given business may also be treated as a prerequisite of transition to a rich society. Its flexibility and speed in value creation, as well as its adaptability to various value creation methods, make it, even in the developing countries, an economic development factor that must not be neglected.

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INVESTMENTS AND ECONOMIC DEVELOPMENT IN THE COUNTRIES OF SOUTHERN AND EASTERN EUROPE AND THE CRISES

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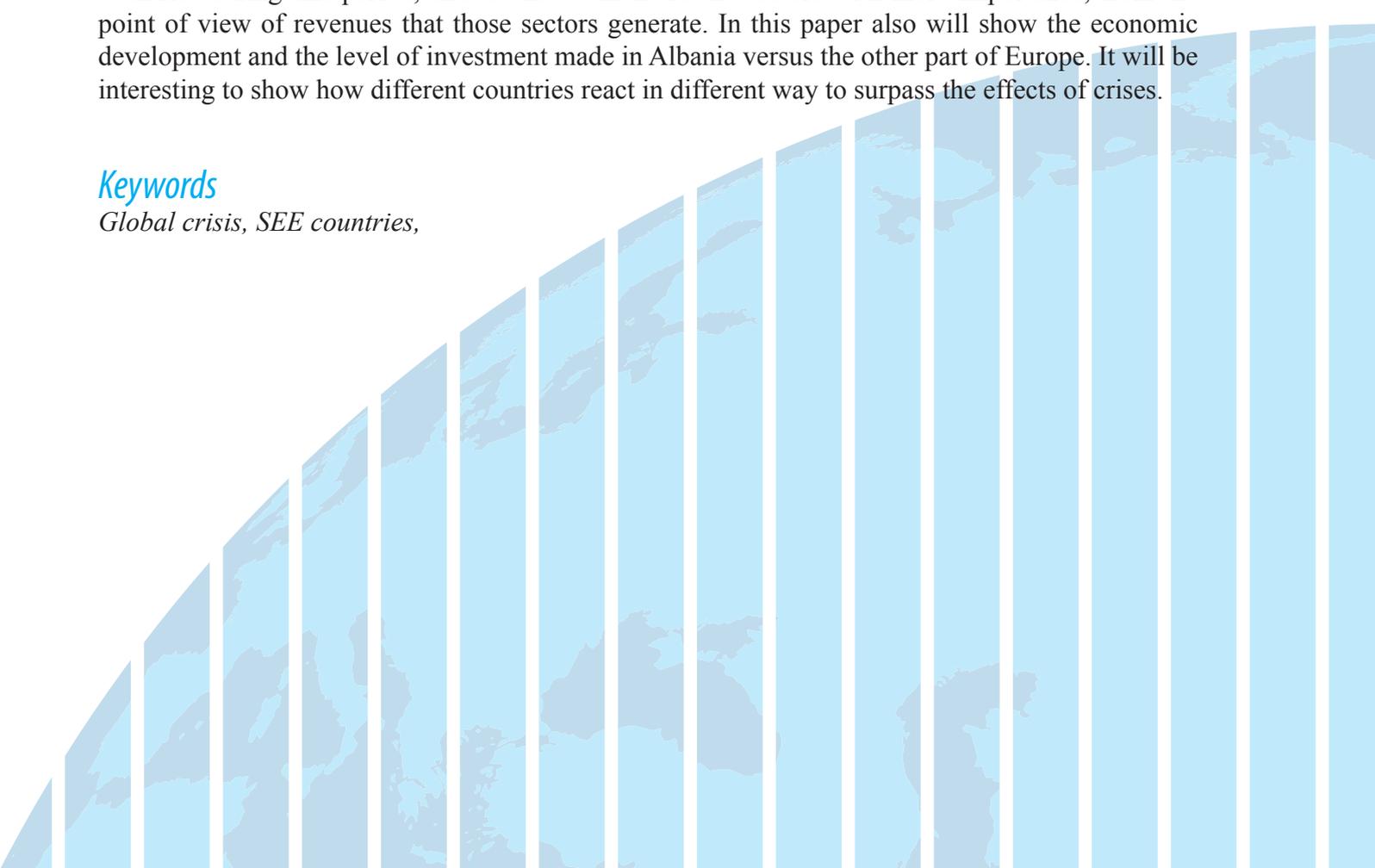
ABSTRACT

South Eastern European economies are facing the challenge of catching up with the enlarged EU countries. The main aim of this paper is to show how much the economy of these countries has changed, especially during the financial crises. Also to show which investment are made in these countries during this period, and to show which are the sectors with more importance, from the point of view of revenues that those sectors generate. In this paper also will show the economic development and the level of investment made in Albania versus the other part of Europe. It will be interesting to show how different countries react in different way to surpass the effects of crises.

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Keywords

Global crisis, SEE countries,



INTRODUCTION

During the past decade, South-Eastern Europe (SEE) has undergone a dramatic transformation. The extent of the progress in economic development, democratic reforms, regional cooperation, and integration into global economic and financial markets was extraordinary even 10 years ago and is unexampled in the region's modern history. But 2009 has proved to be a difficult year for all Balkan countries. The financial crisis that began to affect western markets in the second half of 2007 took a while to be felt in SEE, but by the fourth quarter of 2008 it was clear that this region would also face a major economic downfall. As of early February 2010, there are signs that output is stabilizing. Cautious optimism is being expressed that the worst is over. However, few people expect to see the high growth rates of recent years returning soon. This paper shows how the crisis has evolved in the region and why it was affected by developments that originated elsewhere.

Most people were totally unprepared for what happened, but despite this, the reaction both of governments and of businesses and workers has been generally mature and appropriate to the circumstances. The countries of South East Europe (SEE) have seen strong growth in their economies over the past few years. In 2007, growth in gross domestic product (GDP) in the region reached 6.3%. Political and economic risk in the region subsided, as witnessed by improved credit ratings from the three big credit rating agencies and increased foreign direct investment (FDI) inflows. In 2007, regional unemployment reached its lowest level since 1992 and GDP per capita climbed to USD 5,300. However, the current global economic crisis, prognostic as the worst since the 1930s, creates severe challenges for economic growth in South East Europe countries. What began as a banking crisis in the West has turned into a general financial and economic crisis, exported to regions the world over. Although it is too early to fully analyze the impact of the crisis, data from late last year and the early months of 2009 indicate that it has spread to SEE.

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This paper aims to take control of the current situation and examine the measures adopted by governments and the central banks to facilitate the effects of the crisis. The paper closes with a series of conclusions dealing with the actual situation and with some forecast for the future of these countries, members of South East Europe.

The crisis and South East Europe

The origins of the global economic crisis are by now well-known. They can be traced back primarily to an unsustainable credit and housing boom in the United States. The problems in the United States and some other large economies, notably the United Kingdom, became evident in the second half of 2007, and the situation in the leading industrialized economies aggravation rapidly in 2008. The United States entered recession in the fourth quarter of 2007 and the UK (the fourth quarter of 2008), France (the first quarter of 2009), Germany (the third quarter of 2008) and Japan (the second quarter of 2008) were all in recession by early 2009.

Often described as an “imported” crisis, because its origins flow out from countries in Western Europe and North America, the global downturn is affecting South East Europe. Due to falling demand from key EU trade partners, the region's exports are declining. This has fed through to lower industrial production, aggravated by reduced private consumption as remittances sink and growth in private credit has come to a standstill.

By mid-2008 it was clear that the shocks to the global financial system were of a type and magnitude that had not been seen since the Great Depression of the 1930s. At this time, however, the economies of SEE continued to boom. Throughout the first eight months or so of 2008 there was a feeling that SEE would be able to escape the worst of the contagion from the crisis. Businesses and governments

were still optimistic, after several years of strong growth combined with macroeconomic stability, increasing investment and a sense that the region was on the right path towards integration into the European Union. In fact the main macroeconomic concern in many SEE countries in mid-2008 was not that the global crisis would flow into their countries, but rather how to stop inflation, which had started to raise sharply, mainly because of high oil and commodity prices the situation started to change noticeably in September 2008. The collapse or nationalization of several major financial institutions in the US – Lehman Brothers, AIG, Fannie May and Freddie Mac – caused such disorder in the world economy that everyone realized there would be terrible consequences around the globe, and that no country would be escaped. Nevertheless, the prevailing wisdom of the time was that there would be a significant slow-down of growth in SEE in late-2008 and 2009, but that the figures would remain in positive territory in all cases.

Table 1 compare the forecasts for GDP growth in 2009 from the October 2008 IMF World Economic Outlook (WEO) with those from the October 2009 WEO. The difference is staggering; a minimum of 7.5 percentage points (FYR Macedonia, where 5 per cent growth in 2009 was projected a year ago, compared with the current projection of minus 2.5 per cent), and more than 13 percentage points in the case of Romania (4.8 per cent growth forecast a year ago versus an 8.5 per cent drop projected in October this year).

Table 1.

GDP forecast 2009 - IMF World Economic Outlook Report October 2008 vs. October 2009		
IMF		
	Oct 08	Oct 09
Albania	6.3	0.7
Bosnia and Herzegovina	5.0	-3
Bulgaria	4.2	-6.5
Croatia	3.7	-5.2
FYR Macedonia	5	-2.5
Montenegro	5	-4
Romania	4.8	-8.5
Serbia	6	-4

The drop in economic activity has had a significant impact on other macroeconomic variables, such as inflation, government deficits, and current account deficits. It is also expected to have a serious negative effect on unemployment and poverty in the forthcoming months, raising the possibility of social unrest.

HOW DID THE MAIN SECTORS OF SOUTH-EAST EUROPE REACT TO MINIMIZE THE NEGATIVE EFFECT FROM FINANCIAL CRISIS?

The global financial crisis took time to reach South East Europe, but by the first quarter of 2009 a strong impact had become evident. Already both Romania and Serbia have adopted IMF-supported economic programmes, and other countries are experiencing economic and financial stress. The shocks through conventional procedures, such as trade and remittances, are now being amplified through capital market linkages, as it becomes harder to roll-over external financing.

The region had really taken off in the past decade. It has had a number of years of high growth, low inflation, and record inflows of foreign direct investment (FDI). So when the global crisis hit in 2007, initially there was a feeling that south-eastern Europe wouldn't be so badly affected. But we all – the countries involved and outside commentators – underestimated the extent to which this region would be affected by the crisis. By the end of 2008, it was clear that south-eastern Europe was going to experience a big shock. And that is what happened.

Governments

Throughout the region, professionally managed central banks have introduced sensible monitoring policies to mitigate the worst effects of the crisis. Governments throughout the region faced an immediate dilemma: spend less to offset shrinking tax revenues and risk cutting domestic demand even further, or spend more and risk crowding out private investment and possible credit rating downgrades. But, unlike in the United States and other large western countries, governments in SEE had no obvious means to finance such a deficit-spending programme. During 2009, only Croatia in this region tapped international capital markets to any great extent, doing so in May and October 2009 and raising a total of nearly €2 billion. For others, this was not an option. As a result, most governments announced various fiscal programmes that appeared to be expansionary but in reality have had little impact on the actual economy. For example Romania, where the government announced in February 2009 a €13 billion stimulus package to help counteract the worst effects of the crisis. The idea was to earmark most of it (more than €10 billion) for infrastructure projects. ***So far, As a result, most governments announced various fiscal programmes that appeared to be expansionary but in reality have had little impact on the actual economy.*** So far, An EBRD loan to the deposit insurance agency in Bosnia and Herzegovina, signed in January 2010, will enable the level of coverage to be raised to around €25,000. The “stimulus” has been more imaginary than real; few projects have got off the ground and the effect on economic growth has been negligible. Other countries have tried tax breaks to stimulate businesses. Serbia launched a package in February 2009 which included investment loans at subsidized rates to businesses, as well as consumer loans for the purchase of Serbian goods. In a similar vein, the FYR Macedonian and Montenegrin governments have tried to reduce the tax burden by selective cuts for businesses and households, while in Bosnia and Herzegovina; a targeted programme for the less well-off involved the exemption of certain essential goods from VAT. All of these measures have brought some relief here and there, but they cannot be said to constitute a coherent anti-crisis approach.

Collapsing revenues and limited access to new borrowing therefore forced most governments to reduce spending. In Croatia, where government spending (as a percentage of GDP) is among the highest in the region, the government played a kind of catch-up game last year, revising the 2009 budget three times, with each revision accompanied by further spending cuts and a downward revision of the GDP growth forecast. Those countries that have IMF programmes – Bosnia and Herzegovina, Romania and Serbia – have found the Fund surprisingly lenient (compared with its traditional approach) in accepting relatively substantial government deficits last year, and (in the case of Romania and Serbia) in agreeing to an upward revision of the deficit target for 2009 once the full extent of the economic downturn became clear. But the big fiscal challenges will come this year and beyond. Continued IMF support will depend on serious efforts to place public spending on a sustainable, lower path. In countries that have frequent elections and potentially unstable coalition governments, this will not be easy.

One of the most important steps taken by many governments in the region has been to increase the level of deposit insurance and shore up confidence in the banking system. In the last quarter of 2008, the need for this became absolutely urgent. Several countries were facing a serious loss of confidence in their banking systems, especially Bosnia and Herzegovina and Serbia. In both cases, people have relatively fresh memories of hyper-inflation and of effective confiscation of foreign deposits.

To sum up, governments were right to signal support to their financial systems in late 2008, but had insufficient fiscal means to arrest the crisis and make things easier for firms and households. More encouraging is the fact that they have, almost without exception, avoided the temptation to roll back the structural reforms that have been put in place over the previous two decades. *There has been a significant slow-down in reforms as governments have generally been too distracted with crisis management.*

Businesses

Businesses struggling with the crisis have at times shortened working hours or cut jobs but they haven't been overreacting. At the firm level, the response to the crisis has been broadly as expected. Many enterprises have had to cut back on production and lay off workers. Others have resorted to wage cuts or freezes in an effort to contain costs.

The reaction of ordinary individuals and workers has been perhaps one of the most surprising and encouraging features of the crisis. It is true that there have been some significant protests, but what is perhaps surprising is the scarcity of these events. The biggest worker protest so far was in Romania, which had a major one-day strike in October 2009, when around 800,000 public sector employees protested about government measures to freeze wages and reduce pensions. Other significant protests occurred in Bulgaria in January 2009, involving street rallies; in Serbia in April 2009 when several thousand members of the Sloga independent unions protested in Belgrade against the government's crisis response (or the inadequacy thereof); and more recently in Bosnia and Herzegovina. Since then, unions in Serbia, Croatia and Romania have threatened further strikes, but by early-2010 these had not yet come to pass.

The banking system

The banking system in the region has also proven to be stable and we have seen no big banks fail. In general, central banks throughout the region have reacted sensibly and effectively to the crisis, albeit in different ways. This reflects the fact that, over the past decade, all central banks in the region have built up a reputation for independence, competence and professionalism, qualities that are often lacking in other public sector institutions. *But once the crisis entered into full swing, the central banks generally played an important calming and mitigating role. The tools available to central banks in SEE are limited.* Most can set a key policy rate (usually some kind of short-term repo rate), which in turn affects interest rates elsewhere in the economy; they can vary the reserve requirement rate (with differential rates depending on the denomination and maturity of the deposit); and they can use foreign reserves to intervene on the foreign exchange market to defend the currency. Central banks have used a combination of these policies at some stage in the past 12 months. The biggest reduction in the policy rate has been in Serbia, where the two-week repo rate has been lowered by a cumulative 825 basis points since January 2009, to a rate of 9.5 per cent as of early-February 2010. Inflationary pressures tend to be higher in Serbia than in other countries of the region, and memories of high or even hyper-inflation are still strong. Therefore, the central bank had aggressively raised interest rates during the boom times in an effort to keep a lid on inflation and credit growth. The recession has allowed this policy to be reversed, while still keeping inflation on a downward path. A similar pattern emerged in Romania, although the extent of the reduction was smaller: 325 basis points (down to 7 per cent as of early-February 2010) since the start of 2009. Significant policy rate cuts have also occurred in Albania and Bulgaria. In Croatia and FYR Macedonia, in contrast, the central banks have been reluctant so far to cut policy rates as a crisis response, reflecting a different approach to exchange rate policy. In fact, the move has so far been in the other direction: The Croatia central bank raised the key policy rate from 4.5 per cent to 9.0 per cent in November 2008 as part of its efforts to defend the (relatively) hard currency peg. In FYR Macedonia, which has an even harder

peg, the policy rate was raised in March 2009 from 7 to 9 per cent (subsequently cut to 8 per cent in January 2010). This tool is not available in Bosnia and Herzegovina, which has a strict currency board, or in Montenegro which has unilaterally adopted the euro. ***All countries (except Albania and FYR Macedonia) have lowered the mandatory reserve requirement at some point in the past year, in an effort to ease liquidity and encourage banks to keep lending, or at least to cut lending by less.*** There is still wide heterogeneity in the region in reserve requirements. In Bulgaria for example, minimum reserve requirements on funds attracted by banks from abroad were reduced from 10 to 5 per cent in January 2009, while those on government deposits were eliminated. In neighboring Romania, in contrast, reserve requirements on foreign currency-denominated liabilities have come down progressively from an initial rate of 40 per cent to 25 per cent as of early-February 2010 (those on local currency liabilities are 15 per cent). The overall direction is therefore clear: central banks at present are primarily concerned about getting lending to the real economy, and they recognize that excessive reserve requirements can hinder this process.

As already mentioned, there have been large differences in exchange rate policy within the region, ranging from managed floats (Albania, Romania and Serbia – with Romania and Serbia allowing significant depreciation of their currencies in 2008 and early 2009) to pegs (or near-pegs) in the case of Croatia and FYR Macedonia, currency boards in Bosnia and Herzegovina and Bulgaria, and unilateral eurosation in the case of Montenegro. But despite the differences, one common thread has run through exchange rate policies since the early 1990s. All countries recognize the value of exchange rate stability and are prepared in most circumstances to intervene in the foreign exchange market to prevent excessive fluctuations (the obvious exception being Montenegro where there is no local currency to defend).

The impact of the crisis differs from one country to the other. For example, Albania seems to have escaped the crisis relatively unscathed and managed to record positive growth in 2009. On the other hand, Romania, the largest economy in south-eastern Europe, was quite severely hit by the crisis and recorded a GDP fall of more than 7 per cent. Although there have been differences among countries, there is a general recognition that governments had limited room for maneuver. They were not in the position of having massive deficit-financed packages of the US or the UK type but they received support from the IMF, the EBRD, the EIB and the World Bank, all of which stepped up investments and assistance to the region to help it overcome the crisis.

The support of International Organizations to South-East European countries

The support of IMF is present in countries such as Serbia, Romania and Bosnia and Herzegovina with formal programmers. Romania for example received a combined package of €20 billion from the IMF (International Monetary Foundation), the EU (European Union), the EBRD (European Bank) and the World Bank. This was a very strong signal by the international community in support of the one country in south-eastern Europe that was perhaps the most affected. It is important to note that IMF support has been combined with a major new initiative known as the Vienna Initiative. It is unique first-time cooperation among international financial institutions, including the IMF, the EBRD, the World Bank and the home central banks, the host central banks and foreign banks with subsidiaries in the region.

By signaling support for the region, participants in the initiative are assuring investors that they believe that sensible macroeconomic policies will be carried out, in the context of IMF-supported programmers. Most importantly, private banks are signaling their long-term commitment by maintaining levels of exposure and support for their subsidiaries in the region. This wide cooperation is the best explanation of why there has not been a real banking crisis in south-eastern Europe countries.

ECONOMIC SITUATION OF SOUTH-EAST EUROPE COUNTRIES, DURING THE CRISIS

The past year has brought out clearly the extent to which SEE is now part of the global economy. While this integration process has brought enormous benefits to the region in the past decade, the downside is that crises that originate elsewhere will affect the region, no matter what actions are taken to mitigate these effects. In the case of SEE, the fall in output has numerous causes. Three explanations stand out as particularly important.

- 1. External demand from the main export markets has dropped sharply, especially for some key commodities that are now produced in the region.*
- 2. Access to finance became much more difficult or expensive, which is a serious impediment to the operation of businesses in the region.*
- 3. The volume of remittances has fallen slightly, which in turn is depressing domestic demand as well as hindering the development of small businesses.*

In the first half of 2008, most countries had exports growing at around 30-40 per cent year-on-year. After September 2008, demand from abroad dried up and exports collapsed, to a level where year-on-year growth was close to, or even worse than, *minus* 40 per cent by early 2009. As with the other high-frequency series cited earlier, there are now signs of stabilization, with the possible exception of Croatia (though this may be a base effect, given exceptionally rapid growth a year earlier). In order to get a better understanding of why exports have dropped, it is important to know *what* countries are exporting, and *where* the exports are going to. Virtually all countries in the region have had four or more years in a row of a credit boom, defined as annual growth in total credit to the economy by more than two percentage points of GDP (for evidence on this, see the EBRD *Transition Report 2009*, Chapter 3). The most extreme example is Montenegro, where credit growth at one point was close to 200 per cent (year-on-year). The effects of this growth could be seen in various ways. Many small and medium-sized businesses thrived as they accessed loans at reasonable rates, perhaps for the first time in their existence. Households increasingly enjoyed the new capability of buying (mostly imported) consumer items, as well as taking on mortgages to purchase property. A property boom became noticeable in some of the main cities of the region – Bucharest, Belgrade and Sofia – as well as in tourist-oriented coastal areas in Bulgaria, Croatia and Montenegro. The macroeconomic figures show how bad the situation has become, but it is important to mention some things that could have happened, and might even (based on the experience of previous crises) have been expected to happen, but did not.

- First, there has been no failure of a major bank, and no uncontrolled devaluation of pegged (or near-pegged) currencies.* Among the floating currencies, the Romanian RON and the Serbian dinar both depreciated fairly sharply in late-2008 and early-2009, but then stabilized (although the dinar has come under seasonal pressure again in early-2010).
- Second, there has been no breakdown of social order and no dramatic rise in unemployment, although the latter is rising throughout the region and will continue to do so even as economies return to growth.*
- And third, there has been no major backtracking in reform.*

For central banks, the crisis entailed a major reversal in thinking. Having become accustomed to worrying and warning about excessive credit growth and its inflationary impact, suddenly they had to deal with a possibly precipitous drop in credit, perhaps combined with a loss of confidence in the

banking system. Meanwhile businesses wondered what to do about falling demand – should they cut back production and lay off workers immediately, or would it be better to retain people and hope that things would improve in the near future? And for the population at large, the crisis came at a time when people were already less than happy with their lot. The economic downturn could have been an excuse for further discontent and even social protest.

Analysis of statistical figures in main sectors hit by the crisis

Trade Sector

Export growth in SEE has slowed considerably as its main trading partners in the EU and other important regional markets experience recession. Total trade with the EU-25 in January was almost 40% lower than its peak in July 2008 (Figure 1). Trade with the EU picked up slightly in February, although it was still 13% lower than trade in February 2008. Particularly hard hit have been the manufacturing and chemicals categories, which were both about one-third lower than the levels recorded in February 2008. Between July 2008 and February 2009 chemical exports from SEE to the EU fell at an average monthly rate of about 7%, while manufacturing exports fell on average 5% per month. Trade in construction-related materials, especially glass and metals, has dropped, and there have also been marked declines in exports of ready-made apparel, furniture and transport equipment, all important export industries for many SEE countries.

Figure 1. Total SEE exports to EU-25



Source: Eurostat

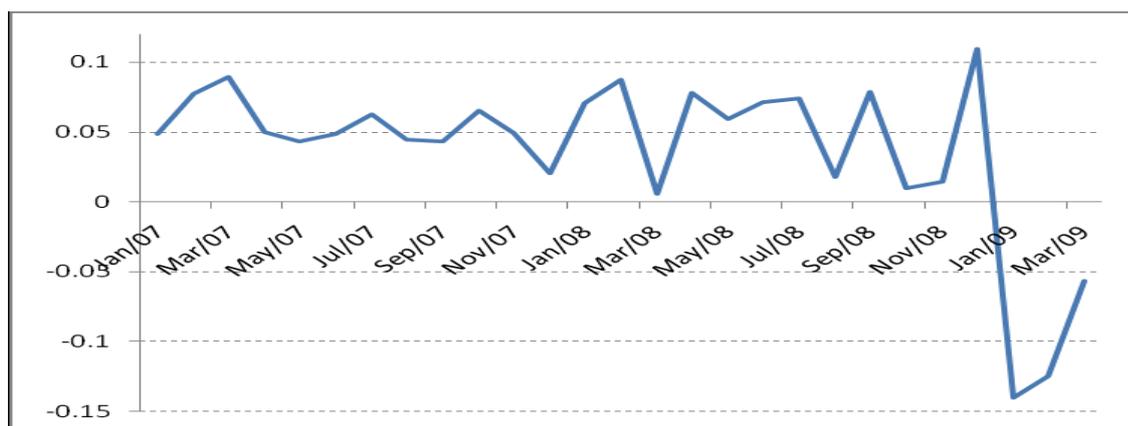
Albania’s export contracted in late 2008 and early 2009 due largely to reduced demand in its largest trading partners: Italy, Greece and Germany. Bosnia and Herzegovina suffered from the collapse in commodity prices, especially for steel and aluminum. Croatian exports have also struggled, particularly in the face of the real effective appreciation of the kuna relative to the euro in 2008. In the Former Yugoslav Republic of Macedonia, merchandise exports declined by 32.2% year on year as of February 2009, largely because of lower demand for its main export products – metals and textiles. Although year on year exports in all SEE economies except Kosovo under UNSCR 1244 registered declines in February 2009, all SEE countries except the Former Yugoslav republic of Macedonia saw trade growth pick up between January and February 2009, and Bulgaria and Romania which have published export statistics up until March 2009 indicate exports grew during that month as well by 21% and 23% month on month, respectively. However, data for Croatia up until April indicates continued declining exports – month on month growth rates of -10% in March and -3% in April.

Industrial production Sector

In almost all countries for which data are available, industrial production declined substantially in 2008 and early 2009. Growth in industrial production peaked in the first half of 2008. Average month on month growth was 6%. However, in growth from August to November slowed to about 3%. In some countries, in particular sectors, the decline in production was still more pronounced. For example, declining prices and reduced global demand resulted in a 50% month-on-month plunge in the mining of metal ores in the Federation of Bosnia and Herzegovina in December. Production cuts have already been announced by the country's main steel producer, Arcelor Mittal. Although production in mining has since increased slightly, manufacturing output contracted by 10.7% year on year. In Bulgaria, output of basic and fabricated metals fell by 16% in November, while the manufacture of basic metals fell by 58% for 2008 as a whole. At the end of 2008, low copper prices forced the suspension of operations at the Macedonian copper mine in Buchim. And in Montenegro, production in the mining and quarrying industry declined by 57% in December, while production has stopped at the country's main aluminum factory. However, as was the case in trade, it appears that industrial production is decreasing at a slower rate, particularly in the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina), Croatia, the Former Yugoslav Republic of Macedonia and Romania.

Figure 2. Industrial production
Percentage change year-on-year

1. Data are a simple average for Bulgaria, the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina), Republika Srpska (Bosnia and Herzegovina), Croatia, Moldova, Montenegro, the Former Yugoslav Republic of Macedonia and Romania.

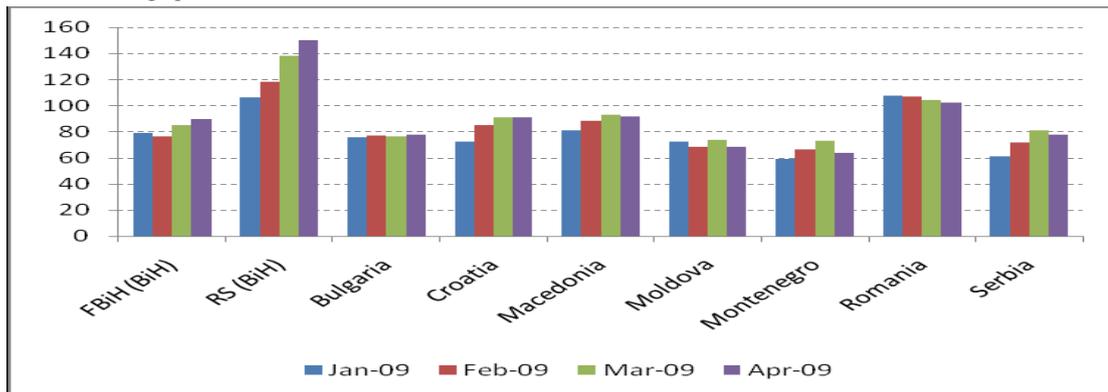


Source : EIU and SEE national statistics agencies

However, it is not only the mining and metals industries that saw sharp production declines toward the end of 2008. Export-oriented manufacturing industries have suffered as demand from the euro zone flattened. Textiles and clothing, motor vehicles and machinery and equipment production were all affected. Romania, for example, experienced a major contraction in the production of transportation equipment. In Montenegro, manufacturing production declined starting in October, and in December was at its lowest since January 2004. However, since early 2009 industrial production has increased in almost all countries.⁴ Manufacturing output in the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina) increased by 13% month on month in April and it rose by 50% year on year in the Bosnia and Herzegovina.

Figure 3. Manufacturing production indices

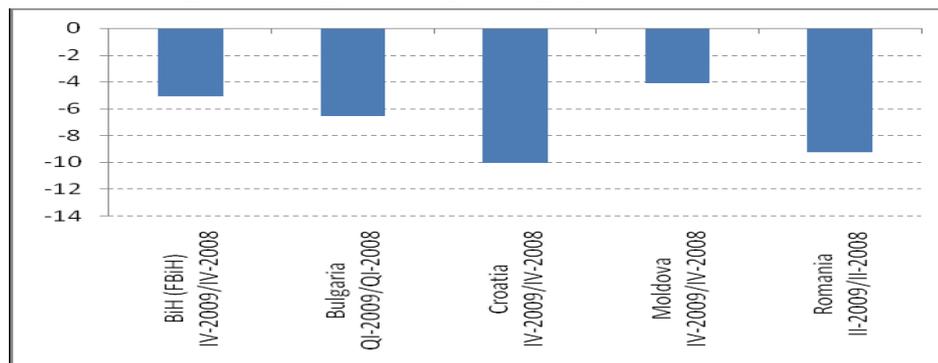
2. Indices compare production to production in the same month one year previously with the exception of Serbia, which compares production to the average production of 2008.



Source : SEE national statistics agencies

Private consumption

Domestic consumer spending and private consumption have fallen throughout the region due to weakened consumer confidence. In all economies where data were available, retail trade was consistently lower than in the same period one year previously (see Figure 4). Croatia had the largest decrease: in real terms, retail trade turnover in January 2009 was only 86.3% of that in January 2008 and continued to fall through February, before growing by 13.6% month on month in March.



The Bulgarian National Statistical Institute indicator of retail sector confidence has declined steadily since late 2008, reflecting managers' grim assessment of future business prospects. In May many managers cited the "uncertain economic environment" and "financial problems" as the reason for their negative outlook. In Romania, the decline in retail trade was particularly evident in the sales of motor vehicles. In April, total motor vehicle and parts sales were down by 32% from April 2008 and sales of cars are down by over 33%.

In Moldova, growth in private consumption has declined from 8% in the first three quarters of 2008 to only 4.5% for the entire year. Remittances have been an important factor stimulating domestic consumption in Moldova and throughout SEE, and part of the decline in private consumption can be explained by reduced inflows of remittances. Remittance inflows, while generally less volatile in the face of external shocks than some other economic indicators, have started to decline in SEE. It appears that net current transfers⁵ (which include remittance flows) in SEE peaked in the third quarter of 2008 but then fell over 23% in the fourth quarter (see Figure 5). Current transfers fell between the third and fourth quarter for all countries except Montenegro, where they grew by 3%, and Serbia. In Bosnia and Herzegovina current transfers fell by 28%, in Croatia by 11%, in Moldova by 7%, and in Romania by 44%. Bulgaria and the Former Yugoslav Republic had the biggest fall in current transfers, by 38% and 46% month on month, respectively. Current transfers in Serbia did increase between the third and fourth quarters but they fell back again slightly in the first quarter of 2009.

Figure 5. Net current transfers



Source : SEE central banks; Data are for Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, the Former Yugoslav Republic of Macedonia, Montenegro, Romania and Serbia. 5 . Current transfers include worker remittance flows, donations and gifts (e.g. international aid), etc. As disaggregated data on remittances are not available in many SEE countries, current transfer data are used as a proxy.

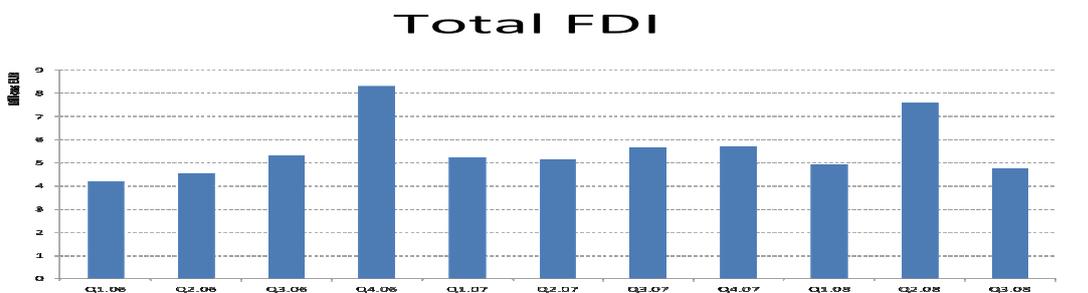
6. Data include Albania, Bosnia and Herzegovina, Bulgaria Croatia, the Former Yugoslav Republic of Macedonia, Moldova and Montenegro. 8

Foreign Direct Investment

Although it is probably too early to fully analyze the impact the crisis is having on FDI inflows, the data for the second half of 2008 and early 2009 point to a decline. After reaching a record high of EUR 7.6 billion in total net foreign direct investment in SEE, FDI dropped off in the third quarter dramatically. Net FDI in the third quarter was EUR 4.8 billion, 37% lower than in the second quarter (see Figure 6). The trend continued in the fourth quarter, where FDI inflows fell by another 6%. In Bulgaria, the Former Yugoslav Republic of Macedonia, Montenegro and Romania, data on the fourth quarter indicate a continuation of the downward trend: FDI in those countries fell by 36%, 20%, 12% and 9%, respectively compared to the third quarter of 2008. FDI surged again during the fourth quarter in Albania, Croatia and Serbia, however fourth quarter data often increase due to statistical reclassification of previous inflows. While quarterly data on FDI are not available for Kosovo under UNSCR 1244, it displays a similar situation: FDI in 2008 was EUR 3.6 million, 15% lower than the 2007 inflows.

Figure 6. Total FDI in SEE

0123456789 Q1.06 Q2.06 Q3.06 Q4.06 Q1.07 Q2.07 Q3.07 Q4.07 Q1.08 Q2.08 Q3.08 Q4.08 Billions EUR



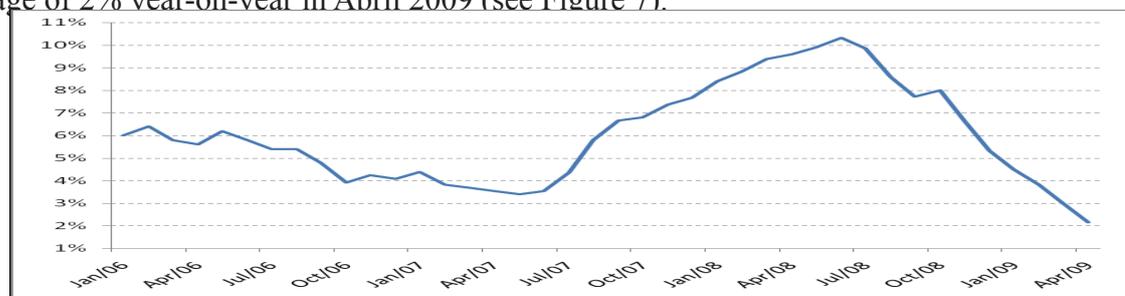
Data are for Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Montenegro, Romania and Serbia.

Source: SEE central banks.



Inflation

Since the middle of 2007 most SEE countries experienced higher rates of inflation, averaging 10% in May 2008, reflecting increases in the international price of oil and surging food prices. However, the fall in world energy prices, the decline in food prices and the slowdown in consumer consumption have served to weaken inflationary pressures in all countries. Growth in consumer prices fell to an average of 2% year-on-year in April 2009 (see Figure 7).



Data are a simple average for Albania (quarterly data until third quarter 2008), Bulgaria, Bosnia and Herzegovina, Croatia, Moldova, Montenegro, the Former Yugoslav Republic of Macedonia and Romania.

Source : EIU, SEE national statistics agencies

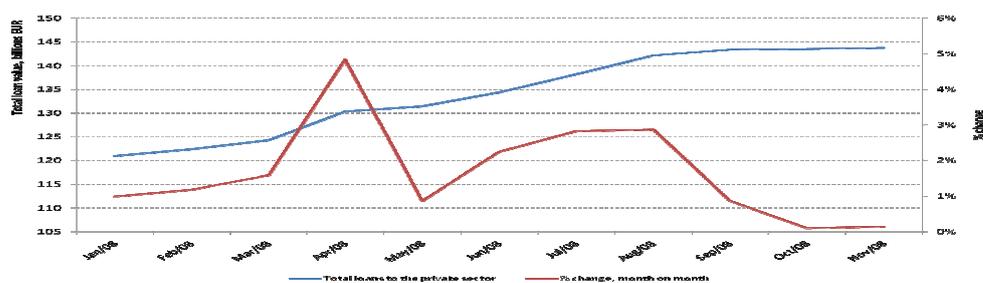
144 In Bulgaria, average consumer prices increased by 12% in 2008 and price increases reached 15% in May through June before falling back to 5% in April. In Croatia, consumer prices peaked at 8.4% in July but then came down to 2.9% in December 2008, the lowest level of inflation for 16 months, although growth as since increased to 4% in April 2009. In Moldova, prices reached 17.1% in May but fell significantly to 1% in March 2009 and actually decreased by 3% in April 2009. Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Romania have also seen falls in consumer price inflation. However, in Romania the fall has been more gradual due to the recent depreciation of the leu.

Lending

The first half of 2008 and the two previous years were characterized by rapid growth in lending by commercial banks. However, commercial lending has stagnated and even declined in some countries with the onset of the financial crisis (see Figure 8). In all countries, growth in credit in the last monthly period for which data were available was less than 1%, with the exception of Moldova, where total loans to the private sector actually increased by 10% between January and February. In many countries credit growth was negative. Indeed, this contraction of credit is expected to be particularly painful for SEE, as buoyant credit conditions have for some time supported growth in the region.

In Albania, total loans to the private sector declined by 0.5% in December, and the IMF predicts further credit contraction. In November, in Bulgaria, the banking sector only disbursed BGN 900 million in loans, the lowest level in over two years. In the first half of 2008, the commercial banking sector made average monthly loans of BGN 2-2.5 billion (EIU, 2009). Lending controls implemented by the Croatian National Bank have served to reduce earlier credit growth in that country (EIU, 2009).

Loans to the private sector



Data include loans to the business and household sectors.
Source: SEE central banks.



Data include loans to the business and household sectors.

Source : SEE central banks

At the same time, average lending and deposit rates have pushed upwards. Average lending rates for SEE (excluding Albania, Bosnia and Herzegovina and Kosovo under UNSCR 1244) were almost 16% in February, compared to 13% in January. Deposit rates have also increased, from 6.5% in January 2008 to almost 8% in February 2009 (see Figure 9). In Croatia on January 27 2009 the Zibor interest rate on overnight loans shot up to 25.6%, from 20.4% the previous day. As a result, the Croatian National Bank intervened in a reverse report auction the next day at a fixed interest rate of 6%, bringing the Zibor down to between 5-10% (EIU, 2009). Several central banks have instituted measures to encourage further lending. The Bank of Albania, the National Bank of Moldova, the National Bank of Romania and the National Bank of Serbia have recently cut interest rates. The Central Bank of Bosnia and Herzegovina and the Bulgarian National Bank, constrained in adjusting monetary conditions by their currency Boards, have reduced reserve requirements. Other central banks in the region have taken similar steps.

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Another worry in the banking sector is the stock of foreign-currency debt. Many countries have had relatively stable exchange rates against the euro and other currencies, encouraging their citizens to take advantage of the lower interest rates offered on loans in these currencies. However, recent currency depreciations in many countries serve to increase the domestic currency value of those loans. In Albania, foreign currency loans represented 72% of total loans to the private sector in January 2009, a figure which has remained relatively stable over the past year. Meanwhile, the Albanian lek has depreciated from 122 ALL: EUR in January 2009 to almost 130 ALL: EUR in March 2009. In Moldova, foreign currency loans also represent a significant portion of total lending to the private sector – about 40% in February 2009. However, data from the National Bank of Moldova indicate that foreign currency denominated debt is declining faster than debt in leu, reflecting borrower apprehension about the exchange rate (EIU, 2009). In Romania, households have taken out a large portion of the total stock of foreign currency denominated debt. They have therefore been particularly affected by the recent depreciation of the leu (the leu has appreciated by 15% since March 2008). In December the depreciation of the leu increased the domestic currency value of the stock of household loans denominated in foreign currencies by almost 5%, to ROL 5.8 billion. This occurred despite the fact that over EUR 1 million of the stock of debt was paid down or matured during that period, while growth in new credit was small.

In recent years, despite record tax receipts, few governments in the region have recorded a budget surplus. Bosnia and Herzegovina, Croatia, Moldova and Romania all recorded a budget deficit in 2007 and according to EIU estimates, the Former Yugoslav Republic of Macedonia has probably joined that list for 2008. Only Bulgaria enjoyed a budget surplus, of 3.8% of GDP in 2007, and

an estimated 3% of GDP in 2008. such surpluses can of course be used to expand fiscal stimulus policies, and are particularly important for SEE countries as these are often restricted in borrowing on the private credit market compared to other countries, especially those from the EU.

SOME PRECAUTIONS TAKEN BY THE GOVERNMENTS OF SEE COUNTRIES IN 2008-2009

Monetary policy

Consumer price increases in the first half of 2008, while partly reflecting local economic conditions, were mostly due to the impact of high global food and energy prices. During this time, monetary authorities were more interested in maintaining high interest rates and introducing administrative lending controls in order to keep inflation and rapid credit expansion in check. However, these developments gave way to slowing rates of inflation in the second part of 2008 and in the early months of 2009, providing central banks with more room to increase liquidity in the domestic banking sector. Among the monetary, prudential and administrative policy tools at the disposal of the central banks are the following:

Measures to increase liquidity and boost credit to households and firms.

Some central banks of the region have been cutting their main policy rates since the end of 2008 (Albania, Moldova, Romania and Serbia). They have also reduced minimum reserve requirements and reserve requirements for funds borrowed from abroad (Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, Montenegro, Romania, Serbia). Some central banks have exempted funds in foreign currency from reserve requirements (Bosnia and Herzegovina, Romania, and Serbia). In addition, some central banks are pumping liquidity into the banking system through regular reverse repurchasing auctions (Croatia).

Table 4. Monetary policy tools in SEE since September 2008

Country	Reserve requirements	Interest rates
Albania	January 2009 – reduced the policy rate from 6.25% to 5.75%	
Bosnia and Herzegovina	April 2009 – cut reserve requirement ratio for deposits with a maturity greater than or equal to 12 months from 10% to 7%. December 2008 – cut reserve ratio for all deposits from 18% to 14%.	
Bulgaria	November 2008 – removed reserve requirements on new credit lines from abroad. December 2008 – reduced reserve ratio for commercial banks from 12% to 10%. January 2009 – reduced reserve requirement for funds borrowed from abroad from 10% to 5%.	
Croatia	December 2008 – reduced reserve ratio for commercial banks from 17% to 14%.	
Moldova	December 2008 – reduced bank reserve requirements (for leu and foreign currency) from 19% to 17%.	May 2009 – cut the main interest rate from 11% to 10%.
Montenegro	February 2009 – reduced reserve requirements to a flat rate of 11% on all deposits.	
Romania	November 2008 – reduced minimum reserve requirements on leu-denominated liabilities from 20% - 18%. March 2009 – cut minimum reserve ratio on liabilities denominated in foreign currency with a maturity over two years from 40% to 0%.	May 2009 – reduced the monetary rate from 10% to 9.5%.
Serbia	December 2008 – slashed reserve requirements on foreign credit, subordinated credit and financial leasing to 0% (until June 2010).	June 2009 – reduced key policy rate from 14% to 13%.

Measures to encourage lending in local currency.

These aim at improving the effectiveness of monetary policy transmission mechanisms and mitigating currency risk. Specifically, central banks are demanding more transparency from commercial banks and requiring them to provide explanations regarding exchange rate risk. Central banks are also introducing tougher provisions on foreign-exchange lending. The Central Bank of Albania has been encouraging local banks to enhance transparency with clients when issuing loans denominated in foreign currency. The aim has been to ensure that borrowers understand the exchange rate risk associated with foreign currency loans.

Measures to prevent potential bank runs.

Following instances of deposit withdrawals, and in order to put domestic banks on an equal footing with parent banks headquartered in the EU, several countries have increased the ceiling for the sums guaranteed to depositors (Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Montenegro, Romania and Serbia). Some countries only provide guarantees to deposits held by households, not firms. Another measure to discourage households and firms from withdrawing their deposits consisted in scrapping taxes on savings held in commercial banks (Serbia). To date, there has been only one instance of a government in the region having to bail-out a private bank (Montenegro).

However, while all countries are using monetary policy, some are more cautious than others. In Moldova, Romania and Serbia inflationary pressures, albeit reduced, remain pronounced and could easily reignite. Moreover, exchange rate fluctuations are leading these same countries to conduct a somewhat more cautious monetary policy. Together with Croatia, these countries are also intervening in foreign-exchange markets to guard against excessive depreciation.

CONCLUSIONS

The global financial crisis poses new challenges for the foreign investment policies of developing countries. Among the main risks is that investment policies of governments become more inward-oriented with negative consequences for outward investment and an open investment environment. Economic stimulus programmes can be an incentive for foreign investment, but many developing countries do not have the financial resources to successfully compete with the investment promotion packages of developed countries. Moreover, incentives based competition for foreign investment may risk lowering social and environmental standards which would be detrimental for sustainable development.

The crisis, however, also provides a chance to develop and implement policies aimed at enhancing the stability of the financial system and stimulating economic growth. Various voices advocate the necessity of going beyond the mere short-term management of the ongoing crisis and of setting up the bases of sounder economic regulations, especially in banking, with more control and restriction on the activities of commercial banks, hedge funds and other financial institutions (UNCTAD, 2008c; Stiglitz JE, 2008). This requires coordinated action at the international level to rebuild financial multilateralism, foster the stability and equity of the global financial system promote stronger transparency or disclosure standards and create guarantee funds to help emerging and developing countries secure the debt of their corporations and reassert the importance of public policies and regulations.

Most governments announced various fiscal programmes that appeared to be expansionary but in reality have had little impact on the actual economy. There has been a significant slow-down in

reforms as governments have generally been too distracted with crisis management. To sum up, governments were right to signal support to their financial systems in late 2008, but had insufficient fiscal means to arrest the crisis and make things easier for firms and households

Businesses struggling with the crisis have at times shortened working hours or cut jobs but they haven't been overreacting. The reaction of ordinary individuals and workers has been perhaps one of the most surprising and encouraging features of the crisis.

The banking system in the region has also proven to be stable and we have seen no big banks fail but once the crisis entered into full swing, the central banks generally played an important calming and mitigating role. The tools available to central banks in SEE are limited.

In sum, for effectively dealing with the crisis and the period of major uncertainty it has opened, it is important that policymakers maintain a favorable business and investment climate and refrain from protectionist tendencies.

In order to make it possible that SEE countries weather the current crisis and go through the process of adjustment that will make it possible to them to return to the path of convergence growth, the increased role of the IMF should be supplemented with:

- Orderly adjustment of real exchange rates in countries with unsustainable current account deficits,
- A support for countercyclical fiscal policy, and
- Support for the continuous credit activity of EU banks in order to avoid the process of deleveraging that leaves mass bankruptcies behind.

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For all these, huge amounts of money are not necessary, political will and coordination is.

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COMPARATIVE ANALYSES OF EFFECTS OF ANTI-COMPETITIVE BEHAVIOR IN SMALL AND DEVELOPING ECONOMIES - ALBANIAN CASE-

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ABSTRACT

The paper consists in view of the significant structural/ regulatory reform and business behavior that at the same time are occurring in Albania and that have an impact on the competitiveness, economic development and affect consumer interests.

Albania like other countries in region such as Montenegro, Macedonia, Kosovo, is a small economy, according to GDP, which means that can support only a small number of competitors in most of its industries.

From year 2004, we are applying competition law/policy, as an economic regulation that affects both the structure of markets and the conduct of market participants. But, as with any form of economic regulation, the effectiveness of competition law needs to be examined in terms of the extent to which its goals are achieved, after regulatory costs are considered. To determine effectiveness it is necessary to look at likely outcomes with and without regulatory intervention.

This paper tries to identify, *inter alias*, how an anticompetitive behavior (price-fixing, abusing of dominant position and market concentration) affect economic growth and consumer welfare.

Albanian Competition Authority prohibits cartels and other anticompetitive behavior in order to improve game's rules that facilitate domestic consumer welfare by lowering prices and increasing output.

We are trying to increase domestic competition, by 'warning' undertakings how to compete with each-other at the same market of relevant product, and this way we try even to increase regional and international competitiveness of Albanian business.

The implication of business behavior is seen in the case of abuse of dominant position and especially abuses that have as object/effect the exception of competitors from the market. Generally the dominant position of one undertaking leaps as a result of efficiency and its extension in the market, or in regulated markets as a result of denationalizations (in countries coming by the centralized economic system in the free market economy- like the case of Albania).

On the other hand, when efficient firms drive inefficient firms out of the market, thereby increasing concentration, they take part in a competitive process that rewards efficient conduct. The goal of promoting competitive trading may be seen as fair and consistent with protecting competitors, particularly small firms.

Regarding the market power, in small economies like Albania, Competition Authorities should find equilibrium between the undertaking/undertakings efficiencies and the consideration of the dominant position in the market with the main objective to facilitate a sustainable economic growth.

Key words

competition, cartel, Balkan region, small economies,

THE CONCEPTUALIZATION AND MEASUREMENT OF SMALL SIZE

The analytical literature on small states covers a wide range of issues of interest to a number of disciplines. It is therefore hardly surprising that while most analyses exhibit some degree of consensus regarding the definition of small states and their inherent characteristics, there has only been limited methodological consistency, even within particular disciplines.

Many studies choose those measures which encompass particular facets of small size and, in turn, determine the identification and implications of the critical characteristics of smallness.

THE MEASUREMENT OF SMALL SIZE

There are four principal economic and geographic indicators according to which small size can be measured; population, GDP, geographical area and the terms of trade, each of which is considered in turn below.

Population size

This is the most commonly used indicator of country size, primarily because of the widespread availability of basic population data, easily comprehensible magnitudes and the ease with which simple thresholds can be imposed. In economic terms, population data is also useful because it represents a crude proxy for the size of both the domestic market and the local labor force.

Early studies of small economies utilise critical population thresholds of between 10 and 15 million (eg, Kuznets, 1960; Chenery and Taylor, 1968; Chenery and Syrquin, 1975).

The steady emergence of new and smaller states however, has resulted in the progressive lowering of this threshold in many later studies. Contrary to this trend, a threshold of 20 million was proposed by UNIDO, based upon a hierarchical clustering algorithm grouping countries according to population (UNIDO, 1979). In the early 1970s, the principal international institutions such as the World Bank adopted a threshold of 1 million, which remains the most commonly used indicator of small size.

Gross domestic/national product (GDP)

This is more normally used as an official measure of the aggregate value of the economic activity undertaken either within a state (GDP). GDP measures have also been used as a size criterion because they indicate the total magnitude of economic activity associated with a particular state and so provide another means of gauging market size and the potential for scale economies.

GDP measures suffer from several specification problems however. States may have similar levels of GDP but differ significantly in their populations and therefore per capita incomes. Normalizing for population produces an indicator of relative economic development (GDP/GNP per capita) but not necessarily of size.

Further, it is difficult to distinguish between separate, but possibly related, explanations of low GDP/GNP; a dearth of economic activity and small size. The aggregate level of economic activity is also prone to annual fluctuation since it is determined by domestic and international market conditions. Finally, GDP/GNP, like population, is also a continuous variable which requires arbitrary breaks to be imposed without theoretical basis.

Geographic area

Geographic area is an indicator of land availability as well as a proxy for natural resource endowment and can be modified to incorporate topographical characteristics, notably cultivable area (eg, Jalan, 1982; Lloyd and Sundrum, 1982). Developments in the Law of the Sea has meant that some island states have gained sovereignty Economic Exclusion Zones (EEZs) which are far greater than their actual land areas, for example Kiribati (see Table 7.2 in Dommen and Hein, 1985).

The problem with geographic area as a measure of economic size, whether in terms of land, cultivable area or total EEZ, is that it only provides sufficient information for a crude proxy for potential resource endowments. It has therefore been used to complement demographic data to provide an indicator of population density, raising a range of economic additional issues, including demographic dispersion (Dommen, 1980, 1985).

The terms of trade

The net barter terms of trade refers to the relative price of a country's imports and exports in international markets. The inability of a country to influence its terms of trade because it has no international market power is a critical assumption underlying analysis of 'small open economies' in orthodox economic theory. Small economic size is thus equated to the absence of market power but in actuality is used to refer to relatively large advanced European industrial economies. The most original and substantive contribution to the economic literature on small size was primarily concerned with countries with populations of between 10 and 15 million (Robinson, 1960).

The post-war growth of world trade together with widespread industrialization has made international markets increasingly competitive such that very few countries are able to influence their own terms of trade apart from the very largest, such as the United States and Japan. Further, the influence of countries with similar populations, income levels and production structures over their terms of trade may be very different because import and export prices are determined by market conditions, market structure, access to technology and the elasticity of demand, supply and income.

The composition and characteristics of trade, particularly with respect to the export of differentiated manufactures, is therefore critically important. The required size threshold of the terms of trade definition is extremely large and therefore has little to offer the analysis of small states.

COMPOSITE MEASURES OF SIZE

Several studies have attempted to capture different aspects of small size by creating composite measures of two or more variables. Taylor calculates the medians of the frequency distributions of the population, GDP/GNP and area variables to establish a size threshold and uses cluster techniques to allocate countries to particular groups (Taylor, 1969). Using the same size variables, an equal-weighted composite country size index using medians is developed by Jalan (1982) while Downes uses principal components analysis to derive a weighted index of country size (Downes, 1988). Unfortunately, none of these composite measures are easily conceptualized, they are also subject to periodic fluctuation and their general results do not differ greatly from the population variable on its own.

Classification of Balkan countries

Regarding the above mentioned methodology, we have listed all regional countries as small economies based on data such as population, GDP, surface and GDP/capita:

Population, GDP and PPP Incomes in Small States and LDCs*

	COUNTRY	POPULATION	GDP 2007 (USD)	GDP/Capita	Surface (km ²)
1	ALBANIA	3,639,453	10,207,000,000	2804.542331	28.748
2	MONTE NEGRO	672,180	4,114,000,000	9800.6102084	13.812
3	MACEDONIA	2,066,718	7,590,000,000	3672.489425	25.713
4	SERBIA	7,379,339	41,581,000,000	5634.78653	77.474
5	B-H	4,613,414	15,144,000,000	3282.601561	51.197
6	KOSOVO	1,804,838	3,237,000,000	1793.51277	10.887
7	CROATIA	4,489,409	51,277,000,000	11421.77066	56.594

Source: CIA Fact Books

THE ECONOMIC SUB-OPTIMALITY OF SMALL STATES

It is useful at this point to consider why small size might be expected to have an adverse impact on the economic performance of small states. In spite of the extensive literature on small states, few studies actually address the fundamental issue of economic smallness and the extent to which critical economic assumptions cease to hold.

The 1957 IEA Conference on the consequences of the size of nations (Robinson, 1960) provides many original insights which have been further developed to create a more robust and consistent analytical economic framework (notably, Jalan, 1982a; Ashoff, 1989; Srinivasan, 1986; Streeten, 1993; Armstrong and Read, 1995, 2000; Armstrong et al, 1996, 1998).

The focus is the implication for the economic analysis of small states when dispensing with certain standard but inapplicable neo-classical economic assumptions; constant returns to scale, perfect competition and zero transport costs. The imperfect markets approach therefore conceptualizes the economies of small states as being sub-optimal (Armstrong and Read, 1995). This perspective highlights the crucial impact of scale economies, indivisibilities, efficiency and competitiveness (Scitovsky, 1960) as well as diseconomies of scope (Streeten, 1996) on the potential of small economies to generate a 'critical mass' in domestic economic activity.

The focus on economic sub-optimality provides a useful, rigorous and more generally applicable theoretical framework for the analysis of small states. This facilitates improved understanding of their salient economic characteristics and implications so as to provide more effective policy prescription. In addition, the approach fits well with the use of population and/or GDP/GNP as an indicator of small size. Although sub optimality is not a perfectly robust concept, it is both theoretically elegant and potentially fertile as the principal unit of analysis. The incorporation of production and trade, and their interaction, is activity-specific and homogenous between states to the extent that tastes and technology are similar. Small states can therefore be considered independently of their topography in terms of the inability to generate the critical mass of domestic economic activities, including those usually regarded as non-trade-ables, which can be reasonably expected within a state.

The small size of the domestic market

The small size of the domestic market in small states follows directly from the critical mass of domestic activity being sub-optimal. Insufficient domestic demand to reach the minimum efficient scale (MES) necessary for the efficient output for many goods and services raises unit costs of local production. The range and extent of economic activity in a small state is therefore a function of the shape of average cost curves below the MES (Knox, 1967) and the cost of transportation. Small states are thus at a structural disadvantage relative to larger states with respect to nurturing large scale industries, particularly those associated with high growth effects (Thomas, 1982). This argument can also be applied to Rand, technical progress and technology acquisition in small states since their small size inhibits the development of indigenous technologies (Selwyn, 1975; Briguglio, 1995).

Competition in small economies

A small domestic market also inhibits competition in many of the domestic economic activities which do take place because of the small number of feasible incumbent firms—equal to the market size over the MES (Kuznets, 1960). This problem is most acute where there are indivisibilities in production, particularly if they affect vertical production stages.

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A small domestic market therefore creates a natural barrier to entry which may also affect domestic service activities, including distribution and retailing (Armstrong et al, 1993). This increases the likelihood that a small domestic market will be characterized by monopoly or oligopoly with adverse implications for welfare. The lack of competition raises the prices of goods and services further with knock-on effects on the cost of inputs into other activities, notably utilities and other infrastructural services. The impact of a small domestic market is likely to be particularly severe on non-tradable because of the potential cost of alternative imports. It will however, also affect those tradable which are subject to diseconomies of scale and lack of competition in transportation and distribution as well as those prone to stock-outs.

The objectives of Competition Policy in small economies;

The main objective of the Competition policy is keeping competitive markets. It acts as an instrument for inducing industrial efficiency, optimal allocation of sources, technical progress and flexibility for adapting to a changing environment. For realizing this objective the duty of the competition authorities is the reservation of competing process and the inducement of effective competition in the market.

The reservation or the inducement of effective competition is necessary taking into consideration the restrictions of the private or public sector, so the competition law prohibits the agreements for price fixing and abuse with dominant position and mergers that abuse with their power in the market.

The realization of this objective is a condition for economic welfare of the society. Developing competition, having equal rules in the market, inducing innovation, having more opportunities of choice and quality of products and services, reaching market equilibriums that produce with real prices, competition policy becomes an important factor for the economic development of the country.

Competition policy is presented in the form of a strategic plan that takes into account economic, social and cultural competition conditions.

It is necessary to point out even some other objectives like:

- Protecting the freedom and the activity of different participants in the market,
- Reducing entry barriers in the market for creating a proper environment for inducing enterprise and increasing the number of small and medium enterprises
- Reserving honesty and correctness of the business relationship

For the increase of competition in the country, competition policy should give an important contribution in improving the macroeconomic indicators like: the level of prices, employment and economic growth.

The competition policy should be coherent with other microeconomic or macroeconomic policies, especially with trade policies and regulators for different markets and also with investment policies.

As it is mentioned above, for small economy countries like Albania, that have high rate of foreign trade, competition policy is closely related with trade policy.

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Liberal policies are the most important ones for countries like Albania where trade deficit is high. They can reduce small economy disadvantages through increasing exports and imports, which will increase the competition among importers and home producers.

Important issues that Competition Authorities face in small economies

According to different authors, small economies can spend more financial and human resources, in comparison with their Gross Domestic Product, for building and functioning Competition authorities than big countries.

The objectives and instruments of the application of the Competition law and policy are similar with small economy countries and the same is even for big economy countries. This happens because the world economy is going toward globalization which makes the application of same policies in different countries more and more indispensable.

Albania is one of the first countries in the region of Southeast Europe that has applied an antitrust law according to the standards of the European legislation.

Even though the small size of the economy, where the GDP is 979 milliard lek,(round 10 milliard American dollars), the objectives of the competition law and policy are identical with those that are applied in big and developed economies.

From this point of view the Competition Commission has uphold its decision-making in the principles of the protection of free and effective competition in the market, in function of the prosperity of the economy and the increase of the society's welfare.

But in small economies the application of the anti-trust law has to be seen with attention for the combination of the competition policy with other policies like: industrial policy, monetary and fiscal policy, and also for the size of the enterprises with dominant position or the effect of a cartel (prohibited agreement) in the relevant market or in the economy. The first complications of the application of the law, relates to the differences in the objectives of the competition policy with other policies for example industrial policies.

At least once, the Competition Commission has expressed its views for the execution of a decision that for the policy of the industrial development of a sector was in contrary with the principles of free and effective competition in the market.

Another important implication, which came from the ‘geographic isolation’ and from the lack of knowledge for the law was the conclusion of a prohibited agreement that increases the costs and fixes the price of a product in a town.

From the context of the effects in the economy and the welfare of consumers, without neglecting the high rate of informality of some competitors that were not part of this agreement, the Competition Authority treated this case carefully penalizing only the initiators of the agreement.

Another challenge for the Competition Authorities in small economy countries like Albania is the treatment of efficiencies of productivity (related to economies of scale) with those that are distributed for the consumers (the rate of concentration of the market) in the cases of merger notification. From one side, the Commission should stop ‘apriori’ mergers that create or consolidate dominant position (according to dominance test) but the best world practices recommend that the evaluation of a notified merger is made based on market efficiency and consumer benefits.

The challenge for small countries (from the characteristics of GDP and from the income/person) where the number of competitors is relatively smaller than in big industrial economies, is finding the equilibrium between the power that one or more enterprises can have and the optimal number of competitors that are accepted in small and developed markets.

Cartel's implications in small and informal economies.

The literature identifies some elements that make the undertakings act formally or informally in the market. The advantage of being “formal” relates in general with the access in financing, the programs of the financial aid from the government and the constraint to act formally especially in regulated sectors where the number of competitors is limited. From the other side the factors that induce the undertakings to act informally pertain the financial and timely costs of the business registering/licensing, the formalities and charges of social insurance and taxation.

In most of the cases monitored and/or investigated from the Albanian Competition Authority, the issue of informality was obvious. Although the theory reckons as admissible a certain degree of informality, in the case of Albania where informality is relatively high (from 30-60 %), Competition Authority assessed widely the influence of the informal economy of the undertakings involved or not in the investigation.

Taking into account the fact that the Albanian economy has a short experience applying the free market rules, we have explored a number of cases from naïve cartels (bread producers in Fieri district) to high covered cartel (bid rigging in public procurement).

Case 1: From naïve to high “covered” cartels

The bread production and commerce was a market where the Competition Authority developed the investigation procedures in a region of the country, Fier where the degree of informality was high.

Based on some evidence of the media, the Authority began an investigation on the existence of an agreement that fixes the price of bread among the producers in this region. From the point of view of the article 4 of the Law “On the Protection of Competition”, this is a prohibited horizontal agreement that fixes prices (from 60 to 80 leke/ bread or from 50-60 cent-euro).

The implications in the enforcement of the Law from this agreement lead up to the decision of the Commission based on the article 45 of the law for the immediate prohibition of the implementation of the agreement. “Automatically” the participants of this agreement should be penalized from 2-10 per cent of the annual achieved turnover. But watching the case carefully results a phenomenon: the high probability that in countries like Albania (with a few experience in the appliance of the free market economy- from year 1992) and because of the short time from the application of the Law (1st December 2003), makes it possible that the participants in the agreement weren’t in the know of the consequences on the level of competition of the market.

In these cases considered as naïve cartels, the participants in the agreement do not try to “cover” the created “cartel” since they don’t know that have committed one of the hardest infringements of the Law “On the Protection of Competition” and the consequences of this infringement. In this case of naïve cartel the procurement of the evidence didn’t comprise a problem but the investigation focused further on the market, the other participants in the market, the market share and the division of the competitors.

From the market analyses resulted a high degree of informal economy with small operators that sold the products in the square of the cities and villages in this district and weren’t registered. This made more difficult the definition of the size of the market because except the formal players of the market, informal businesses competed as well. This evidence was utilized as an argument of the participants in the agreement for evidencing the difficulties of their business due to more competitive prices (lower ones) of bread of the informal undertakings, which do not pay taxes and other expenses. This, according to formal undertakings, had set them in difficulty and with very low rates of earnings or in the majority of cases, loss as a result of the pressure of the “underground” supply.

During the analyses of the case was taken in consideration that “bread baking” does not comprise any industry with large invested capitals and low rates of earnings (failures) during this period and what is more important the lack of knowledge of “the bread-baking entrepreneurs” related to the restraints brought to the competition in the market infringing article 4 of the Law “On the Protection of Competition”. From the other point due to the high degree of informality as a result of the high level of “the grey” economy in Albania but also by reason of the special qualities of this business, in the assessment of the case was penalized only the head of the Association of Bread Baking, who was the organizer and the initiator of the agreement for the increase of bread price with about 20%. From the other point, the Competition Authority evaluated that do not exist barriers of entry in the market and signaled the fiscal authorities regarding the high degree of informality of this market in the district of Fieri.

Case 2: Investigation in the market of procurement of new vehicles

1. During the preliminary investigation in the procurement of new vehicles has been noted that exist electronically stored, as well as hard copy evidence of coordination between four companies: Classik Sh.p.k, Ultramotors Sh.p.k, Noti shpk and Hyundai shpk for the participation in public procurement, which may constitute a coordinated behavior between the companies that operate in the relevant market. The companies use the scheme of covered offers, by accepting to offer at a higher price than the bid of the preferred bidder.
2. It has been observed that the companies increase the value of the winning bid from 95%–99%, therefore close to the limit fund, which maybe a result of coordination. In the tenders where participation is greater than these four companies, the wining bids result at 83% – 86 % of the limit fund.
3. The results of the preliminary investigation show the possibility of the existence of a coordinated behavior in the meaning of Article 3, paragraph 4 and Article 4 of the Law No. 9121, dated 28.07.2003, titled “On the protection of competition”, between the companies “Hyundai” Shpk, “Ultra Motors” Shpk, “Classic” Shpk, and “Noti” Shpk in the relevant market of new vehicles procured through public funds.
4. So the Competition Commission decided to open the in-depth investigation procedure in the market of procurement of new vehicles into the following companies: 1. Classic Sh.p.k; 2. Ultramotors Sh.p.k; 3. Noti shpk; 4. Hyundai Auto Albania shpk, with object the verification of the existence of agreements containing offers that restrict competition on the market of procurement of new vehicles.

Market efficiency and market power (the abuse of dominant position)

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In the assessment of the infringement of the competition law should be carefully seen the relation between the undertaking efficiency and market power or the classification of one/some undertakings with dominant position. In the assessment of the dominant position the Albanian Competition Law (that is used also for the authorization or not of concentrations) relies especially on the legal and economic doctrine, as well as in the Commission and European Community law-court decisions.

Especially the implications can be more carefully seen in the case of abuse of dominant position and especially abuses that have as object/effect the exception of competitors from the market. Generally the dominant position of one undertaking leaps as a result of efficiency and its extension in the market, or in regulated markets as a result of denationalizations (in countries coming by the centralized economic system in the free market economy- like the Albanian case).

It is necessary that the Competition Authority in collaboration with the regulatory entities provide that in markets dominated by one/some competitors, the sectional regulatory policies do not create strong entry/exit barriers from the market.

From the other point, in markets where the number of undertakings is limited due to the kind of product/service (natural monopolies, utility services), the regulatory entities should restrict the operators' costs that pursue their activity through clear and explicit methodologies of costs determination and non-incrimination of artificial ones or their reduction through rebuilding.

Anyway, the methodologie of costs determination and according to the price of products/services should be assessed by the sectors and case by case.

Case 3: Abuse of dominant position in the Mobile Telecommunications Market, by Albanian Mobile Communication sh.a. and Vodafone Albania sh.a.

1. For the purpose of analyzing the behavior of the undertakings under consideration during a larger period of time, the Competition Authority has analyzed the mobile telecommunications market for the period 1996-2005.
2. The relevant product market is the public service of mobile telecommunications, or the transmission of phone calls to the end user (either generated by the end user, or destined for the end user), offered by each of the mobile telecommunication companies, AMC and Vodafone.
3. Behavior of undertakings in the market: During all the investigation period, the undertakings have applied similar tariffs that have remained quite unchanged, so that there was not any indication of competitiveness. Both undertakings, AMC and Vodafone, have applied national termination tariffs and pre-paid service tariffs that are more than twice higher than the respective average applied by the countries in the region.
4. According to Law No. 9121, dated 28.07.2003, titled "On Protection of Competition", Article 9, paragraph 1 "*... is prohibited any abuse of dominant market power, by one or more undertakings* ", and paragraph 2, letter "a", "*Abuse [of dominant power] may constitute the application, done either directly or indirectly, of excessive purchase or sale pricing, or imposition of any unfair trading condition.*
5. For these reasons the Competition Commission decided to impose a financial penalty to AMC equal to 2 % of the annual turnover of the relevant product in the year 2005. The amount of the financial penalty, expressed in value, inequality 211 552 000 Lek. In relation to violations of the Law, the undertaking Vodafone Albania is imposed a financial penalty equal to 2 % of the annual turnover of the relevant product in the year 2005. The amount of the financial penalty, expressed in value, is equal to 242 633 000 Lek.
6. During the investigation period the Competition Authority has collaborated with the Telecommunication Regulator Entity regarding the exchange of information and at the end of the investigation CC gives some recommendation to faster the competition in the relevant market.

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Comparison analyses of concentration control

For the notification of a merger/concentration we will see the form of concentration between:

- a) The merger of two or more undertakings or parts of undertakings hitherto independent of each other;
- b) any transaction when one or more undertakings acquire, directly or indirectly, a controlling interest in all or parts of one or more other undertakings;
- c) joint ventures exercising all the functions of an autonomous economic entity.

The second condition for notification is the trash hold. The concentrations of undertakings are notified for authorization nearby the Authority if, in the last business year preceding the concentration:

- a) the combined worldwide turnover of all participating undertakings is more than 70 milliard Lek, or the domestic combined turnover of all participating undertakings is more than 800 million lek, and
- b) the domestic turnover of at least one participating undertaking is more than 500 million lek.

Turnover of concentration control

No	State	GDP 2007 (million US Dollar)	Turnover in internal market of 1 undertaking	Turnover in international market (of all undertakings)	Turnover in domestic market (of all undertakings)
1	Mal I Zi	3.712		> 15 mln Euro	> 3 mln Euro
2	Malta	6.375	> 10% of E16		> 2,3 mln euro
3	Macedonia	7,590	> 2,5 million euro	> 5mlneuro	
4	Albania (ex law)	10.207	(4 mil. Euro)	(570 mln Euro	> 6,5 mln Euro
	Albania- draft-law	10 207	(1.6 mln euro)	(56 mln euro)	(3.2 mil euro)
5	Bosnia Herzegovina	15.144	>2,5mlnEuro	>50mlnEuro	
6	Lithuania	38.328	> 1,45mlnEuro		> 8,69mlnEuro
7	Bulgaria	39.549	> 1,5 mln Euro		> 12,8mlnEuro
8	Serbia	41.581		> 50mlnEuro	> 10mlnEuro
9	Slovenia	45.451	> 1 mln Euro		> 35mlnEuro
10	Croatia	51.277	> 13,8 mln Euro	> 138mlnEuro	
11	Hungaria	138.182	> 2 mln Euro		> 63mlnEuro
12	Czech Rep	168.142	> 9 mln Euro		> 54mlnEuro
13	Denmark	308.093	> 40 mln Euro		> 510mlnEuro
14	Austria	377.028	> 5 mln Euro	> 300mlnEuro	> 30mlnEuro
15	Italy	2,107,481	> 45 mln Euro		> 448mlnEuro
16	Franca	2,562,288	> 50 mln Euro	> 150mlnEuro	
17	Germany	3,297,233	> 25 mln Euro	> 500mlnEuro	
18	Nederland		> 30 mln Euro	> 113mlnEuro	
19	Norwegia		> 2,5 mln Euro		> 6mlnEuro
20	Rumania		> 4 mln Euro		> 10mlnEuro
21	Slovakia		> 10 mln Euro	> 35mlneuro	
22	Spain		> 60 mln Euro		> 250mlnEuro
23	Sweden		> 22 mln Euro		> 108mlnEuro

Table 2: Trash hold for notification of an concentration-comparison between great and small countries

The third condition is the time. According to the Albanian law on competition, the concentrations shall be notified within one week after the conclusion of the agreement, or the acquisition of a controlling interest, or the announcement of the public bid. Actually, in new drafting-law we have proposed the extension of this period in 1 month with the intention to escape this deadline as it is in *acqui-communitaire*.

Competition Authority evaluates the undertaking mergers as an essential instrument in the increase of the market efficiency and authorizes them in case they do not create or strengthen the dominant position. For the small economies concentrations are a very efficient instrument for the increasing of efficiency through the increase of the size of undertakings (through the merger) or their strengthening (control presumption or joint-ventures) and this happens more often than in large economies where the companies have more possibility to expand their capital or the size of the enterprise.

For these reasons the possible anti competitive effects of concentrations should not be automatically presumed with the increase of the degree of concentration in the relevant market after the merger, but the analyses should be focused in the efficiency of the attained concentration.

In the concentrations assessment, almost all of Competition Authorities applied the same methodology based on impact on effective competition through the assessment of expected result after concentration. Competition Commission prohibits a concentration which is expected to create or strengthen a dominant position by one or more undertakings.

Case 4- Mergers: The concentration realized through the merger of the American Bank of Albania and the Italian-Albanian Bank.

1. Parties participating in the transaction: The American Bank of Albania and The Italian-Albanian Bank (IAB).
2. On **6 November 2007** entered an agreement, which consists on the merger of the American Bank of Albania and the Italian-Albanian Bank. As a consequence, the Italian-Albanian Bank ceases to exist as a juridical person, and all its assets and liabilities, as well as all the agreements and transactions where the Italian-Albanian Bank was a party to, should be transferred at the American Bank of Albania, in compliance with the Law.
3. This transaction constitutes a concentration and therefore fulfills the conditions of becoming subject of review by the Competition Authority, in conformity with the Article 10, paragraph 1, letter “a”, and Article 12, paragraph 1, letter “b” of the Law No. 9121, dated 28.07.2003, titled “On the Protection of Competition”.
4. **The assessment of the impact into competition:** The transaction consists on the merger, through the takeover procedure, of the Italian-Albanian Bank by the American Bank of Albania. As a conclusion of this transaction, a new bank emerges, the American Bank of Albania (the name remains the same as before), and the Italian-Albanian Bank ceases to exist as a juridical person, and all its assets and liabilities, as well as all the agreements and transactions where the Italian-Albanian Bank was part to, should be transferred at the American Bank of Albania, in compliance with the Law.
5. The undertakings participating in the concentration operate at the same horizontal level of the product market. After the concentration, the market share of the new American Bank of Albania is: 16.44 % of the asset market, 16.05 % of the credit market, 7.05 % of the treasury bonds market and 14.35 % of the deposit market. The market is opened to competition, with no entry barriers and is characterized by swift changes, with respect to the geographical extension and the offering of new products.

CONCLUSIONS AND RECOMMENDATIONS

The ideal case for all the Competition Authorities would be the intervention in the right moment each time the competition is impinged in proportion with the noticed infringement and taking the appropriate measures for the renewal of competition.

But in the real world the restraint resulting owing to human resources and institutional context often destroy this “ideal” version. Neither Competition Authority has the necessary resources to cover all the cases of competition infringement in the appropriate moment.

In small economies, Competition Authorities should find an equilibrium between the undertaking/undertakings efficiency and the consideration of the dominant position in the market.

In the regulated sectors of the market on one hand the intervention of the Competition Authority could and should be wreathed with the sectional policies and on the other hand the regulatory entities should be careful to alleviate as much as possible the entrance in the market and not raise the costs of natural monopolies that would have impacts in the prices for the final consumers.

In these sectors the Competition Authorities can countenance the behavior of the undertaking/undertakings with dominant position or oligopoly as a consequence of their behavior could be the creation of the productive and dynamic efficiency.

During the composition and implementation of the Competition Policy, the Authorities should take in consideration the other policies, especially the trade policies due to the advantages of the market disclosure for the small economies like the export as well as for the imports.

As regards the coordinated practices, the market conditions in the small economies favor a reduced number of clients (notably in sectors with high entry barriers) and more possibilities of the behavior orientation for the price determination or the market division.

However, in countries with a small economy some “restraints” of competition owing to the alignment in societies of smaller competitors (for example in the electronic communication market the grouping of the small operators could raise the degree of competition with the main operator) can be permitted if they have pro competitive effects.

The evaluations of concentrations executed in small economies should be countenanced till the measure that after the concentration has positive effects for the consumer and increase of the productivity, regardless of the fact that the achieved transaction creates or strengthens a certain market power of the pairs involved in the concentration.

In the cases of anti competitive practices the relatively high degree of economic informality could warp the market conditions analyses. For this reason, Competition Authorities should closely work with the fiscal authorities helping in the reduction of the informal economy, as one of the instruments to put the competitors in equal conditions. The formalizing of the “grey” economy has positive effects not only for the state budget but also for the undertakings themselves, which “formalize” increasing them the axes in information, borrowing, public funds, technology and making them more efficient in the long run.

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MONETARY OR FISCAL POLICY TO OVERCOME FINANCIAL CRISIS? SOME REFLECTIONS ON THE CURRENT GLOBAL CRISIS FROM A DEVELOPING COUNTRY PERSPECTIVE LIKE ALBANIA

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ABSTRACT

The current financial crisis in rich countries is transmitted as an adverse external shock to many developing countries. Slower growth in rich countries has reduced demand for developing country exports and lowered remittances, and the seizure of credit markets has led to a sudden stop in external financing for many market and especially for developing economies. This situation has brought attention to discretionary fiscal policy as one of the tools potentially available to developing countries to lessen the severity of the growth slowdown. But successful episodes of countercyclical discretionary fiscal policy in developing countries have been rare. From the other side, of course, a monetary response lead to risks as well, including downward pressures on exchange rates, and accompanying high inflation.

Motivated by debates on policies and strategies to overcome current financial crisis this paper studies the impact of monetary or fiscal policy on it, pro and cons of one policy vs. the other. Furthermore, using data and indicators from Albanian economy this paper aims to offer an interpretation of the current situation of financial system and outlook rooted in the policies to deviate and to overcome the crisis. The paper takes a brief view on policy instruments like monetary and fiscal policy and their effects on overcoming the current financial crisis. Specifically, the paper examines how policymakers need to consider the scope for coordinated monetary and fiscal interventions.

Key words

financial crisis. monetary policy, fiscal policy, developing countries.



INTRODUCTION

In nowadays, we are faced to global financial crisis and also faced to consequences of it. Some financial crises have little effect outside of the financial sector, like the Wall Street crash of 1987, but other crises are believed to have played a role in decreasing growth in the rest of the economy. Since the current financial crisis began to spread across the developed world, questions about its potential consequences on different economies or developed and developing countries began to surface. Initially, the discussion is focused on the existence of a possible decoupling of business cycles. Currently the debate centers rather on the intensity of the impact, that is, whether the outcome will turn out to be a significant slowdown of growth or a recession, and on the possibilities of the region's governments to effectively find solutions to overcome the crisis. From another point of view, one fact is evident: the current financial crisis in rich countries is transmitted as an adverse external shock to many developing countries.

But what about Albania like one of Europe's poorest countries? After financial "tsunami" of 2008 the Albanian economy has undergone the global crisis "fairly well so far".

THE CURRENT SITUATION IN ALBANIA PRE AND POST FINANCIAL "TSUNAMI" OF 2008

Macroeconomic situation in Albania

During the last years macroeconomic situation in Albania in contrast to most other transitional economies, is almost accompanied by rapid non-inflationary economic growth. These years, Albania has continued to pursue a policy of an economic permanent development as demonstrated by macroeconomic data. Albania's economy had resisted shocks waves from the global financial crisis and is estimated to have grown by about 6% in 2008 and was expected positive growth for 2009 too. Despite severe economic downturns and confidence shocks in much of Europe and other advanced economies, and associated drops in Albanian exports and remittances, Albanian GDP is estimated to have registered some 3 percent growth in 2009. The budget deficit rose from 3% of GDP in 2007 to 5.7% in 2008, and 7 % in 2009, most of the expenditures being capital investments in infrastructure. This is not only because the government was trying to anticipate the decrease in consumption that was to ensue, but also because of high expenditure of electoral campaign of elections of June 2009. This was an important factor in pushing public debt to close to 60 percent of GDP (59.5% of GDP in 2009), and in 2009 generated an accumulation of expenditure arrears of 0.4 percent of GDP. These trends risk crowding out private investment and undermining debt sustainability. Inflation had been anchored at the level of 3 percent, which is the target of the Bank of Albania. (Annual Reports of BoA. 2008,2009)

The channels that expose the Albanian economy most to the shocks from the world economic environment consist of falling hard currency inflows and the tightening of financing in general.

The situation on Albanian Financial System

The structuring of financial system has been a key element of transition reforms. Over 20 years of transition Albanian financial system, has undergone dramatic changes as a results of the successes and failures of macro and micro reforms and changes in the institutional framework. The main features of Albanian financial sector structure are:

- i. The market structure of the Albanian Banking Sector has changed evidently in recent years. On 1990s, our country have experienced deregulation, foreign bank penetration, and an accelerated process of consolidation and competition in the banking sector. The banking sector remains the largest and the most development segment of the Albanian financial market. Actually, there are 16 second level banks on banking market. After two decades of transition process, the Albanian financial sector belongs to the type of model that is *“The financial sector dominated by the bank sector”*.
- ii. Capital market is under-developed and non- estimating. Capital markets barely exist and regulatory capacity remains weak. Albania’s capital markets remain embryonic. The Tirana Stock Exchange was established in 1996, but no companies have yet been listed. . There is a well-developed primary market for government securities, where most banks ‘park’ their excess supply, but the secondary market for government treasuries is poorly developed.
- iii. The more sophisticated market is foreign exchange market. Furthermore derivatives are almost never used by corporations but they show up here and there in the commercial banks’ balance sheets in the foreign exchange sections.
- iv. Debt markets are hugely underdeveloped and they hardly exist. Credit is constrained by difficulties to assess credit-worthiness, the lack of collateral (especially land titles) and limited institutional framework .
- v. The lack of financial market sophistication has meant that the sources for investment/speculation are rather limited. The majority of savings is still channeled into treasury bills. The spectrum of financial services is only broadening slowly.
- vi. For banking sector diversification is almost non-existent. Instead, the banks provide loans for mortgages at very high interest rates or invest the treasury securities
- vii. The banking sector seems rather strong for the time being, mainly due to the lack of investment in foreign assets. The banks have focused in the domestic market, and only 10% of their portfolio is invested in foreign markets. The return on capital in 2008 was 11.4%, lower than the 20.7% in 2007, but still quite high. About 62% of the deposits have been reinvested in loans. On average the banks in the system are holding about 17.2% of the capital.
- viii. The non- developed financial markets in Albania naturally associated with under-developed of non-banking intermediaries

How will be transmitted to and affect the inancial crisis in Albania?

We will be conscious the situation post crisis from three main channels that will be discussed here: (i)banking failures and reductions in domestic lending, (ii)reductions in export earnings, and (iii) reductions in financial flows to Albania.

- i. The biggest initial fear from crisis was financial contagion. In Albania foreign owned banks are significant players on banking sector although there are no bankruptcy of banks. Between end-September and mid-December 2008, 8 percent of banking system deposits were withdrawn and are only gradually returning. Albania suffered a run on its banks in October 2008, in the panic created by the collapse of US investment bank Lehman Brothers. The bank run ended in January, but there has not yet been a significant increase in deposits. Current funds in the banking system are largely invested in loans or in government bonds, and banks have no

available money to invest. This lack of liquidity remains the largest problem, despite strong interventions from the Central Bank. There are high levels of non-performing loans, about of the 6.4% on 2008 and 10.4 % on 2009. During last year, banks have mostly financed businesses involved in trade activities(38.1%), industry (26.1%) and construction(21.1%). Agriculture remains the least financed sector by the banking sector, absorbing only 1.2% of business credit. Reductions in bank lending will have the impact of reduced investment, lower growth and an increase in unemployment.(13% in 2008 – LSMS,2008 INSTAT). "After an 11-month period, the banking system's performance is presented stable. The position of liquidity in the market has recovered substantially and bank deposits have grown at stable rates as a result of the improved public confidence"-declared the governor of Bank of Albania on press conference on march 2010.

- ii. The crisis is likely to lead to a substantial decline in exports earnings. This will be results of a decline of commodity prices, a decline in demand for exported good from Albania to the other countries and a decline in tourism. Relating to earning from tourism, there are no decline in it. Tourism has been boosted significantly by ethnic Albanian tourists from throughout the Balkans. Otherwise Albania's trade imbalance is severe. Albania continues to be an import-oriented economy and the export base remains small, narrow, and undiversified, due mainly to a lack of price competitiveness, poor infrastructure, and a challenging business environment. In 2008,Albanian imports amounted to \$5.25 billion and exports were \$1.35 billion.(World Bank's Poverty Assessment 2008)The trade deficit continues to widen and, according to the estimates of the Ministry of Finance, reached 26% of GDP for 2008, up from 23.3% in 2006.In 2009 comparing with 2008 the imports fell down to 2% ; the exports with 8.6%. while the trade deficit increased with 2%(INSTAT Albania) .
- iii. Albania as a developing country needs financial inflows from the other countries or international organizations to facilitate and accelerate economic growth, trade and development. These flows include :investment flows including and foreign direct investment(FDI),trade credits and flows of remittances. Remittances from Albanian emigrants fell 16 percent in 2008 compared to 2007 and by 6.1 per cent to 394 million euro during the first half of 2009, compared to 2008, data published by the central bank. Despite the growing crisis in countries where Albanians are employed, remittances have remained high. This is mainly due to the high deposit interest rates in domestic currency 6% (Lek) and foreign currency (5% Euro and 2% USD), for one year deposits.

In South East Europe, Albania and Montenegro only had a positive growth in FDI flows in 2008, against the year 2007. Compared with transition economies worldwide, Albania ranks second, after Armenia, in FDI growth in 2008, marking a 45% growth in FDI flows (UNCTAD World Investment Report 2009) The significant growth in FDI flows in Albania, is mainly due to the "privatization of large previously state-owned companies and improvement of the business environment" says the report, in its chapter focusing on the South-East European region. The most important challenge for Albania and countries in the region is the future of these privatizations in bringing more jobs and performance for the country. So FDI in Albania contributes to positive economic growth, and are a source of capital for developing countries such as Albania but recorded not a high figure account for GDP, only 7.6 % in 2009. (World Bank Report 2009)

Actually Albanian economy has felt a limited impact from global financial crisis. Slow integration to the global markets,the prudent economic policies and the lack of financial markets have eventually spare Albanian economy by financial crisis but not so much from economic crisis. With the adoption of the required policies, Albania can achieve still positive growth, maintain low inflation, and start redressing some of the economic imbalances that are now emerging.

PRO AND CONS FISCAL POLICY TO OVERCOME FINANCIAL CRISIS- ALBANIAN CASE

Keynesian economics suggests that adjusting government spending and tax rates are the best ways to stimulate aggregate demand. It can be used in times of recession in order to achieve a strong economic growth.

Keynes opponents claim that taxes may be a necessary “evil” to finance government operations and public services, but they distort incentives, reduce investment and labor supply and dampen growth.

Related pro arguments to fiscal policy in developing countries, we list some of them:

The fiscal expansions can stimulate aggregate demand and output in developing countries in the short run whether they occur in booms or recessions. Some recent studies conclude that there are at most small positive immediate effects but overall we have controversial finding according to the medium-term (Blanchard and Peroti, 2002).

The balance of tax cut versus spending increases need to be adapted to country circumstances. It is a role for discretionary expansionary fiscal policy that can be sustainably financed. Spending increases are more effective at stimulating aggregate demand, as households might simply save tax cuts or direct transfers. In many developing countries there is a tradeoff because of weak fiscal and oversight institutions. Another factor is that tax cuts and/or social insurance transfers will not attain many of the poorest household and firms in the informal sector.

Spending increases should concentrate on areas where the expenditures are either reversible or likely to increase growth in the future because of the weakness of public finances.

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The fiscal expansion must be timely but not rushed. Fiscal interventions need to be timely in order to be effective and that inopportune interventions can be counter-productive.

Over the past three decades a broad consensus against discretionary fiscal policy has emerged in economics profession and policymaking practice (see Creel and Sawyer, 2009, pp. 134–135). The discretionary fiscal policy is issue to a number of delays (from decision to implementation) that make it impossible to use it quickly and flexibly in response to shocks. According to cons arguments overcome to:

The procyclical bias in fiscal policy reflects underlying fundamental challenges facing developing countries. The factors which could effect this procyclicality of discretionary fiscal policy are:

- i. (i) the inability of developing countries to access external finance to pay for fiscal expansions during downturns (Kaminsky, Reinhart and Vegh, 2004)
- ii. (ii) political economy problems that contribute to an overspending of public revenues when they are abundant in good times (Tornell and Lane, 2004).

There is strong evidence that fiscal policy is procyclical. Fiscal expansions tend to take place in good times, and not during bad times when they might play some role in smoothing output declines. This applies to a various indicators of fiscal policy, including expenditure, public consumption and public investment. Recent evidence suggests that it mostly reflects a mis-timing of discretionary fiscal interventions (Gavin and Perotti, 1997).

Fiscal expansions are difficult to reverse. If government commit to unsustainably large spending programs during recessions as a countercyclical device, these may be very difficult to reverse when times improve, threatening fiscal sustainability in the long run (IMF, 2008).

Fiscal procyclicality in developing countries arises from both the weakness of automatic stabilizers and the procyclical bias of discretionary policies. While in industrial countries countercyclical discretionary policy contributes to reduce aggregate fluctuations, in developing economies discretionary policy is usually procyclical. In most developing countries automatic fiscal stabilizers are too small to have a significant smoothing effect on aggregate fluctuations (Suescun, 2007).

But what about the applied fiscal policy in condition of crisis in Albania?

Fiscal policy was more expansionary in 2008 reflected in higher public expenditure and wider budget deficit. Budget revenues and expenditure increased by 15.3 and 22.6 percent, respectively, accounting for 27.3 and 32.9 percent of GDP. Budget deficit deepened by 2.2 percentage points in annual terms, it accounts for 5.7 percent of GDP. Fiscal stimulus has now become a risk, as it aggravates already existing vulnerabilities. The fiscal deficit, which floated around 3 percent of GDP up to 2007, has climbed to some 7 percent in 2008 since, as sharp government expenditure growth has outpaced revenue collections, though privatization receipts limited the borrowing requirement. It was an important factor in propelling public debt to close to 60 percent of GDP, and in 2009 triggered an accumulation of expenditure arrears of 0.4 percent of GDP. A large part of domestic public debt needs to be rolled over month while the privatization program is unlikely to generate significant proceeds. The current account deficit reached 15 percent of GDP in 2009, a level well in excess of projected future financing sources. These trends risk crowding out private investment and undermining debt sustainability.

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The recent growth of expenditure has spread doubt on the government's ability to maintain a small public sector. In the first instance, this calls for not spending all 0.4 percent of GDP of remaining contingency reserves in the 2010 budget. It is important that public investment be scaled back to more financeable and administratively manageable levels after the end of the Rreshen – Kalimash road. Investment expenditure -mainly on Durrës - Kukës motorway- provided the main contribution to the further deepening of fiscal deficit. Capital expenditure rose by 2.8 percentage points as a share of GDP in annual terms.

Some of developing countries have introduced significant countercyclical fiscal expansion packages. But the challenge is to ensure that spending on social protection is not compromised. Actually is the opportunity for many countries, including Albania, to implement and/or strengthen their social safety net. According to Albania is not implementing an expansive automatic fiscal policy which it is related to employee payments and transfers to poor households.

The expansionary fiscal policy has provided a fiscal drive to the economy. However, fiscal trends and the necessity of long run stability suggest that the Albanian economy can not rely for a long time on fiscal stimulus. Against this background, in 2010 a more conservative fiscal policy is necessary. We emphasize that fiscal sustainability should be ensured through a clear and prudent fiscal rule in a medium- and long-term period.

PRO AND CONS MONETARY POLICY TO OVERCOME FINANCIAL CRISIS- ALBANIAN CASE

Taking in consideration the actual financial crises, there are pro and cons arguments regarding the effectiveness of the easing monetary policy adopted. If the arguments that agree that this policy has not been effective are more of an “intuitive” kind, the counterarguments that support this policy are mainly based on the concept of the *valuation* and *macroeconomic risk*.

As mentioned above, the easing of the monetary policy was expected to reduce the credit cost especially for households and businesses. But what really happened is that despite a consistent lowering of the funds price from the FED, ECB and other central banks all over the world, for these households and businesses it was more difficult to access liquidity as the second level banks and other financial intermediates sharply tightened the credit standards. Thus, if the monetary policy adopted did not assure the necessary liquidity because of not being able to lower the credit cost, this means that the monetary policy is therefore ineffective.

On the other hand, we will need to introduce the concept of *valuation* and *macroeconomic risk* in order to analyze the effectiveness of the easing monetary policy during the past two years. *Valuation risk*: The market, realizing the complexity of a security or the opaqueness of its underlying creditworthiness, finds it has trouble assessing the value of the security. Meanwhile, the *macroeconomic risk*: refers to an increase in the probability that a financial disruption will cause significant deterioration in the real economy. In particular, strains in financial markets can spill over to the broader economy and have adverse consequences on output and employment. (Mishkin, 2009)

After introducing these concepts, let's analyze what would have happened if the central banks had not significantly cut the rates during the actual crises. It is possible that the valuation risk would have remained at the same levels because of a tighter monetary policy. Moreover, there wouldn't have been any facility in evaluating securities based on their decreased level of opaqueness or by assessment of the credit risk.

But on the other hand, a tighter monetary policy would make macroeconomic risk to increase. A tighter monetary policy would have a negative effect by restraining consumer spending and business investments. As a result of this, the economic downturn would be even more severe, which would also bring a higher uncertainty level regarding the assets value. This negative effect would continue further as a greater uncertainty assets value will cause an increase on the credit spread causing further contract to the economic activity.

Based on the above facts, if the rates were not aggressively cut, this would result in both higher interest rates on treasury securities and also considerable increase in macroeconomic risk with higher credit spreads. As a result the interest rates, which are relevant for households and business according to their spending decisions, would have been much higher than we actually see. The aggregate expenditure would have been lower and the current economic even more severe. Concluding, this means that tighter monetary policy would have been very costly indeed.

From the above results can be deducted that the monetary policy has not only been effective during the actual crises, but it has been even more effective than during normal times. In fact, as a result of this policy there has been a decrease in the interest rates on default – free securities and in the credit spread as well. However, despite the measures taken, the aggressive monetary policy easing has not been enough to contain the crisis, mainly due to the continuous widening of credit spreads and tightening of credit standards.

But what we can say about the effectiveness of the monetary policy in Albania? Differently from the other developing countries that were effected in a progressive way from the global crisis, the Albanian economy in the first moment succeed in facing the crisis because it wasn't directly subject to international financial market. Thereupon, during this period the central bank followed a moderate monetary policy, keeping the base interest rate unchanged at level 6.25 percent, associated with tighten measure towards management of credit risk.

During the last two months of 2008, as e result of a decrease in the discount rate for government debt and the widening of some risk premiums, was inflicted an increase in interest rate of government securities and in some case of the loans as well. In response to that development, the central bank injected liquidity in the money market with different maturity term according to the necessity of the bank system. Also, to help the second level banks, the central bank in November of 2008 changed the procedure of REPO's auction without value limitation.

However, the Albanian economy would be affected by the financial crisis during the 2009 as a result of inducing foreign currency and restraint of financing term in general. Taking these facts in consideration, the Supervision Council of central bank cut the interest rate of REPO (effectively lending) by 0.59 basis point percent. Thus, the base interest rate reached the level of 5.76 percent. This decrease would decrease the cost of borrowing from the banks and more specifically would create premises for a positive reaction from the banking system to decrease the percentage of the interest rate for loans disbursed in ALL. During this period, the banking system displaced the credit activity from foreign currency to local currency. This displacement was valuated positively as it created the right premises for an increase of effectiveness of monetary policy and its influence on the economic agents' behavior. Moreover, it helped reducing the exposure of the Albanian banking system to the fluctuations of exchange rates and also contributed to the protection and consolidation of financial stability.

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As a result of outrider arrangements, the third quarter of 2009 was characterized by positive signals in the Albanian economy and financial markets. This period was characterized by a considerable increase of the trust in banking system. In this context, after analyzing the financial and economic progress in the country and the risk balance for the future months, the central bank cut the base interest rate by 0.5 basis point percent. After this decrease, the interest rate reached the level of 5.25 percent.

Concluding, we can say that all the above-stated measures make it necessary the macroeconomic and financial stability as well. Of course that the macroeconomic stability is crucial for all the other economic and financial situations, but on the other hand, economic stability without financial stability would be utopia.

CONCLUDING REMARKS

1. The goal of this paper is to analyze the effects of fiscal and monetary policy to overcome financial crisis from a developing country perspective like Albanian economy. The current financial crisis of 2008 in rich countries is transmitted as an adverse external shock to many developing countries, included and Albania.
2. Empirical results of several authors showed that the banking crises would occur probably in a weak macroeconomic environment characterized by slow GDP growth and high inflation. Albania's economy had resisted shocks waves from the global financial crisis and is estimated to have grown by about 6% in 2008 and have registered some 3 percent growth in 2009. Otherwise

the inflation had been anchored at the level of 3 percent, which is the target of the Bank of Albania. There are no bankruptcy although bank deposits dropped by 10% since September 2008, and lower liquidity has forced commercial banks to tighten lending procedures.

3. Also banking crises depend not only on macroeconomic variables; meanwhile depend on structural characteristics of economy and particularly financial sector. Slow integration to the global markets, the prudent economic policies and the lack of financial markets have eventually spare Albanian economy by financial crisis but not so much from economic crisis.
4. There is no 'commonly accepted theory of financial crisis' to provide fail-proof advice on the correct policies that each particular country should adopt in the wake of the crisis(Jonung 2008: 566). However, from past experiences of financial crises the probable responses required in developing countries would need to include immediate, short-term(stabilization) and long-term (structural) policy responses. Immediate and short-term policy responses are related with minimizing of crisis impact in real economy and increasing of public confidence in financial system. Over the longer term, countries should focus on their domestic financial development concentrating on: rise of the access to finance; improvement of domestic resource mobilization; improvement of efficiency of banking sector; improvement of supervision and regulation etc.
5. The monetary policy has not only been so effective during the actual crisis, but it has been much more effective comparing with periods of time when the crisis is not evident. Regardless of it, this has not been enough to contain the crisis, mainly due to the continuous widening of credit spreads and tightening of credit standards. Meanwhile, in the case of Albania the central bank has applied a conservative monetary policy by reducing the interest rate by only 1%, as the country was not "infected" considerably by the financial crisis because of the limited exposure in international markets. As a result of this monetary policy it was expected a decrease in credit interest rate; meanwhile it happened the opposite. This reflected the fact that the transmission mechanism of monetary policy has not worked very well. Despite this monetary policy followed be the central bank can be considered as effective.
6. Developing countries, in any case, should consider expansionary monetary policies carefully, because of due to the combination of a credit crisis and liquidity trap, the policy becomes ineffective .
7. The presence of government debt affect the government's ability to conduct countercyclical fiscal policy. Fiscal policy that attempts to minimize extreme fluctuations in the business cycle, as by increasing spending and reducing taxes during periods of decline.
8. Developments in the fiscal sector in the course of 2009 have been under the impact of the internal and external macro-economic factors, as well as budget policies of the Government to minimize the negative effects of the economic and financial world crisis. This fiscal expansion had to stimulate macroeconomic sustainability through discreet fiscal rule.

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FLAT RATE TAXES IN ALBANIA

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ABSTRACT

The aim of this paper is to emphasize the implications of flat tax in Albania, its great impact in fiscal policy and economy.

This paper will give a brief description of fiscal system in Albania for the last years and the standards that should come up with the integration in European Union. Our hypotheses consist in implication of flat rate in our economy as in an inappropriate time application and economy conditions. We will explain the results of flat rates by giving statistics of the rates and incomes in other countries that have applied the flat tax to their system before us.

What does flat rates theoretically mean, and argument pro and con on this case? The way the flat rates were implemented in Albania fiscal system, what was our aim in implementing it in 2007? We will give the results of flat tax in our country, the factors of this results and the way in how the flat tax will follow in upcoming years.

At the end of the paper, we will recommend suggestions for the fiscal system in Albania in order to have a stable economy and also to adapt it in European fiscal policies.

Key words

Fiscal policy, flat rates, income tax, distribution of income and economic stability.

FISCAL SYSTEM AND ITS STANDARDS

Tax system in its optimal form should have some characteristics, which to some point can be called optimal standards of the tax system. We have to take in consideration the fact that a fiscal package is very influenced from the duty of collecting as much taxes as possible, and in the mean time to have minimal complains from the tax payers. Meanwhile, this is completed without eliminating the standards.

While talking about standards we can mention transparency, administrative costs imposed from the system, equality (horizontal and vertical), justice, flexibility or automatic stabilizer, economic affectivity, etc.

The goal of the progressive system is social. Rich people pay more money because they posed more. Money is reallocated between people in order to have a social equality. Without reallocation, a country can easily fall in a bipolar society, leading to two extremes, very rich and very poor people.

The purpose of paying taxes is not only connected with the fact that the state can collect income, but also, taxes are considered a social responsibility. Without a social harmony, rich people are the ones that lose more. Being in front of this reality of why rich people don't pay in proportion? Who pays if the rich do not? Would it be the middle class?

WHAT IS FLAT TAX?

.....174 “Flat tax” means that every person has to pay an equal norm on the personal income, and every business has to pay the same norm on the profit tax. So for the Albanians paying the flat tax means that the income tax, social security's and profit tax have to be in the same level of 10%.

The first application of the flat tax in Albania has been applied on 05 august 2007. This tax was applied on the personal incomes and the profit of companies. The tax on personal incomes in the end of the 2007 resulted to 14.8 milliards lek, comparing with 8.3 milliards lek for the year 2006, which actually shows a considerable increase. While the profit tax faced a big decrease, it resulted an increase of the flat tax. (From 18.3 milliard lek in 2006, to 21 milliard lek for 2007). The increase of the tax collection from year to year has decreased the obligation, leading to an increase of profit declarations, meaning more formalities

It seems like in this faze except of the tax collection increase from year to year has also influenced the decrease of the obligation, which brought the result that was expected, the increase of the profit declarations, meaning also more formalities. (this is confusing, look above and see if that makes sense)

Several countries have not applied the flat tax because it influences the income of people with low wages. The profit of the government from the flat tax is related with the fiscal administration, because it cuts the costs of tax administrations and in the mean time is easily applied. But this cannot be a reason that justifies the flatting of the taxes because it shoots directly to the biggest mass of the employees who receive low wages.

The debate of applying the flat tax sets the irrelevant idea that this tax brings more income for the government. This is noticed in other countries and the application of the tax has shown to be very productive. Being in front of this fact, we face another dilemma. Is the goal of a good government collecting as much money as possible for the state budget or the welfare of the citizens?

The problem that is mostly faced with the adaptation of this tax system is the fact that countries that adapt this are countries with late development and in the mean time have the problem of the income collection that in most cases is transformed into corruption and informality. Logically this situation is automatically connected with the public investment sector, increasing the question if the extra money will ever arrive to the destination. In this supposed case, we may think that we have to do with a vicious circle.

The flat tax is mostly applied to the east European countries, therefore when we come to the western European countries, such as Germany or Spain, when it was mentioned as an option it has faced immediately with oppositions. If we take in consideration the statistics of countries that have applied the flat tax, we will notice fluctuation of the governments before and after applying the tax.

According to the studies of international monetary fund - The “Flat Tax(es)”: Principles and Evidence - (Michael Keen, Yitae Kim, and Ricardo Varsano), we notice that countries that have applied this tax in the last 12 years— including Baltic countries like Slovakia and Romania, which in turn may be obliged to abandon this scheme. The evaluation states that the existing schemes in eight countries of Eastern Europe are extremely different from each other. Additionally, it states that the empirical proves of their effects are limited.

According to the authors, what remains unclear is the sustainability of the flat tax. From the structural view, the flat taxes that are applied until now, do not provide coherent bases for difficulties that countries are facing in the taxation of capital income that flows from one country to the other. The biggest disadvantage of these economic schemes is the fact that they have brought negative effects for small enterprises.

The study also shows that there exists an exaggerated marketing in the flat taxes, “A distressing element faced on the discussion on the flat tax is related more with dilemmas and rhetoric than with real analysis or arguments”. The authors believe that the trend may bring the destruction of the schemes, “the expansion of the flat tax on its own decreases its values because it is very easy to be imitated” (Michael Keen, Yitae Kim, and Ricardo Varsano). The authors conclude that even though they would not doubt that there will be new actors in the scheme of flat tax application, they are interested if there will be any defection.

One of the objectives of the application of this tax in Albania is related with the attraction of the foreign investments. Are taxes the primary concern of foreign investors? The primary problem is related with the owning of buildings and territories. This is a problem that does not give the possibility to companies to build their businesses.

COLLISION OF PHILOSOPHIC IDEAS

Translated in an orthotics language, the flat tax goes against the philosophy of progressive tax because it uses the formula that a hat can be used for all heads, a period in which, the more income is provided, the more money is paid with a relative value leading to more monetary obligations given to the state. So in percentage, this obligation is equal for all taxpayers. The protectors of the idea of the flat tax say that it is a way to prevent discrimination, meaning that if somebody is able to acquire more money doesn't mean that this person has to be penalized. On the other hand, the group against flat rate expresses the idea that this tax goes against the social morality and hurts the unprotected group. The concept of equality or that of the justice in the fiscal system is always a topic to be discussed.

Even though in the progressive tax we face real discrimination, discrimination is not the argument. This term, on its own, does not represent something negative. In this situation the protection and equal chances for the less protected one are part of the philosophy of the democratic system. For this reason, the right to vote of the individuals with a low income is entirely equal with that of the president of the state.

On the other hand the democratic system is based on the principle of worthy. In 1948, Karl Marks was protecting the system of progressive taxes of the manifest communists. As an example, we can take the communist systems that attempt to have a social equality and logically are considered a failure in the formulation. Individuals that are more able and active will always gain more, even by following the regulations of the system that automatically results as a social differentiation. In front of this situation it's normal to use the reallocation principle that also resulted as a failure because the concept of the ownership more than lecture or experience is a human instinct that supports the individual's ego. The progressive tax system seems to be going against worthiness and human nature where as the flat tax attempts to regulate this injustice. On the other hand we have to underline that the progressive taxation found a very effective application in the capitalist countries and not in the communist ones like Marx was wondering.

The flat tax improves the transparency of income taxes, it decreases the costs and if the norms are low, it decreases the temptation for deviation. It also stimulates increasing according to its protectors. But in the mean time it also has a price moving toward norms that stimulates the division of the incomes. The protectors of these ideas like say that Russia is showing the best side of it in economy and it also was positive in countries in transition like Slovakia. In the mean time this idea has shown to be interesting also for countries like Italy, Greece and Mexico. (Jeffrey Owens Director, OECD Centre for Tax Policy and Administration)

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Flat tax helps "not-well-educated" individuals or the elderly who may have a problem with the complexity of the fiscal system. The key question is whether the flat tax rates distribute the fiscal burden fairly. Depending on the rate fiscal system, reforms make individuals with high ages gain at the expense of individual's medium wages whom have to pay higher rates. While the lower strata take an advantage from that depending on the basic previous rules.

According to the two principles of horizontal and vertical equality, taxpayers with the same level income should be taxed the same and taxpayers with the highest level of income should be taxed more according proportionally on their income. The advantage of this system is the movement limitation income, essentially an individual with high labor taxes (wages) transformed into a person with low capital taxes (other income). As well as the weakness of this system is the reduction of efficiency due to higher and progressive rates and high administrative costs. No country has the simple fiscal system but generally they have specific taxes or rates for specific items (profit, home, pensions, etc.).

Scandinavian countries have applied a combination exactly where a progressive system of revenue on salaries and a proportional system for other income (capital). Proportional system on the other incomes comes as a result, because capital incomes are much more mobile than income from wages. But still a weakness of this system may be that income tax revenues will depend on the relative amount of wage income and other income received. This may underestimate the vertical equity because the income from other income (capital) is more at higher levels of society. And of course in such a dual system there exist an incentive to move from higher taxes on lower paid in taxes on capital.

Although academic in the USA had more than a quarter century to discuss the tax is exactly Russia, which adopted it in 2001 with a rate of 13%. Within a year their incomes increased in real terms at

26%, and their GDP grew by 20%. Next a number of countries that seek to exceed the transition adopted the flat Ukraine, Slovakia, Romania, Estonia, etc.

It is difficult to determine if a flat tax could sufficiently address one of the largest global challenges of the economy: maintaining a strong tax base in a world where movement of capital is bigger every day. Given the need of the state for income, having a system of flat tax rates on personal income and payment may require a higher rate which can create problems because of the basis tax of capital movement. On the other hand lower rates are implemented will underestimate the profits of the system and redistribution of income is affected.

No country has applied a system with fully flat rates although the trend seems to be flat rates. How long will this trend stay in the states is an open question. Taxes can be flattest but more time is needed.

The impact of flat tax on employment promotion is not proven (no evidence) as well as the effect of the provisions of versus flat rates distribution; it is complex due to reforms that are included in the basic increment.

Keen, Kim and Varsano have discussed and debated on this and, they have protected the idea 'movement towards flat rates to strengthen the automatic stability, not weaken it. "Flat rates are mainly adopted by countries which have been anxious to make a deep movement of the regime towards a more open market.

In many cases the signals have been well understood." Authors end with a question about the sustainability of the policy movement towards flat rate. "What remains unclear is the sustainability of the flat tax. On the structural form flat tax is adopted but has not provided any evidence of how it can face with the difficulties that these countries may encounter in international tax capital movement." What if flat rates are free to be administrated by the administrator and taxpayer"? Flat rates are good policies but not optimal as long as the other system has often been subject to numerous abuses.

Why happens if only rich people propose flat tax in developed countries? While social equality is, or at least should be when 80% of revenues go to 20% population and when this 20% appeal means that there is something that does not go well in that system or in that country.

HOW THE FLAT TAX WAS APPLIED IN ALBANIA

The previous system of the taxes, that minimum salary of 14 000 lek, which was taxed with 1%, and taxes came progressively to the maximum salary which is over 200 000 lek. In the previous system, an employee whose salary was 20 440 lek, he paid 440 lek taxes or 2.2 percent of gross wages. With the flat tax system, an employee who has actual salary is 20 000 lek pay 2000, or about 4.5 times more than before.

The economic advantage of flat tax comes to those employees who have very high salaries, which according to what government figures out there are about 600 in public administration. So they, with progressive regulation, pay a tax rate higher than 10%. But most administration employees have average salary about 300-400 thousand lek, and this had a negative impact on their income. Despite the tax is a simple system and transparent in appearance, created specifically to attract foreign investors, and to increase GDP, probably got different credit from what it really deserved.

ADVANTAGES AND DISADVANTAGES

In a written analytical Reuters claims that “foreign investment is not absorbed by lowering taxes, but by fighting corruption and creating a climate in favor of businesses”, while “Industry Watch” highlights the fact that “the income of the poor with flat taxes will be the more penalized”.

To eliminate the flat tax impact on low public administrators’ salaries the government has undertaken a salary increase budget. This way the private sector low wages were left aside. Government should not think only for budgetary employees, but for all those who in the absence of a job, work in small economic activities in the private sector. The flat tax was sold to perspective and us as a very simple. Establishing this tax with these bases doesn’t justify the transparency that government owes to its citizens, at a time when the flat tax is not a magic wand but the deviation from the normal economic system followed so far. The success of this reform will depend above all on the ability of government to make the distribution of money collected from taxes, under the form of services and investment for its citizens. But this requires a different space to be well explained.

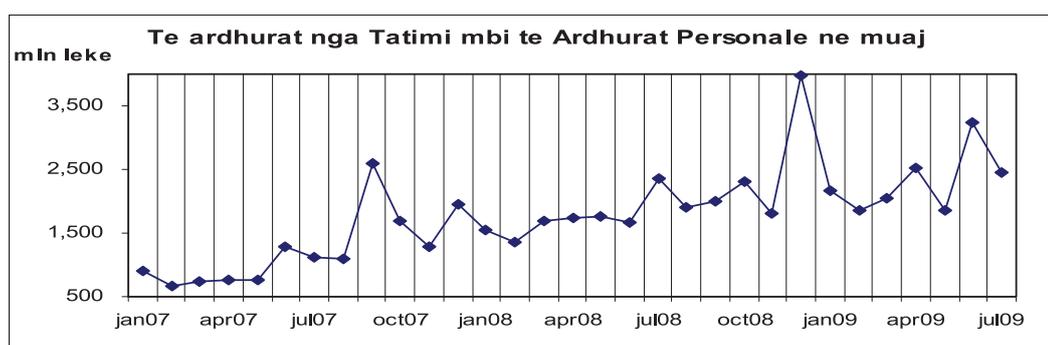
From July 1, 2007 we declared a tax level, about two times lower from 2005. This is a very bold step and a more serious commitment of the government. A very large contribution to increased efficiency provided by the administration to reduce fiscal burden, to reduce the level of taxes, to make our economy more competitive and to provide more business opportunities to be self-financing capacity increased him, to modernize and develop quickly.

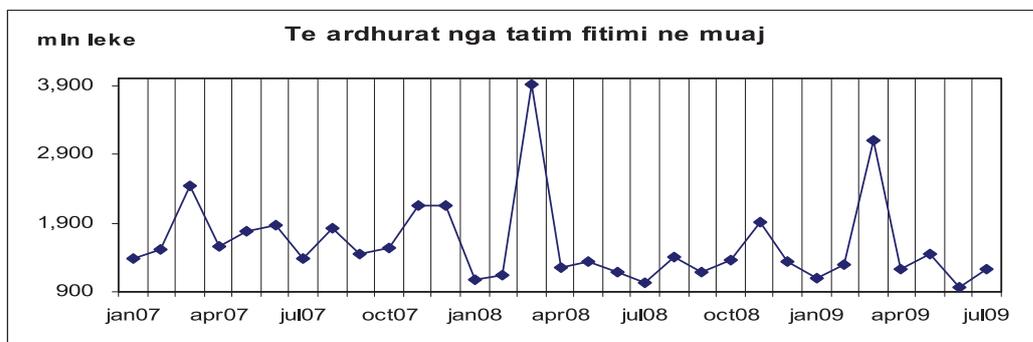
However, the Bank of Albania states that the total revenue of the state budget, the impact of the flat tax is only 3%. Already been accepted by the government that the effect of the flat tax personal incomes from individual employment resulted from an increase of tax level in absolute terms for wages up to around 140 000 lek per month. While salaries for over 140 000 lek personal income taxes suffers decline compared with the current progressive system. Consequently, individuals with low or medium income suffer a reduction of the average of their monthly income.

To offset this decline in income individuals, the government predicted compensation (salary increase) for public administration, but of course, to the private sector not found any solution. One of the factors that lead to this kind of tax is the inability to execute the fiscal system and, this blow so these individuals come from inability of execution.

FLAT TAX EFFECTS

From the two following tables are clearly reflected the effects of flat tax in state case for year 2007, 2008 and, 2009 in 3 monthly reports.





FISCAL FORECASTING FOR 2009

The state budget revenues for 2009 were revised based on the performance of macroeconomic indicators in the following fiscal year and the revised macroeconomic framework. The main assumptions for the performance of the forecasts are based on:

- Reviewing the macroeconomic indicators for 2009 as economic growth (4.8 percent);
- The rate of inflation and the GDP deflator (respectively 2.3 and 2.4 percent); Nominal increase of imports of goods (-1.7 per cent in CIF value including the effect of exchange rate) to date performance (January to July, 2009) of the income realization for each item;
- Effects of announced government policy taxes;
- Succession of administrative improving effects.

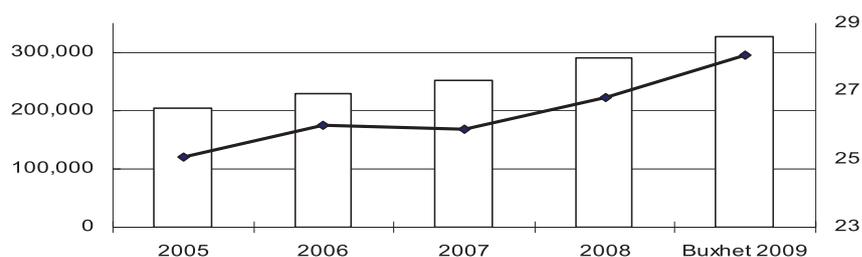
As we saw above, the flat taxes are always accompanied by a series of fiscal reforms which obstacle the calculation of the impact of flat tax in the state case. Through the main elements of tax policy for the period in 2009, can be mentioned:

- Reducing taxes on work (social security contributions paid by employer) from 20 percent to 15 percent starting May 1, 2009.
- The government's decision to increase the excise on certain goods, such as coffee and alcoholic drinks and tobacco products.
- Continued reduction of customs duty as a result of implementation of tariff commitments in the Interim Agreement Albania EU, CEFTA, FTA with Turkey.

Given the above, revenue in the revised budget for 2009 will be:

- Total revenue is forecast at 327.1 billion lek level, with an increase of 12.3 percent versus 2008. From where:
- The revenue from customs tax is forecasted 222.7 miliard lek, with an increase of 8.5 % with respect of last year. With respect on prior budget there is decrease of 7.5 miliar lek.
- The revenue from social security is forecasted in 54.9 miliar leke, with an increase of 14.8 % form last year and e decrease of 2.5 miliard leke from the prior budget of 2009.
- The revebue from lokal taxes remain the same with respect to the prio budget of 2009, 18.4 miliard lek.
- The total change of the revenue with revised budget 2009 is 7.7 miliard lek less.

TOTAL REVENUE, 2005-2009

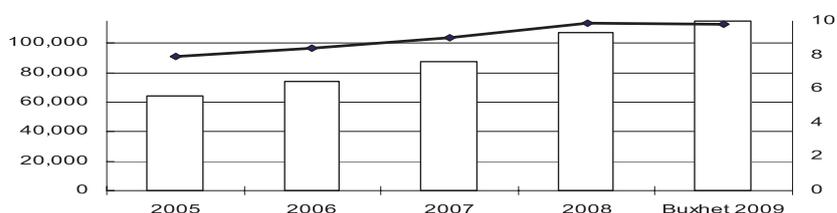


REVENUE FORM VAT

- The total revenue form Vat is predicted to be with an increase of 7.1 % with respect to 2008, from a total of 114.7 78.8 milliard lek with an increase of 5.1 % comparing with 2008. Forecast for VAT from custom is based on the nominal level of imports and according to the historical data of elasticity coefficient of this revenue.
- Tax administration tend to collect 35.9 milliard lek forecasted with in this item, custom administrate tends to collect in monetary value from VAT an amount with an increase of 11.6 % form the previous year. The forecast is based on last year data, on the economic activities of different sectors and also on the characteristics of elasticity coefficient.

THE REVENUE FROM VAT, 2005-2009

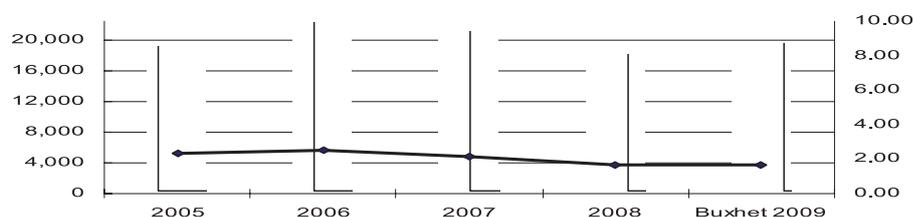
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THE REVENUE FROM INCOME TAX

The revenue form this tax is forecasted in 19.4 miliard lek, with in an increase of 7.3 % according to last year. And they are 1.4 miliard less comparing with prio budget of 2009.

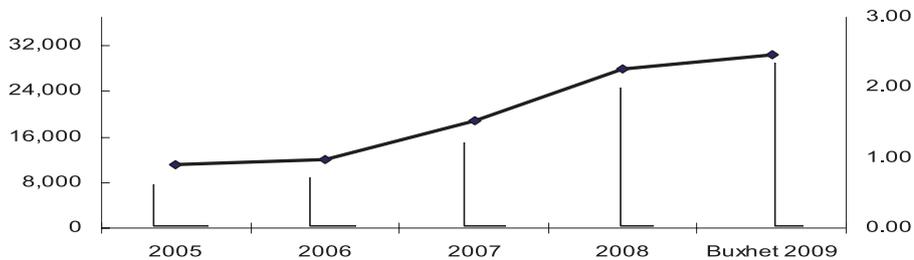
THE REVENUE FROM INCOME TAX, 2005-2009



PERSONAL INCOME TAX

It is forecasted as 28.7 milliard lek, with in an increase of 17.3 % according to the last year and comparing to the prior budget it is 2.7 miliard lek more.

PERSONAL INCOME TAX, 2005-2009



CRITICAL APPROACH

Proportional system might be applicated on those economies where the level of income has no fluctuations.

In Albania, the businesses variates in extreme in revenue terms.

On modern history tax system has a significant role in income reallocation and market disorder. Flat rate system has a regressive impact. This is because it pemits the rich people to hold more form their income.

Flat rates does not necessary mean a decrease in tax rate. A decrease in tax rate and flat rate tax are two different things.

Although the theoretical argument, in practice progressive system is playing a minor role in economic growth.

Progressive system is complex. Tax system reflects financial system on which the world economy work on. Applicating a simple tax system on an complex and global economy is not that much productive.

Progressive system and “Automatic Stabilizator”. Progressive system functions as a automatic stabilizer in cases where the economy is very well developed (by increasing the probability for inflantionary pressure) or where the economy is slowing down (by increasing recession probability).

On moments where budget is in deficit flat rate tax converts to a dangerous instrument. If government plan to increase the expenses, in impossibility of increasing the tax rate it will deepen the budget deficit. This will decrease the foreign inverstors trust.

CONCLUSIONS AND RECOMMENDATION

The new economy of Albania is not ready for a “lazy” tax system like the flat rate tax. The alternative solutions can be:

- More efficient exploitation of existing sources.
- Online software tax system in order to decrease the time of data for proceeding.
- Reduction in bureaucracy procedures in order to minimize the fiscal evasion and to reflect the real state of the country.
- Harmonization of laws and policies for fiscal government.
- The effectiveness in tax administration should be improved by professional promotion.

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MONTENEGRIN STOCK EXCHANGE CHARACTERISTICS BASED ON FINANCIAL TIME SERIES ANALYSIS

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ABSTRACT

The capital market is the central point of the Economic Reform Agenda for Montenegro (2002-2007). Mass voucher privatization (MVP) has been the initial promoter of the capital market development in Montenegro and it had a basic impact on the nature of the transition process. Montenegro is a small country and also a developing one. Having in mind these two facts, it is no doubt that the establishment of the capital market institutions has been a foundation of the capital market development.

In the last five years the number of transactions on the stock exchanges in Montenegro has been growing rapidly. This phenomenon has had a considerable impact on the transition of Montenegrin citizens' mental blueprint.

NEX Montenegro stock exchange is an important capital market agent. Therefore, data series of its indices NEX20 and NEXPIF provide valuable research reference. The main objective of this paper is to undertake econometric analysis of the NEX20 and NEXPIF indices time series aiming to derive the main characteristics of the Montenegrin capital market. Therefore the standard methods of financial time series econometric analysis will be implemented in the paper. Research will include stationarity test and Box-Cox's transformation, if necessary. Non-stationary time series, which is usually the characteristic of financial time series, will be tested for cointegration. In order to better understand the Montenegrin financial time series the appropriate ARMA model, in case of stationary, or ARIMA model in case of non-stationarity, will be estimated.

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Key words

capital market, stock exchange indices, risk, stationarity, cointegration

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INTRODUCTION

NEX20 and NEXPIF indices series, attained from the NEX Montenegro stock exchange, are the most important data reference for our research. The data are given on a daily level for the period from March 3rd 2003 until April 1st 2010. The sample consists of 1849 observations.

The paper has four segments. In the introduction some basic information regarding the analyzed time series are presented. The second part of the work is dedicated to the methodology of time series analysis. The third part contains the results of the empirical analysis of time series of NEX20 and NEXPIF stock exchange indices. The final part of the paper presents conclusions of the analysis.

New Montenegrin Stock Exchange (NEX Montenegro) Podgorica was founded on September, 20th in 2001. Authorization for its work was issued on November, 11th, 2001 by the Montenegrin Securities Commission. The basic goal of calculating and publishing indices of the Securities Exchange NEX Montenegro is to provide the public with the information on dynamics in the certain segments of the market. The NEX Montenegro Stock Exchange currently calculates two indices, NEX20 and NEXPIF.

Index of the NEX Montenegro Stock Exchange, also known as NEX20, consists of 20 issuers' share determined on the basis of market capitalization, turnover and number of concluded transactions. The last update of the index structure was made on December 15th 2007. Index of privatization investment funds on the NEX Montenegro stock exchange, or NEXPIF, consists of common shares of all six privatization investment funds in Montenegro.

The starting value of these indices is 1000 stock market points. Indices are being calculated according to the following methodology:

$$NEX20 = \frac{\sum_{i=1}^{20} p_{i,t} \cdot q_{i,R}}{\sum_{i=1}^{20} p_{i,0} \cdot q_{i,R}} \cdot 1000 \cdot C_T \quad NEXPIF = \frac{\sum_{i=1}^{20} p_{i,t} \cdot q_{i,R}}{\sum_{i=1}^{20} p_{i,0} \cdot q_{i,R}} \cdot 1000 \cdot C_T$$

where

- | | |
|--|--|
| t – day of trading; | $p_{i,t}$ - stock price on the day t; |
| R – day of index revision; | $p_{i,0}$ - basic stock price on a day of index foundation |
| T – moment right before index calculation with the new structure | $q_{i,R}$ - number of shares |
| C_T – correction factor that provides index continuity | |

The correction factor is implemented only in cases of structural index change.

THE METHODOLOGY

Standard procedure of the time series analysis will be applied to NEX Montenegro stock indices.

Empirical work based on time series assumes that the underlying time series is stationary. That is why the first step in financial time series analyses is to run the test of stationarity. The stationarity is an essential property in defining a time series process. Stationary time series is one whose parameters, such as mean, variance, autocorrelation, etc. are all constant over time. Most business and economic

time series are far from stationary when expressed in their original units of measurement, and even after deflation or seasonal adjustment they will typically still exhibit trends, cycles, random-walk, and other non-stationary behavior. Nonstationarity can have important consequences for regression models and inference. Autoregressive coefficients of non-stationary time series are biased; t-statistics have non-normal distributions even in large samples and regression models of those series are usually spurious regression. Stationarity can be tested by Dickey-Fuller test which is appropriate for AR (1) processes, or augmented Dickey-Fuller test for time series which has a more complicated dynamic structure.

If a time series is non-stationary it can be transformed in order to make it stationary. Different types of transformation can be used. If a time series has a trend, i.e. if a time series is non-stationary, than it can be transformed into a stationary one by using first-order differences. If a time series has quadratic trend, than transformation imply second-order differences. If a time series has non-constant variance than transformation includes generating new time series by doing logarithm on non-stationary time series. In this case Box-Cox transformation can be used as well.

If there is a stationary linear combination of nonstationary random variables, the variables combined are said to be cointegrated. Johansen’s test of cointegration is implemented in this research.

ARIMA models are the most general class of models for forecasting a time series which are not stationary but can be transformed into one. ARIMA model is classified as an “ARIMA (p,d,q)” model, where p is the number of autoregressive terms, d is the number of nonseasonal differences, and q is the number of lagged forecast errors in the prediction equation.

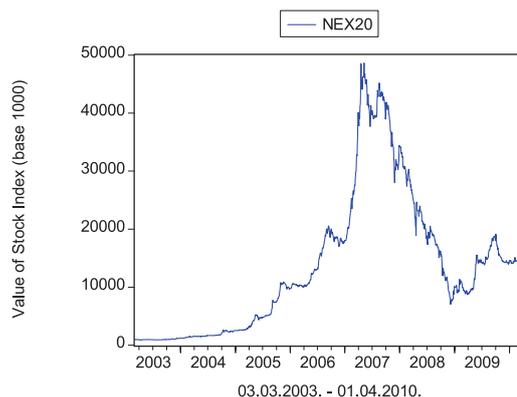
DESCRIPTIVE METHODS IN TIME SERIES ANALYSIS

Time series graph view

There are two basic roles of using graphs in time series analysis. Originally they were the instruments for replacing the tabular view of data, because the tables are not suitable for showing some important characteristics of observed phenomena. After the graphs were developed, they became a very important element for complex research of statistical observations.

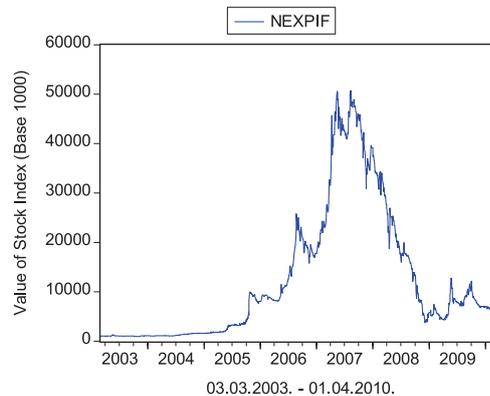
The first graph in this section represents the values of the stock index NEX20 during the period from March 3rd 2003 until April 01st 2010. Observations were taken on a daily basis, taking only workdays into consideration. The sample has 1300 observations.

Figure 1: Value of the stock indices NEX20 during the period from March 3rd 2003 till April 01st 2010



The trend on the graph is ascendant. Rising value of the stock index NEX20 is steady until the end of September 2004. After that period the index measures aggressive growth due to the rising value of the stocks of the Montenegrin Telecom company. The same sharp look of the trend line is recorded in May 2005. From January until April, 2007 the value of the index has raised from approximately 18,000 to 40,000. However, September of the same year was rugged for investors, because from that period until the end of the 2009, the stock index had a descending trend. According to the value of the stock index NEX20, in 2010 recovery of capital market is on the run.

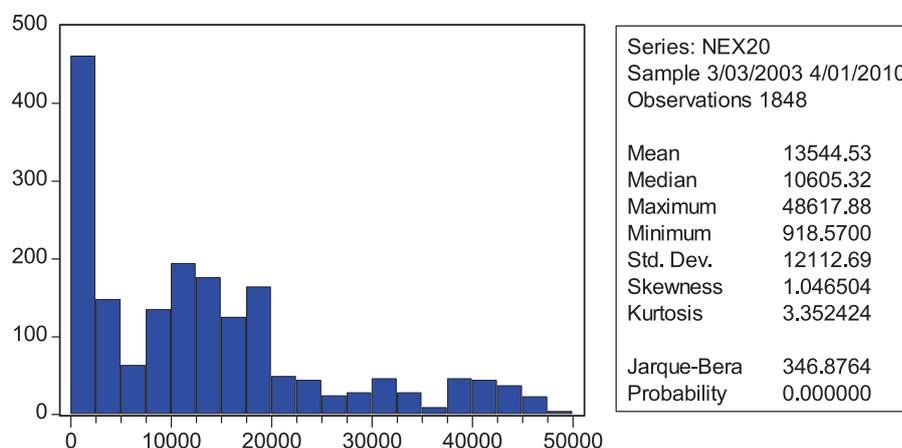
Figure 2: Value of the stock index NEXPIF during the period from March 3rd until April 01st 2010



Comparing this graph with the previous one, it can be concluded that the value of the stock index NEXPIF was almost constant until July 2004. After that, steady growth can be observed until June 2005. Investors were very lucky in the next period, and generally speaking their activities on the stock market were successful. The critical period for their investments was the end of 2007. From then on until the end of 2008 the stock index was decreasing. According to the movement of the stock index NEXPIF it seems that recovery of stock exchange came in 2009,.

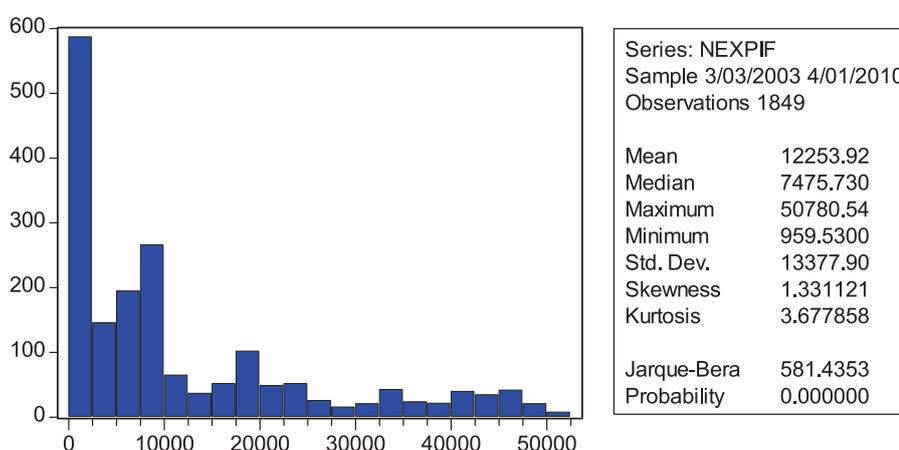
More information about the characteristics of analyzed time series can be obtained using a histogram.

As we can see on the histogram below, the width of the interval groups is 2,500 stock market points. Most of the values are recorded in the interval between 0 and 2,500 stock market points. There were 481 observations in this interval. The next interval with the highest value of frequency is between 10,00 and 12,500 stock market points. There are 194 observations in this interval. The third interval with the highest value of frequency is the one between 17,500 and 20,000 stock market points with 164 observations.



Descriptive statistics gives additional information about this time series. The expected value of the series NEX20 is 13,544.53 stock market points. Median is 10,605.32. The highest value of this index in the period of analysis is 48,617.88 and the lowest 918.57 stock market points. Standard deviation of the series is 12,122.16. Skewness of the series is 1.046504 which means that the distribution has a long right tail. Kurtosis is 3.352424 so the distribution is peaked (leptokurtic) relative to the normal. Jarque-Bera is a test statistic for testing whether the series is normally distributed. The reported probability is the probability that a Jarque-Bera statistic exceeds (in absolute value) the observed value under the null hypothesis. In this case the value of probability is zero and that leads to the rejection of the null hypothesis of a normal distribution.

Histogram for the series NEXPIF is given below. The interval in which the most of the observations occurred is the one between 0 and 2,500 stock market points. Exactly 587 observations are in this interval group. The next interval with the highest measured frequency is between 7,500 and 10,000 stock market points with 266 observations. The last group, which consists of 195 observations, is the group between 5,000 and 7,500 stock market points.



The descriptive statistics of the NEXPIF series are: the mean value is 12,253.92 stock market points; the median is 7,475.73 which is approximately 2,500 stock market points less than in the case of the NEX20 series. The maximum value of the analyzed series is 50,780.54 and the minimum value is 959.53. Standard deviation is 13,377.9 points.

If we take into consideration the skewness, kurtosis and Jarque-Bera coefficient values we can make a conclusion that the series NEXPIF does not have a normal distribution. The series has a long right tail because the skewness coefficient is greater than zero. The series is almost as convex as normal distribution because the kurtosis is approximately equal to 3. Jarque-Bera value and the probability below indicates that if the null hypothesis (normal distribution) is rejected the chance of making a mistake is zero.

Stationarity

Stationarity is one of the crucial preconditions for successful research based on time series. A stochastic process is considered stationary if its mean and variance are constant over time and the value of the covariance between the two time periods depends only on the distance or gap or lag between the two time periods and not the actual time at which the covariance is calculated.³ A time series which has stationarity is also generated into stochastic process with a constant number of parameters.

³ Gujarati, N. Damodar, "Basic Econometrics", McGraw-Hill Higher Education, New York 2003. page 797

Parameters are constant during time (no trend, variations are steady). This is the definition of weak stationarity. Strong stationarity implicate stochastic processes which are independent of time.

If the series is stationary, its dynamics can be generalized in one sample used for forecasting. The most popular test of stationarity is the Unit root test. This test is based on a model:

$$Y_t = \rho Y_{t-1} + u_t$$

Series Y_t has random walk if u_t represents white noise with an expected value of zero, and a variance of σ^2 . This model resembles Markov's first-order autoregressive model. If the ρ is equal to 1 than we have a Unit root problem and the series is nonstationary. If the absolute value of ρ is less than one, that series is considered to be stationary.

The estimated Markov's first-order autoregressive model of the series NEX20 is as follows:

Dependent Variable: NEX20
 Method: Least Squares
 Date: 04/11/10 Time: 23:31
 Sample (adjusted): 3/04/2003 4/01/2010
 Included observations: 1848 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NEX20D	0.999997	0.000448	2231.260	0.0000
R-squared	0.999165	Mean dependent var		13550.52
Adjusted R-squared	0.999165	S.D. dependent var		12121.93
S.E. of regression	350.1803	Akaike info criterion		14.55531
Sum squared resid	2.26E+08	Schwarz criterion		14.55830
Log likelihood	-13448.11	Durbin-Watson stat		1.272219

According to the results, the slope of this model is approximately equal to one so the model has unit root problem and is nonstationary.

The same model of the series NEXPIF is estimated:

Dependent Variable: NEXPIF
 Method: Least Squares
 Date: 04/13/10 Time: 23:31
 Sample (adjusted): 3/05/2003 4/01/2010
 Included observations: 1847 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NEXPIFD	0.999996	0.000448	2230.259	0.0000
R-squared	0.999165	Mean dependent var		13549.75
Adjusted R-squared	0.999165	S.D. dependent var		12125.17
S.E. of regression	350.2731	Akaike info criterion		14.55584
Sum squared resid	2.26E+08	Schwarz criterion		14.55883
Log likelihood	-13441.32	Durbin-Watson stat		1.272215

Estimation results are almost equal to the one of the series NEX20. Slope of the model has value which is almost one so we deduce that unit root problem is present, i.e. the series NEXPIF is nonstationary too.

Nonstationarity of NEXPIF and NEX20 series can be confirmed by the Augmented Dickey-Fuller (ADF) test.

Test results of ADF are presented in the following table:

Null Hypothesis: NEX20 has a unit root

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-1.602065	0.4813
Test critical values: 1% level	-3.433716	
5% level	-2.862913	
10% level	-2.567548	

Augmented Dickey-Fuller Test Equation
 Dependent Variable: D(NEX20)
 Method: Least Squares
 Date: 04/13/10 Time: 23:33
 Sample (adjusted): 3/25/2003 4/01/2010
 Included observations: 1833 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NEX20(-1)	-0.000969	0.000605	-1.602065	0.1093
D(NEX20(-1))	0.401603	0.023393	17.16748	0.0000
D(NEX20(-2))	-0.172711	0.024972	-6.916276	0.0000
D(NEX20(-3))	-0.038867	0.025298	-1.536332	0.1246
D(NEX20(-4))	0.110446	0.025300	4.365395	0.0000
D(NEX20(-5))	-0.045158	0.025431	-1.775684	0.0760
D(NEX20(-6))	0.007838	0.025453	0.307932	0.7582
D(NEX20(-7))	0.009535	0.025428	0.374957	0.7077
D(NEX20(-8))	0.014362	0.025428	0.564813	0.5723
D(NEX20(-9))	0.049860	0.025430	1.960652	0.0501
D(NEX20(-10))	0.002081	0.025457	0.081763	0.9348
D(NEX20(-11))	0.011757	0.025434	0.462246	0.6440
D(NEX20(-12))	0.037365	0.025306	1.476513	0.1400
D(NEX20(-13))	0.003338	0.025311	0.131879	0.8951
D(NEX20(-14))	0.151182	0.024985	6.050938	0.0000
D(NEX20(-15))	0.071166	0.023409	3.040041	0.0024
C	16.17847	11.02637	1.467253	0.1425
R-squared	0.212098	Mean dependent var	7.637376	
Adjusted R-squared	0.205156	S.D. dependent var	351.5270	
S.E. of regression	313.4005	Akaike info criterion	14.34207	
Sum squared resid	1.78E+08	Schwarz criterion	14.39321	
Log likelihood	-13127.51	F-statistic	30.55339	
Durbin-Watson stat	1.995681	Prob(F-statistic)	0.000000	

The first part of the test consists of the value of ADF test statistics and test critical values with a certain significance level. The ADF statistic value is greater than the critical values with all three significance levels, meaning the null hypothesis cannot be rejected; hence the series has a unit root problem. The second part of the output shows the intermediate test equation that was used to calculate the ADF statistic.

The same procedure was done for the series NEXPIF:

Null Hypothesis: NEX20 has a unit root

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-2.490886	0.3327
Test critical values: 1% level	-3.965294	
5% level	-3.413356	
10% level	-3.128711	

Augmented Dickey-Fuller Test Equation

Dependent Variable: D(NEX20)

Method: Least Squares

Sample (adjusted): 3/24/2003 2/22/2008

Included observations: 1269 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
NEX20(-1)	-0.003200	0.001285	-2.490886	0.0129
D(NEX20(-1))	0.466079	0.027177	17.14988	0.0000
D(NEX20(-2))	-0.239640	0.030312	-7.905755	0.0000
D(NEX20(-3))	-0.016455	0.030988	-0.531036	0.5955
D(NEX20(-4))	0.108440	0.030992	3.498980	0.0005
D(NEX20(-5))	-0.081936	0.031285	-2.619025	0.0089
D(NEX20(-6))	0.020707	0.031429	0.658863	0.5101
D(NEX20(-7))	0.024018	0.031490	0.762725	0.4458
D(NEX20(-8))	0.000908	0.031499	0.028814	0.9770
D(NEX20(-9))	0.038376	0.031509	1.217940	0.2235
D(NEX20(-10))	0.046303	0.031491	1.470357	0.1417
D(NEX20(-11))	0.018668	0.031333	0.595801	0.5514
D(NEX20(-12))	0.102419	0.031316	3.270538	0.0011
D(NEX20(-13))	-0.086074	0.030741	-2.799990	0.0052
D(NEX20(-14))	0.277574	0.027713	10.01599	0.0000
C	-23.66153	20.97193	-1.128248	0.2594
@TREND(3/03/2003)	0.109092	0.048412	2.253415	0.0244
R-squared	0.281346	Mean dependent var		22.52968
Adjusted R-squared	0.272162	S.D. dependent var		357.6812
S.E. of regression	305.1500	Akaike info criterion		14.29279
Sum squared resid	1.17E+08	Schwarz criterion		14.36173
Log likelihood	-9051.775	F-statistic		30.63416
Durbin-Watson stat	1.995343	Prob(F-statistic)		0.000000

Comparing the values of ADF test and critical values it can be concluded that the series NEXPIF also has a unit root problem and it is nonstationary.

Time series transformation

Since NEX20 and NEXPIF indices time series are nonstationary they have to be transformed so that they can be used for model estimation. To eliminate the trend from series we will use differentiation procedure. In time series transformation a very popular type of transformation is Box-Cox transformation and differentiation. This procedure is shown below:

$$\Delta \log(X_t) = \log(X_t) - \log(X_{t-1}) = \log\left(\frac{X_t}{X_{t-1}}\right) \approx \frac{X_t}{X_{t-1}} - 1 = \frac{X_t - X_{t-1}}{X_{t-1}}$$

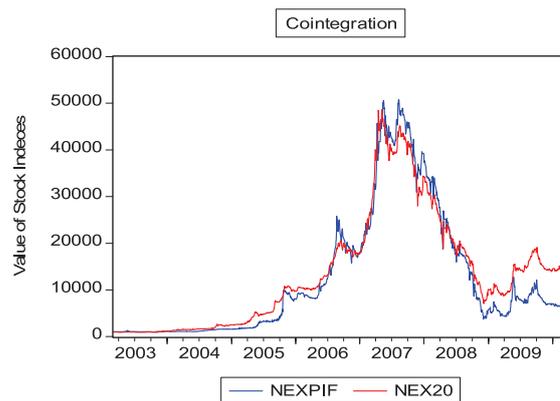
First difference of logarithm is approximately equal to the rate of growth of the time series if the quotient $\frac{X_t}{X_{t-1}}$ is relatively small.

After running the ADF test on both transformed series we concluded that those series are stationary now.

Cointegration

Cointegration is the concept that connects nonstationary time series during the model estimation process. The first step in testing whether two series are cointegrated is to examine their graphical representation.

Figure 3: Value of the stock indices NEX20 and NEXPIF during the period from March 3rd 2003 till April 01st 2010



Series NEX20 and NEXPIF have a long-run, or equilibrium. That means that despite being individually nonstationary, a linear combination of two or more time series can be stationary. The results of the Johansen test of cointegration are the following:

Date: 04/14/10 Time: 00:04
Sample (adjusted): 3/10/2003 4/01/2010
Included observations: 1838 after adjustments
Trend assumption: Linear deterministic trend
Series: NEXPIF NEX20
Lags interval (in first differences): 1 to 4
Unrestricted Cointegration Rank Test (Trace)

Hypothesized		Trace	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.009695	19.30674	15.49471	0.0127
At most 1	0.000761	1.399977	3.841466	0.2367

Hypothesized		Max-Eigen	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.009695	17.90677	14.26460	0.0127
At most 1	0.000761	1.399977	3.841466	0.2367

NEXPIF	NEX20
-0.000337	0.000369
2.58E-05	5.45E-05

Unrestricted Adjustment Coefficients (alpha):

D(NEXPIF)	45.87853	-6.805009
D(NEX20)	-11.18114	-7.610954

1 Cointegrating Equation(s): Log likelihood -27191.30

Normalized cointegrating coefficients (standard error in parentheses)

NEXPIF	NEX20
1.000000	-1.095847 (0.05795)

In the first part of this test the calculated probability indicates that if we reject the hypothesis according to which there is no cointegration, our mistake would be 0%. With the probability of 95% there is at least one cointegration equation of those two series. One suggestion of a cointegration equation of the two analyzed series is:

$$\text{NEXPIF} = -1.095847\text{NEX20}$$

The metaphor story can be used in order to explain why cointegration of two series which doesn't have predictable path is important. Assume that we have one boy and the old woman. The old woman and the boy are unrelated to one another, except that they are both on a random walk in the park. Information about the boy's location tells us nothing about the old woman's location. Now we can imagine old man who is the owner of one dog. The old man and the dog are joined by one of those leashes that have the cord rolled up inside the handle on a spring. Individually, the dog and the man are each on a random walk. They cannot wander too far from one another because of the leash. We say that the random processes describing their paths are cointegrated.

ARIMA

The starting point of ARIMA model estimation is an assumption that the series NEX20 is stationary. The stationarity will be accomplished by using the first difference of original series NEX20 and NEXPIF. Autocorrelation function (ACF) and Partial autocorrelation function (PACF) of analysed series will suggest the order of ARIMA model.

The criteria to judge for the best model are: relatively small value of Schwarz criterion, relatively small value of standard error of regression, relatively high adjust coefficient of determination and Q-statistics and correlogram which show that there is no significant pattern left in the ACFs and PACFs of the residuals, i.e. the residuals of the selected model are white noise.

The following are the results for NEX20 time series:

ARIMA model	Schwarz criterion	S.E. of regression	Adjusted R ²
ARIMA(1,1,0)	14.42233	326.5849	0.131616
ARIMA(1,2,0)	14.76358	388.0290	0.038150
ARIMA(1,0,0)	14.56231	350.2622	0.999164
ARIMA(2,0,0)	14.42562	326.5458	0.999273
ARIMA(3,0,0)	14.39784	321.4697	0.999296

According to the results, best model for NEX20 time series is ARIMA (3,0,0) which is practically only autoregression model of order 3. Correlogram of residuals in estimated ARIMA (3,0,0) model shows that residuals are stationary and that the model can be accepted.

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Representation of the estimated model is as follows:

Dependent Variable: NEX20
 Method: Least Squares
 Date: 04/15/10 Time: 21:59
 Sample (adjusted): 3/06/2003 4/01/2010
 Included observations: 1842 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	21861.64	13230.82	1.652327	0.0986
AR(1)	1.428280	0.022944	62.25064	0.0000
AR(2)	-0.608970	0.037875	-16.07849	0.0000
AR(3)	0.180004	0.022937	7.847626	0.0000
R-squared	0.999297	Mean dependent var	13584.30	
Adjusted R-squared	0.999296	S.D. dependent var	12112.29	
S.E. of regression	321.4697	Akaike info criterion	14.38585	
Sum squared resid	1.90E+08	Schwarz criterion	14.39784	
Log likelihood	-13245.37	F-statistic	870561.6	
Durbin-Watson stat	1.990485	Prob(F-statistic)	0.000000	

Coefficient next to AR (1) has value greater than 1. That means that analyzed series is nonstationary and “explosive” in growing.

If the same procedure is applied to NEXPIF time series, the similar conclusion is obtained.

ARIMA model	Schwarz criterion	S.E. of regression	Adjusted R ²
ARIMA(1,1,0)	15.39526	531.2112	0.040979
ARIMA(1,2,0)	15.76889	642.4163	0.119719
ARIMA(1,0,0)	15.43562	542.2858	0.998357
ARIMA(2,0,0)	15.39885	531.1473	0.998424
ARIMA(3,0,0)	15.39574	529.4642	0.998414

Hence, the best fitting model is ARIMA (3,0,0). Correlogram test is in favor of estimated model.

Results of estimation are given in the following table:

Dependent Variable: NEXPIF

Method: Least Squares

Date: 04/15/10 Time: 22:17

Sample (adjusted): 3/06/2003 4/01/2010

Included observations: 1846 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	15043.91	12157.51	1.237417	0.2161
AR(1)	1.220640	0.023215	52.57999	0.0000
AR(2)	-0.307722	0.036006	-8.546326	0.0000
AR(3)	0.086047	0.023212	3.707039	0.0002
R-squared	0.998437	Mean dependent var	12272.16	
Adjusted R-squared	0.998414	S.D. dependent var	13381.12	
S.E. of regression	529.4642	Akaike info criterion	15.38377	
Sum squared resid	5.16E+08	Schwarz criterion	15.39574	
Log likelihood	-14195.22	F-statistic	392199.6	
Durbin-Watson stat	2.008556	Prob(F-statistic)	0.000000	

AR (1) coefficient has value of 1.22 which means that NEXPIF series is explosive autoregressive series.

CONCLUSION

NEX Montenegro stock exchange indices, NEX20 and NEXPIF, are not stationary. Speaking in layman's terms, investors who want to invest their funds in the Montenegrin capital market have to know that this market is marked with the red flag of a high risk market. The other side of the medal is the high rate of return on investment. It is well known that along with return comes risk and that risky investments earn risk premiums.

These short econometric analyses have shown that the stabilization of the stock index values can be achieved by implementing the Box-Cox transformation. This transformation will diminish trend and the variance of the series. After providing transformation on nonstationary time series, standard technique of econometric modeling can be implemented.

After running cointegration tests, the conclusion was that the series NEX20 and NEXPIF are cointegrated and variation of one of them can be used for forecasting the future value of the other series.

Investors can also use the autoregressive function or appropriate form of ARIMA model, which are estimated for both series in order to predict future values of the NEXPIF and NEX20 indices.

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THE ROLE OF TAX AUDIT IN IMPROVING FISCAL MANAGEMENT

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ABSTRACT

The purpose of this study is to highlight the features of the tax audit reform in Republic of Albania. This paper's policy prescriptions are some certain conceptual issues of tax audit, existing scenario of tax audit in Albania focusing on tax system, tax audit practice, audit organization, tax auditor quality and management. Emphasizing international experience, the authors have evaluated the performance of tax audit reform in Albania starting with legal reform and improvement of policies, rules and procedure. General and specific audit techniques evaluation, audit criteria and audit approach will be on the focus of authors. The prescription followed by audit approach and selection criteria through risk analysis of real cases. Role of IT is described as a key concept for effective management audit recourse as well as for risk base selection criteria for tax audit. Role of other data, knowledge and external recourses are evaluated as other important methods of audit selection. Some arguments are given about necessity of cooperation between countries for auditing of multinational enterprises. Some restructuring problems pertained specification of tax audit functions and tax inspection duties, follow the completion of the tax audit process. Based on knowledge and best international experience, the trial of authors is evaluation of reform achievements as well as highlighting the obstacles and shortcomings of tax audit system in Albania.

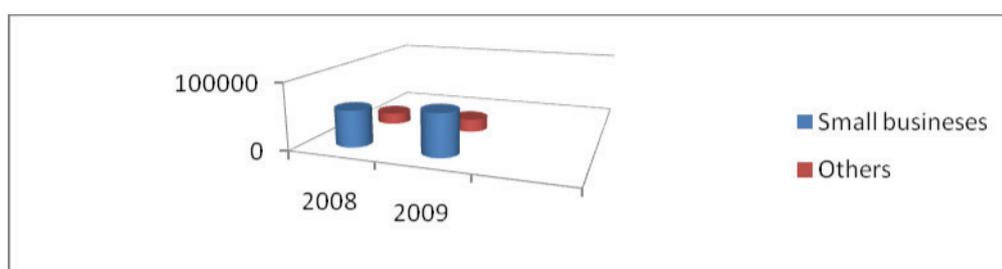
Key words

tax audit: risk evaluation: audit techniques: tax audit management:

THE INTRODUCTION

Fiscal Albanian Highlights: The principal business entities in Albania are as follows: (i) Sole proprietorship (ii) general partnership; (iii) limited partnership; (iv) limited liability company; (v) joint stock company ; (vi) a branch; and (vii) a representative office. There are 15 regional revenue agencies in Albania. For two recent years based on the statistics of National Tax Agency number of businesses counted in Albania are showed in Table & Graph below:

Total number of businesses	2008	2009
Businesses under an annual turnover limit ¹	55 704	64 618
Businesses over an annual turnover limit	17 766	19 923



As above, the by 2009 reform, the number of businesses was increased. Tax revenue structure (in %) for two last years is showed in Table below²

Taxes	2008	2009
Total	100	100
VAT & Excise	52.85	44.54
Profit tax & Personal income tax	17.29	16.21
Social & health contribution	18.53	19.75
Others	11.33	19.50

Except as above, revenues from taxes for two last years (respectively 2008 & 2009) have been 264,421 ALL million and 236,000 ALL million, reflecting the effects of global crisis among other internal factors.

Existing scenario of Albania tax system has two categories:

1. National tax.

Currently in Albania all businesses 5 ALL million and over are subjects of the following direct taxation: Corporate taxation - Profit tax rate of which is 10% as of January 1st, 2008. (Dividend income is generally considered taxable income, unless the participation exemption or a double tax treaty relief is applicable). Personal income tax - taxation rate is 10%. Taxable income –includes: a) Income from wages, salaries, as well as from other forms of employment compensations, b) Income from profit (dividend): c) derived from copyright or royalties; d) derived interest from deposits, and securities and from sale of securities on a net basis, as well as other income by low.

¹ Annual turnover limit which was 8 ALL million for 2008 and 5 ALL million for 2009, by which tax administrate assign that all businesses over above limit are obligated to be registered with VAT.

² ECONOMIC AND FISCAL PROGRAM 2010 – 2012 (January 2010) www.minfin.gov.al

Indirect taxation- VAT is applied on the supply of goods, services, mixed supply, as well as imported goods. The rate is 20%, while the VAT of exports is 0%. VAT credits are given when fuel is used for technological purposes. Excise is different regarding different excise goods in the Republic of Albania. Excise is given in relative number per unit. Excise goods are- coffee, fruit juices and other non alcoholic beverages, beer, wine, alcohol and other spirits, tobacco, energy recourse products, perfumes and toilette waters. Tax on registration of gambling, casinos, hippodromes, which is payable once at the beginning of such activities

2. Local taxes by local government legislation. Simplified Profit Tax is imposed on small businesses with a total annual turnover between ALL 2 - 5 million. When annual turnover total is less than ALL 2 million, the tax is characterized as an individual income tax.

3. Other types of national taxes are:

Portal tax rate (given in absolute number per year or month)	Tax on acts and stamp
Consular service taxes	Mineral rent tax
Tax for radio television devices	Annual tax on road used
Professionals tax	Carbon tax
Education institution registration tax	Fishing activity annual tax

4. Real property tax that which was collected by local government (based on the occupation of real property) which is different for capital city from of 2% to 4% in capital city and 1% to 3% in other municipalities.

Transfer Tax –10% transfer tax is imposed on the seller on a net basis from for the transfer of the immovable property as of January 1, 2008.

5. Social and health insurance contributions.- Contribution paid by the employer amounts to 21.7% of the secured compensation between ALL 14,830 and ALL 74,150, effective July 2008.

FISCAL AND TAX AUDIT REFORM IN REPUBLIC OF ALBANIA. SOME CERTAIN CONCEPTUAL ISSUES OF TAX AUDIT. THE EXISTING SCENARIO OF TAX AUDIT AND TAX AUDIT EVOLUTION IN ALBANIA.

1. **The last fiscal reform** undertaken in 2007 has done the Albanian tax system the most alleviating and the more stimulating tax system of the regional countries for the business development, matching the strategic priorities of the government. In the same time, the distribution of tax burden in a less deformed and a more equal manner has been a component and another important feature of this fiscal reform. The goals of fiscal policy have stimulated the business and economic development as well and approved in the fiscal package of July 2007, consisted in the below elements:

- i. Application of flat tax level of 10% for personal incomes, eliminating progressive tax rates previously applied.
- ii. Alterations of excise level for some goods approximating it with the regional level.
- iii. Reduction of profit tax rate from 20% in 10%, which was firstly applied on 1st of January 2008.
- iv. Growth of some local taxes level, like wealth tax for buildings that are inside the territories of tourist villages.

During the second half of 2007, other important fiscal changes occurred:

- i. Elimination of VAT of medical and dental treatment goods and services, providing children and elder health protection; cultural, sportive and educational services; periodic, journals, magazines, books etc.
- ii. Provision of fiscal facilities to two important sectors: a) energy and b) agriculture. (The reimbursement of the excise paid of the use combustibles for subjects that construct and product electricity resources with the installed intensity not smaller than 5MW per recourse. Farmers will get a 6% compensation to partially cover the VAT paid from them buying goods and services necessary for their economic activity).

These fiscal system reforms aim not only to formalize the Albanian economy but also to help fighting informality and to create a favorable environment for the business.

2. Tax audit reform

The term tax evasion simply refers to the dishonest tax reporting or underreporting of taxable money income with the intention to escape taxes, or illegally avoiding paying taxes, while the tax avoidance, is using legal methods to minimize a tax burden. Tax avoidance is the legal utilization of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. By experience, the tax avoidance is thus encouraged by the complexity of tax legislation

The government imposes strict and serious penalties for tax evasion. By Albanian law fiscal evasion penalized with 100 percent of the underreporting amount founded, while other penalizations are applied for non compliance of respective tax laws, with the exception of cases that are criminal acts.

Administrative changes as well as decrease of income tax and profit tax rate have targeted reduction of tax evasion. For the period of transition, there is no quantitative evidence of the tax evasion in Albania, which is known as significantly higher than in developed market economies. However by different surveys results conducted during the years show that³: i) Tax evasion increases with the tax rate and with income; ii) Tax evasion decreases with the level of fines and with the audit probability; iii) The decision about tax evasion is made jointly with the decision on how much effort to put in income earning ⁴

The last reform of Albanian tax auditing system has come into force on May 1-st, 2009. The reform starting with policies and legal improvements, also audit selection criteria audit approach and audit techniques. Till May 2009, Albanian auditors often are unaware of the information that was used to initially select the case and may waste a great deal of time by focusing their audit research in the wrong areas. Have been using two major methods of Audit selection which were implemented by Albanian tax administrate till April 2009⁵;

- i. Manual screening – by local officers by which auditors decide on cases with high risk. This is not a systematic method, hence some non-compliance can be missed and internal data and local knowledge is used for selection only, ensuring that over a period of time all taxpayers are audited, with the time allocated to the audit commensurate with the risk to the revenue from that taxpayer.
- ii. Random selection- is based on stratified sampling better representation of taxpayer strata. The auditor has no bias in audit selection, and the high opportunity cost of auditing was presented.

3 Friedland et al., 1978

4 Collins and Plumlee, 1991

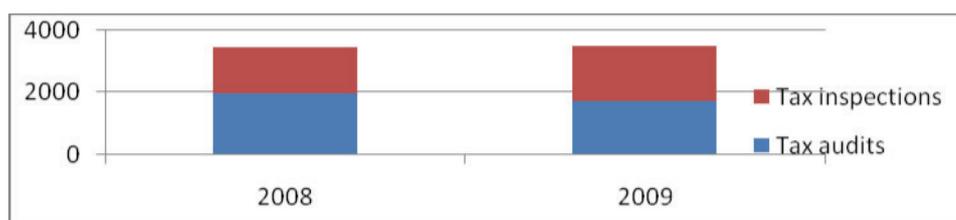
5 Tax Audit Manual-Albanian National Revenue Agency

Starting from May 2009 and onwards began implementation of automatic risk base selection method for tax audit, regulated by law as a process of identifying taxpayers who are most likely to be non-compliant with tax obligation, using of “risk-scoring” techniques and taxpayer profiling as good topics of risk selection. Risk base organization is a key concept of the effectiveness of tax audit as well as an important key for a good management audit resources. Tax Audit reform in Albania is in its infancy. By the Audit Manual, 60% of tax audits are selected by software automatically while, 40% are selected based on manually risk assessment considering a series of indicators, like business credit situations, information from third parties, requirements to close the business, requests for reimbursement etc. The assessment of reform impact in 2009 compared to 2008 is presented in table below (000/ALL and in %)⁶.

By main taxes	2008	2009	2009/2008
VAT	3,498,428	3,702,569	105.8
Profit tax	2,888,853	3,019,666	104.5
Social contribution	375,056	397,957	106.1
Others	1,584,228	1,910,508	120.6
Total	8,346,565	9,030,700	108.2
Total auditing conducted	3476	3521	101.2
Finding per each auditing pr.	2401.2	2564.8	106.8
Number of audits	240	270	112.5
Finding per each audit	34,777.3	33,447	96.17

For the past two years, indicators related audits conducted (in absolute number), are shown in table & graph below:

Indicators	2008	2009
Total f taxpayers audited	3476	3521
i) Tax Audits	1966	1725
ii) Tax inspections	1510	1796
Number of audits	240	270
Audits for each audit in a year	14.5	13.04



As is showed above, the number of audits per each auditor has been lower in 2009 to 2008, because of increasing of fiscal inspections with about 18.7%, so transforming the rate from 1.3:1 to 1:1 approximately.

The evaluation of tax audit effectiveness through indicators is given below

Indicators	2008	2009
Total tax revenue	264,421,000	236,000,000
Audit findings	8 346 565	9,030,700
Audit finding/Total tax revenue (5)	3.1	3.8

The impact of tax audit reform has affected tax evasion, redacting it with about 0.8% to a year before.

6 National Revenue Agency: Tax Audit department statistics.

AUDIT PLANNING PROCESS AND TAX AUDIT SELECTION CRITERIA. SOME GENERAL AND SPECIFIC AUDIT TECHNIQUES EVALUATION.

How to increase revenue through improving audit techniques in particular tax audit selection criteria? Today's tax agencies of developing countries typically lose 10%–15% of total revenues to tax evasion and other types of noncompliance known as the “tax gap”. As a result of these pressures, tax agencies continue to rely on audit selection approach. By mid 2009, in Albania, about 16% of all audits resulting in no change to the amount of tax due⁷. But these “no-change” audits expend valuable staff time and resources to investigate taxpayers. So it was necessary to address these issues, toward developing a Tax Audit and Compliance System, a comprehensive, integrated solution designed to improve auditor productivity and increase tax revenues. But is this system powerful, and can it give sophisticated solution that can be configured to meet a given agency's particular compliance needs? Here is real example of risk base selection systems and key indicators that software processes for automatic selection (only 60% of subjects who audited every month are selected by software system already).

Name & Identification Fiscal Code	K513XXXXXX
Type of business (Industry)	Construction, trade, production etc.
Tax Period	2008
Sale with VAT	2,438,182,689
Sale without VAT	9,492,482
Purchase with VAT	2,507,215,844
Purchase without VAT	164,813,070
Declared Exports	28,597,071
Exports by Customs	28,823,635
Declared Imports	647,738,858
Imports by Customs	646,180,837
Secondary licenses	13
Actual year- number of employees by payroll	309
Number of employees by payroll for last tax period	186
Actual year- number of employees by tax declaration	307
Number of employees by tax declaration, last period	142
Actual year Tax obligation by payroll	37,559,169
Last year tax obligation by to payroll	27,191,717
Actual year Tax obligation by tax declaration	37,560,160
Last year tax by tax declaration	26,633,109
Last intervention of tax administration	0
Total income two years before	1,446,952,819
Total income one year before	404,035,205
Total income of current year	0
Profit tax obligation	-7,814,139
Total actual turnover	2,476,272,242
Total last year turnover	1,442,788,475
Total current year purchases	3,319,767,772
Total last year purchases	1,384,567,726
Total current year income	2,489,936,613
Total last year income	1,446,952,819
Total current year expenditures	2,514,394,444
Total last year expenditures	1,427,159,824
Current year EBIT	14,612,864
Last year EBIT	22,492,085
Last year/current year Profitability (%)	4/3

7 National Revenue Agency; Tax Audit evidence 2008, 2009

The real spreadsheet of indicators of this Large Taxpayer that was developed by system for November 2009 is given below: (amounts in ALL)⁸. Though a confidential formula the calculated points are showed for each indicator.

Automatic risk evaluation system through numeric point	
Indicators	Points
Income difference	42
Expenses difference	43
Difference in purchases with VAT	74
Difference in income and turnover	1
Difference in employees by payrolls	40
Difference in employee by tax declaration	54
Reliability	1
Points based on period between two auditing	5
Points for redacting income	0
Points for increasing expenses	6
Import difference	10
Export difference	5
Size of exporter	10
Number of secondary licenses	6
Taxpayer size	24
Points for tax fluctuation	1
Total points	322

There where 20 taxpayers from 703 in total as more risky then ours selected to be audited by the system for November. Analyzing indicators listed above we argued a series of shortcomings. The first of all is: i) The system owns the data for each business in a casual order which are not grouped according to branch of industry to be comparable and to selected more risky of them. To show the effect of that, we have experimented through calculation of the gross profit margin for each 23 construction business choosing from 710 taxpayers of Regional Revenue Agency of Elbasan. The indicators and gross profit margin derived are given below⁹.

⁸ National Revenue Agency; Tax Audit software selection criteria

⁹ In collaboration with tax audit of regional tax office of Elbasan we have studied data of the IT

GE-ECO CODE	Total sales (1) ALL)	Total purchases (2) (ALL)	EBIT (3= 1-2) (ALL)	Gross profit margin (%) (4= 3/1)
4500	225,473,826	184,314,373	41,159,453	18.2
“	19,281,460	12,207,652	7,073,808	36.6
”	24,783,238	17,191,925	7,591,313	30.6
“	15,004,563	13,022,225	1,982,338	13.2
“	78,565,120	39,145,274	39,419,856	50.0
	39,145,274	41,554,233	(2408956)	0
	71,844,592	69,121,052	2,723,540	3.6
	145,601,760	142,372,045	3,229,715	2.2
	147,468,557	103,462,209	44,006,348	29.8
	6,545,443	2,270,501	4,274,942	65.3
	44,148,846	26,394,115	17,754,731	40.2
	61,332,749	60,530,449	802300	1.3
	29,549,436	24,335,653	5,213,783	17.6
	6,283,266	3,449,820	2,833,446	45.0
	19,963,142	21,109,489	(1,146,346)	0
	41,401,145	29,401,145	12,324,377	27.7
	64,529,458	63,127,096	1,402,362	2.1
	16,691,936	16,126,981	564,955	3.4
	2,186,916	1,016,048	1,270,868	58.1
	7,866,999	6,663,544	1,203,455	15.3
	20,238,101	14,251,394	5,986,707	29.6
	11,555,080	8,438,828	3,116,252	27.0
	22,072,626	13,475,622	8,597,004	38.9
	6,283,266	3,449,820	2,833,447	45.0
	Av. EBIT			25.06

Average rate of EBIT for 24 taxpayers was 25.06%. 11 taxpayers or 47.8% of total have had gross profit margin lower than average of industry. If we refer to the automatic system which manage taxpayer's data not grouped by industry, it has been selected for audit just 1 of list above through point-evaluation method which is the last one. By our point of view, the last taxpayer does not result in higher risk if we consider rate of EBIT level calculated above. By using a statistical indicator like standard deviation $\bar{\sigma}$, we find that as large as to be $\bar{\sigma}$, as large will be the risk.²

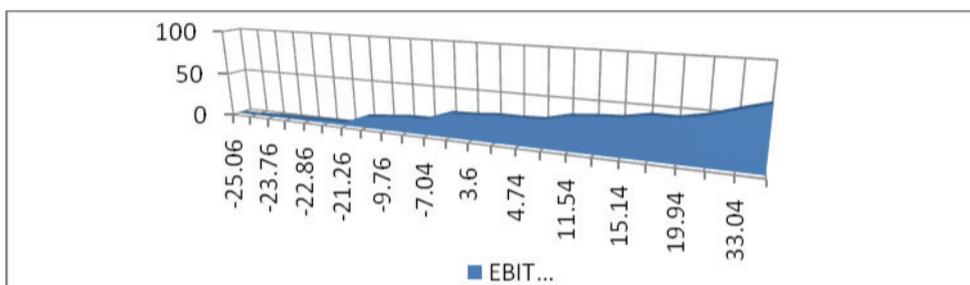
$$\bar{\sigma} = \frac{1}{n} \sqrt{\sum_{i=1}^n (c_i - \bar{c})^2}$$

where c_i is the EBIT of each taxpayer
 \bar{c} is the EBIT of the industry

We now that $\bar{\sigma} = \sqrt{\sum_{i=1}^n (c_i - \bar{c})^2}$ the greater $\bar{\sigma}$ be, the higher will be the risk

Calculating by the formula above we find that the $\bar{\sigma} = 11.06\%$

Since we have a great probability distribution of taxpayers with EBIT rate lower than average of the industry, the risk is considerably higher. The graph below shows the distribution of the taxpayers on both sides of \bar{b} , showing that depreciation up to level 11.06 of \bar{b} is too extended.



Besides the above, we have identified other several shortcomings like:

- ii) All business indicators used, belongs past two years while referring best international experiences indicators used belongs for at list last three years to be more objective.
- iii) Automatic system in use makes selection based on risk analysis for VAT and Profit Tax separately already.
- iv) The taxpayers are not categorized into groups by risk level. The best experiences, gives indicators by which we must have this risk categorization. We recommend some of them which must be:

Request for reimbursement especially for the first time	High risk and audit is necessary
Request for tax reassessment over a limit amount	High risk
Before reimbursement requests refused or decreased after an audit	High risk
Debtor Taxpayers	High risk
Taxpayer is penalized before because of late payments, dishonest tax reporting during past 12 months.	High risk
The requested amount exceeds the amount approved before	Moderate risk
Request for reimbursement over a limit amount	Moderate risk
Other requests for reimbursement	Low risk

We found that from the above topics, the two first are considered manually by Albanian tax audit. Selecting for audit every request for reimbursement, (not the first time only), it request a large part of the audit recourses, while no resulting changes to the amount of tax for some of them.

- vi) The data processed by the system does not meet more than two years, while to consider a subject with low risk should be provided that subject has been correct regarding) Exporters with at least 3 years history: ii) Keeping the accounting records by rules for the past 3 years: iii) Fraud is no sign visible in the past 3 years: iv) Has not required significant reimbursement during the last 3 years: v) Has paid taxes in the correct amount and on the time during the recently last 3 years: vi) Has a bank certificate statue that shows that the account's financial situation is good during last 12 months: vii) Some indirect methods are not used in assessing the risk to taxpayers, such are: selection based on specific issues for a certain group of taxpayers; selection based on location, etc.

TAX AUDIT PROCESS AND TAX INSPECTION DUTIES. TAX AUDITORS AND TAX AUDIT QUALITY AND MANAGEMENT. CRITERIA APPROACH AND TECHNIQUES OF TAX AUDIT.

The purpose of audit is to effectively and efficiently determine the correct amount of tax based on an analysis of relevant tax statutes, regulations and case law as applied to the taxpayer's facts. The challenge is: **Getting the right case to the right person at the right time.** Once potential offenders are identified, audit managers can assign cases based on the skills and experience of each auditor. By reducing the number of no-change audits, as well as the length of the audit process, the more effective tax audit and compliance system can enhance auditor productivity. Finally, when taxpayers understand that their returns will be quickly and scientifically analyzed, voluntary compliance rates may be rise, which could help agencies avoid costs and further improve revenue collections.

A tax audit is an examination of a taxpayer's business records and financial affairs to ascertain that the amount of tax due should be reported and paid in accordance with tax laws and regulations. The main objective of tax audit is to encourage voluntary compliance with the tax laws and regulations and to ensure that a higher tax compliance rate is achieved under the Self Assessment System. To incite voluntary compliance, the tax audit activity is one of the measures undertaken by tax administrate to educate and create awareness of taxpayers towards their rights and responsibilities under the provisions of the low. These requests developing of the audit capacities that mean especially ability development to: i) analyze accounts and taxable transactions to determine true taxable income: ii) analysis of financial statements: iii) Financial ratio interpretation and application. iv) knowledge and awareness of complexity and loopholes of tax law: v) ability to obtain and use external information sources: vi) knowledge of other relevant laws, e.g., corporate law, customs and VAT regulations, civil and criminal law: vii) to consider training & capacity building of audits, as ongoing process.

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To facilitate the tax auditing process is necessary to outreach programs for education of taxpayers and private sector as well, likes; Publicize tax law and regulations relating to risk based audit system; Conduct workshops and seminars illustrating provisions of the system; Involve private sector and tax authority in jointly disseminating information etc. Knowledge is power: taxpayers must know they can only be audited if they do not comply with the tax law. Albanian reforms have been more focus its training tax administration than taxpayers.

The auditing process comprised the following stages; **1.** Planning, translating the audit assignment into an audit program; **2.** Execution of the Program; **3.** Forming a judgment & summarizing the audit findings. **4.** Reporting of information that may be important to the levying and/or collection of taxes.

Albania Revenue agency carries out two types of audit; A desk audit is held at the tax office where taxpayer may be called for an interview at tax office if further information is required. A field audit is one that takes place at a taxpayer's premise and involves the examination of the taxpayer's business records (even examination of non-business records such as personal bank statements, etc. in the case business records are incomplete). Detailed steps to carry a tax audit, are: **1.** A taxpayer who is selected for an audit, notified by through a letter of notification of audit before audit visit, to give the right to defer or no by business circumstances or reasonable grounds. **2.** An audit visit, applicable to the field audit, starts with an interview to enable the audit to meet the taxpayer, obtain an overview of business activity, accounting and record keeping system and to discuss the audit topics. **3.** The purpose of audit plan is to formalize the groundwork to establish lines of communication, like an audit tool that provides a work document, of how will progress and identifies key potential audit

issues. Audit plan will be not standard but differed, based on circumstances like, sensitive audit issues; advice of the audit supervisor or auditor's judgment. **4. Tax Return Preparation**-Obtaining information on how the return was prepared will provide valuable information on how to address issues. Examination of records and financial statements as well as physical examination usually implemented by auditors in Albania, while other effective criteria and techniques that widely used by international experience, are;

Examination of Records as well as stock and equipments inspection physically for verification of the claims made, is the fundamental technique. In certain circumstances, there may be a need to examine records other than business records where it involves the audit of sole-proprietorships and partnerships. The challenges is where records and books of accounts are kept in electronic form, the audits must be qualified to be able for e-examination. Taxpayer can obtain guidance in relation to record keeping from the guidebook and rulings to record keeping which have been issued: i) Record keeping for business. ii) Records other than business records like, Statement of personal bank accounts; iii) Records relating to the purchase of properties; iv) Records relating to the taxpayer's personal expenses and others. The audit officer may apply alternative approaches or indirect methods for the purpose of ascertaining whether the appropriate amount of income has been reported.

Audit Time Frame is applicable only to field audits and requires to complete an on-site examination of records is 2 to 3 days; however it depends of size and complexity of the business, the form in which records are kept, or the extent of co-operation from the taxpayer.

Audit Issue Presentation Sheets; is a rapport to communicate the specific audit issue, the facts developed the relevant law and the audit recommendation on the issue. After concluding the audit work, the audit officer will prepare an audit findings report for approval by the branch. Rights and responsibilities; an audit officer must adhere to rules and codes of ethics to carry out his duties in the following manner; i) professional, ii) well mannered; iii) trustworthy; iv) honest and v) with integrity; vi) knowledgeable and fair in administering tax laws; vii) co-operative and always ready to give advice and guidance to the taxpayer; viii) ensure that the audit is carried out smoothly with minimal disruption to the taxpayer; ix) request for documents, books of accounts and information that are relevant to the audit only; x) explain the proposed tax adjustments and provide reasonable time for taxpayer to give responses on issues raised; and xi) ensure the rights and interest of taxpayers and tax agents as well as documents of taxpayers are safeguarded. An audit officer is prohibited from having any personal or financial interest in the business of a taxpayer being audited; Responsibilities of a taxpayer are; be co-operative, well mannered, fair, and honest and with integrity, providing facilities and assistance to the audit officer to carry out his duties. The taxpayer is prohibited from giving any form of gifts, payment or transacting any business with the audit officer. A taxpayer can appeal against tax audit assessments to the Appeal Department within 30 days after the audit notice. The dissatisfaction party may apply to the Court. (Establishment of Administrative Court and Institute of tax consultants in Albania are failed).

Fiscal Inspection- is the specialized activity unfolded by fiscal organs for the checking-up of the fulfillment by the passive subjects of the law fiscal procedural relationships, others than fiscal organs, of the obligations they suppose within these relations. The purpose of fiscal inspection is to establish the precision of the achievement of fiscal liabilities by the contributor. In view of fulfilling the above-mentioned attributions fiscal inspection in Albania is not under the full efficiency while the tax inspection reform is fragile; there is not yet a special manual to display methods, criteria, methods, framework, fiscal inspection rapport and other rules. The last month was experimented on-line declaration of taxpayer sales which will make them comparable with the client's purchases. Even it was been the first test, it was carried out by about 80% of taxpayers. This will cause that the electronic tax inspection must be developed in the future.

EXCHANGING OF INFORMATION AND INTERNATIONAL MUTUAL COOPERATION, AUDITING OF MULTINATIONAL ENTERPRISES.

The international exchange of tax-collection information is an increasingly vital key factor in aiding tax authorities to carry out their enforcement and inspection duties in an effective manner, thereby ensuring fair application of tax laws in an international stage where globalization is the order of the day, and specifically for developing countries like Albania which aspires to join EU. It is becoming increasingly difficult to control tax evasion without the aid of information on economic events occurring partially or fully outside of the national boundaries involving people residing abroad and possessions in the other countries. The phenomena of transfer cost, tax havens, misuse of treaties, lack of funding, e-commerce and others, are everyday's problems for tax authorities all over the world. By helping each other revenue agencies will be able to exchange information so there is a widely accepted need for International Corporation agreements, to provide the signing states with access to information. Actually Albania has assigned 26 tax treaties with other countries, while 2 are waiting to enter in force and 4 are under negotiation. Those treaties are drafted by international regulations, however by our opinion the access that they provides to insure the necessity information for tax auditing of foreign companies, (subsidiary or parent of local company) is not widely used, seeing drafting and signing of treaties more as obligations towards the EU membership requirements. We see also lack of qualification of tax audits and tax inspectors implementing of these treaties. In terms of expansion of foreign investment and foreign businesses in Albania, using agreements in force as well as new assignment to other countries takes great importance for all forms of treatments (exchange general information, spontaneous, or upon request, double taxation etc). More effective will be automatic information exchange, why not assistance in person of a tax officer of one county after request can be permitted to be present in an audit of investigation in another country, especially when books and accounts of a company are kept in another country. Recently observed tendency of developed countries to carry out the simultaneous audits that means carrying out different audits at the same time, which is considered the last form of International Corporation. This stipulates the possibility for examination of books, records and other documents in another signatory country. Some other form will be effective like audits with in person assistance, join audits or audits in the territory of another state permitted, which will be achievable by efforts of the countries to accept these agreed.

SOME CONCLUSIONS AND RECOMMENDATIONS.

1. Improvement of risk base selection system through evaluation of more risky indicators like gross profit margin of industry and other particular financial ratios, statistical methods, based on specific issues for a certain group of taxpayers, on location, or some business characteristics.
2. Better use of resources of tax authority, few cases audited, most professionally competent officers can be deputed to tax audit cell, as well as: i) lower cost of tax collection: ii) better quality of process and higher qualification of tax auditors and tax inspectors: iii) Reduce interface between tax inspectors and taxpayers, minimize corruption: iv) audit plan will be not standard but differ based on several circumstances & professional judgment.
3. Improvement of the taxpayer education through; i) taxpayer service orientation: ii) promote a tax culture of voluntary compliance: iii) tax system should be based on trust taxpayers self-assesses their taxes.
4. Improvement computerization system of tax administration in Albania in terms of; i) the tax administration should not operate in a rudimentary IT environment: ii) the regional offices which operate on Local Area Networks, must be linked to the headquarters: iii) tax returns must processed fully online for all regions: iv) the excise must be include in database of system.
5. Fiscal inspection has not executed its attributes so should: i) draft the Tax Inspection Manual. ii) expand on-line statements in all regions and determination of the on-line inspection procedures, using IT data.
6. Establishment of Institute of Tax Consultants as well as Administrative Court, are two core problems related to tax audit improvement system, and tax reform in general.

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MONTENEGRO'S LATE TRANSITION: THROUGH INSTITUTIONAL CHANGE TOWARD EUROPEAN INTEGRATION

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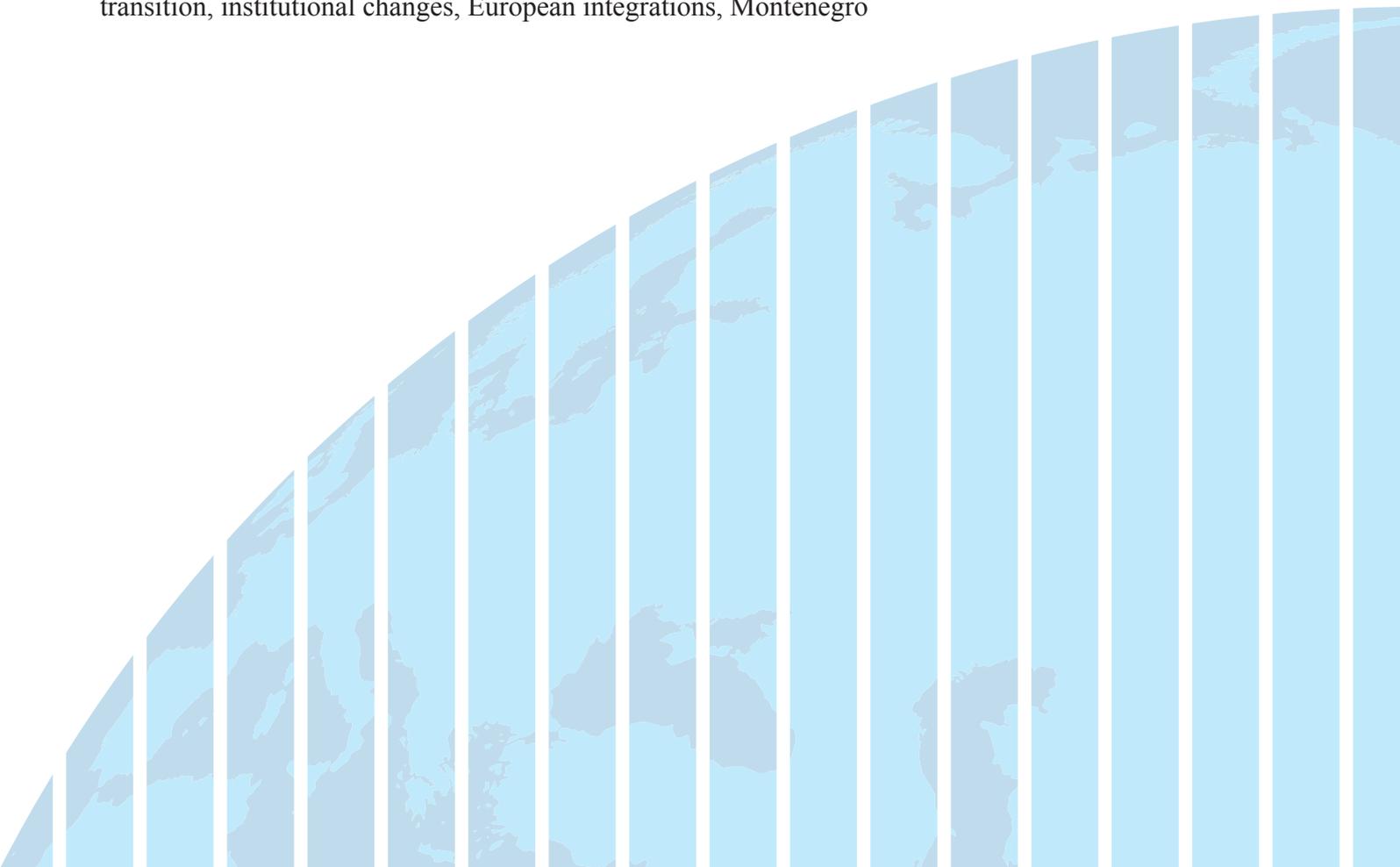
ABSTRACT

In 1989 it seemed that the main question for socialist European countries was the pace by which these societies should run from socialist economy to a market economy of an European type. Consequently, questions as privatization, economic stabilization and restructuring, and shock therapy were addressed. At the same time, transaction costs and new institutional economy theories were reemerging in Western literature revealing the importance of the rule of law for efficient market functioning, thus redirecting a focus of the transition process from political and policy issues to capacities of a society to introduce democratic institutions. Over the time, many countries have found themselves stacked in the economy of informal institutions, captured by corruption and organized crime. As the article shows, Montenegro faces severe problems of the kind, delaying its processes of transition and European integration. It seems that the critical issue of its European integration concerns a time consuming (re)consolidation of democratic forces of the society.

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Key words

transition, institutional changes, European integrations, Montenegro



INTRODUCTORY NOTE

While most transitional countries paid a high price of economic and social transition, some researches show that the prices were not the same for all those countries. As Babic et al. (2001) argue, transitional achievements partly depended on a country's initial readiness for transition – its economic structure, political relations, democracy level, relations to developed Western countries. Concerning these conditions Slovenia and Croatia were at the top positions in former Yugoslavia in 1990s, and Montenegro and Kosovo at the last. The war that followed influenced the transition process differently to each of former Yugoslav republics, to a degree that vested interests inherited from the past along with those attained through the war, both extended to organized crime and corruption, caused considerable slowdown in the transition process.

BACKGROUND

Besides the war, organized crime and corruption, of the outmost relevance for the optimal speed of transition is the role of informal sector employment (Bouev 2004). Macroeconomic stabilization and economic recovery in Montenegro were accompanied by two low points in employment: the first was due to the privatization in 2001 and the second was the consequence public administration reforms in 2003. Estimated employment in the informal economy ranged from 45.000 to 65.000 workers i.e. between a quarter and a third of total employment. In order to reduce informal employment and create new jobs, the government introduced tax exemption measures in 2003 that resulted in the legalization of approximately 30.000 jobs and creation of 5.000 new jobs (ILO – Council of Europe 2007). But, according to Bouev et al. (op.cit.), high taxes per se don't impede successful development of the new (private) sector, but rather the burden they create on new firms in comparison to the burden on their informal counterparts. In addition, they argue that reducing the opportunities for investment hold-ups in the new sector in comparison with the informal sector is one policy implication of the model of successful transition. From this perspective, WBG (2009) ranked Montenegro as 105 out of 181 countries in terms of starting a business, 130 in terms of enforcing contract, and 24 (shared position with 14 countries) in terms of protecting investors.

In addition, Bouev et al. emphasized the role that informal economy plays for the optimal speed of transition. Concerning this issue, Montenegro faces some serious problems - Financial Standard Foundation (2009) assessed smuggling of cigarettes as a major illicit activity (Prime Minister Milo Djukanovic being accused by Italian legal authorities of facilitating cigarette smuggling). In addition, Greco (2008) indicated that organized crime and money laundering in Montenegro were serious problems. Confronting these statements to the USAID (2008) data on foreign direct investment (5 year cumulative per capita, 2004-2008), where Montenegro was ranked first among transition countries, and ILO – Council of Europe (2007) remarks on jobless growth, serious question arises on the very basis and sustainability of economic growth.

Regarding the progress in economic and democratic reforms, USAID (2008), on the basis of EBRD and WB data, weighted Montenegro by 2.8 out of 5 in economic reforms (3.8 in the first stage economic policy reforms, 2.1 in the second stage economic policy reforms), 3.1 in democratic reforms, and 3.4 in macroeconomic stability.

MONTENEGRIN EXPERIENCE IN THE LIGHT OF SOME LITERATURE FINDINGS ON TRANSITION, INSTITUTIONAL CHANGE AND EUROPEAN INTEGRATION

Transition

Gradualism vs. big-bang reforms. According to Dewatripont - Roland (1992), gradualism is advantageous when the political acceptance of full and immediate reforms implies excessively costly compensations, being the case in almost every transition country except Eastern Germany where its Western counterpart absorbed these costs. Reforms in Montenegro have been gradual, but started with considerable delay by privatization (selling firms to foreign investors), followed by gradual compensated lay-offs, mass voucher privatization and reform in other sectors (banking and labour). This is in accordance with Dewatripont and Roland opinion concerning the situation when the government could pre-commit itself to reform plans, where allocative efficiency could be reached only in the second period at a lower financial cost than under alternative full or 'big bang' reform. The issue of reaching the allocative efficiency is questionable in case of Montenegro, since its government has rather been resisting to reforms than deliberately pre-committed itself to them, as reported by ESI (2001) on reforms in Montenegro. The post-independence (since 2006) economic boom has been fueled by very large and, to a considerable extent, unsustainable external capital inflows and "compensation payments" have been mainly avoided by overwhelming employment in public administrative sector, that nowadays emerged as critical wage bill - the single largest component in the current budget that ought to be curtailed as a share of general government spending (WB 2008b)¹. Thus, "compensation payments" were delayed for the future, not allowing allocative efficiency to be reached under the partial reform of public administration.

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In sum, Montenegro prolonged payment of high costs of immediate reform by choosing gradual reforms, accumulating and delaying those costs to the future. Nowadays, prospects for covering those costs are not bright since the GDP growth is decreasing in the last three years and "competitive" tax regime adds an element of pro-cyclicality, obliging government to increasingly rely on imports as a source of fiscal revenue. So, a large-scale public investment program is required to attract private investment and increase the economy's growth potential. In 2001 Millar (2009) discussed problem of covering costs of transition in Russia as avoiding tough decisions due to the IMF, World Bank, EBRD, and USAID funding that served as substitute for raising taxes and reducing expenditures, while much of it was apparently stolen. Similar, or even worse, notion could be relevant for Montenegrin case², especially in the light of the statement of former USA ambassador in Serbia and Montenegro, William Montgomery, that Montenegrin Prime Minister was allowed to organize tobacco smuggling since there had no been money to finance him.³ One would object this as not being completely true since in the late 1990s Montenegro, along with Israel, was a country that received the highest USA donations per capita (CEDEM 2002). On the other hand, as reported by Financial Standards Foundation (2009), it is widely believed that Montenegro is used by Russian oligarchs and organized crime figures as a base for money laundering, mainly by means of real estate.

1 "Apart from tourism receipts and foreign acquisitions of companies, banks, and shares of publicly traded enterprises, more than one-third of capital inflows consisted of elements that are temporary and will dissipate over the medium term—in particular, purchases of (coastal) real estate by foreigners (20 percent of GDP in 2007) and external borrowing by the domestic banking sector (14 percent of GDP)." (p. ii)

2 For the EU and USA assistance to Montenegro see ESI (2000, 2001).

3 <http://www.dan.cg.yu/?nivo=3&datum=2009-08-24&rubrika=Vijest%20dana&najdatum=2009-08-20&clanak=198259>

Berkowitz (2002) addressed the Roland's stance towards gradualism vs. big-bang reform in the light of conditions that favor each.⁴ In that respect, one could expect that gradual reforms in Montenegro have been adjusted to the prevailing standing to gain from reform and to the time individuals need to learn and adjust to new market institutions. The result has been just opposite - Montenegro is among the most unequal countries in the Western Balkans, with the possibility of further widening the large gap between rich and poor (UNDP - ISSP 2005). But, it was only rhetoric that leads government to stay in power over time and its members to become wealthy winners of transition (ESI 2001).

However, according to Stiglitz - Ellerman (2000), the dilemma of gradualism vs. big-bang reforms is a false one.⁵ Actually, there is a third alternative - basically sitting on one side of the chasm and erecting many half-bridges that go nowhere - many pseudo-reforms that are dead-ends. It seems that the ESI Report (2001) in the very title – Rhetoric and Reform - clearly addressed the issue in the case of Montenegro. Additionally, Stiglitz - Ellerman (op.cit.) put another interesting notion discussing the Russian transition that proves correct today in Montenegro, as well - in addition to legacy of socialism, there is another new legacy – a “mafia” that has grown even faster than group of young entrepreneurs.⁶ And, not the least important, there is a question of rule of law that Stiglitz - Ellerman related to the inner interest of middle class, not to one of the oligarchs. Having the biggest gap between the richest and the poorest population in the region, meaning that the middle class has been almost extinguished, it seems that Montenegro doesn't have a social class that is inherently interested in the rule of law.

It is recognized nowadays that transition process can't be completed over night and that each country is specific, so for countries that aspire to join the European Union, the accession process actually supports time consuming process of gradual reforms toward democratic society and market economy.

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Democracy and political constraints. In addition to various assessments of state of democracy and political changes in transition countries, significant efforts have been done to explain the causes of the actual state. ESI (2001) document explained it under the term of “socialist legacies”:

Administrative cultures, the expectations of government officials about what is “normal” and “acceptable” in a given organisation, evolve in response to concrete problems and incentive structures over a long period of time. Even when such cultures become dysfunctional, it remains necessary to understand their roots if one wishes to improve governance in a durable way. In the case of Montenegro this requires an understanding of the incentive structures and the mental models about the role of government in society that the political elite inherited from past decades of socialist development. (p. 5).

The “socialist legacy” is by no means an important aspect that should be kept in mind while reading various progress reports, USAID's (2008) being the one that says Montenegro shows progress in democratic reforms and the middle position among transition countries.⁷

4 “Gradualism is appropriate when most people stand to gain from reform, but individuals need time to learn and experiment with new institutions such as free market pricing, etc. When, however, there is a great deal of individual uncertainty about who stands to gain or lose from policies, such as the development of financial markets, a big-bang policy is appropriate because it is the only way to overcome the tendency of the population to support the status quo.” (p. 217)

5 “Some have formulated the public debate about the transition as a question of fast versus slow. But that seems an ill-formulation since one can find successes and failures on both sides of the fast-slow dichotomy. Some countries tried to “jump over the chasm in one leap” such as Russia but their leap did not reach the other side and now they will take much longer to climb back out of the chasm. Other countries progressed more incrementally and found that well-designed incremental reforms, such as the Chinese agricultural reforms, can proceed quite rapidly. Other countries tried to just “go slow” and sat on one side of the chasm erecting many half-bridges that went nowhere – many pseudo reforms that were dead-ends.” (p. 42).

6 <http://www.blic.rs/society.php?id=4970>

7 “Democratic reforms in the Southern Tier CEE was a “wash” on balance in 2007; i.e., four countries progressed (Kosovo, Croatia, Bulgaria, and Montenegro), four countries regressed (Serbia, Macedonia, Bosnia-Herzegovina, and Romania), and one country (Albania) saw no change in democratization.” (p. 19).

In addition, Tridico (2006) claims that economic growth is not always concurrent with human development.⁸ He found that macroeconomic stabilization was not a sufficient condition for economic growth but human development, promoted by institutional policies, seemed to be a sufficient condition for economic growth. Tridico (op.cit) points out that Montenegro is among the worst performing countries.⁹

However, the newest update of Human Development data for Montenegro (UNDP 2008) that show progress of HDI over income, are not comparable across different publications, and HDI is not a comprehensive measure of human development, as it has been emphasized in the last statistical update.¹⁰ According to the USAID's (2008) more comprehensive ratings (1 to 5), Montenegro is rated as 3.3 in economic performance and 3.9 in human capital.

There is also a slowdown in democratic development in transition countries that according to some explanations are due to social capital inherited from the past that has eroding impact to physical and human capital (more on this see below under the *Institutional change/Social capital and governance*) .¹¹

When talking about constitutional changes and the rule of law, Wheat - Schwartz - Apperson (2003) made an interesting point on the democratic constitution and its effectuation, explaining that - cultures long founded in principles of autocracy don't believe in "modern constitution".

In this respect, Commission of the European Communities (2008) assessed the state in Montenegro as "Corruption continues to be widespread and inefficiently prosecuted, particularly in cases of high-level corruption", recommending that "the main challenge for the Montenegrin authorities will be to transform the Action Plans and National Strategies into concrete and visible results." The same notion of lack of principles of democracy in Montenegro could be find in CMI (2007).¹²

Confronting the above assessments to the findings of Fjelde - Hegre (2007)¹³ on political corruption influence to democratization we agree that "corruption substantially reduces the likelihood of transition towards democracy and makes autocratic and inconsistent polities more persistent to change". That is why, in our belief, the transition process in Montenegro is extremely under the question today.

The importance of democracy for the transition was timely perceived in the literature. Dewatripont - Roland (1992) argued that democracy could be an obstacle to reform and showed that a government in control of the agenda of reforms can win majority approval for plans which end up hurting majority interests over the time. That is exactly what happened in Montenegro where the same party and the

8 "...economic growth can contribute to increase the level of human development, but is not "the means" to human development. The income is not the final aim. On the contrary, the final aim is the well-being of individuals and the human development. Human development is considered to be a process which allows for an environment where people enjoy long, healthy and creative lives." ... " In this context institutions and institutional policies are crucial for a development process. In fact, for better distribution and access to resources as well as for social cohesion, well-designed institutions are needed." (p. 5).

9 "The majority of countries experienced a reduction of HDI and a reduction of income levels: Russia, Bulgaria, Romania, Moldova, Kyrgyzstan, Ukraine, Kazakhstan, Macedonia (TFRY); plus Bosnia-Herzegovina and Serbia-Montenegro. They are the worst performing transition economies." (p. 41).

10 "The index is not in any sense a comprehensive measure of human development. It does not, for example, include important indicators such as gender or income inequality and more difficult to measure indicators like respect for human rights and political freedoms. What it does provide is a broadened prism for viewing human progress and the complex relationship between income and well-being." (UNDP 2008).

11 For more on social capital, initial conditions and reforms see EBRD (2001); UNDP-ISSP (2005).

12 "The most serious speculations about "grand" corruption are at the central executive level in general, and with the privatization process in particular, along with a number of sectoral development proposals such as the spatial plan and the energy strategy. Experience from other transition economies suggests that privatization is a "one-off" issue, and that reversing privatization contracts might be more damaging than beneficial for future investments and confidence in the economy. That said, the way in which the Montenegrin government has warded off any insight into the process despite years of legitimate public pressure is astonishing. Such practices, along with some other reactions by leading politicians that characterize legitimate criticism from NGOs as "against the country interest", suggest that principles of democracy have not been truly embraced." (p. 6).

13 "In spite of democratic elements in the formal institutions of the state, inconsistent regimes with high levels of political corruption are remarkably resistant to pressure for democratization. Political corruption seems to trap these regimes in an equilibrium, where a number of individuals derive so significant economic benefits from their association with their patrons that their incentives to press for more accountable political institutions are small."(p. 26).

leader (Milo Djukanovic), as communist party descendants, have been ruling for twenty years now. ESI (2000)¹⁴ qualified this regime as a good example of “illiberal democracy”.

There is an additional point Dewatripont - Roland (op. cit) made that helps explain Montenegrin “changing political situation”. It concerns possibilities that the government is seeking a variety of majorities over the time, threatening to switch majorities in order to extract more rents from such a ‘divide and rule’. In Montenegrin case it repeatedly happens on ethnic and national basis. Nevertheless, the authors made two additional points: (1) democracy should not necessarily be overestimated as an obstacle to transition, as China case shows, contrary to their European counterparts, and (2) it is rather matter of a degree of legitimacy that allow governments to control the reforms. While the first point is relevant for the comparison of China vs. its European counterparts (China introduced economic changes prior to political, not allowing for risks of new institutions to jeopardize transition), the second point we find crucial in the most Western Balkans countries, where minimum of legitimacy might still be lacking.¹⁵

Institutional change

The questions of formal democratic and market institutions vs. informal institutions in transition countries are of considerable importance for the full effectuation of the transition process. In Western countries development of democratic and market institutions took centuries, while it has been “only” two decades since the fall of Berlin Wall in 1989. Thus, the process of institutional changes both complex in enduring.

Institutions and history. The immense contribution of Douglass North to the New Institutional Economics and transition from socialism to market economies has been very well summarized in Mendelski’s (2006) work. North’s analysis is descriptive and historic hence offers an understanding of the successful development in the past (path dependence development due to the endogenous factors) and no instruments/recipes in the short and middle-run on how to achieve long-lasting economic growth (under the influence of uncertain future, exogenous factors). It seems that only by time and other countries experiences comparison it is possible to envision “the best solution” for particular country. That is exactly what Mendelski aimed at.¹⁶ In order to foster understanding and implementation of measures that have been set as priority for Montenegrin transition process today (namely the one of corruption, organized crime and rule of law), we will emphasize some of North’s general and abstract ideas, as emphasized by Mendelski.

Firstly, North claimed that institutional development is shaped by interactions between institutions (rules of the game), formal and informal, and organizations (players) and by effectiveness of enforcement. That is why the mixture between formal and informal institutions need to be moved toward more formal rules and enforced by the law.

Secondly, ideas, ideologies and beliefs influence human perception of the reality and its preferences, so for institutions to be changed and enforced one should consider human ability and willingness to change, as well as the role of intellectuals in a society.

14 “From 1990 to 1997, Montenegro was a good example of what has been called “illiberal democracy”: a political system that went from socialism to formal democracy without major changes either in its ruling elite or the way in which political power was exercised.” (p. 2).

15 While Montenegro was not under the MPRA (2009) study on political determinants of economic reforms in the post-communist transition countries, its results could be illuminating for the prospective Montenegrin transitional policies concerning politics. This study examines how political institutions and electoral outcomes have affected the economic reform process in the post-communist transition countries and its results suggest that the institutional structure of the economy has been of importance, at least for the western-most transition countries. Democratization and a relatively short exposure to communist rule have been conducive to economic reform, while the timing of elections and whether the government commands a majority in parliament appear to have been unimportant. Governments with right-wing ideology have implemented more market-economic reforms than governments with other ideologies.

16 “As nowadays many transition countries already joined the EU, application potential remains for actual transition economies and developing economies. For this purpose we have to learn from the mistakes of the history with the help of qualitative-comparative studies and adjust present theory concepts.” (p.89).

Thirdly, as a deeper cause of institutional change North mentions changes in relative prices (e.i. labour to capital), information costs, and changes in technology. That is why the liberalization, information infrastructure, transparency, access to information and investment in new technology matter.

Fourthly, North tried to answer the issue of inefficient institutions persistence, i.e. resistance to institutional change, by path dependency theory. Each country has its specific path of institutional development over history that is reinforced by: (1) positive feedback – economies of scale, complementarities and network externalities, and (2) informal institutions which interact with formal institutions. Certainly, there are additional contributions to the issue of “survival of institutions” that help explain Montenegrin case (Kuljak 2010).¹⁷

Fifth, as a consequence of the above influences North argue that in the long run this interplay leads to irreversible path of institutional development and economic structure of a country. This stance put a serious doubts on possibilities to make a democratic society out of criminal one.¹⁸

Sixth, if there is no compatibility between formal and informal institutions (especially those existing prior to communist era, i.e. culture and tradition), transaction costs and resistance to institutional change increase, resulting in lower economic growth and wealth. In fact, Montenegrin prevailing tribal and orthodox tradition and values are not compatible with market and Western values. Thus, an old social pattern of “doing a favor” has easily been transmitted into criminal and shadow social and economic area of life. Besides, possibility to travel and be in touch with Western culture has been limited for twenty years, contributing to the persistence of local institutional patterns.

Seventh, incompatibility between formal and informal institutions give rise to transaction costs and make the enforcement of new formal institutions difficult. As a consequence, corruption and underground economy emerged, “enforced” by weak state and non-functioning legal system.

Eighth, unfortunately, North didn't consider future and external influencing beneficial factors, as it emerged at later stage of the transition process when the influence of EU legislation is concerned. As Mendelski (op. cit.) put it - EU provide financial support to candidate countries prior to accession and maintain strong pressure to fulfill the accession criteria and adopt the “Acquis Communautaire”. Thus, EU could be a third party that via national government enforces the rule of law (European), while IMF and WB influenced the economic policy in transition countries.

Social capital and governance. It was only in 2001 when first data on social capital and its positive correlation with growth in the transition countries appeared (EBRD 2001). The authors addressed two groups of social capital definition. According to the first group, distinguishing traits of social capital are the universalistic morality and “extended trust” (as a public good) that permit societies to

17 “The success criteria of a political-economy project generally come from two complementary economic and philosophical approaches. The first one is the ‘contractual’ approach based on state consensus. James M. Buchanan (1999) developed the approach based on Pareto criterion that explains that if a state level consensus is reached in an adequate and transparent way, and within a correct (realistic, internally consistent, robust and behaviorally vigorous) theoretical analysis of institutional design, then there are considerable chances for certain version of political-economy agenda to come into reality. Thus, within the ‘contractual’ approach to political economy analysis, the political implementation is the ultimate criterion of success, despite persistent existence of inefficient institutions in democratic societies that serve some powerful interests i.e., according to Pareto criterion, there is no better solution.

Therefore, the success criterion is exogenous i.e. external to the nature of a political-economy agenda, and is articulated through the final voluntary acceptance of an agenda.

The other approach to success criteria originates from Hayek (Witt, 1992). He defines endogenous requirements for success of a certain political-economy agenda. The one concerns general character and approach of economic policy (GDP maximization, not the individual net present values), and the other deals with basic ideological principles (system of social values that articulates expectations of economic agents thus making it easier for individuals to cope with intentional or unintentional consequences of economic policy and make them less averse to changes of political norms).

These two approaches are made closer in Wicksell's works (Wagner, 1988), as he insists on coherent programs of economic policy, broadly based on historically stable (“constitutional”) state level consensus. He acknowledges that implementation of such policies to certain groups and individuals require a process of persuasion in order to make them cooperative in political and economic processes.” (p. 5).

18 “Fighting corruption is a long-term prospect, and there are no quick fixes. That said, and being mindful of the structural and historical constraints that impact the pace of reforms, moving forward donors need to take a more critical stance on the delays in delivering reforms. Not doing so should not be viewed as “doing a favor” either to the Montenegrin government or its citizens, who deserve a competitive and well-governed state.” (p.83).

evolve into a modern and market-based society. From the political point of view, the focus is on the connection between social capital and the development of those political institutions that foster the rule of law, facilitating economic exchange. The second group of definition draw upon investment in social networks by individuals, therefore social capital is the sum of the “relational capital” (as a private good) which is enforced by peer pressure.

The importance of the two group of definitions lies in their focus on two different roles that social capital may pursue in facilitating economic transactions. According to the first group, moral obligations are reinforced in social networks and social capital is accessible to all (similar to a formal institution such as a legal right or liberty). Thus, social capital is complementary to formal institutions and its effect on economic performance of a country is positive. According to the second group, social capital may facilitate economic transactions between individuals but often at the expense of excluding others, having uncertain and negative influence on the wider society.

And if “[T]he real test for all dense social networks is how they adapt to new economic circumstances that would require transactions with non-members”, as cited in EBRD (2001), it would be an interesting area of further research in Montenegrin case, especially having in mind the problem of “captured state”.¹⁹

Also, there are findings in the literature that explain that governance matters for the growth. According to Hall and Jones (1998) up to 50% of growth rate changes could be explained by governance, so more appropriate social institutions could explain better economic performances of countries after the Second World War, as well as European colonization strategies provided exogenous institutions that consistently affected productivity among many developing countries.²⁰ Koulikov (2004) presented a new paradigm in economic policy and economics - the information paradigm that represents the progress and growth of knowledge in economics, thus widening possibilities of state to complement the market. This is obviously functioning in democratic countries with developed ICT, whose administrative capacities are high and corruption low. However, in transition countries, Montenegro as well, the issues of investments in ICT, reform of education, public administration capacity building, and fighting corruption, along with rhetoric on market and democracy reform, are those “bridges” that should be built simultaneously. Meanwhile, society functions within an inefficient mixture of formal and informal institutions.

The importance of governance for the transition has been widely recognized today and amounted to significant support by international organizations as WB, UNDP, and EBRD. WB (2009) Worldwide Governance Indicators show that Montenegro is in a “yellow zone”, meaning that it is in a range of approximately 50 percentile position out of 212 countries, along six criteria of governance – voice and accountability, political stability, governmental effectiveness, regulatory quality, rule of law, and control of corruption.

European integration

Norms and culture certainly have considerable power in the process of integration, but there is an additional explanation why leaders in less democratic regimes don’t find the EU membership attractive (Mattli - Plumper 2002).

We have shown that, in the wake of the economic transition crises of the early 1990s, leaders in more democratic countries had a strong incentive to implement politically costly and

¹⁹ For more on trust in formal institutions in Montenegro see NDI (2003); and on state capture in Montenegro see Uzelac (2003).

²⁰ “A country’s long-run economic performance is determined primarily by the institutions and government policies that make up the economic environment within which individuals and firms make investments, create and transfer ideas, and produce goods and services.” (p. 114); more on this issue see Olson et al. (1998); Rodrik (2004); Acemoglu et al. (2001).

protracted ‘institution-building’ reforms that constituted a natural stepping stone towards EU application. Leaders in less democratic regimes, who are not overly concerned with the general well-being of the population, felt less pressure to contemplate deep reforms. Their survival depended largely on the support of a few powerful interest groups that derived great economic and social benefits from the politico-institutional status quo. EU membership was decidedly unappealing to these leaders. (p. 570).

In addition, governance literature explains how European colonization strategies provided exogenous institutions that consistently affected productivity in many developing countries. Obviously there are lessons from the past that could be relevant for countries that have no favorable endogenous factors of transition. The influence of EU legislation at later stage of the transition process could be considered as external beneficial factor of transition, on the conditionality basis.

On the other hand, policy measures that transition countries have been introducing could have positive effects on national productivity (Petrovic - Antevski – Vesic 2008).²¹ There are no relevant data and researches concerning Montenegro on the issue, so far. However, the EBRD Transition Report 2008 rated Montenegro as 2.8 in economic and 3.1 in political reforms (in scale from 1 to 5); further, its first stage economic reform rate is 3.8, and second stage economic reform is 2.1. Obviously, there are expectations that Montenegro should turn from rhetoric to action (CMI 2007):

Montenegro’s EU aspirations should be used as the main instrument for advancing the political will for reform. The government’s European rhetoric should be matched with holding it accountable for implementing genuine reform. Donors should make clear, where possible, that they are ready to take an in-depth look into the quality of the reforms as reported by the government. (p.80).

Besides, Commission of the European Communities (2008) has clearly addressed criteria and area of expected progress to be done.

CONCLUSION

Explaining and assessing progress of transition process are fundamental issues for answering the question of where a country goes. Not only the current state but prospective paths are equally important issues to be addressed. In that sense, explanatory approach of NEI (that institutions and history determine path of transition, as well as the mixture of formal and informal institutions) should be complemented by governance and social capital approach. It means that transition process is a political issue in that it concerns not only the political reforms but decision making and responsibility, as well.

When assessing the progress, GDP and HDI need to be considered from a long-run perspective i.e. assessment of political sustainability of market reforms, including the rule of law, for the benefit of large fraction of population and a middle class. The European integration, as gradual and reliable process, is a big chance for those countries that lack endogenous factors of transition, Montenegro being the one.

21 “The European integration process has intensified the problem of competitiveness of the national economy by the following: first, by the reduction of protection measures, and second, by the liberalization of regional trade. It has been a good way to upgrade and strengthen competitiveness of the national economy. Regional economic integration is a supporting means for a gradual increase of competitiveness of a small open economy in transition. Full membership in the European Union involves strong competitive pressure on new member countries, on one hand, and a certain degree of collective protection, on the other.” (p. 1)

As a starting point, the “whence” question of transition is still important for Montenegro. Once it was on the occasion of the fall of Berlin Wall in 1989, and nowadays, when “the wall” still exists in the form of the unchanged ruling elite, leaving the transition process to exogenous, mostly European, factors to succeed. Thus, the question of “whither Montenegro”, should be simultaneously reconsidered with the question “whence Montenegro”.

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THE POVERTY REDUCTION IN RUSSIA: THE DINAMICS AND STRUCTURE

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ABSTRACT

We investigate the dynamics and the structure of the Russian poverty for the period of 1994 – 2005 in the context of the government socio-economic policy of poverty reduction. The development of effective programs of fighting poverty requires analysis of successes and failures of past policies. The paper shed light on poverty alleviation programs in Russia by analysing data for the period 1994-2005, covering both the period of deep socio-economic crisis and major economic resurgence. The trends in the depth and severity of poverty and income deficit for various socio-demographic groups are presented.

Key words

Poverty profile, income, social policy, househods

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JEL classification: C19, D31, I32

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INTRODUCTION

Alleviation of poverty is one of the primary objectives of Russian economic development. In order to evaluate the effectiveness of the poverty reduction programs it is necessary to analyze poverty development during a sufficient period of time. The analysis should capture not only the total number of people living in poverty but also focus on the specific socio-demographic groups which were more likely to experience poverty in different periods. Knowing poverty dynamics of a particular socio-demographic group allows us to describe changes in the poverty profile and thus to evaluate the effectiveness of the government poverty reduction programs targeted to specific socio-demographic groups.

Since 1992, Federal State Statistics Service of Russia (Rosstat) publishes information on the share of population with the monetary income below subsistence minimum. However this information may not be enough to assess the level of poverty because the contribution of non monetary income sources, such as income in kind and intra family transfers, has risen sharply. The necessity of better understanding the effects of the government policy on poverty trends in Russia was one of the reasons for conducting household surveys such as the Russian Longitudinal and Monitoring Survey (RLMS). The RLMS dataset covers the period from 1994 to 2005 and allows to monitor and evaluate government social policy in the area of poverty alleviation².

The objective of the paper is to explain the changes in the structure of the Russian poverty in the context of the government policy of poverty alleviation. To meet the objectives of the study we have to determine the trend in the level, depth and severity of poverty for various socio-economic groups of households.

224 The literature dealing with the issues of poverty measurement is large and well established. Ravallion (1999) presents a comprehensive overview of the literature on the issues related to poverty measurement. The impact of aggregate welfare on poverty and inequality in Russia is investigated in Ovcharova and Tesliuc (2006). World Bank (2005) presents in-depth analysis of the Russians poverty trends including the regional poverty trends. In the analysis of poverty one of the most widely used indexes are FGT indexes (Foster et, al., 1984). These indexes allow additively decomposing poverty according to geographical and socio-economic impacts. Recent studies presenting decomposition of Russian poverty using FGT indexes include Gustafsson and Nivorozhkina (1996, 2004, 2005).

REVIEW OF THE MACROECONOMIC TRENDS IN THE CONTEXT OF SOCIAL POLICY, 1994-2006

The start of economic reforms in Russia led to the significant decline in all sectors of the economy and lasted well throughout 1990s. An adverse effect of the reforms was increased uncertainty of Russian households about the future. Privatisation and insolvency of state owned companies led to the rise in unemployment and deterioration of the social security system often provided by the employer. Wage arrears and unpaid leaves became a norm. Many individuals found their education and skills outdated and of no use in the market environment.

Subsequent period was characterised by the economic upheaval and improvement in living standards. Table 1 presents the main macro indicators for the period 1994-2006.

² In a context of a considered problem we understand the efficiency of state policy as productive reduction of poverty. At such approach this multidimensional concept can be characterised as economic or social, macroeconomic, group or individual efficiency.

The GDP growth remained negative throughout the most of the 1990s. High levels of inflation eradicated savings and negatively affected consumption. In 1997, the Russian economy showed some signs of recovery, which followed by the financial crisis of 1998 (Brown, 1999; Buchs, 1999), and subsequent economic upheaval. In 1999, the period of strong growth started and by 2000, the Russian economy reached a record 10% GDP growth rate.

According to the official statistics, wage tends to be the main source of income, however from the beginning of reforms its contribution has declined by 2.5 times. Since the end of the 1990s the real wages were increasing, with the highest growth rate in the year 2000. During the period 2001-2005 the growth rate of the real wage had slowed down.

According to the official statistics the Gini index increased from 0.260 in 1991 to 0.409 in 1994. At the later period the coefficient has declined till the 2005 but still remains high comparing to other European countries.

Russian trends in the wellbeing of the socially deprived groups indicate that their position had deteriorated throughout most of the 1990s.

The Russian system of social insurance failed to protect low income families. A number of important social security components were regarded as inadequate. For example, child benefits amounted to 3% of subsistence minimum in 2004.

From the beginning of the 1990s, new types of benefits had emerged: unemployment benefits, benefits for low income families, assistance to the forced migrants from the republics of the former Soviet Union. As a result in the year 2000 federal budget financed around 150 social programs for over 200 eligible groups.

In the middle of 1990s 70% of Russian population were eligible to state support. At the same time, due to the complicated procedure and low level of benefits, only 33.8% of Russian households received state subsidies. Among households with income levels below the subsistence minimum only 27.4% received state support. At the 2004 attempt to switch from in-kind transfers to monetary transfers did not improve the situation (Ovcharova et al., 2005).

Table 1. Macroeconomic indicators 1994 – 2006

Indicator	Year												
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP (in percentages to the previous year)	87,3	95,9	96,6	100,9	95,1	105,4	108,3	110,0	105,1	104,7	107,3	107,2	106,4
Consumer price index (in percentages to the previous year)	320	230	121,8	111,0	184,4	136,5	120,0	119	115	112	111,7	110,9	109,0
Unemployment, thousand individuals (at the end of year)	132	118	100	120	110	102	77,1	89,1	97,9	92,3	101,6	90,2	89,0
Annual average of employment (as % of total): Manufacturing sector	27,1	25,8	24,8	23	22,2	22,4	22,6	22,7	22,2	21,9	22,2	21,7	21,2
Agricultural sector	15,1	14,7	14	13,3	13,7	13,3	13	12,3	11,8	11	11,2	11,1	10,6
Service	42,7	43,9	44,6	47,8	48,6	48,7	48,6	49,0	50,1	50,8	54,1	54,4	55,2
Real income (1994=100) ³	100	78,9	95,8	102,6	73,4	81,0	83,2	90,5	106,2	128,8	144,2	160,1	110,2 ⁴
Real wage (monthly average, 1994=100)	100	90,2	96,6	109,3	72,4	81,7	90,0	107,7	124,4	142,4	153,3	168,6	113,4 ⁴
Real pension (monthly average, 1994=100)	100	95,5	103,6	105,8	63,2	59,9	78,62	99,9	102,3	115,1	113,3	124,6	105,1 ⁴
Gini coefficient	0,409	0,381	0,387	0,401	0,399	0,400	0,399	0,396	0,397	0,402	0,407	0,409	0,416

Source: World Development Indicators (2005), Russian Statistical Yearly Book (issues 1995-2006 years).

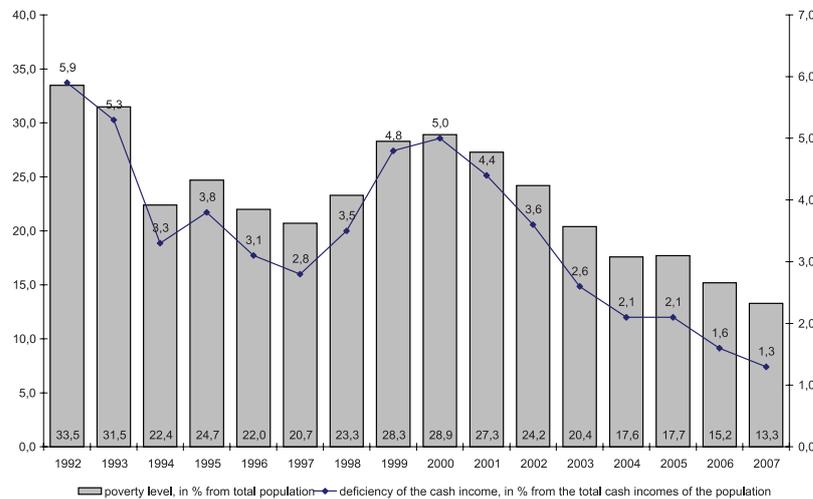
³ In relation to the year 1991 the real income in 1994 amounted to 57.9%

⁴ In relation to previous year.

One of the outcomes of economic recovery at the end of 1990s was better funding of social programs. Nevertheless the share of social spending in the federal budget remains relatively low, reaching 8.8% of the GDP in 2005. Therefore, real pensions still accounted to only 66.4% of their pre reform period.

Economic stabilization started in 2000 led to increase in real incomes. Wages and pensions grew at the accelerating rate, exceeding the rate of the GDP growth. The share of households with incomes below subsistence minimum declined (Figure 1).

Figure 1. Official estimates of the level and extend of poverty



Source: Rossiya v cifrah. 2009: Krat. stat. sb./ Federal'naja sluzhba gosudarstvennoj statistiki. - M., 2009. - S. 113-114.

In the period 1992-1994 the proportion of individuals living below the poverty line, defined by the state, was decreasing. This however can be partially attributed to the changes in methodology of the statistical agency rather than real improvements in the wellbeing. The trend in the poverty alleviation was brooked abruptly by the financial crisis of 1998. The next significant decline in poverty levels started in the year 2000. However, the true decline is masked due to adoption of more “expensive” survival equivalent. Starting from 2001 we observe steady decline in poverty levels, which point to the positive impact of economic development on income growth. (Ovcharova, 2005, 2007). According to (Ovcharova, 2007) the income deficit of poor households remained relatively stable at the level of 31%.

DATA AND METHODOLOGY

We utilise the information provided by ten rounds of the Russian Longitudinal Monitoring Survey (RLMS) for the period 1994-2005⁵.

The object of our study is a household. In the household we identify the household head – an individual with the highest income. For each household we take into the account the following characteristics: size and structure of the household, number of children and working members and type of settlement.

We construct a measure of household disposable income as a welfare indicator. We adjust the disposable income to account for non monetary sources of income.

We consider the household to be poor if its disposable income is less than 50% of the median disposable percapita income of the households in our sample. Such approach is not free of methodological pitfalls, but it allows as to analyse the poverty trends using consistent definition of poverty.

⁵ <http://www.cpc.unc.edu/projects/rlms>

A popular class of poverty indexes which possess a number of useful properties and allow additive decomposition is FGT indexes (Foster, et al., 1984). In general form the index can be written as follows:

$$FGT = \frac{1}{N} \sum_{i=1}^n \left[\frac{Z - Y_i}{Z} \right]^\alpha,$$

where Y_i – personal income, N – sample size, n – number of individuals below poverty line, Z – poverty line.

When $\alpha=0$ – index represents the proportion of a population in poverty; $\alpha=1$ – is an estimate (in % from poverty line) of the average shortfall of individual income from the poverty line; $\alpha=2$ – index gives higher weight to a large shortfall of individual income.

FGT index is a useful tool for building of a poverty profile. Let the population be divided into m mutually exclusive population subgroups forming poverty profile. The poverty profile is simply the list of poverty measures P_j for $j=1,2,\dots,m$. Aggregate poverty can be written as the population weighted mean of the sub-group poverty measures

$$P = \frac{1}{N} \sum_{j=1}^m n_j P_j, \text{ where } P_j = \frac{1}{n_j} \sum_{i=1}^{n_j} p(Z_j, Y_{ij})$$

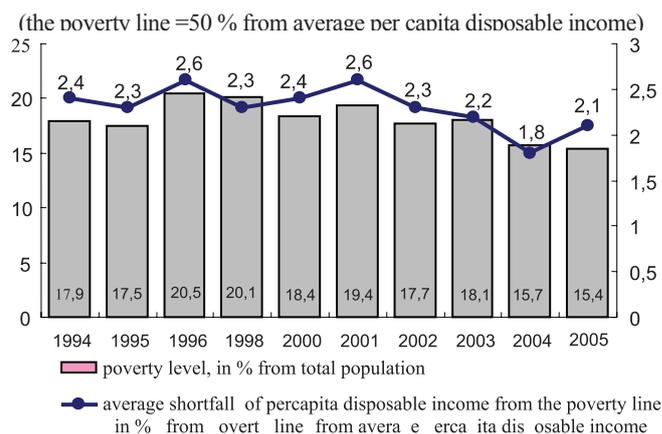
is the poverty measure for j 'th sub-group with population n_j , having income Y_{ij} for $i=1,2,\dots,n_j$ and the total population is $N=\sum n_j$. The $p(Z_j, Y_{ij})$ is the individual poverty measure, taking value zero for non-poor ($Y_{ij} < Z_j$) and some positive number for poor.

Subgroup decomposability also implies that an income improvement in one of the subgroups will necessarily improve aggregate poverty if the incomes in other subgroups have not changed (Foster et al., 1984).

DECOMPOSITION OF THE DYNAMICS AND STRUCTURE OF RUSSIAN POVERTY

Our results based on the RLMS dataset are somewhat different from the results reported earlier (figure 1). This could be explained by the fact that the poverty line used in the analysis includes less poor individuals comparing to the poverty line which is based on the subsistence equivalent. Moreover, our income definition is wider comparing to the official one and is consistent over time. Relative poverty line rises in the beginning of the investigation period and reaches the pick in 1996-1998. After 1998 the poverty level starts to decline at an increasing rate. The proportion of poor individuals went up from 17.9% in 1994 to 20.1% in 1998, when it declined to 15.4% in the year 2005. Income deficit reached its pick in 1996 and 2001 and went down to 1.8% in 2004 (figure 2).

Figure 2. Estimates of the level and extend of poverty, RLMS data



The effectiveness of the government social policy could be viewed by its success to help the groups with high poverty risk to escape poverty or to reduce its incidence and severity. The development of poverty trends often vary among subgroups. The impact on aggregate poverty of each subgroup depends on its size as well as incidence and deepness of poverty in each subgroup.

The poverty profile in Russia varies depending on the residence area (Appendix 1). During the period under investigation the highest levels of poverty were found in the rural area. Even accounting for income in kind the level of poverty in rural areas was three times higher comparing to regional centres.

The level of poverty in rural area went up from 0.317 in 1994 to 0.362 in 2001. After the year 2001 poverty levels in rural area started to decline reaching the level of 0.281. The share of rural population went down in the middle of 1990th and then bounce back to 0,265 in 2005. As a result the rural poverty had a large impact on the aggregate poverty. During the period under investigation the relative contribution of rural poverty to the aggregate poverty went up from 0.421 to 0.484. The absolute contribution of urban poverty to aggregate poverty reached its pick in the year 1996 and remained persistently high until 2001 when it dropped sharply. Initial increase in the impact of urban poverty on aggregate poverty may be explained by the prevalence of wage arrears in the middle of 1990th.

The relative contribution of cities to aggregate poverty went down from 0.258 in 1994 to 0.198 in 2005, while the contribution of towns decreased only slightly from 0.252 to 0.246.

The urban-rural poverty gap remained stable during the whole period. However diverging social-demographic trends led to the increase in the gap in the contribution to poverty between rural and urban areas. The gap was smallest in 1996 and increased dramatically afterwards.

The analysis of the FGT index for $\alpha=1$ и $\alpha=2$ showed that the relative contribution of income deficit in rural areas did not change much, but the values were higher comparing to results found for $\alpha=0$, at the same time results for urban areas indicate opposite relationship. This indicates that poverty in rural areas was deeper and more severe. Since 2004, in cities the share of poor declined, but the deepness and severity of poverty increased. This phenomenon can be explained by the growth of income of individuals who were just below the poverty line, while marginalized groups remained unaffected.

To a large extend the gap between rural and urban areas in poverty profiles may be explained by socio-demographic structure. Thus, it is warranted to present decomposition according to the socio-demographic type of the household.

The analysis of different type of households supports a stylized fact that the most poor are the single parent households, the poverty level in that group increased from 22.1% in 1994 to 27.3% in 2005 (Appendix 2). The share of these households though is relatively small and remained stable – about 4.5% of total number of households. The second poorest group is married couples with children, and the households with several generations of relatives. The poverty in this group has been decreasing during the period of investigation, but the share of households with two children was decreasing, while the share of “multigenerational” households was increasing.

There are several explanations for the observed phenomena. Despite the growth in nominal incomes, the living standards of Russian households remain relatively low. One of the consequences of low living standard is the fact that young families are often reside with their parents due to lack of funds for purchasing or renting their own housing. In the presence of two able-bodied couples in a

household, even the presence of children is unlikely to decrease the per capita incomes below the poverty level. In other cases, a retired female member of household often takes care of children while the mother can continue to work.

Moreover, in the period from 1996 to 1998, characterized by the presence of wage areas and high unemployment, pensioners were often the main source of income in the multigenerational households. This observation is indirectly supported by the fact that during the 1998 financial crisis, the contribution to poverty and its extent decreased in multigenerational households but increased for the couples with children.

After 1998, the contribution to poverty of the couples with children decreased while the contribution of other types of households remained relatively constant. From our perspective, these facts indicate that the diversification of resources allows multigenerational households optimize consumption and decrease the risk and extent of poverty. Single-member households, and couples without children were less prone to poverty. The level of poverty in these households is up to four times lower than in other groups, while their share remained relatively stable.

During the period under investigation we observe a substantial increase in the number of households without children and households with one child. The share of households with two children has exhibited a significant decrease while the proportion of the households with three and more children has decrease only marginally.

The poverty index clearly indicates an increase in poverty with an increase in the number of children in household (Appendix 3). Moreover, the economic downturn is closely correlated with the increase in poverty of households with two or more children.

The level of poverty for the household with one child went up from 16.3% in 1994 to 20.7% in the year 2000. Between the year 2000 and 2005 we observe the decrease in poverty rate to 13.8%. At the same time the share of households with one child increased from 31.3% to 34.8%. It is also interesting to note that the contribution to aggregate poverty of the households with one child was smaller when that of households with two children from 1994 to 1999. However, after 1999 the contribution to aggregate poverty of the households with one child started to increase and exceeded the contribution of the households with two children.

The share of poor rose among households with two children during the economic crisis of 1998 and went back to the level of 24.3% in 2005. The level of poverty for the households with three or more children increased from 36.2% to 48% in the period 1994-2001 and than declined to 28.5% in 2005.

In the period prior to 1998 the largest contribution in aggregate poverty had households with two children. However, as the number of such household declined, the contribution to aggregate poverty of household with one child and childless household increased. The impact of single parent household on aggregate poverty is the smallest. Their contribution declined from 7.2% in 1994 to 5.1% in 2005.

Deepness and severity of poverty developed similar to the level of poverty in all groups. However, for households with two and more children the relative impact on aggregate poverty is higher when $\alpha=1$ и $\alpha=2$ in the FGT index, comparing to the case when $\alpha=0$.

Do we observe an effect of the government social policy on the poverty levels of households with children?

When we examined Russian macroeconomic trends we pointed out relatively small level of child and maternity transfers during the period of investigation. Nevertheless, on the aggregate level, these transfers could still affect the poverty trends of households with children. According to official statistics, the real growth of child and maternity transfers amounted to 4.8% in 2000, 7.4% in 2001, 9.5% in 2002, -7.5% in 2003, and - 11.2% in 2004⁶.

This trend does not correlate with the poverty levels of households with children, indicating the lack of effect of these transfers on poverty levels of targeted groups.

The primary reason for the child poverty lays in the fact that after the birth of the child mother interrupt work for several years.

Households with one employed member had a high risk of being poor. In 1994 their share was 0.216 and 0.224 in 2005 (Appendix 4).

The lowest incidences of poverty are among households with three members employed, it is somewhat higher in households with two working members. However both groups exhibited declining risk of poverty after 1998. Before 2001 the risk of poverty for households consisting of non-employed members was smaller than that of households with one working member. By the end of the study period the poverty risk was the same for both groups.

The later finding can be explained by the fact that households where all members are non-employed are usually pensioners' households, while households with one employed member predominantly consist of employed male, housewife and small children. During the 1990s, the pension benefits provided low but stable standards of living allowing pensioners to be better off than households with one employed member. Starting from 2000 the rate of wage growth exceeded that of pensions. Households with one employed member are no longer poorer than households where all members are non-employed.

We observe the spike in poverty level, its depth and severity among households with employed members during the years 1996 – 1998. These were the years of high wage arrears and financial crisis.

It is also interesting to compare households where all members are non-employed to households where two members are employed. The increase in the number of households with two working members was absolutely symmetrical to the decline in the number of households where all members are non-employed. Pension arrears and declining living standard made pensioners to look for a job. After the 2000 we observe parallel trends in the proportions of these households and strong divergence in the year 2005.

The households with one employed member have the highest contribution to the aggregate poverty. Commonly these are the households consisting of the relatively young individuals with children. However the depth and severity of poverty in this group is close to the other groups. Households with two employed members also have a high contribution to the aggregate poverty. The impact of this group tends to diminish over time. Moreover the depth and severity of poverty tend to decrease faster among households with two employed members. The smallest contribution to the aggregate poverty had households with more than three employed members. Finally, households where none of the members are employed tend to increase their impact on poverty. The depth and severity of poverty in this group tend to increase faster comparing to the number of poor.

⁶ "Social'noe polozhenie i uroven' zhizni naselenija Rossiju", Rosstat, 2005.

CONCLUSION: determinants of poverty and policy proposals

We started the analysis with the year 1994. That time the reforms initiated during the 1990s brought levels of poverty and inequality to a socially intolerable level. However, the situation remained relatively stable which indicates that Russian households adapted to the complex environment of economic reforms and learned to survive.

The review of the macroeconomic trends from 1994 to 2005 in the context of the social policy showed that the social policy was inadequate. The poverty level followed macroeconomic trends and only small fluctuations of the values of the index (especially transfer-sensitive indexes such as FGT for $\alpha=2$) captured the impact of wage and pension indexation on the level of poverty for specific groups of households. We managed to clarify and add the following points to the analysis of the Russian poverty:

The analysis of the poverty profile among residential areas confirmed that the highest level of poverty is among rural households. Rural poverty is also deeper and more severe than in the cities. Interrelation of the demographic and migration processes among different types of residential areas resulted in the fact that the lowest gap in the contribution to poverty was registered in 1998, after this period we observe a diverging trend in the poverty contribution and increasing poverty gap.

In the situation when government was incapable to develop effective mechanisms of the household social protection, households developed their own mechanisms of poverty alleviation. Among such mechanisms are decrease in fertility rate which resulted in the increased number of households with one or no children and decrease number of households with two and more children. Another observed tendency is the increase in the number of employed members in the household.

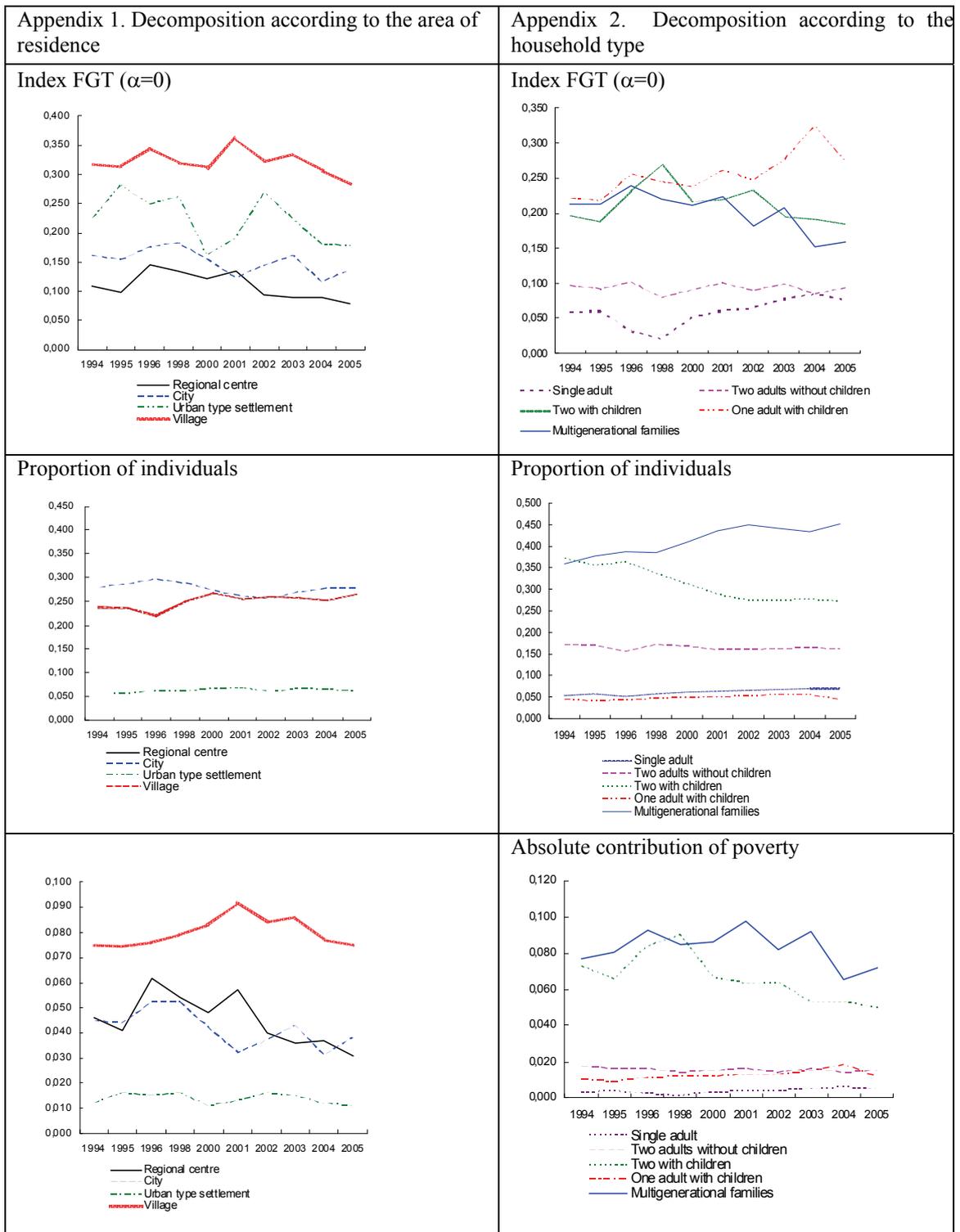
It should be noted that the presence of three and more children in the household results in the higher level of poverty. However, the share of such households remained relatively stable and did not exhibit large decline comparing to the share of households with two children. The likely explanation to this finding is that the decision to have more than three children is dictated by non-economic factors.

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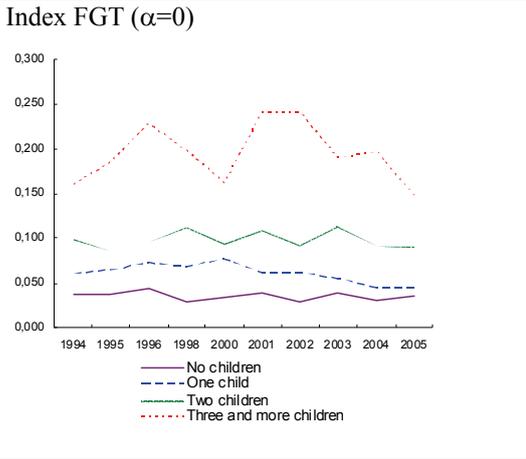
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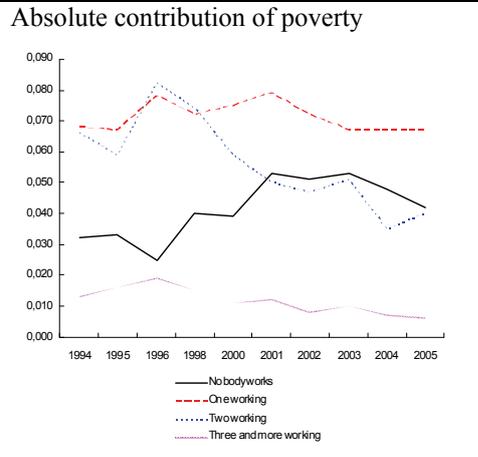
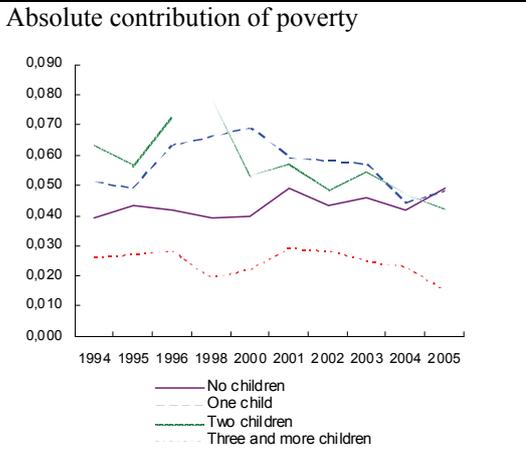
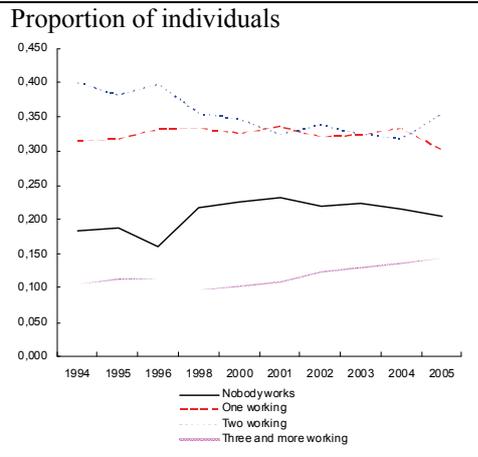
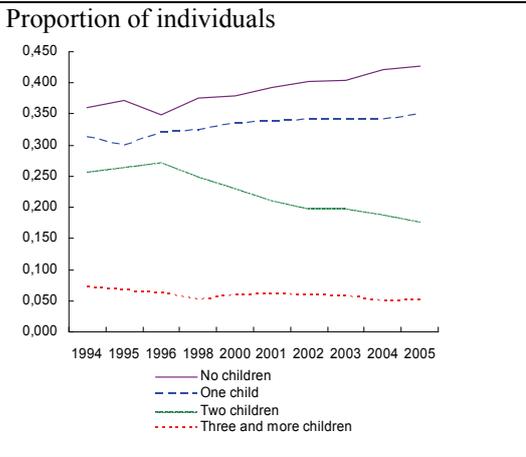
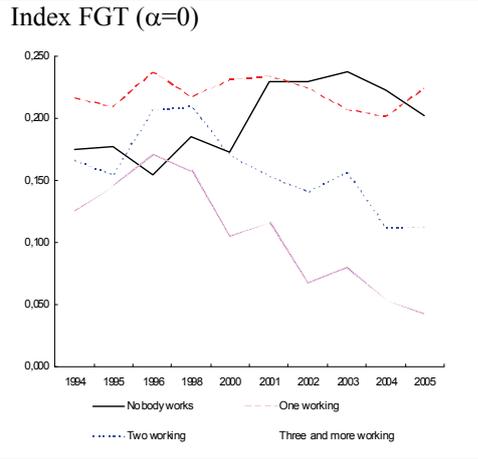
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Appendix 3. Decomposition according to the number of children



Appendix 4. Decomposition according to the number of working members



ACCOUNTING PROFESSION IN LIGHT OF THE ACCESSION OF MONTENEGRO TO THE EUROPEAN UNION

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ABSTRACT

Harmonization of accounting regulations in the European Union is an integral part of the process of creating a single European market. The aforementioned harmonization is a complex and long-term process because of many factors that affect this process, starting from the differences in accounting and financial tradition and to the legal and tax systems of member countries. Numerous studies have pointed to significant problems, but the advantages of the process of harmonization of financial reporting are reflected in building a unified framework (accounting framework) which should be used to create a comparable, understood and transparent financial reporting in order to represent the basis for monitoring the growth and development of companies in market conditions in the European Union and beyond. Many events in the past decade in the field of strengthening the market mechanism as well as in expansion of interest of foreign investors in Montenegro clearly impose a fact about the necessity of improving the degree of harmonization and greater application of International Accounting Standards. Unfortunately, the great social importance to the accounting profession and importance of qualitative characteristics, especially the transparency of financial reporting are recognized recently in Montenegro, partly because of economic and financial crisis. It is realistic to expect in the future that the government will run, improve and coordinate existing educational programs and professional training programs, especially for accountants, using specific measures. It should be also understood that without respect of the IFAC Code of Ethics for Professional Accountants, which is a reflection of the process of regulation and self-regulation within the accountancy profession, cannot be a reliable basis for making professional judgments, neither by auditors.

Montenegro's strategic commitment in order to acquire the status of full membership in the European Union launched a series of reform processes in order to harmonize the normative basis of Montenegro with the legal regulations of the European Union. One of these processes includes the harmonization of normative basis of financial reporting in Montenegro with the normative basis of financial reporting in the European Union. Development of the normative basis of financial reporting in Montenegro, in line with the normative basis of financial reporting in the EU, aims to create readable, relevant, reliable and comparable financial reports that will provide easy access to financial markets around the world, and also provide a reliable basis for making business decisions.

Key words

accounting regulations in Montenegro, the accounting profession, financial reporting, harmonization

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INTRODUCTION

The information process is a special activity, with a significant degree of public accountability. Viewed from the perspective of corporate reporting, the degree of public accountability is even more pronounced because the ratio of participants of corporate governance according to quality of provided information can protect or endanger the interests of information users as well as companies to whom the information is related. Today, in light of major corporate scandals, we can say that modern accounting profession faces two major challenges. The first concerns the analysis of all external and internal factors that determine the quality of financial reporting and definition of measures with actions taken for its improvement. Another challenge is the success of the process of harmonization as a prerequisite for the comparability of financial reporting in the EU and the world, and thus increases the quality of the reports. The process of globalization of economic activities inevitably encouraged the process of harmonization of financial statements in order to raise the level of national comparability of financial statements in global financial markets. Montenegro's strategic commitment to gaining full membership status in the EU is a sufficient reason for inclusion in this process and thus starting a series of reform processes in order to harmonize the normative basis of financial reporting in Montenegro with the normative basis of financial reporting in the EU.

The first part of this article heads to the basic characteristics of the normative basis in the EU, in order to display in the second part what is achieved in the harmonization of the normative basis of Montenegro with the EU's normative basis. The third part indicates the possible solutions offered by professional accounting organizations in Montenegro in terms of approaching the European practice of financial reporting.

PROFESSIONAL REGULATION OF THE ACCOUNTING PROFESSION IN THE EUROPEAN UNION (EU)

The importance of accounting information dates from the periods of the first forms of markets and trade, but it was changing intensity, shapes and form. Requirements in terms of quality of accounting information emerged with the development of markets and forms of trading, and that created the need for the creation of accounting rules that will allow greater comparability in international cooperation, and thus make radical progress towards achieving a single European market with free flow of goods, services, people and capital. The free flow of goods, services, people and capital demands the free flow of information. This was the reason why need for harmonization of accounting regulations became imperative. The introduction of double-entry accounting principles in the regulation of the accounting profession harmonized the process of entering and recording data in the accounting information system, but the introduction of general International Financial Reporting Standards and the process of harmonization of financial statements are trying to harmonize the process of obtaining high-quality output information.

The first indications for the harmonization of regulations on financial reporting within the EU, then known as European Community (EC), were set up almost simultaneously with the adoption of the First Directive in the area of Company Law in March 1968⁵, in the form of directives as the Fourth (1978) and Seventh (1983) EU Directive. Fourth and Seventh EU Directive were determined by the form and content of annual and consolidated financial statements.

⁵ K. Skaric Jovanovic, "Harmonization of the normative basis of financial reporting in Serbia with the European Union requirements" Proceedings of the XXXIX Symposium, Association of Accountants and Auditors of Serbia "The role and tasks of the financial reporting in the process of accession to the European Union", Zlatibor, 2008

Fourth EU Directive (78/660/EEC) was adopted on 25.12.1978 in order to formulate the form, content and criteria for preparing the balance sheet and income statement and notes to the balance. For the purpose of modernization and adaptation to the contemporary dynamic business rules on the capital market, the Fourth EU Directive on May 1, 2004 reflected in following changes:

- Introduction in section 7a), which refers to the evaluation of financial instruments to fair value;
- Extension of Article 46 which requires a balanced and detailed view of the most important financial and non-financial indicators of legal entities in the annual report;
- Amended criteria for determining the size of the company.⁶

Seventh EU Directive (83/349/EEC) was adopted on 13.06.1983 with the aim to standardize the consolidation of financial statements in the member states. Directive prescribes conditions for the preparation of the consolidated balance sheet, consolidated income statement, consolidated audit reports and the publication of consolidated reports. The consolidated financial statement comprises the consolidated balance sheet and income statement with notes to the financial statements.

The process of harmonization of accounting regulations began by creating a single normative framework through the adoption of the Fourth and Seventh Directives of the European Union, but their adoption has raised many discussions that are mostly focused on the question of whether their adoption provided a higher level of national comparability of financial statements in the EU.

In early 90's harmonization process of financial reporting in Europe is continuing under the influence of the process of internationalization of capital markets and the tendency to reduce the cost of acquiring capital. If companies that were listed on international exchanges wanted to be competitive and attractive to international investors, they should have adopted International standards of reporting and thus their reports made understandable for the majority of potential investors. In order to expand this practice not only to companies listed on international capital markets EC, and later the EU, has initiated harmonization of financial reporting by numerous regulations, starting with the adoption of the document entitled „A New Strategy vis-à-vis International Harmonization“ (1995) and to the adoption of the Regulation of the European Parliament and of the Council 1606/2002 as well as Commission Regulation (EC) / 1725/2003. The European Commission (EC) adopted in 2000 the new financial reporting strategy called “EU financial reporting strategy: the way forward” in the form of proposal that all companies in the EU which are part of the capital market prepare their financial statements in accordance with IFRS. In March 2002 the European Parliament and the Council accepted the proposed strategy through the adoption of Regulation 1606/2002 which governs the application of IAS / IFRS, and orders to all companies in EU member states, which are listed on stock exchanges, to apply IFRS in the preparation of financial statements starting of 1st January 2005. The process of harmonization (alignment) in the EU is implemented in two phases:

1. The adoption of IAS / IFRS⁷ at the level of the European Union;
2. The process of harmonization IFRS with U.S. GAAP.

Until the adoption of Regulation 1606/2002 the majority of European companies applied the national accounting standards (300 companies), so that the adoption of IAS / IFRS in Europe represent one of the radical changes in financial reporting driven by the highest levels of government (about 7,000 companies). Application of IAS / IFRS which were enacted by IASB⁸ (International Accounting

6 Criteria: Total Assets: Small Company- 3,65€, Great Companies - 14,60€;

Criteria: Total income: Small company-7,30€, Great Companies - 29,20€;

Criteria: Number of employees: small company-50 employees, large companies - 250 employees.

(“Improving corporate governance in Montenegro”, the Commission for the Securities, June 2009, p.213)

7 The term International Financial Reporting Standards (IFRS) has a broader and narrower meaning. In the narrow sense, IFRS are the new series of IASB's standards and different from series of IAS issued by the IASB's predecessor IASC. In the board sense, IFRS are including the overall IASB's publications, standards and interpretations issued by the IASB, as well as standards and interpretations issued by IASC. www.iasplus.com. “The term IFRS”

8 International Accounting Standards Board is an independent private sector body that develops and publishes the International Financial Reporting Standards (IFRS). IASB started work in 2001 in London doing reconstruction of the International Accounting Standards Committee (IASC), a body founded in 1973 year, which brought and published accounting standards.

Standards Board) was a common set of application standards of financial reporting in Europe and beyond. Simultaneously, they adopted the following Directives of the European Parliament and the Council who were a supplement to Fourth and Seventh EU Directives:⁹

- Directive 2003/51/EC of the European Parliament and of the Council (in addition to the Fourth and Seventh Directives, the Directives for banks and other financial institutions and insurance companies, to modernize the accounting principles);
- Council Directive 2003/38/EC (in addition to the Fourth Directive, the amounts that are expressed in Euros in the financial statements of certain types of companies);
- Commission Regulation (EC)/1725/2003 and complaints related to the adoption of certain IAS's under the Regulation (EC)/1606/2002;
- Commission Regulation (EC)/707/2004 in addition to the Commission Regulation (EC)/1725/2003.

The process of adjustment of IFRS with U.S. GAAP went on simultaneously with the adoption of a common set of financial standards in the EU. The cooperation and convergence between FASB and IASB starts since 2000, and in 2002 “The Memorandum of Understanding” also known as “The Norwalk Agreement” was signed. That was the first step in the process of adopting International Financial Reporting Standards. The aforementioned process of equalizing the positions and the process of making a set of new standards is achieved through two phases:

- By the end of 2008 in the form of short-term management objectives IASB and the U.S. FASB¹⁰ has adopted the following short-term actions shown in the table;
- Continued work on the process of harmonization.

EU experience shows that integration processes cannot result in a satisfactory pace of economic impact if they are not accompanied by harmonization of financial statements at the level of integration. For these and many other reasons there is a need to continually work on harmonization of the normative framework of Montenegro with the EU requirements, as soon as possible.

HARMONIZATION OF ACCOUNTING REGULATIONS IN MONTENEGRO WITH THE REQUIREMENTS OF THE EUROPEAN UNION (EU)

Impact of harmonization of financial reporting at the global level, also is reflected on the countries of the Balkan. The process of harmonization of regulations in the countries of Central and Eastern Europe (CEE) funded by the EU (1995) with adoption of “White Paper for the preparation of associated countries of Central and Eastern Europe for integration into the EU internal market”. The candidate countries on their road to joining the EU must adopt its “National Programme”, and the European Commission, every year, consider a report on the progress of candidate countries towards the adoption of EU legislation (Acquis Communautaire

In terms of compliance of accounting legislation with regulatory requirements of EU, Montenegro has got „offer“ for technical support from World Bank, which is run through a long-term project called REPARIS (The Road to Europe: Program of Accounting Reform and Institutional Strengthening) that provide faster and better access to the harmonization of legislative, institutional and practical solutions with EU requirements and best practices in accounting. At the same time, they stimulated the development of cooperation between countries and exchange of experiences and development of the accountancy profession and enhance the quality of financial reporting and auditing. Supervision and evaluation of progress will be made during the project of updating the ROSC (Reports on the

⁹ Kllivac Ana, “Financial Reporting in the European Union”, Mate doo, Zagreb, 2008

¹⁰ Financial Accounting Standards Board

Observance of Standards & Codes) report. Accordingly to the tasks of the adopted program in 2006, The World Bank team visited the Montenegro, and after that prepared the Report on the Observance of Standards and Codes (ROSC) in relation to accounting and auditing (A & A) in Montenegro.

” The new Law on Accounting and Auditing adopted 2005th was a reflection of the desire for continuous improvement and harmonization of financial reporting framework in Montenegro with the Acquis Communautaire, but the frame is not yet complete and is fully compliant with the Acquis. This framework is not always consistent, and limited human resources contribute to institutional weaknesses in some areas.... The following questions must be given special attention: preparation of reports on the management, semi-annually reporting for listed companies, the electronic publishing of financial statements, approval and registration of an audit companies, and preparation of consolidated reports.“¹¹

Respecting of the ROSC recommendations, the Ministry of Finance founded the National Council for Accounting and Auditing (NSC) by the decision of the Minister of Finance (from 22 November 2007.), with the aim of creating a better environment for the improvement of accounting and auditing regulations and practices in Montenegro. NSC has held four sessions, which discussed the Report on the Observance of Standards and Codes (ROSC), an overview of the priorities presented in the report and on which is adopted the strategy and action plan for improving financial reporting in Montenegro and the Law Amendment to the Law on Accounting and Auditing.¹² Accordingly, the Government of Montenegro has supported reform of accounting regulations by adopting the document titled „**Strategy and Action Plan for Improving Financial Reporting in Montenegro**“¹³, at its meeting held on 30.10.2008. The document represents a clear and systematic program of measures for improving of the legal framework, institutions and the accounting profession, especially the part related to accounting, auditing and business culture, in order to achieve high quality of financial reporting. Strategy aims to identify and define the activities and instruments that will lead to the harmonization of the regulatory framework of financial reporting with the Acquis, including the preparation of consolidated financial statements, regulations of the audit firms and electronic publishing of financial statements, and to define the proportional financial reporting requirements for small and medium-sized enterprises. In the frame of the Strategy is developed an action plan and time frame for developing and implementing the same. Based on the recommendations of the ROSC report, the Law Amendment to the Law on Accounting and Auditing is adopted (“Official Gazette of Montenegro” No. 80/08). Novelty in comparison to the previous Law on Accounting and Auditing from 2005. (“Official Gazette of RM” no. 69/05) are:

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- Prescribed duty for the establishing of the Council for Accounting and Auditing. The Government of Montenegro made the Decision on the establishment of the Council for Accounting and Auditing (Official Gazette of Montenegro, No. 32/09 of 12 May 2009). The task of the Council is to consider and take positions on issues: the development and improvement of accounting and auditing practices in Montenegro, to provide advice to those who create policy, regulators and governmental bodies, providing technical assistance to improve the quality of financial reporting and other issues relevant to the fulfilling and improvement of accounting and auditing practices in Montenegro. The Council consists of representatives from the Ministry of Finance, Ministry of Economy, Central Bank of Montenegro, the Commission for the Securities, Commercial Court, the Agency for Supervision of Insurance and institution which is, by the competent authorities, entrusted with affairs of state administration that is amenable for accounting and auditing activities, and who possess knowledge in accounting, finance and auditing. Council for the Accounting and Auditing at the session of 23.07.2009. passed the „Rules of Procedure of the Council for Accounting and Auditing“, which closer settle

11 “Montenegro - Report on the Observance of Standards and Codes of Accounting and Auditing (ROSC)”, the World Bank, May 2007, page II

12 Retrieved from the document “Information for members of the Council for Accounting and Auditing of past and planned activities on implementation of the strategy and action plan for improving financial reporting in Montenegro”, the site of the Ministry of Finance (www.mf.gov.me), 10/02/2010

13 Below Strategy

organization, operation and decision of the Council for Accounting and Auditing, and other issues of importance to the work of the Council.

- The prescribed criteria for classification of legal entities. Legal entities, according to this law, shall be classified in small, medium and large, depending on the average number of employees, total revenue per annum and total assets. According to this law, mean of medium legal entities will get companies who on the day of preparation financial statements comply with two of the three following criteria:
 - 1) that the average number of employees, in the year for which an annual Report is related, is from 50 to 250;
 - 2) that the total income per year is from 10,000,000 to 50,000,000 Euro;
 - 3) that the total assets is from 10,000,000 to 43,000,000 Euro.

Legal entities which are two of the three criteria is lower than the lowest criterion in paragraph 2 this Article, shall be classified as small entities, and entities which are two of the three criteria is higher than the highest criteria in paragraph 2 of this Article, shall be classified into large legal entities.¹⁴

- Prescribed duty for the submission of quarterly and annual reports, as well as the consolidated financial statements in paper and electronic form.. The Law on Accounting and Auditing (Official Gazette of Montenegro “no. 80/08) introduced the quarterly reporting obligations for joint stock companies and other entities which emit securities and other financial instruments traded on a regulated market, as well as the obligation for the parent legal entities to prepare consolidated financial statements. The aforementioned entities are required to submit, annual and quarterly, financial reports, in printed and electronic form to the Commission for Securities¹⁵;
- The legal entities organize accounting by the general act in accordance with the law, and companies are requested to deliver the same internal regulations of accounting and accounting policies, together with delivery of set of financial statements of general purpose¹⁶;
- Business transactions are recorded only by the method of invoiced realization. This law deletes Article 5 of the Law on Accounting and Auditing from 2005 in which the law stipulates that legal entities who have an annual income less than 500,000 euros are required to apply a cash realization method during compilation of annual reports, which is contrary to the determinants of IAS / IFRS, which are based on the method of invoiced realisation;
- Modified the deadline for submission of financial reports. Legal entities are obliged to submit financial statements in paper and electronic form to the Central Registry of the Commercial Court no later than 28th February, while the Law on Accounting and Auditing from 2005 obliged the entities to submit financial reports to the Central Registry of the Commercial Court by 30th June of this year for the previous year;
- List“ of persons responsible for the published financial statements of general purposes is expanded. The financial statements of the legal entity must to be signed by the person who prepared the financial statement of the legal entity, head of financial accounting activities, the president of the board of directors or executive director, and they are also responsible for their accuracy.

¹⁴ The Law on Amendments to the Law on Accounting and Auditing (“Official Gazette of Montenegro” No. 80/08), Article 3a applies from 01.07.2009.

¹⁵ Content rules, deadlines and manner of publication of financial statements of issuers of securities (“Official gazette of Montenegro”, no. 20/09) are defined deadlines for submission of quarterly financial statements (within 45 days from the expiration of the period to which the report relates) (Article 4, paragraph 5).

¹⁶ Article 4 is applied from 1 July 2009

- The introduction of the inspection control. Obligations have been introduced with the aim of creating conditions so that through the inspection control and application of sanctions imposed by the law reduce abuse and increase the quality of financial statements, and to increase corporate culture, transparency, quickly and easily obtaining the necessary data and the information needed to shareholders and investors, and other interested parties;
- More detailed questions are settled about licensing auditor, performing audits, the contents of the audit opinion, obtaining and revoking licenses, the obligation of informing the audit committee;
- The prescribed obligations of forming of audit committees and the establishing of an internal audit function;¹⁷

Making of the Rules of detailed requirements and documentation for obtaining the title of Certified Accountants is in progress. With the Law on Accounting and Auditing (Official Gazette of RM “no. 69/05 and Official Gazette of Montenegro, no. 80/08) the Ministry of Finance has introduced the obligation of issuing licenses to auditing companies. So far issued 13 licenses to existing and newly founded auditing companies.

PROFESSIONAL ACCOUNTING ORGANIZATIONS IN MONTENEGRO – SCOPES AND PERSPECTIVES

The overall reform of the Montenegrin economy means the creation of a high-quality regulatory and institutional framework for accounting and auditing. Therefore, an important next step in that way refers to the proper and continuous implementation of the adopted law and regulations. An important role in the entire reform process have professional organizations that operate on the territory of Montenegro. It is about two independent and professional associations: The Institute of Certified Accountants of Montenegro and the Institute for Accounting and Auditing. Global goal of stated institutes has been recognized as a quality and continuous education of its members with the intention of improving the qualitative characteristics of accounting information, by the delegation to them the responsibility in the implementation of accounting and auditing standards and regulation of accounting and auditing profession. Historical way of development of aforementioned two institutes is a very long and completely matched up to 2006, after what they split from each other. Namely, the life cycle of a professional accounting organization in Montenegro dates back in 1956 to the founding of the Association of Accountant of Montenegro in former Titograd (Podgorica), and than in 70's stated the Association changed its name to Association of Financial and Accountig Workers and in mid-'90's, to the Association of Accountants and Auditors of Montenegro. At April 2002 The Union referred to the Law on Accounting and Auditing and International Accounting Standards establish the Institute for Accounting and Auditing, and finally in 2006 was formed other professional accounting organizations in Montenegro - Institute of Certified Accountants of Montenegro¹⁸.

The aim of the mentioned Institutes are to promote, enhance knowledge, abilities and skills, and continuously promote the competency of its members in the field of accounting and auditing profession in line with International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), International Standards on Auditing and International Standards Control Quality. Therefore, mentioned bookkeeping and accounting and audit staff education is carried out in accordance with national accounting standard CORS-1, and by organizing seminars, symposiums, conferences and through professional publications (magazines).

¹⁷ Large legal entities and audit societies are obliged to comply their operations by 1st January 2012

¹⁸ The above information is downloaded from the site of the Institute for Accounting and Auditing of Montenegro and the Institute of Certified Accountants.

The aforementioned Institutes, between other activities, perform their main activities:

- continuous professional education of accountants for acquiring of professional titles in accounting and auditing as well as the issuance of appropriate certificates for the obtained titles;
- Implementing of IFAC's Code of Ethics for Professional Accountants;

However, despite the fact that in Montenegro there is a real opportunity for quality professional development of staff in the field of accounting and auditing, the fact that here exist two Institutes often creates confusion among potential staff and inspire suspicion in the quality offered by these institutes. Therefore, if Montenegro wants to successfully implement its idea to gain full membership in the EU must think very seriously about significant "omissions" that occur and can occur in the field of professional accounting education. This must be done because Montenegro, during the transition to a market economy, has done a really great effort on the essential components of the institutional and legal framework in the field of raising the quality of financial statements. However, what has been achieved is only the first, initial step so that in future professional accounting regulations, and thus the accounting profession in Montenegro will face the big challenges in achieving the ultimate goal - the establishment and proper functioning of the financial reporting framework customized to the needs of the Montenegrin economy, all in accordance with the EU *Acquis Communautaire*¹⁹, IAS, best practices and etc.

In the end, what objectively in the future can be expected is the start of certain activities, mainly by the Government, which would improve and harmonize the existing educational programs and professional training programs for accountants. Because the Institutes in Montenegro are pledged to respect the IFAC Code of Ethics for Professional Accountants, it is necessary to be implemented consistently, because they reflect the same process of regulation and self-regulation within the accounting profession, without which there can be no reliable basis for making a professional judgments, neither by the auditors.

CONCLUSION

The tendency towards the harmonization of accounting reporting and obtaining the status of full membership of the EU requires the creation of high quality regulatory and institutional framework for accounting and auditing, and hence the necessity of radical reforms of the existing legal and institutional framework and systems. The goal is to create, above all, transparent and simplified financial reporting framework tailored to transitional needs of the Montenegrin economy, which imply modification (which is done in the big part) of valid existing legal measures harmonized with EU *Acquis Communautaire*, IAS. Best practice show the necessity of the construction and application of (own) national standards for small and medium enterprises in line with IAS, IFRS and the EU Directives, all with the intention of reducing the complexity of the preparation and disclosure of instruments for financial reporting. We believe that with this act will be greatly reduced or completely removed anomalies that currently meets the regulatory and institutional framework for accounting and auditing in Montenegro (which are said by surveys and research) and than would be created high quality model for the regulation of the considered area. Of course, a big part in that should play the existing institutions (institutes) for the accounting and auditing with its educational programs, that should improve and continually work on development of the quality of peoples' knowledge. Stared processes of reform activities of the Montenegrin economy may come in effect only with the help of quality people who thanks to his knowledge back and run all the upcoming changes and implement them in practice. A wave of market changes therefore didn't skip an accounting and

¹⁹ Indicates the model for the regulation of accounting and auditing standards is a set of legal decisions that obligate all EU member states. (The Commission for the Securities, page number 203)

auditing profession, so that today in Montenegro is evident the increase in demand for personnel of the profile. Therefore, responsible and educational structures in Montenegro should not ignore this clear message of the market, since the further development of the accounting profession as well as the inclusion of Montenegro in the process of harmonization of accounting to a large extent will depend on the educational status of accounting staff and the willingness of institutions and personnel to implementing the latest technological achievements and modern accounting and auditing methods and techniques. In the end, regardless of the upcoming changes as well as the willingness of the accounting and auditing profession to respond adequately to them, however traditionally rooted moral principles of any professional accountant behavior remains unchanged and they are reflected in the preservation of the integrity and objectivity, professional competence, confidentiality and professional behavior or in suspense as the fundamental principle of ethical auditors behavior. All of these principles must be completed in its entirety, in order to acquire the confidence and remove all doubt in the financial reporting with the EU Directives and IAS.

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INTERNET AND ITS FUNDAMENTAL IMPACT ON FUNCTIONING OF THE NEW INFORMATION ECONOMY

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ABSTRACT

In just a few years, the Internet has changed the the way of living of almost every man in the world becoming the foundation of the new economy. Changing the way people work and communicate, reducing costs, crossing national borders Internet made new virtual frame for new economic system with new, essential factor of production – information. Information and knowledge as its final product become the most important inputs, bringing the whole economy in new position – nationally and internationally more competitive by bringing many markets closer to theoretical textbook model of perfect competition with perfect information.

With a fundamental impact on the functioning of the new economy, Internet leading to the process of globalization of the world economy, causes essential changes in process of performing business activities, changing the organization model and management. The most important characteristics of this new economy are: information become the most valuable input, easy transfer of intellectual capital, new services backed by products, flexible, network organization become dominant, knowledge and education become the most important factor of social and economic development. Even when the new economy causes a number of negative cosequences such as unemployment, growing inflation or widening gap between the development on general and individual level it still leads to a number of advantages compared with the old (traditional) one. New economy is the objective condition and a chance for each national economy to incorporate into this new information economy and use its opportunities.

Key words

internet, new (information) economy, information, knowledge, globalization, virtual and network organization, management change

INTRODUCTION

During a period of only few years, Internet revolution has caused changes which completely transformed the way of living. The way we communicate, our means of studying and acquiring knowledge, how we research, the way we work and the place from which we perform our work, have changed in a very short period; this is visible especially in comparison to decades before development of society, human kind, and therefore economic reality as its inseparable part. Internet has changed the terms like distance and time; it has entered into our social lives, completely excluding some ways of traditional communication. What is the most characteristic feature of Internet as a phenomenon is the speed in which it essentially changed some of the common models, in social, economic and cultural sense.

“If the eighties were a symbol of quality, nineties a symbol of re-engineering, years after 2000 will certainly be related to speed, speed of changes of business activities, and the speed of conducting business activities”, says one of the biggest magicians of modern business, Mr. Bill Gates.

Internet as a global multimedia recourse experienced its revolution in two last decades of the 20th century, it stopped the continuity in development, it lead to radical changes and creation of new technological and economical paradigm, and it became a basis of new (information) economy. Internet, together with its technological, institutional and cultural environment, has essentially changed modern economy, and economic globalization is a manifestation of these changes.

INTERNET AND GLOBALIZATION – INSEPARABLE IMPULSES TO DEVELOPMENT OF WORLD ECONOMY

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Globalization and information revolution are inseparable, they overlap, and develop together, giving new impulses to development of world economy in a synergetic way. The main associate and instigator of globalization in this process is Internet, and this is a logical sequence of removing the boundaries – both in communication area and business models.

Economic globalization is deleting the borders of national economies, creating a unique, global economic frame, with general standards of behaviour, at the same time leaving the space for expressing national, individual and collective specifics. Additionally, this influences further development of information technology and further globalization. Because of all this, Internet can never be observed like as a one-sided phenomenon, because it is much more than this – Internet is changing the world on all of its levels: social, economical, political and institutional; it has an impact on new forms of communication, new labour distribution and this resulted in flexibility and acceptance of these changes from all market participants (customers as well as producers). It is very difficult to measure and quantitatively present the impact of Internet on development of new economy, but the benefits that are not measurable are however multiple and their influence is visible and positively reflected on the business principles and way of thinking in the new, global hierarchy. New economy is based on **information, knowledge, and network organization of business** on both micro and macro level.

The most relevant impact of Internet on development of new economy is visible and it mostly reflects through:

1. Significant decrease of operational and transactional costs,
2. Increased efficiency of managers, especially when it comes to efficiency of managing (shortening the time and decreasing the amounts of money) the supply chain and a lot easier ways of communication with employees, partners and customers.

3. Increase of competition, more transparent prices, bigger market for sellers and buyers, which directly influences suppliers, making them implement and develop new business techniques, decreasing their costs and therefore decreasing service prices,
4. Direct communication with customers,
5. Product and service for individual customer,
6. Creating value added for the product,
7. Transforming material basis of the modern world,
8. Manufacturing is more and more relying on the quality of information, their processing and output of knowledge and management.

The use of Internet solved many problems in connecting distant locations – sections of companies, connecting computers made by different producers and with different software platforms, connecting companies who cooperate and whose simultaneous access to information is of big importance. Principles of classic economy – countries and companies from region are mostly cooperating, producing and exporting with neighbouring countries – became irrelevant. New digitalization and virtualization era, which have in many area completely changed the traditional concept of products, services and market in general, is in total symbiosis with the new paradigm of management, and this represents simply one segment of new “*information technology*”. **Information** becomes a new resource, whose value is not only spent by its use, but it is increased, and when adequately processed it creates another more qualitative resource – **knowledge**, which is completely opposite to the so far known understanding of producing factors.

Power is moving from the hands of those who have a tangible value – capital – into hands of those who possess intangible value – knowledge and skills.

We have noticed a tendency of focusing on those business areas which are full of intensive knowledge and creative work, where technological change is achieved through new product, service or business model. Production activity is moving from material to non-material area, from product to service and intellectual property, and at the same time the individual is becoming primary to collective, mass and private. Knowledge as a new resource is changing the economic map of world, we are witnessing fast and immediate changes regarding richness of individuals, structural changes in global geographic setup of leading economic regions, as well as changes in development of certain countries in regional frames, such as demographic and new economic leaders India and China.

Internet is making an impact on access to information, which is mostly evident in possibility to use financial information, and that is affecting the transformation of abstract categories into reality. Economic system on global level is becoming more transparent, while the fast and reliable movement of information becomes very important. It is the first time that a global market of capital is created with help of information technology; this market of capital is acting in real time and the cash flow is very fast. Due to these conditions, the capital is made, integrated and coordinated through financial flows on global market. The financial area is dominating the real economy because the main processes are done in financial, not in real area, which is completely the opposite from previous form of capitalism, as a social structure. Mobility of the capital is questioning the principles of neo-classical theory, based on the lack of producing mobility.

In his work “Rethinking in a Netw (or Why Michael Porter is Wrong about the Internet), Strategy + Business“ Tapscott¹ is criticizing Porter’s analysis of Internet and pointing that Internet is much more than a simple technical development; Internet brings a new quality – it is a powerful, universal communication media. Compared to classic media, Internet is much more substantial and interactive, and its development, exploitation possibility and its ability to penetrate in all areas of life is much

1 Tapscott, „Rethinking in a Netw (or Why Michael Porter is Wrong about the Internet), Strategy + Business“, 2001

faster and much more penetrating compared to all so far known historical and social phenomenons. He also points to six reasons considered as reasons for existence of new economy:

1. New infrastructure for creating richness, Internet;
2. New business models, used by companies to create successful businesses activities;
3. New sources of value, knowledge and intellectual capital;
4. New ownership of wealth, ownership of actions is in hands of individuals, small and medium enterprises are the carriers of economic development and business entrepreneurship is becoming an initial impulse for development;
5. New educational models and institutions. Internet is supporting new ways of interactive studying, and philosophy of constant improvement and development;
6. New management. Interaction between citizens and state institutions is now enabled through Internet, it is easier to manage traditional administrative work and provide different information; also, new models of organizational design are decreasing the traditional hierarchy in business systems, as well as other institutions.

NEW ECONOMY – NEW RESOURCES AND CONCEPT OF ORGANIZATION

One of the main features of Internet is that it completely changed the way of company organization and it imposed a new organization model – *network*. Information society network is bringing many changes in all levels. Network template is becoming a dominant form, not only regarding the internal structure of the company, but also in relation with other companies. The whole global economy is becoming one networked system based on different forms of cooperation between multinational companies, its decentralized units and networks of small and medium enterprises. One of the basic clauses of market system in information economy is that its changes are constant, namely the demand is not any longer predictable, when it comes to both quality and quantity. The company is faced with constant adjustments to this new demand, through constant and fast changes of the product (product lines, quality, design), and this caused the switch from mass to flexible production. This is especially emphasizing the importance of small and medium companies, which are able to reorient to flexible production, and which are made, shaped and reorganized in accordance with big changes in demand. Small and medium enterprises are becoming initiators of dynamics and flexibility, and they are inspiring big corporations to build their organization on the principle of open network. A global company must be big and strong, but at the same time flexible enough, bearing in mind the fact that its system is not based on physical organization but on quality of relations within company. New companies are transforming and developing new models, necessary for modern business activities through different types of merging – strategic alliances, big corporations, licensed arrangements and sub-contracting market. This kind of network configuration is influencing relations between actors from economic and social fields; it brings flexibility, dynamics, and efficiency of the whole system. The essence of success lies in distribution and widening the knowledge of employees. Instead of specialization, employers are seeking for persons with wide education, which is extended during work and adjusted to needs.

Today it is not possible to imagine a single job position for which knowledge is required without use of modern computers that enable access to information. Presence of a large number of information is creating confusion and a possibility to make wrong decisions based on contradictory sources of information. This is one of the biggest negative consequences of information systems causing decrease of potential growth of business efficiency.

A phenomenon known as “IT noises” is used to mark difficulties during rational decision making because of large number of wrong information. Human attention² is especially important, whether we consider a customer that is “under constant pressure of million new things and possibilities³”, or if we consider a manager who must make the best decision in order to make business activities more effective.

A quality of processing information is of utmost importance in differentiation of successful and non-successful decision making, which is again a task of technological sophistication. To possess right information in right time enables an individual or organization to be proactive and to react to changes on time. In order to enable employees to use information in the right way, a company must develop methods and ways to manage knowledge. Knowledge management has an aim to: improve the organization efficiency, by increase of intellectual specialization and ability to work on right things, to increase efficiency (*to do right things in a right way*), to avoid repetition of work, improve focus and to eliminate work that could be automated. The aim of organization based on knowledge includes learning, renewal and sustainability.

Knowledge based on experience is becoming a new resource which enables a company to satisfy the needs of an individual customer – collaborative filtering and data mining as products of Internet development are contributing to this unique possibility, and this happens in a very short period and without any additional costs. This kind of model, which makes it possible to answer to each demand of customers, is specially having an impact on increase of flexibility, as one of basic performances of new organization. Virtualization of business activities is leading to significant competence advantages, especially because these organizations are becoming *organization of creative knowledge*. Namely, new knowledge is constantly created through management in very complex conditions, and this knowledge is treated as a resource and implemented into chain of values in creation of products and services. The aim is to make the accumulated knowledge present anywhere at any time in organization, when needed in a specific moment. Process of knowledge management can be described in a following way – as more people became members of a network using its services, network gets more value, i.e. organization is strengthening its values. All of this is confirmed by Metcalfe’s Law – “*value of the network is increasing in square as the number of its users increases*”.

Design of this organization is based on possibilities given by the environment, i.e. managers see the company as a map of resources and possibilities to create values. This is related to distribution of knowledge between employees, teams, development groups (no matter where they are); through intensive communication they are extending the knowledge and creating new ideas. That is the reason why a special accent is put on innovation as a specific thing that makes a difference between successful and non-successful company, as well as society in general.

New economy and new business models are demanding new access to management, less strict and radical, and more open and constructive. New way of thinking, planning, and allocation of responsibility, coordination between different groups or departments of a company, employees’ initiative and new ways of communication are essential for success of business of *new network organization*.

While transforming organization, management must consider the balance between need for fast and radical change and stable, flexible, organizational structure and culture. It is necessary to be flexible, but not at cost of losing stability. This issue is emphasized in big organizations, where changes must be thoroughly prepared and implemented, and in this case implementation of electronic business is made to certain parts of company segment by segment.

2 C.Shapiro, H.Varian, *Information Rules : A Strategic Guide to the network Economy*, Boston, 1999

3 K.Kelly, *New Rules for the New Economy*, Penguin Books, 1998

Only after full implementation, we can move on to next steps, such as: creating new organizational culture and value, because managers of modern time, virtual managers believe that structure and organization are completely temporary and subject to constant changes.

During the whole process of adjusting to new circumstances and the way the organization is transforming, focus is on people, processes, shorter time for all of the processes, changes in organization, adoption and acceptance of changes - mental revolution and energy. As soon as the employees become aware of the significance of new performances and principles, new organizational culture will be created and it will become a frame for new changes. This especially becomes significant because new economy and development of information technology had a special impact on transformation of labour force, and certain professions, especially those with higher education are enlarging their share in total employment, compared to those with lack of qualifications. A new type of employment is visible – part time and temporary work, which represents the majority, i.e. labour force engaged according to needs. Increase of unemployment is a logical consequence of this system, and this can be moderated and reduced only through parallel functioning of state's strategies (as a necessary institutional frame) and business policies of organizations which are investing in permanent education and creation of new values and knowledge, that in their exponential growth cause better productivity.

NEW ECONOMIC AND NEW WORLD ORDER – ADVANTAGES AND SHORTCOMINGS

250 The new information economy is essentially different from the traditional economy. Radical and fast changes made in the last decades are pointing to a new stage of development, which is conceptually and historically changing the economic and social frame. Information revolution and communication technology has influenced the development of new technology not only on national level like in traditional economy, but on global level. Together with the new economy (with help of informatics technology), new industrial structures are created, based on the concept of sustainable development. This again leads to creation of network, network society functioning on a global level. Globalization has a crucial impact on development of new economy and it creates new models of economic relations, which further implicates that economical relations from nowadays won't be projected in future. Globalization dynamics has an uncontrolled character, because the unpredictable, immediate and unexpected technological changes have a significant effect on the complete world order. This so-called “creative chaos of new economy” will significantly define total changes of the new economic order.

Dynamics of development of new national economies will further more depend on competitiveness of its economy (national companies) on global level. Interactivity of the network has enabled decrease of costs, and as a consequence we have transfer of not only industrial production to east, but also producing of high technology and accumulation of capital, which will especially reflect on new economic order. M. Castells⁴ thinks that the dominant role of USA in world economy will become questionable in future, because changes and especially fast technological and economical growth of Japan, China and India are based on the implementation of technological development and potentials⁵

The global economy is full of asymmetry, in sense of big concentration of technological development and informatics structure, industrial production and financial capital. The technological gap

⁴ M. Castells, *The Internet Galaxy Reflections on the Internet Business and Society*, Oxford University Press, New York, 2001

⁵ M. Castells, *The rise of the network society*, Blackwell Publishing Ltd, 2004

between developed and undeveloped countries is becoming bigger. The influence of new economy is geographically limited, and the benefit of its use is distributed in favour of developed countries, opposite to those who are undeveloped or in transition. The most significant contributions of the new economy to the countries who are still developing or are in transition is evident micro-level (an important development of electronic banking, electronic trade and Internet in the most developed countries in transition), but still, this is too minor effect and it can not be reflected on the macro-economic level, nor cause a significant improvement of economic growth. Reasons for impossibility to achieve a positive productivity rate of investments in information economy are lack and nonexistence of complementary investments in infrastructure, knowledge, research and development. The issue of implementation of information technology and inclusion in global economic trends is not questionable – this is a strategic imperative of development. As soon as certain national economies are included, their productivity and competitiveness will become more important. In order to create a situation where all countries could equally participate in new, global, information society, it is necessary for them to get included in the new system through creation of national information structures of information society. Only those countries who will invest in science, development and education, together with technological development, will be able to have a future success in new global economy. Through affirmation of creative, constructive and original ideas individuals and whole systems will be included, and they will be able to use all the benefits of new economy, independent from the state itself. This actually is a specific feature of networked, new information economy, which is giving an equal chance to everybody, and you need is to reach for it.

CONCLUSIONS

The state, together with its mechanisms and development strategies, has a special role in transformation into networked, information economy and the ways of fitting in global trends.

This especially refers to strategy of managing the labour force, which is in a less favourable position compared to capital. Intensive investment in information literacy on one side, and building up information structures and permanent educational system on the other, are a precondition for successful integration into modern economic trends.

In order to achieve better productivity, lower costs and bigger efficiency, it is necessary to fulfil many conditions. Some of the most important conditions are the following:

- The Government should increase investments in development of Internet on the level of society,
- Manner and speed of adjustment to often bureaucratic structures of companies and the level of awareness of management about the advantages that this kind of business has on final performances of a company,
- Increase of penetration rate of Internet, better quality of Internet services, decrease of price of Internet services, bigger use of different types of Internet services,
- Increased use of broadband Internet by small and medium enterprises and entrepreneurs, etc.

As an example or a reminder, it is enough to point to some of the evident influences of Internet to certain areas. In the field of medicine in USA, this impact has a big repercussion in economy. Decrease of costs in sense of simplified procedure in record keeping and testing the patients' health condition, together with all information regarding the history of illness, is available to patient's doctor. Besides the decrease of costs, there is an increase of efficiency and better quality of medical care for patient. Of course, users of Internet have more advantages in area of financial services, with a simple check of the account balance and management of financial transactions from any spot, at any time, and in a very simple way.

It is needless to point to all the benefits that citizens have from this type of communication. We will only mention how Internet decreases transactional costs on all Government's levels. This is specially related to better, more efficient, cheaper and more complete exchange of information between Government and citizens - in example of billing tax online, which is causing shorter procedures and decreasing costs for both sides. Of course, it is necessary to have a high level of Internet use, but from the experiences of other countries which are considered as leaders in use of e-Government, such as USA, it is obvious that electronic business of Government is built parallel with a thorough action of raising awareness about the importance of Internet in everyday life. Therefore, there are many reasons why citizens should understand and accept the use of Internet, not only as a fun tool, but as a way to communicate and fulfil obligations towards society and state.

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ARE WE REALLY AWARE OF THE NEED FOR A VIGOROUS COMPETITION POLICY? COMPETITION POLICY IN TRANSITION ECONOMIES.

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“Protectionism ...is like a pregnancy: you think it's about nine months but there are decades of consequences.”
Neelie Kroes

ABSTRACT

Among the few things most economists would agree on is that “market competition is a good thing for the economy”. Competitive markets have been shown to be the best way of allocating resources to the best possible use. Competition makes a pressure on firms continuously to innovate and reorganize their business activities in order to improve their productivity and supply market-desirable products and services. Also, competition produces positive effects that can boost the efficiency of an entire industry, including related and supporting industries in the surrounding region.

Many empirical studies have detected the positive link between increased competition and better economic performance through higher productivity. Gains from market competition are beneficial both for firms and consumers. Thus, developed market economies nurture a market competition through regulating natural monopolies and implementing a competition policy.

A critical concern underlying the motivation for this paper is the recognition that an effective competition policy facilitates the creation and growth of efficient and competitive firms that can both deliver goods and services to the nation's own citizens and effectively engage in trade and competition in international markets. This paper analyses implementation of a competition policy in (SEE) countries and tries to answer whether a competition policy in these transition countries has a proper role in their system of economic policies for supporting economic growth.

Key words

competition policy, benefits from competition, transition economics, economic growth,

WHY COMPETITION?

Among the few things most economists would agree on is that “market competition is a good thing for the economy”. Economists have made a number of research studies dedicated to competition and its benefits for the whole society. Some of them are having been very influential, such as Adam Smith’s “invisible hand” who believed that competition and free market mechanism can produce superior results from the aspect of efficient allocation of resources and to ensure higher social welfare.

Also, there are numerous empirical evidences that supporting the positive relationship between competition and productivity growth. Results of country analyses of competition and productivity in the UK, Germany and Korea revealed that productivity is higher in those sectors of the economy where competition is stronger. Many OECD studies have also detected the positive link between increased competition and better economic performance through higher productivity and increased employment. Increasing productivity is the most important precondition for dynamic economic development, and therefore, only fair and intense competition in all sectors of an economy is a necessary condition for rapid productivity growth. For instance, in the 1990s, Australian’s reforms which promoting competitive pressures in the economy, triggered a wide economic recovery that led to the longest economic expansion since 1960s (D. Purcell and M.Fox, 2009).

Competition is a process of rivalry between firms, where each firm seeking to attract a higher number of customers and to keep a bigger market shares. Firms can compete on price, on quality of existing products and services, or use entrepreneur or research skills to develop new products and services. The benefits for consumers from this rivalry are that prices will be close to an efficient level of costs (marginal costs) and a diversity of product offerings will meet the heterogeneity of consumer needs and tastes.

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Competition also encourages firms to innovate and to reorganize their business activities in order to improve their cost structure and to increase their factors’ productivity. Over time, competition weeding out inefficient firms from markets and reallocating productive resources from failing firms to new entrants or more efficient competitors. Long-term benefits from competitive markets may arise from both greater efforts to innovate and from fast spread of new technologies. But from the aspect of firms, vigorous market competition might be a mixed blessing (Geroski, 2006 p.24-25). On the one hand, vigorous competition keeps firms working at their best and that often produces a proper innovative response to the changes in the dynamic market environment. But on the other hand, working in a high competitive market can be hard work for firms and a source of intensive pressure for their managers. Sometimes, this rivalry can lead to some waste and duplication of efforts and resources. Beside the fact that many firms and their managers are explicitly committed to competition, intuitively and implicitly they are inclined to increase firm’s market power, and consequently to this their profits will be higher and easily to earn in a more monopolistic markets. Therefore, these “acquired anomalies” of the market mechanism impose the need of competition policy enforcement.

In a nutshell, there is a general consensus between economists that market competition is the social desirable condition for good functioning of the economy. Gains from market competition are beneficial both for firms and consumers. Thus, developed market economies nurture a market competition through regulating natural monopolies and implementing a competition policy.

COMPETITION POLICY – DO WE REALLY NEED THIS POLICY?

The main theoretical analyses and the majority of empirical studies come to the conclusion that competition needs protection. These findings were arising big debates between theoreticians about what kind of protection is needed. Some theoreticians propagate laissez-faire approaches with no or minimum antitrust rules, but others are emphasizing the need for enforcement of an active competition policy in order to create “an optimal competition pressure”.

Without pretensions to enter into these debates in detail, findings from a number of empirical studies, (Postema et al. 2006, Baker 2003, Kai 2008)¹ that competition policy enforcement might reduce the deadweight welfare loss of abusing market power, and consequently to realize better market performances than without such policy, are a good justification for implementation of competition policy. Geroski (2006) emphasizes the fact that countries with lax competition enforcement regime have higher prices comparing with the countries with active competition policy enforcement.

Furthermore, competition policy is, by design, both selective and episodic, which means that it is designed to yield large pay offs from minimal resources. Competition authorities swing into operation only when serious competition problems exist on the market. For instance, in the UK, fewer than 5% of all mergers end up at the Competition Commission, and an average of 1-2 market investigation per year are processed by their competition authorities (Geroski, 2006).

In 2000 in Lisbon, the EU member states signed up to a programme of economic reforms designed to make the EU “the world’s most competitive and dynamic knowledge-based economy” by 2010². So, competition policy is one of the principal elements to foster competitiveness of EU’s industries and to achieve the competitiveness objective of the European Union and the Lisbon Strategy. Therefore, the new and reformed EU competition policy is characterized by:

- i. improvement of the regulatory framework for competition which facilitates vibrant business activity and dissemination of knowledge throughout the internal market; and
- ii. enforcement practice which actively removes entry barriers and impediments to effective competition in the internal market.

The benefits for consumers from the active competition enforcement regime might be expressed in the lower prices than they otherwise would be in the cases with lax competition enforcement. Additionally, there are many intangible benefits for consumer in the form of better services and a wider diversity of products. Benefits that an active competition policy delivers to consumers very often are hard to estimate. However, it is important to note that competition policy delivers net positive effects to consumers. For instance, Postema et al.2006 using a cost benefit analysis estimated the net benefits of Dutch merger control at about 100 million EUR per year in the period 1998-2003.

Competition policy helps to improve performance of the market and of the industry, and the performance of the whole economy. An economy that wishes to be internationally competitive should has an active enforcement of competition policy. A good example for this is the Irish economy. Between 1949 and 1961, the average annual GNP growth rate was 1,9%, while between 1961 and 1978 the average annual GNP growth rate was 4.1%. The former period was a period when protectionist measures and protectionist policies ruling the Irish economy activity while the latter was period when protectionist measures were withdrawn and active competition policy was

¹ Besides the positive effects from competition policy enforcement, some empirical studies (Crandall and Winston (2003), Ivaldi and Verboven 2001, Stewart and Kim 1993) argued that merger policy may have negative effects on consumer welfare. The available empirical evidence on actual mergers demonstrates that a merger may increase prices and inflict harm on consumer welfare.

² Communication from the Commission: A pro-active Competition Policy for a Competitive Europe, COM (2004), Brussels.

introduced (D. Purcell and M.Fox, 2009). Another example, where the absent of active competition policy and promoting protectionism increased the economic inefficiencies is the Japanese economy during the 1990s, when the Japanese companies were not internationally successful, but Japanese economy was highly protected.

In a period of economic recession, the task of competition advocacy is more difficult. Firms' representatives can use the pressure from increased unemployment, decline in demand for firms' goods and lower economic growth for a lobbying for a protection and subsidies from government. However, even under these circumstances, competition authorities through promoting benefits from competition and educating the public of the futility of protectionism should help policymakers in their responsibilities towards consumer and social welfare. Therefore, policymakers should clearly determine whether a distress industry is in that position due to an external shock or is it due to an inevitable decline in demand for its goods. The former may benefit from some intervention without distorting the rest of the economy, while the aid given to the latter only transfers resources away from their productive uses and harms the whole economy.

Summarizing, competition policy is essential for an economy both in good and bad times. There is a clear lesson in all mention above: an active enforcement of domestic competition policy is essential for an open and small economy that wishes to be internationally competitive, i.e. competition at home enhances firms' ability to compete abroad.

3. COMPETITION POLICY IN TRANSITION ECONOMIES

Analyzing the competition policies in the countries from South East Europe (SEE), we have to bear in mind the specific circumstances in their economies at the beginning of the 1990's, which are relevant for the understanding of the transition in relation to "market mechanism".

Firstly, the market mechanisms, market institutions and prices system were completely absent in the previous economic systems. The bureaucratic coordination had several negative effects on the economic performance: lack of motivation and inefficiency, inappropriate product mix, and lack of innovative activity due to the lack of need for competition.

Secondly, the state ownership was a typical characteristic for socialist economies. Private ownership and profit-oriented practices were largely absent across the region. The lack of private property led to absence of firms' incentives and additional inefficiencies.

Thirdly, there were two most important distortions in the production structure compared to established market economies, and they were: (i) a relatively overdevelopment of heavy industry and underdevelopment of services and (ii) an incentive in favor of big firms and against small firms.

In the second half of the 1990's almost all countries from SEE adopted a competition law, except Bosnia and Herzegovina, which started the systemic transformation the last from the Balkan countries due to the civil war. The process of the implementation of the competition polices was followed by transition's uncertainty, and a weak economic performance of their industries. The absence of market mechanism in the previous system prolonged the period of the creation of demand for credible market institutions and policies. At the beginning of the markets' development, the existing firms used their political power in order to keep their monopoly positions at the markets. Very often, the governments themselves suspended the enforcement of competition law.

Table 1: Adoption and amendments of competition laws

Countries	Adoption of competition laws
Albania	1995 (2003)*
Croatia	1995 (2003)*
Macedonia	1999 (2005)*
Bosnia and Hercegovina	2001
Serbia	1996 (2005)*
Montenegro	1996, (2005)* (2007)*

Note: The main amendments have been made in the legislation in these countries.

The frame for competition legislation in the SEE countries is broadly similar to the Treaty of Rome, reflecting the approximation required by the Association Agreements. The coverage of competition laws is similar to that in established market economies. During the process of accession and economic integration with the European internal market has stimulated reforms towards EU-style competition law and there were a number of legislative improvements in most of the analyzed countries. According to EBRD, implementation of competition policy has also advanced in the past few years. Some countries, are taking measures to remove entry barriers and easy market's exit restrictions by streamlining licensing requirements and establishing one-stop registration shop (for instance Croatia, Macedonia, Albania).

Even though the improvements in the competition legislation have been made, its enforcement is still weak with negative effects on the market competition. Market structures and behavioral habits are still a matter of concern in these countries. In effect, there is a striking gap between the weak state of product-market competition and the task that it is expected to perform in SEE countries.

ARE TRANSITION COUNTRIES FROM SEE AWARE OF THE IMPORTANCE OF AN ACTIVE COMPETITION POLICY?

We have to point out the fact that there is still very little systemic evidence about competition policy enforcement and its impact on the intensity of economy-wide competition in transition economies from South East Europe. Most of the surveys were administrated by the EBRD and they consist of descriptive information for the business environment in these countries. In addition, most of the data are classified and it is a very difficult task to provide personal research of this issue.

Dutz and Vagliasindi (2000)³ analyzed 26 countries in transition from Central East Europe (CEE), SEE and former Soviet Union, and they found a significant variation across the countries about the effectiveness of competition policy and its impact on the intensity of competition.

They defined three criteria for measuring the effectiveness of competition policy implementation:

- *enforcement* - it includes assessments of the effectiveness of enforcement activities against enterprises and against state executives bodies;
- *competition advocacy* - it reflects an assessment of the effectiveness of written comments and objections concerning a broad range of economic policies affecting competition; and
- *institutional effectiveness* - it is based on assessments of the degree of political independence of the competition authorities and transparency of the agencies.

³ Therefore, in this section is presented the criteria for assessment of the effectiveness of competition policy, which were defined by Dutz and Vagliasindi (2000) and as well as the results from their research.

Dutz and Vagliasindi (2000) showed that the enforcement and the institutional effectiveness are positively related to the intensity of competition on domestic markets. This implies that the factors related to institutional effectiveness are indeed critical in ensuring that competition policy has its intended economy-wide effect. They revealed that the state of competition in the selected SEE transition economies is still far from the one in the established market economies.

The competition advocacy in the analyzed countries is on a very low level and as a criterion has no significant effect on the intensity of the competition in the SEE countries. Additionally, Dutz and Vagliasindi (2000) revealed that the countries with stronger corporate governance structures (for instance countries from CEE) have a market competition that is more vigorous, and to some extent, the stronger corporate governance structure substitutes the enforcement of an effective competition policy. The results of their analysis also show that while the increased average concentration in the industry acts as a brake on the expansion of more efficient firms, competition pressure from foreign countries might positively affect the resources mobility. Unfortunately, this is not the case with the economies of the SEE countries. Foreign firms have weak effects on the behavior and performance of domestic firms. Domestic firms work at lower productivity, their products are less competitive on the international markets, and as a result of these trends, the rate of import penetration is very high in the transition economies.⁴

According to the Global competitiveness report 2008-2009, the selected transition countries rank in the second half on the scale of the world's competitive economies. These positions refer to unfavorable business environments in their economies. Croatian economy holds the best rank among the analyzed economies, but it is still away from the developed European economies (see Table 2).

Table 2: Some selected indicators for business environments

Countries	GCI 2008- 2009 Rank (out of 134)	Selected indicators for business environments Rank (out of 134) for 2008-2009			
		Intensity of local competition	Extent of market dominance	Effectiveness of competition policies	Prevalence of trade barriers
Albania	108	127	126	125	63
Bosnia and Hercegovina	107	98	106	134	53
Croatia	61	68	90	86	64
Macedonia	89	107	117	107	79
Montenegro	65	91	82	85	56
Serbia	85	128	131	129	96

Source: The global competitiveness report 2008-2009, World Economic Forum

In these countries, the competition institutions and legislations are politically influenced. They face similar problems with enforcing competition policy where there are regulatory or professional barriers to entry. The results of analysis reveal that the dominant problem in these countries is the abuse of the dominant market position and the lenient approach towards mergers, and the lack of action against hardcore cartels.

The lack of competition culture in these countries is one of biggest problem and it is a key impediment to pro-competitive reforms and effective fight against attempts to restrict market competition.

⁴ For instance, the rate of import penetration in 2005 for BIH was 82.5%, for Croatia was 47.5 % and for Serbia 42 % (EBRD Transition reports 2007).

Often, competition authorities are the only advocates of competition culture in SEE countries. Very often, even, some of these authorities are not convinced about the importance of the advocacy role and do not have sufficient political support for acting that role. Owing to the lack of competition culture, many SEE competition authorities have insufficient resources to enforce competition rules vigorously. Furthermore, the competition officers and judges are still moving along a learning curve, and consequently it is arising problems which are relating to priority-setting in competition law enforcement, which may lead to inefficient use of available resources.

CONCLUSION

The cause for low level of competition in the analyzed economies lies in the chosen model for their systemic transformation, where more attention was put to the systemic stabilization vis à vis the systemic development. In the early phases of the transition process, markets' institutions development was completely missing and the lack of competition culture became the most pervasive problem in all SEE countries. The microeconomic conditions in their economies create unfavorable business environment that generate less productive firms to be established on the market.

Most of the SEE countries have a high level of competence of competition legislation in the books, but very low level of their enforcement. Competition institutions and legislations are politically influenced in these countries. They face similar problems with competition policy enforcement. The results of the analysis reveal that the dominant problem is the abuse of the dominant market position and the lenient approach towards mergers, and lack of action against hardcore cartels. Thus, the absence of strong impact of competition advocacy reflects on difficulties with the competition policy enforcement. In order to improve the enforcement of competition policy, the competition authorities have to improve their expertise and increase their independence from the political pressures.

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However, for the market mechanism and firms to function well, the government in these countries must take an important role to establish the necessary market-supporting institutions and policies. Ensuring that all sectors of the economy are as competitive as possible is imperative for all SEE countries to embark on a path for sustainable growth. Therefore, the main precondition in doing this is an applying the full and vigorous of competition regulation to all sectors in their economies. Competition authorities in these countries should have an important role in the process of transition to effective market economies by providing guidance to economic reform and defending markets against attempts to restrict or eliminate competition. Consequently, they will contribute to an economic environment favorable to investment and entrepreneurship.

In a nutshell, in strengthening their economies, creating fundamentals for sustainable economic growth and building legal and institutional capacities, the SEE countries will need to implement competition law enforcement and integrate competition policy into various fields of economic policy.

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GREEN MARKETING AND SUSTAINABLE ECONOMIC DEVELOPMENT

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ABSTRACT

Sustainable development is perhaps the most significant and yet the most challenging issue that marketing – and human economic activity in general – face at the beginning of the third millennium. Conventional marketing practices, which might be called ‘brown’ marketing, have been criticized for their lack of ecological sustainability. For the new century, the key challenge for mankind is to find more sustainable and equitable ways to produce, consume and live. The integration of environmental concerns into marketing theory and practice, which has created a concept of ‘green’ marketing, is viewed by some as simply an extension of the social marketing concept.

Thus, ‘green’ marketing incorporates a broad range of activities, including product modification, changes in the production process, changes in packaging, as well as modifications in advertising. However, it is more helpful to view the concept of ‘green’ marketing, which has developed in response to the green movement of today, as something which integrates and expands upon the ideas embedded in the ecological and societal marketing concepts.

Key Words

green marketing, sustainable development, environment, consumers

INTRODUCTION

Without undue exaggeration, sustainable development can be regarded as the most significant and yet the most challenging concern that marketing – and human economic activity in general – face at the beginning of the third millennium. Modern production methods and marketing systems have brought unparalleled material comforts to most people in affluent societies, to many in the so-called emerging economies, as well as to a few in less developed societies. But this level of material wealth has come at a high price, as the earth's natural resources are increasingly seen to be under enormous stress, the most significant example of which is perhaps global climate change. This is one global environmental problem that can be directly linked not only to the production of material goods but also to their consumption. Making marketing – and production, consumption and everything else that goes with it – more ecologically sustainable is therefore one of the major challenges ahead.

GREEN MARKETING AS AN OPTION

Conventional marketing practices, which might be called 'brown' marketing, have been criticized for their lack of ecological sustainability. The key points of criticism are that they promote excessive consumption and materialism, and that product design is often environmentally wasteful due to short durability of products, products not being designed for recycling and excessive use of materials. No part of the marketing chain is without criticism. Excessive packaging, production of marketing materials and the transportation of finished goods often over long distances are all criticized as being wasteful of resource (Velasquez, 2002). In this sense, marketing and environmental sustainability are often seen as directly opposed.

262 According to the marketing concept as presented in widely used marketing texts, "achieving organisational goals depends on determining the needs and wants of target markets and delivering the desired satisfactions" (Kotler, Armstrong, Sanders, Wong, 2001). Defenders of marketing practice might therefore argue that it is unfair to lay all these environmental woes at the door of marketing, as marketing does not create consumer needs – even those in an overly materialistic society – but merely reflects them. Therefore, if consumers were not willing to buy all these products offered in the market and happily accept or demand ever more and new consumer goods, no amount of advertising or other marketing techniques could ever make them do so. However, if marketing techniques, including advertising, do not actually have the potential to propose new needs to consumers, to charm and seduce them, and thus, if not create, then at least nourish their materialist wishes, then it is difficult to see why consumer goods companies would spend quite as much money on advertising that seems so obviously designed to do just that. At the very least it would seem true to say that marketing practice and consumer demand encourage and feed off each other in a circle of mutual influence and dependence.

Modern marketing must be environment-oriented. It should be understood as an element of a system of the environment management.

Such marketing has received various names: new marketing, ecological marketing, eco-marketing and even green marketing (Grundley, Zaharia, 2008). However, the name is here a minor issue; it is the essence that is important. A concept of environment-friendly marketing fulfils the criteria of a Kotler's model of societal marketing. The societal marketing concept holds that the organization's task is to determine the needs, wants, and interests of target markets and to deliver the desired satisfactions more effectively and efficiently than competitors in a way that preserves or enhances the consumer's and the society's well-being. The concept calls upon marketers to balance three considerations in setting their marketing policies, namely, company profits, consumer want satisfaction, and public

interest (Kotler, Keller 2007). Nowadays, a state of the environment is obviously of public interest and has a big influence on the society's well-being.

'Green' Marketing has been proposed as a solution, at least a partial one, to the environmental issues connected with conventional marketing. The premise here follows ecological modernisation thought, i.e. that transformation towards an environmentally sustainable economy can be achieved within the current market system (Young, 2000). The logic here is that there is a rising consumer awareness of and concern about environmental issues. Consumers therefore demand more environmentally responsible products and production processes. Marketers react flexibly to these consumer demands, changing products and processes to achieve the same consumer benefits with less environmental detriment. Marketers that do not respond to these market demands are perceived by consumers to be environmentally irresponsible and are eventually pushed out of a competitive market. This process constitutes a rebuilding of a more sustainable market system from below, whereby a snowball effect of demand for more environmentally benign products and processes and increased monitoring at all levels drives pro-environmental change through the entire supply chain.

Management theory in general is firmly rooted in an economic and technical systems perspective which concentrates on exchanges, products, production and profits. Over time it has evolved to become more 'human', with the emergence of disciplines like organizational behaviour, human resource management, business ethics and societal marketing. The fact that businesses are physical systems which exist within a finite and vulnerable physical environment has, until recently, largely been ignored as a management and marketing issue. During the 1990s, the marketing discipline began to seriously discuss the physical implications and sustainability of marketing.

The roots of green marketing can be traced back to the wave of environmental concern of the 1970s which spawned the 'ecological marketing' concept (Baker, 2003). This was largely concerned with those industries with the most severe environmental impacts, and with developing new technologies to alleviate particular environmental problems. There are some important differences between the environmental movement of the 1970s and the green movement of today, which are summarized in Table 1.

Table.1 The evolution of environmental concern

Factor	1970s environmentalism	1990s green
Emphasis	<i>Environmental problems</i>	<i>Underlying problems with social, economic, technical or legal systems</i>
Geographic focus	<i>Local problems – pollution</i>	<i>Global issues – global warming</i>
Identity	<i>Closely linked to other anti-establishment causes</i>	<i>A separate movement embraced by many elements of 'the establishment'</i>
Source of support	<i>An intellectual elite, and those at the fringes of society</i>	<i>A broad base</i>
Basis of campaigns	<i>Used forecasts of exponential growth to predict future environmental problems (e.g. limits to growth)</i>	<i>Uses evidence of current environmental degradation (e.g. the hole in the ozone layer)</i>
Attitude to businesses	<i>Business is the problem. Generally adversarial</i>	<i>Businesses seen as part of the solution. More partnerships formed.</i>
Attitude to growth	<i>Desire for zero growth</i>	<i>Desire for sustainable growth</i>
View of environment/ business interaction	<i>Focused on negative effects of business activity on the environment</i>	<i>Focuses on the dynamic interrelationship between business, society and the environment</i>

Source: Baker M. J. (2003), *The Marketing book*, Chpt 28 Peattie K., Charter M., 5th edition, Butterworth & Heinemann, pg 729

The integration of environmental concern into marketing theory and practice is also viewed by some as simply an extension of the societal marketing concept. However, it is more helpful to view the concept of 'green marketing', which has developed as a response to the green movement of today, as something which integrates and expands upon the ideas embedded in the ecological and societal marketing concepts. We can define it as the holistic management process responsible for identifying, anticipating and satisfying the needs of customers and society, in a profitable and sustainable way.

The key differences (Baker, 2003) between the green marketing concept and societal marketing lie in:

- ↳ an emphasis on the physical sustainability of the marketing process, as well as its social acceptability;
- ↳ a more holistic and interdependent view of the relationship between the economy, society and the environment;
- ↳ an open-ended rather than a long-term perspective;
- ↳ a treatment of the environment as something with intrinsic value over and above its usefulness to society;
- ↳ a focus on global concerns, rather than those of particular societies.

In both the ecological and societal marketing concepts, the emphasis on socio-environmental issues for marketers has mostly been framed in terms of costs and constraints. Another important new dimension that green marketing introduced was an emphasis on socio-environmental issues as a potential source of innovation and opportunity for marketers.

Sustainability is the keystone of the green marketing philosophy, which resolves this apparent paradox. A sustainable approach to consumption and production involves enjoying a material standard of living today, which is not at the expense of the standard of living of future generations. It is a deceptively simple concept comprising two parts (Baker, 2003):

- ↳ Using natural resources at a rate at which environmental systems or human activity can replenish them (or in the case of non-renewable resources, at a rate at which renewable alternatives can be substituted in).
- ↳ Producing pollution and waste at a rate which can be absorbed by environmental systems without impairing their viability.

Green marketing's key concepts of sustainability and holism are both apparently simple, but can be extremely difficult to translate into action. This is largely because conventional management wisdom emphasizes reduction and specialization, and is founded on economic theories which mistakenly treat environmental resources as limitless, free (beyond the cost of extraction) or, for market-less commodities like stratospheric ozone, worthless. Green marketing attempts to relocate marketing theory in general.

This optimistic view of green marketing has been criticized by a number of scholars over recent years. Majority of them stress that the environmental crisis rests not within specific behaviour, such as the purchase of particular, non-green products, but within a materialist 'dominant social paradigm' that is reflected in our entire production and consumption systems. Contemporary green marketing fails to move beyond that paradigm and is therefore unable to provide a solution to the crisis. Some scholars argue that green marketing is a myth, designed to prop up an unsustainable industrial system rather than to overcome or change it fundamentally. If all is not well with green marketing from a conceptual viewpoint, problems also arise with the spread of green marketing practice. The greening of marketing has been found to be more rhetoric than substance. The economic rationale for green marketing is being questioned as well.

SUSTAINABLE ECONOMIC DEVELOPMENT IN MODERN ERA

Sustainable development is a pattern of resource use that aims to meet human needs while preserving the environment so that these needs can be met not only in the present, but also for future generations. The term was used by the Brundtland Commission (Smith, Rees, 1998) which coined what has become the most often-quoted definition of sustainable development as development that meets the needs of the present without compromising the ability of future generations to meet their own needs. Sustainable development ties together concern for the carrying capacity of natural systems with the social challenges facing humanity. As early as the 1970s sustainability was employed to describe an economy in equilibrium with basic ecological support systems. Ecologists have pointed to *The Limits to Growth* and presented the alternative of a “steady state economy” in order to address environmental concerns. The field of sustainable development can be conceptually broken into three constituent parts (Smith, Rees, 1998):

- ↳ environmental sustainability,
- ↳ economic sustainability,
- ↳ socio-political sustainability.

Green development is generally differentiated from sustainable development in that Green development prioritizes what its proponents consider to be environmental sustainability over economic and cultural considerations. Proponents of Sustainable Development argue that it provides a context in which to improve overall sustainability where cutting-edge Green development is unattainable. For example, a cutting-edge treatment plant with extremely high maintenance costs may not be sustainable in regions of the world with fewer financial resources. An environmentally ideal plant that is shut down due to bankruptcy is obviously less sustainable than one that is maintainable by the community, even if it is somewhat less effective from an environmental standpoint.

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Sustainable development is the central issue of the contemporary science and practice. It emerged and has been developing as a strategy and humanity’s rational response to the challenges of the global economic crisis and the evolution of the modern civilisation into a specific “global risk society”. Therefore, only providing a harmonious and integrated economic, technological, social and cultural development, conforming to the standards of protecting and improving the environment, can lead to an enhanced quality of life as a higher value, to which modern civilization aims. Among others, sustainable development in economy implies a critical, responsible and active approach of economic entities to all the elements of environmental management related to conducting business activities, included in the Business Charter for Sustainable Development (1991) and the ISO 14000 international and national standards. In the developing countries, the issues of sustainable development, and especially sustainable economic development, are not only the subject of theoretical research, but also of their practical resolution. At the corporate level, it means increased fund allocation for eliminating the detrimental impact of technological processes on nature and human resources; reducing the possibility of causing environmental and business risks through increased environmental responsibility; adapting the entire business operations of an enterprise to the demands of environmental standards and the requirements of Quality Management System in compliance with ISO 9001/2000; increased environmental investment; planning and implementing rational environmental and economic behaviour in spending natural resources; introducing “clean” technologies based on the concept of ecologisation of production; increasing complex management responsibility in achieving environmental parameters in corporate life, with regard to all environmental standards; forming and introducing environment-friendly policies into corporations; regular control of environmental impact and informing the public about, it, etc. In the transition countries (including Serbia), such high standards are still not implemented in corporate operations, but the development of the European eco-management system points to the need to improved environmental performance.

The sustainable development policy implies (Zekovic, 2003): (a) the policy of dematerialisation of material inputs/outputs in production; (b) the policy of production/consumption optimization; (c) the substitution of products (non-renewable resources); (d) the possibility to recycle products or waste. The implementation of sustainable development is not possible only by applying diagnostic instruments, planning and forecasting mechanisms, but also requires the development and implementation of instruments, means and actions at various levels. According to UN experiences, an integrated approach to planning and implementing sustainable economy implies setting up regulatory, economic and social policies and their instruments (Table 2)

In addition to numerous legal instruments (laws, regulations, by-laws, directives, international conventions, protocols, resolutions, declarations etc.), the implementation of sustainable development policy also makes use of economic instruments, such as voluntary / non-governmental environment protection instruments (e.g. Business Charter for Sustainable Development, International Declaration on Cleaner Production, Energy Charter Treaty, conventions etc.), as well as various integrating mechanisms and planning instruments (such as environmental licences, Strategic Environmental Assessment (SEA), Environmental Impact Assessment (EIA), Integrated Prevention and Pollution Control (IPPC), urban and spatial planning and construction permits etc. In addition to introducing the “new” integrated environment protection planning instruments (SEA, IPPC etc.), the key role in implementing the sustainable development concept is played by the choice of strategies and approaches to economic and market instruments (Zekovic, 2003).

Table 2. General instruments of regulatory and economic policies in the implementation of sustainable development (according to UNEP experiences)

Dematerialisation of material and other inputs	Optimisation of resource consumption
Tools and actions on the national level	
Indicators	National accounts
Normative methodologies	Targets – financial, social and qualitative targets
Standards-setting for efficiency of products and processes; reporting and labelling standards.	Standards-setting for all environmentally-relevant behaviour.
Information – gathering and publishing aggregate data on energy and material use levels;	Policy guidelines/instructions, policy integration –sustainable consumption integrated across policy spectrum.
Regulatory and economic policies	
Legislation – legally binding requirements to change levels of material and energy use.	Legislation – legally binding requirements to change sectoral behaviour.
Assessment, enforcement – legislation useless without these.	Assessment, enforcement – legislation useless without these.
Taxes/charges on resource extraction – inducement to greater process and product efficiencies.	Environmental Tax Reform (ETR) – taxing ‘bads’ not ‘goods’, ring-fencing new revenues.
Taxes/charges on products – penalising process or product inefficiencies.	Removal of perverse subsidies – exposing uncompetitiveness of dirty sectors.
Taxes/charges on emissions – material emissions into air, water, ground; socially-harmful emissions such as noise, light.	New investment, subsidies, tax breaks – supporting fledgling, green industries.
Investment – promoting <i>Dematerialisation</i>	Internalisation of costs (Polluter Pays Principle) – letting prices reflect true costs.
Ad-hoc support – tailored support for specific industry efforts toward <i>Dematerialisation</i> .	Tradable emissions permits – letting the market decide where best to target pollution reduction.

Source: “Sustainable consumption and production”, UNEP, 2000/2001. Slavka Zeković, *Economic and market instruments in the sustainable development policy in Serbia. The paper is a part of the MNTR scientific project – “Planning and managing sustainable development in the conditions of transition to market economy – institutional harmonisation of the practices with the EU standards”*, Faculty of Economics in Belgrade Institute of Architecture and Urban Spatial Planning, Belgrade

STRATEGIC IMPLICATIONS FOR MODERN BUSINESSES

Implementing a philosophy of sustainability in the practice of marketing would require businesses to become more sensitive to the efficient use of all resources over a longer period. In particular, the loss of natural resources may significantly affect a company's product line and overall production process. This change in orientation, from short- to long-term, would be part of any requisite structural changes - changes in corporate culture and communication and information systems. Perhaps the most persuasive argument is that waste represents costs to organizations; therefore waste reduction, reuse of materials, and recyclability are important cost savings activities in the long-run. Marketers should be encouraged to assess the cost of new laws and regulations, the cost of endless litigation, and the potential loss of competitive position as integral and critical components of an ecological approach. Additionally, firms should thoroughly consider the implications of a potential loss of corporate and product credibility due to perceptions of inaction totally by passing any environmental initiative, or forced compliance-environmental actions are pursued only when mandated by regulations.

Unfortunately, very often managers who try to radically change corporations from within are often stymied. Corporate culture and political pressures provide almost insurmountable resistance against any sudden and even enlightened change. Some experts advocate that perhaps the solution to this dilemma lies between "saving it all" (limits to growth environmentalism) and "using it all" (unbridled capitalism). The issue then becomes one of educating managers along the lines of cost-benefit on the one hand, and along the lines of social responsibility or the role and obligations that organizations have as active participants of the social system within which they operate.

Green Gauge Report released by Roper Starch Worldwide US (Grundey, Zaharia, 2008) showed that the percentage of consumers willing to pay more for environmental products has declined from 11 % in 1986 to 5 % in 1996. Marketing greener products will have to entail more than attaching a green label or featuring images of wildlife in media advertisements. In developing value-added on ecological bases, organizational leaders would have to establish a level of environmental commitment that is most suitable and feasible given the conditions that the organization faces.

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Companies that have adopted some type of environmental accountability have found some benefits in the adoption of an ecological approach. Some of the activities that have been implemented include (Grundey, Zaharia, 2008):

- 1) building consumer demand for green products;
- 2) spending revenues to educate buyers;
- 3) building new infrastructure to facilitate recycling and prevent pollution.

Being branded a green company can be potentially beneficial to business organizations. The green image generates a more positive public image which can, in turn, enhance sales, increase stock prices, and open access to public capital markets.

A green image may enhance the overall perception of product quality and, when coupled with the environmental benefits inherent in a product and/or its use, may provide the added value that consumers would favour. However, note that even seemingly "simple" things have a significant effect on the marketing of certain products. Changes in regulations will influence marketing decisions and strategies that an organization may pursue.

CONCLUSIONS

A significant number of experts today view the notion of sustainable development as dangerous because the consequences have unknown effects. In economy like in ecology, the interdependence rule applies, and isolated actions are impossible. A policy which is not thought out carefully enough will carry along various perverse and adverse effects for the ecology as much as for the economy. Many suggestions to save our environment and to promote a model of 'sustainable development' risk indeed leading to reverse effects. Moreover, they evoke the bounds of public action which are underlined by the public choice theory: the quest by policymakers of their own interests, lobby pressure, partial disclosure etc. Critique has been developed by noting the vagueness of the expression, which can cover anything - it is a gateway to interventionist proceedings which can be against the principle of freedom and without proven efficacy. Against this notion, there are many of proponents of private property who want to impel the producers and the consumers to save the natural resources. The improvement of environment quality depends on the market economy and the existence of legitimate and protected property rights. They enable the effective practice of personal responsibility and the development of mechanisms to protect the environment. In this sense, implementation of the Green marketing concept in business and in economy in general, can and will create conditions which encourage the people, managers, businesses, and government to achieve development and, at the same time, to save the environment.

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THE CHALLENGES OF EMIGRANTS RETURNING IN ALBANIA

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Poverty is not shame, but many times it has a price. *Spanish proverb*
Necessitous men are not free men. *Franklin Delano Roosevelt*
You can recognize a poor person by his face. *Andersen*

ABSTRACT

The paper is based on a research done 2 years ago for IOM. The data are based in the data taken from the Total Information Management System (TIMS), which is a computerised system to support the border polic force, introduced in Albania since some years and from a survey based on a questionnaire. The return of illegal migrants is presently being carried out in the framework of readmission agreements, for those countries where a readmission agreement is in force, or under other bilateral/multilateral cooperation agreements.

The data collected from the TIMS indicate that irregular migration is still a prevailing phenomena in Albania, even though in lower levels as compared to the previous years. Bthe study shows that many of the irregular migrants were found to be recidivists, crossing the borders irregularly more than once. Greece is the main returning country, which leads to the conclusion that it is the main destination country of irregular migrants. The number of returnees reaches its peak, especially on April and September, with the start of the seasonal works. The number of the returned minor migrants is problematic which demands for specific care and attention during the procedures of readmission (return, handover by the returning countries, readmission and etc.).

From the questionnaire, based on the returned emigrants structure, in 4 BCP is collected some information, which in general is not available throught TIMS as: education, duration of the stay, the professions of migrants, the main reasons of emigration etc. There is a light trend to represent poverty as the main reason to emigrate at young ages rather at middle ages the lack of job opportunities is stated as the main reason to emigrate.

At the end of the paper there are conclusions and recommendations.

Keywords

migration, data collection, socio economic profile

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INTRODUCTION

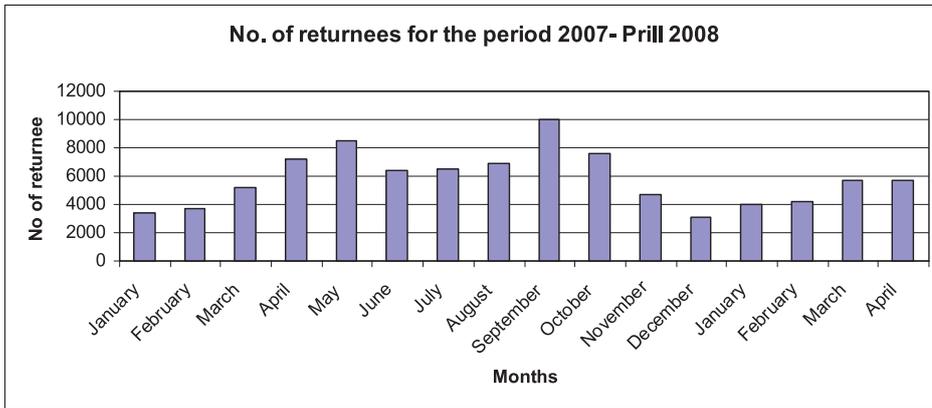
The paper is based on a research done 2 years ago for IOM. The data are based in the data taken from the Total Information Management System (TIMS), which is a computerised system to support the border police force, introduced in Albania since some years and from a survey based on a questionnaire. The return of illegal migrants is presently being carried out in the framework of readmission agreements, for those countries where a readmission agreement is in force, or under other bilateral/multilateral cooperation agreements. The subject of this paper is the socio economic profile of the emigrants returned to Albania in the period 2007 -2008.

Total Information Management System – TIMS (*Sistemi i Administrimit Total të Informacionit*) is helping the police forces to prepare reports and statistics according to: the entrance of Albanian citizens, the entrance of Foreign citizens, the departure of Albanian citizens, the departure of Foreign citizens, the entrance and departure of vehicles (according to number plates and types), the returned and suspicious citizens (the deportee and inad), information regarding the visas given at the BCP, information regarding the fees payed from foreigners in BCP, wanted and arrest order persons, the documents declared lost, stolen, invalid and blocked at border, the stolen and lost vehicles.

DATA ANALYZE

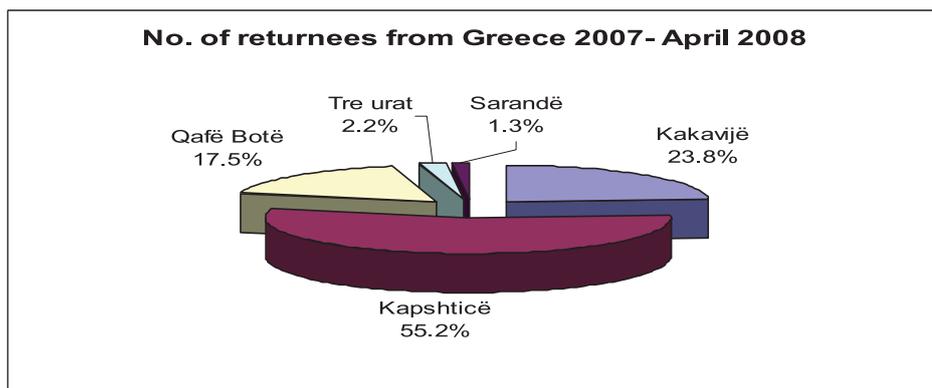
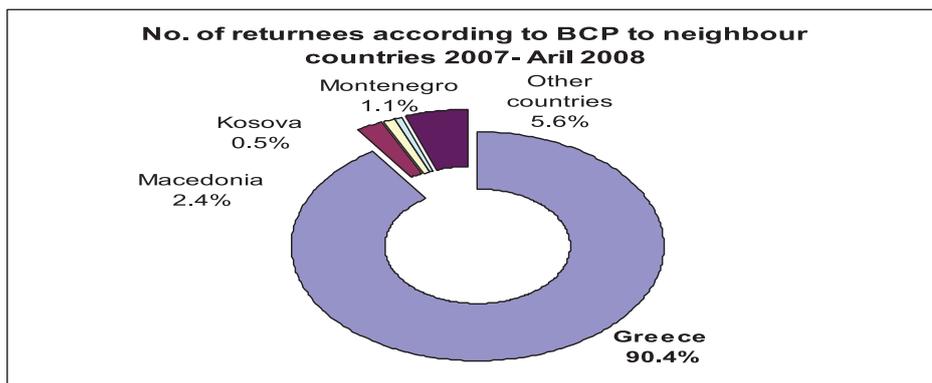
Based at the fact that the deportees are 94.8% of the total returnees (113.288 persons), they have a great impact on the process so the research will be continued for the total number of the returnees. Based on the structure of TIMS it is possible to access different data that after being elaborated will allow making many socio economic analysis relating to the returnees. Let us analyze acquired and elaborated data in the light of this research. The TIMS is generating data for the returnees on a monthly base in total and according to the BCP. Based on the data 2007- April 2008 we could underline that:

1. The average number of daily returnees is 193.5 persons.
2. The majority of them are coming from the BCP with Greece and in particular through Kapshtica BCP.
3. The number of the emigrants varies through months (it is predominated from the variations). The flux of the returnees is lower in January and it is increased until the peak in May, continues to decrease during the period June – August. The second peak is at September and continues to decrease for the period the October – December. Though it is noted that the peaks belong to the periods when the Greek farmers needs more labour force for the season works.
4. If we compare the returnees from the BCP with Greece we will note that the major part was returned through the Kapshtica BCP that has a higher weight when compared with all the other BCP-s taken together. (Kakavija, Qafë Bot, Tre urat (Three bridges) and Saranda). We think this is related to the fact that the flux of the returnees covered by this BCP is higher. We suppose that this is due to the fact that from Kapshtica BCP pass (and as a result work in the North Greece) major part of the illegal emigrants coming from North Albania, Northeast and East.
5. The number of the emigrants returned from Rinas BCP fluctuates continuously and does not have a regular model of behavior according to months. However the number of the returnees for the first four months of 2008 is lower when compared with the level of the returnees for the same period of 2007.



The information presented above shows that we should look in details the structure of the emigrants according to different. From the data we note:

1. Kapshtica BCP amounts for more than 50% of the returnees.
2. Three first countries for the returning of the emigrants (total of 87.255) are PKK and Greece.
3. 5 BCP from 7 BCP listed above (7 first countries) belongs to Greece and the 2 remaining to BCP Rinas and BCP Goricë.
4. The structure of the returnees is respectively 90.4% o BCP with Greece, BCP with other countries 5.6%, BCP with FYROM 2.4%, BCP with Montenegro 1.1% and BCP with Kosovo 0.5%.
5. The ranking of the BCP with Greece according to the number of the returnees is as follows: Kapështica 55.2%, Kakavia 23.8%, Qafë Bot 17.5%, Tre urat (Three bridges) 2.2% and Saranda 1.3%



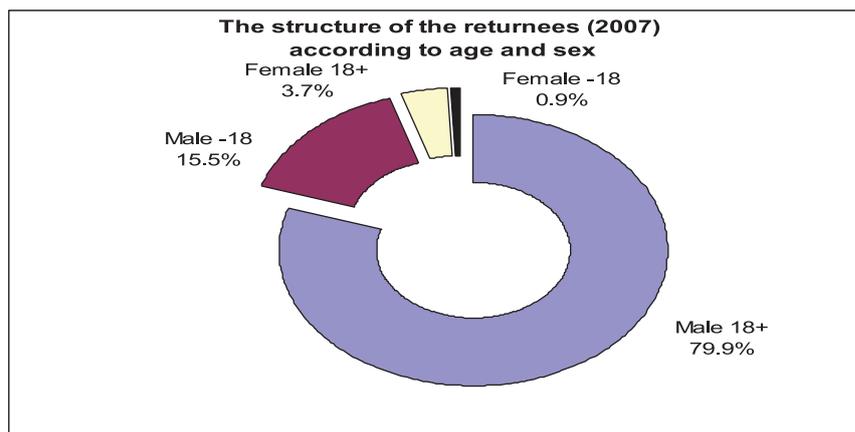
The following table shows that there is not any decrease on the flux of the returnees in the last two years. In the first trimester it is noted an increase on the umber of the returnees, meanwhile in April 2008 it is noted a decrease when compared with April 2007. This decrease could have happened occasionally or as a result of a decrease on the flux of the returnees (the second option is less likely), this will be verified from the data belonging to the next months.

Year	Jan	Feb	Mar	Apr	Total	Monthly average	Daily average
2007	3429	3677	5193	7243	19542	4885.5	162.85
2008	4015	4198	5671	5720	19604	4901	163.37

Also, TIMS provides data for the returnees according to their sex, where male predominates (95.4%), this phenomena is related not only to the structure of the illegal emigrants that attempt to pass the Greek border, but also due to the fact that female tend by nature to avoid the irregular and illegal cross of the border. We think that the irregular cross of the border for female happens mainly as a result of the human traffic or due to the problems faced with the provision of the regular documentation for join their family.

The structure of the returnees according to age and sex is showed through the following graph (up to 18 years and old and above 18 years old). Based on the acquired data it is noted that the major part of the returnees are male above 18 years old. But also a very high level of the specific weight of the minoren returnees have to be stressed out. (15.5%+0.9%). This fact should be taken in consideration from the government and also from the entire Albanian society as an important social problem.

It should be emphasized also that the structure of the minoren returnees within the sex category represents small changes if we compare female (3.7%/0.9%=4.11 times higher than the adult females) with males (79.9%/15.5%=5.16 times higher than the adult males).



The problem of the returnees according to the state from which they were returned will be treated taking in consideration the data provided from the following table, based on which we can draw these conclusions:

1. The total number of the states from which returnees were returned is 60.
2. The table includes in total 62 countries, because in it are included apart from the 60 countries mentioned in 1. Also categories such as “Unknown” or “Albania”. These two category show clearly that there are problems not only with the level of the qualification of the employees of the Border Police for the appropriate use of the TIMS, but in the same time another reason may be due to the momentum heavy work at the moment of the returnees flux. The second reason is mostly likely in BCP Kapshtica, where the number of the returnees is very high.
3. It should be clearly noted from the table that the number of the returnees from many of the countries listed in the table is very low and we should stress out that in most of the case we have countries where the number of the returnees represents les than 0.1%. The data for the period 2006 – April 2008 show that only 23.3% of the countries (14⁴ from 60 countries from which returnees were returned) have the level above 0.1%. We should emphasize that these countries including the “error” (“Unknown” and “Albania”) represent 99.44% of the total number of the returnees.

4 In this number we have included also Montenegro with 0.09%, because the data belongs to 2007.

4. Some small countries are also included on the list of the countries from which they were returned, faraway and undeveloped countries (often almost unknown) like Anguila, Dominican Republic, Grenada, French Guiana, Ghana, Guinea, Guatemala, Haiti, Comoros, Sierra Leone, Reunion, Kazakhstan etc.
5. The accurate research of the returnees according to the state from which they were returned should be done divided at least in two groups. The first group will include countries where there is a considerable number of emigrants from our country and where usually most of them go to work and the second group will include countries where there are less emigrants and the reason of going in these counties is unknown or even doubtful.
6. 31 countries of the world returned not less than 10 emigrants for a period of 28 months. 35 countries of the world returned not more than 20 emigrants for a period of 28 months, 37 countries of the word returned not more than 30 emigrants for a period of 28 months, and 43 countries of the world returned not more than 100 emigrants for a period of 28 months and so on.

Table 5. Returnees according to the main country of destination (more than 0.1% of the total)

Nr	Main countries	% of total	Nr	Main countries	% of total
1	Greece	76.40	9	France	0.37
2	Unknown +AL	14.94	10	Croatia	0.35
3	Italy	3.10	11	USA	0.31
4	UK	1.56	12	Slovenia	0.22
5	Swiss	0.57	13	Nederland	0.12
6	Germany	0.48	14	Serbia	0.12
7	FYROM	0.42	15	Montenegro	0.09
8	Belgium	0.39	Total		99.44

By the tables 4 and 5 we could conclude that:

1. The table 4 shows that 15 out of 62 countries represent 99.44% of the returnees. So, the rest, 47 countries count only 0.56% of the returnees.
2. There is a considerable number of returnees marked as “Unknown” 13.94% and “Albania” 1.00%. It is clear that the policemen at the BCP are not well qualified to use the system. They have recorded by a clear mistake the data regarding 14.94% of the returnees. We have no evidence if they are recording other data wrongly.
3. By other tables we count that 90% of the returnees are from Greece. At the same time this table shows that 91.34% are marked “Greece, Unknown, Albania”. So we must suppose that mainly the problems are at the policemen using the system at the BCP with Greece.

SOME GENERALIZATIONS DROWN FROM THE ELABORATION OF THE DATA FROM THE “SPECIAL” BOX OF TIMS.

As stressed out since the beginning at this report, the “additional” declaration in the box at the end of the page of TIMS includes information in a format questions and answers from the Police employee with the returnee. In some cases this declaration includes information that for the Police is considered as secrets to conduct investigation. This declaration does not have a defined and strict structure but it is done according to the circumstances and the judgment of the Police employee at the moment when the returnees reenter in Albania.

One of the objectives of our work is to attempt to realize a selection relating to the data that could be acquired from the information in these boxes. This objective faced some difficulties. Firstly the information in such boxes was not found in all the cases, secondly not always the information was put at our disposal (thin in cases related to investigation objects) and thirdly in most of the cases the unstructured information and different according to different emigrants. This fact made it completely impossible the acquiring of the information in a quantity form. We thought that taking in consideration these conditions the best choice would be to select and to generalize some of the acquired information. This would require indispensably the undertaken of an additional research for the returnees (research that would be completed on the second stage of the work). Here below we are presenting some summarized data.

Passing in exit with visas or regular documents in exit from Albania

There are many cases of the passing in the BCP (especially in the main BCP) through the usage of the visas or other regular documents.

- To countries like Switzerland, Italy, Germany, UK, Greece, USA, Belgium
- To work as simple worker in construction, plumber, joiner, singer, unoccupied, etc.
- To work without regular documents, with forged documents.
- To return to get married with citizens of these countries
- To get united to the family, to be able to legally take the consort
- Different reasons are given to explain why they deported from a given country.
- Their documents have expired or their residence permit is not renewed.
- Persons under penal prosecution for different penal actions such as clobber, transport of monetary values, transport of hashish etc...
- Returned in more than one case not only from Greece, but also from other countries.
- With different terms of the prohibition to enter in different countries, often up to 10 years.
- With use of forged documents as Kosova people citizens.
- Deported with the pretend that they are under request from another country.
- Minoren that have gone without the knowledge of their parents.

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Passing in exit without regular documents in the exit from Albania

Illegaly walking to Greece

- Walking in groups and some repetitious (they know the way)
- Unoccupied, occasional employment, painter, construction etc...
- Attempt to leave Greece to Western Europe, USA and often by paying an intermediary.
- Attempt to unite the family because the Embassy did not grant a visa.
- Convicted that have suffered part of their conviction and who return
- Short period without documents (up to 10 years)
- To unite with the relatives and to work in Greece
- Family with more than one member and with low economic level

TIMS FUNCTIONING: IMPROVEMENTS AND PROBLEMS RELATED TO THE TREATMENT OF THE RETURNED EMIGRANTS

TIMS is functioning on 15 BCP distributed in different location of the country. These are the BCP with the biggest flux of the people and vehicle movement in the entry/exit to/from our country.

From the visits carries out during June 2008 (in BCP Hani i Hotit, Qafë Thanë, Kapshtica, Tre urat, Kakavija, Porti Saranda and Qaf Bot) it was noticed that practically the system was totally functioning in all the above mentioned BCP. Also, the employees of the Border Policy were trained

and they were generally familiar with the practical way of the work in the system. It is natural that they have encountered many problems during their work.

As we mentioned during the analyze, there are a lot of cases of the wrongly data entry by the operators during the returnees interview. This situation is explained by one side by the tiredness and overload of the operators during the high fluxes of emigrants and by other side even the insufficient qualification of operators at some BCP (see the data for the emigrants origine, where the majority of returnees, 51.6% of them are form the Devolly district)

Also, it should be stresses that the treatment of the returnees from the side of the Border Police forces was according to the rules and respecting the human dignity. Pursuant this information it should be emphasized that from the returnees generally stated during the conversations that Greek Police did not maltreated them and at the moment of the deportation to the Albanian party in the different BCP all the personal effects that were taken away at the moment of the detainment.

The deportation of the emigrants is done through groups of different sizes and with different transport means. When the emigrants are captured in a non significant distance after passing the border they are returned in small size groups through usage off roads vehicle (JEEP) ore with police minivans. Meanwhile the emigrants captured in deepness of the Greek territory they are firstly gathered and than dispatched towards the Albanian border through buses loaded over their carrying capacity. This is the group that is worst treated and that face problems regarding the treatment.

It should be emphasized that there are many cases of the persons that tempt to illegally cross the border being captured from the Albanian border policy. These persons are treated from the employees of the BCP in the same way as the returned emigrants. Not treating in details the improvements and good work carried out from the Border Police Forces in the visited BCP, here below we are presenting the main problems difficulties encountered from the heads and operators of the TIMS in these BCP.

a. Investments in BCP are not carried out taking in consideration apart from other elements even the variable of the intensity of the returnees. In some BCP where the flux of the returnees was lower, the working premises were spacious to work, meanwhile in the BCP where the flux of the returnees was high, (in particular in Kapshtica) the working premises were not appropriate. Thus in the BCP of Hani i Hotit, where the flux of the returnees was very low there were premises with special rooms for males, special rooms for females and special rooms for minoren. The premises were in good conditions at BCP “Tre Urat” and improvements were made at BCP Kakavija.

The opposite situation was encountered in the BCP of Kapshtica where the premises were not sufficient. Also very problematic was the situation in Qafë Bot, where the entire BCP was composed through provisional containers. Problems were identified even in the BCP of the Saranda Port due to the insufficiency of the premises and the location very near the premises of the control for the other passengers. (Please refer to photos attached to this material)

b. Investments for equipment and for the creation of the normal working condition on the visited BCP were non good in general and the main part of the BCP there identified emergent needs for equipments in order to be transformed in normal reception premises. In the main parts of the BCP there was lack of the furniture and equipments and also the level of hygiene – sanitary was very low. Based on the conditions of BCP with a high flux of the returnees I think that the fulfillment of investments for some minimal reception equipment and also the investment for special premises for WC.

c. Also the distribution of the TIMS operators was not based on the variable of the returnees. Thus in the BCP of Kapshtica there was only one operator, meanwhile in the BCP of Kakavija there

were two operators. The number of the operators at the BCP with the highest flux (please refer to the data above) was bearing the work with great difficulties, let us say that the situation was normal only where the flux of the returnees was not high low. In the moments of the high flux the operators were performing their duties with great difficulties and delays. The high load of the work is one of the main sources for the errors on the above presented data.

- d. It should be stressed out also that the returnees emphasized that there were many cases when the employees of the Greek policemen left them without food. They stated in their answers that “It depends on the policemen. When there are good people the give food and water to us. We have suffered a lot. The conditions of the transport are very bad and often they crashed us as the sardines in a can.” Other stressed out: “Please do not question us, we are fed up. We have suffered a lot” Or “They keep us as detained for about 30-40 days detained until there are a sufficient number of emigrants to overload the bus to depart”.
- e. Another problem that is very important is the not informing in advance from the Greek Police Forces relating to the deportation process. The Greek police does not inform in advance in any case regarding the time and the number of the returnees. This information is not related to the detailed list of the emigrants to be returned, but only for minimal information regarding their number and the approximate time when they will arrive at the BCP. Generally the massive deportations are performed during the day (8.⁰⁰ to 16.⁰⁰), but also there are some cases of deportations during the nights or during other daily hours.

CONCLUSIONS

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The following conclusions are drawn from the above analysis:

1. The majority of the emigrants, as it results form the TIMS, are male, of a young age and with a low education level (up to eight years old)
2. The returned emigrants from Greece have a lower education level and female predominates when compared with the emigrants returned from the more developed European.
3. The duration for the illegal emigrants is found to be shorter or females rather than in males. Also a higher duration of emigration is found at emigrants who went to U.K. when compared with those directed to Greece.
4. The duration of the return is shorter from emigrants who return from Greece rather than from those ones who return from UK This is due also to the fact that the returnees fro U.K. where subject to criminal conviction before the deportation.
5. The returnees from Greece often are captured since when arrive at the border or at the territory, instead the returnees from U.K. are captured more often at home or while working.
6. The professions of the returnees are different, but the lack of a profession predominates or common professions such as those related to agriculture, construction even service workers like erector, hydraulic, etc... The works that these emigrants performed while in emigration are often similar with the one performed in Albania. The returnees from U.K. stated that they did not work in job related to agriculture.
7. The main reasons of emigration are found to be the lack of job opportunities and poverty, but females state also as a reason the union of the family. There is a light trend to represent poverty as the main reason to emigrate at young ages rather at middle ages the lack of job opportunities is stated as the main reason to emigrate.
8. There is only a light relation between the number of the illegal crossing of the border where young ages tend to have a higher number of repeating the illegal crossing of the.
9. More than half of the emigrants have sent money to their families or relatives in Albania. The transfer of the money is mostly done from males, of a middle or old age, emigrants fro U.K. and emigrants who

- stayed for a longer time abroad. The ways through which the money is sent are “Through relatives or friends” and “Through banking system”. The returnees from U.K. use more often the social relations.
10. Almost all interviewed emigrants are willing to emigrate again and in the same time nearly all the interviewed are require and assistance in order to not emigrate again. There is not an inconsistency in this fact because the emigrants have understood that the assistance will be very low.
 11. The majority of the emigrants require an intermediation in order to find a job, financial assistance and assistance in order to get a visa. Females tend to require more financial assistance, assistance to get a visa and for the union of the family, males mostly require intermediation for find a job and for training.
 12. The majority of the interviewed emigrants do not have any knowledge for the existence of the REO or VTC in their area. Emigrants with an age over 50 have a higher level of knowledge regarding the existence of the REO than the average level. Instead the younger ages have higher level of knowledge for the existence of VTC, again the higher the level of education has an impact on the knowledge regarding the existence of the VTC.

RECOMMENDATION

1. I think that the Albanian government should do more regarding the compilation of the more efficient policies as well as stronger trials for the application in practice of the policies related to the legalization of a part of the illegal emigration, according to some specific conditions. This will include more intensive negotiations with countries where the Albanian illegal emigration is higher in number.
2. Stronger trials should be done from the National Service for Employment as well from the Regional Offices for Employment in order to have a more complete and precise, to serve in this way for the true aim for which is founded. I think that the REO have to create and develop a better cooperation with the structure of the border police in order to complete the register of the emigrants through their voluntary will to register since at the border. This may be realized through a registration form.
3. The central, legislative and executive power, but also the local government have to play a more active and powerful role regarding the compilation and application of the more qualitative policies related to legal employment and the war against the illegal employment. Also continuous control should be applied upon the businesses related to employment, wages and daily working hours
4. REO and VTC have to play a more active role for a better information of the public and for the opportunities they offer for finding a job and for training. I think that REO and maybe VTC may create boards with informative materials in all the BCP from which emigrants are returned.
5. A more active role have to play also the Non profit organization, especially those local regarding a better information of the public and especially of the returned emigrants for different problems through which employment and professional training.
6. In the same time it should be taken in consideration from the Greek Police the opportunity that to shorten in some cases the return duration for the emigrants, using smaller vehicles (not buses) and to not overload these vehicles above their capacity. We are aware that this request is related to the costs that the Greek State should bear for the deportation of the emigrants.

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THE IMPACT OF FOREIGN DIRECT INVESTMENT ON ECONOMIC FREEDOM IN HOST COUNTRIES

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ABSTRACT

The objective of this paper is to determine if a direct relationship exists between the level of inward FDI and changes in economic freedom in host countries. We will analyze the impact of inward FDI on host country freedom.

Economic freedom is both a means to as well as an objective of development. While researchers have established that foreign direct investment (FDI) is a stimulus for economic growth, less is known about its impact on the development of economic freedom within host countries.

Foreign direct investors are generally believed to operate within the constraints imposed on them by their hosts. In this view, economic freedom is exogenous to the activities of multinational corporations.

However, to the extent that free market increase the value (or decrease the risks) of their investments, foreign direct investors may actively support economic liberalization. Economic liberalization may also result from spillovers and acculturation that are the byproducts of firm activities.

On the other hand, if firms consider economic freedom to be detrimental to their interests, they will actively attempt to suppress host country freedoms in an effort to protect the value of their investments. In this view, foreign direct investors are catalysts for change within host countries.

Key words

Foreign Direct Investment (FDI), economic freedom, host countries, multinational corporations, investors, economic liberalization, etc...

INTRODUCTION

This paper presents the relationship between inward foreign direct investment and changes in economic freedom within host countries. Economic freedom is the extent to which one can “engage in economic transactions, without government interference but with government support of the institutions necessary for that freedom, including rule of law, sound money, and open markets” (Deardorff, 2005).

It exist a direct relationship between the level of inward foreign direct investment and changes in economic freedom after controlling for the effects of other influential variables. The foreign direct investment is a stimulus for host country economic growth. However, unlike economic growth, which is generally defined as increases over time in a country’s real income, economic development can be considered a more comprehensive phenomenon involving changes in a broad range of economic, social and political institutions.

In addition to contributing to faster growth, foreign direct investors can contribute to host country development by transferring modern production capabilities, acting as role models to indigenous firms, and injecting capitalist work cultures into the local economy. Conventional wisdom suggest that in order to realize the positive contributions of foreign direct investment, host country officials should embrace free markets.

Economic freedom provides market participants with incentives to produce more valuable output and includes institutions like a rule of law that protects:

- ❖ private property,
- ❖ trade and foreign exchange liberalization,
- ❖ efficient capital markets,
- ❖ and limited government intervention (Berggren, 2007).

Host countries that place arbitrary limitations on the operation of a free market are accused of squashing the economic incentives that enable growth and development. Indeed, a free market may be an important factor in the firm’s decision to invest in a particular country. Some even suggest that freedom should be considered the ultimate objective of development.

THEORIES OF FOREIGN DIRECT INVESTMENT: WHAT ARE THE DETERMINANTS OF FDI?

Until now, researchers have treated economic freedom as exogenous to foreign direct investment. Multinational corporations are generally believed to maximize profits within the constraints imposed on them by host countries. However, to the extent that free markets increase the value or decrease the risks of its investment, foreign direct investors will actively support economic liberalization within host countries.

If firms consider economic freedom to be detrimental to their interests, they will actively attempt to suppress host country freedoms in an effort to protect the value of their investments. In some cases, economic liberalization may result from spillovers and acculturation that are the byproduct of firm activities within the host country. In this view, the direct investor is a catalyst for change within host countries.

Given the unique ability of some firms to transfer resources and business practices abroad by establishing production facilities in foreign countries, we consider whether freedom is endogenous to the actions of those companies. The dynamic interplay between firm activity and the economies in which they operate may result in institutional change – that is endogenous to foreign direct investment and results from the maximizing efforts of multinational corporations.

Although researchers have considered the impact of inward foreign direct investment on host country economic growth, its role as an agent of change for freedom has not been examined.

We therefore ask:

1. To what degree do foreign direct investors promote freedom in the countries in which they invest?
2. Are multinational corporations a conduit for the institutions of freedom?

The theory of international capital movements proposes that capital moves in response to higher expected rates of return elsewhere. Given that firms seek to maximize expected marginal returns, they will transfer capital from areas with lower rates of return to areas with higher rates of return over time (Lizondo, 2006).

Firms may choose to produce abroad in response to large and growing markets for their products; to secure access to cheap inputs and/or important raw materials; to circumvent barriers to trade that make exporting costly; to protect market share from competitors; or to diversify risk (Appleyard & Field, 2008).

Early theories also assumed that goods and factors could be transferred at zero cost. In the real world, of course, the transfer of goods and factors is often costly, creating barriers to international transactions. Examples of transfer costs include physical transfer costs – the costs incurred in packaging, transporting, and handling products, and the costs of government regulation of international trade, including import duties, taxes, quotas, and exchange restrictions.

Location theory postulates that firms must consider a host of revenue – and cost – related factors associated with a particular production location in an effort to maximize profits. In addition to physical transportation costs and the costs of government regulation, these factors include (Peterson & Lewis, 2008):

1. The availability, cost and productivity of labor supplies.
2. The availability and cost of energy resources.
3. The availability and cost of raw materials.
4. Proximity to markets for output.
5. Local population and governmental attitudes toward business.

Early theories of foreign direct investment further assumed that markets were perfectly competitive and information was free. Later theorists relaxed the assumption of perfect competition in goods and factor markets in an effort to provide a more complete explanation of international production.

Starting with Hymer (1960), modern FDI theory is based on the notion that the market is an imperfect exchange mechanism for goods and factors. Imperfect competition arises when markets for goods and factors exhibit monopoly or oligopoly characteristics. International production via FDI has been described as a firm expanding overseas to capture excess profits via economies of scale.

Imperfect competition also results when firms lack complete knowledge about markets and face uncertainty associated with future transactions. A so-called ignorance gap forms because is not free. Distance, language and cultural barriers, and scarce and unreliable data increase the acquisition cost of information in foreign markets (Root, 2008).

Uncertainty exists due to the firm's incomplete knowledge of the foreign market and because the future business environment is unknowable; hence it increases the risk associated with the firm's overseas activities. Firms may therefore opt for international production in an effort better tailor their product to local demand conditions, to decrease the risk associated with alternative forms of international transactions, and to enhance their responsiveness to changing business conditions.

Imperfect competition in goods and factor markets allow firms to realize these advantages and represent the necessary conditions for investment. Included are advantages arising from differentiated products or services; administered pricing and cost advantages; discrimination in access to capital and managerial skills; internal and external economies of scale; and other advantages stemming from government fiat (Buckley & Brooke 2007).

Transaction cost market imperfections are exogenous to the firm and arise when goods and factor markets fail to provide adequate exchange mechanisms. Here transaction costs associated with administered exchange can be less expensive than market-based exchange due to such things as high negotiation costs, inability to control quality or timing of product delivery, high cost of property rights enforcement, and unreliable sources of supply (Dunning, 1980; Teece, 1981).

Markets can also fail as an allocation mechanism altogether, as in the oft-cited case of "the failure of the market mechanism to set a price for the private production and dissemination of knowledge" (Rugman, 1980b). Firms augment existing goods and factor markets or create markets where none existed before in order to transfer intermediate goods at a lower cost and thus use proprietary assets more efficiently. Firms replace market solutions with internal transactions via international production in order to overcome costly imperfections in international markets for goods and factors. In doing so, they reduce transaction costs and ensure an adequate return on firm-specific assets.

In sum, Dunning insists that the propensity of a firm to engage in international production rests on 3 main determinants:

1. The extent to which the firm possesses assets which its competitors do not possess,
2. Whether it is to the firm's advantage to sell these assets or make use of – internalize – them itself,
3. How far it is profitable to exploit its internal assets in conjunction with the indigenous resources of foreign countries beyond the resources of its home country.

TYPES OF FOREIGN DIRECT INVESTMENT

Researchers typically differentiate among the following four types of FDI: resource seeking; market seeking; efficiency seeking; and strategic asset seeking. Resource seekers are “prompted to invest abroad to acquire particular and specific resources at a lower real cost than could be obtained in their home country” included in the category are primary producers and manufacturers engaged in resource – extractive activities who are interested in securing low – cost sources of physical resources, including minerals, raw materials and agricultural products. Also included in this category are firms from countries with high real labor costs that are interested in obtaining cheap unskilled or semi-skilled labor to supply labor intensive intermediate or final products for export (Dunning, 1980).

The key ingredients of economic freedom are personal choice, voluntary exchange, freedom to compete, and protection of person and property.

Gwartney & Lawson’s Economic Freedom of the World index measures the degree of freedom present in 5 major areas:

- ✓ Size of government: expenditures, taxes, and enterprise
- ✓ Legal structure and security of property rights
- ✓ Access to sound money
- ✓ Freedom to trade internationally
- ✓ Regulation of credit / capital, labor, and business

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The issue of endogeneity remains unresolved, however. Establishing a relationship between FDI and economic freedom leaves unresolved the question of whether the actions of foreign direct investors motivate the loosening of repressive economic policies within the host country. After all, FDI does flow to countries where freedoms are suppressed.

CONCLUSION

There is still much to learn about the relationship between FDI and changes in economic freedom. There appears to be no a priori rationale to expect multinational corporations to treat the host country investment climate as fixed.

Firms should not be expected to maximize profit within the constraints imposed on them by the host country environment as long as they have the means to promote alternative policies and reason to believe that the net result of the change will be positive.

Their actions should be factored into a calculus of development that is expanded to include the full range of economic, social, and political impacts.

Rather than emphasize the institutional pre-conditions that must be met in order to reap the full benefits of FDI, we should take note of the fact that FDI flows also into countries where freedoms are suppressed and further investigate what, if anything, firms are doing to change the climates in which they operate.

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THE PROCESS OF BUILDING A BRAND IN THE TRANSITIONAL COUNTRIES – CASE STUDY “MONTENEGRO”

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ABSTRACT

In the present conditions of economy characterized by the increase of globalization and competition, one of the most powerful “tools” of the company (probably the most reliable) becomes the **brand**. Brand helps customers feel somewhat “security”. For the competitors it makes a difficult task how to parry such an image of a company or a product. The same principles of branding are applied to countries and their enterprises. Only methods are different. An important part of the strategy of appearance on the international market stage is gaining the epithet of the country of origin – “*Made in*”. In the same way when landscapes, towns and celebrities represent their countries carrying the attribute “*Made in*”, so do particular enterprises as well, products and brands that represent nations they come from. In this sense it is important to envisage this phenomenon in the context of Montenegrin enterprises and the whole expression of “*Made in Montenegro*”. This particularly for the reason that business operation of economic entities from Montenegro are, normally, characterized by the low level of marketing application together with the low level of competitiveness or more exactly small chances for our enterprises to fight the competitors properly.

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Key words

brand, brand management, brand-building, “*Made in Montenegro*”...



THE CONCEPT OF BRAND BUILDING PROCESS IN THE COUNTRY: BRAND BY COUNTRY - WHAT IS IT?

Globalization, numerous and very dynamic changes of modern economy, impose new conditions and relations at the world market, and the nations “compete“ in exports, tourism, investments and so on. Each nation builds its brand (identity), promotes its „personality“, culture, history, tourism, all in order to achieve development, market and political purposes. It needs to be emphasized that **the brand does not represent what the politicians or citizens of some country think about it, but what foreigners (primarily tourists) think and the way in which they experience a certain country through its integrated supply!** The brand building process in the country (state) requires a lot of time and commitment of all structures within the country. Current country brand is the result of effort of all generations in historical terms.

Building a „nation’s brand“ is possible only in conjunction with a variety of separated messages, which have some unifying elements, and not through the „small number of large individual events“. Thus, country branding requires systematic and systemic approach; it includes a large number of synchronized activities and engaging substantial number of institutions (in culture, art, sports, industry, education, and foreign affairs and of course tourism and environmental protection). Country brand creating represents the **sublimate of many inter-linked and integrated brands. At a given time, all the individual brands (positively and/or negatively) influence a unique country brand as a whole.** And just because of all these activities (factors), it is difficult to create or make a unique „image“ - brand of some country.

When countries create their brand they should note the following:¹

- All actions being taken in order to create the brand, have an impact on its understanding;
- When creating a brand, it is most important to maintain „truthfulness“ and „honesty“ of that brand;
- It is important to understand how „the brand message“ is understood by the people of different cultures;
- Each message must be relevant, convincing and unique in order to be effective;
- Broad research will show the usual understanding and the most useful repositioning or positioning possibilities;
- It is always better to use brand strengths rather than try to overcome brand weaknesses;
- When creating a brand, patience is a quality that is always paid off to those who have it.

The country brand building process is extremely complex, it requires a long realization period, as well as support and participation of not only the large number of experts, but also of all its citizens. In nation branding program, it is necessary to separate a significant time for creating, and then for implementing the program. For the program implementation it is necessary to use „every chance“, not only the „obvious things“, such as fairs, advertising and working within the embassy, but also other forms of promotion - film, art, sports, food, etc. Consistency and creating of a unique image of nation is the ultimate instance of this process. The unique image of nation includes a clear presentation and in all segments implementation of its name, the spoken language, religion, ethnicity, culture, national anthem, flag, tradition, folklore and so on.

It is a reasonable question to ask: and what is the role of Government of that country? It is undeniable that for the implementation of branding program, adequate Government support in the country is necessary, as a part of continuous program of creation and increase country-level branding.

¹ www.brandchannel.com

However, it should not have too much influence in this program, so that the brand would not be characterized as „politically colored”. The process of creating the brand of a country implies the following activities:²

- The involvement and participation of Government representatives, representatives from the business sphere, art, education and media in the creation and implementation of branding program.
- Analysis of the current situation or perception of the country, both internally, by the people who live in it, and externally, using qualitative and quantitative methods.
- Comparison of analysis results with the opinions of leaders in society.
- Creating a brand strategy, where the brand communication campaign is one of the most important steps. Country brand strategy has to start from the basic idea on which the nation brand will be based. This has to be visualized with colors, symbol, and typography - for example, the symbol of the sun in Spain.
- The implementation of branding strategy through the „visible” programs and campaigns (as, for example, arranging the city center, marked by historical and other important places, etc.).

Building a „national brand” is very important for the position of one nation in the world. Most people know little about other nations, and what they know comes down mostly on „rumors and anecdotes”, which may be true, but do not have to.³ In the extreme case it is very simple: India is „spiritual”, Germany is „effective”, Spain is „passionate” Britain is „traditional” and so on. All of these associations, moreover, may affect the trade, exports, tourism, and foreign investment and so on. In order to achieve economic objectives of the country, it is very important to present the nation or the region in a „striking and attractive” way, which distinguishes it from the other nations or regions.⁴ The problem of prejudice and possible ignorance of the nations can be resolved through advertising, brochures, web sites, presentations, organization of special events, and with all marketing and institutional communication tools. Next standpoint should always be present: **Nation branding is not a new idea, what is new is a brand as a term!** In fact, terms such as: national image, national identity, national reputation are traditionally used; only now they are all under the term „brand”.

2 www.superbrands.com.au

3 www.branding.com

4 In the process of building “country brand” countries invest a lot of investment, time and commitment, in order of the best differentiating among others. An example of a good starting the process of branding place and nation represents the case of agency “*De Beer Marketing & Communication*” from New Zealand, who worked on the strategy of positioning of their country brand. The result of this campaign was that tourists and foreigners began to see it as a green and clean country – “*100% pure New Zealand*” City Auckland has also successfully branded, in the following way: first of all, it was pointed out what the specifics of this city are - the nature, 82 volcanoes, whales, dolphins, art etc. All of these has been transformed into design and advertising. Each item in the city, whether the fence or basket, had to have an artist who worked on its creation. For the city has also been created a web site, where all the necessary information is available and where the most representative picture of the city can be seen. The motives of the country and the city are, of course, stamps. As a result of this campaign there is a growing interest in New Zealand as a tourist destination, and many global companies have filmed their movies in this area (for example, the world hit “*Lord of the Rings*” etc).

THE EFFECT OF COUNTRY OF ORIGIN IN THE FUNCTION OF NATIONAL BRAND BUILDING – WITH REFERENCE TO MONTENEGRO

Relationship between brand and country of origin

Interdependence among country of origin and product/brand exists when essential characteristics of certain categories of products, also represent a significant association, or the image of country of origin. **Country of origin effect** can be defined as any influence that country, in which some product is integral produced, made or designed, has on the perception of consumers, related to this product.⁵ That perception may be positive, representing an element of potential advantages over the competition or negative, which then greatly reduces the potential of the brand to become globally widespread. Researchers in this field claim that a numerous conducted analysis about country of origin effects showed that consumers consider information about particular country of origin brand as an indicator of quality.⁶ Generally speaking, dependence of the image of the country of origin and product / brand can be:⁷

- **Cost effective – certain country of origin positive image dimension is seen as an important feature of the product/brand;**
- **Unfavourable – certain country of origin negative image dimension is seen as an important feature of the product/brand;**
- **Neutral - country of origin image does not represent essential characteristics for assessment of the product/brand.**

When there is a **beneficial (positive) interdependence** between product/brand and a country of origin, country of origin should be emphasized, because customers will respond positively (eg, products of high fashion - France). Otherwise, it is not desirable to emphasize the country of origin, but then the other strategies of expansion are applied to a foreign markets, that is, for example, association with a local company that has already built its own image. If the country of origin has a clear, positive associations related to a specific product category, then it just may be the basis for the product differentiation of that group in international markets. Activation of country of origin associations is possible to initiate in several ways:

- Appearance of names of the country/region/city in a brand name (eg. Bayerische Motoren Werke - BMW);
- combining the names of countries/regions/cities with a product/brand name (Bailey's Irish Cream, Montenegro Cormorant);
- Appearance of the country/region/city of origin as a main theme in advertising campaign (known photo sites, emphasizing the name of the country, etc.).

In the case of **negative interdependence**, which is unfortunately to some extent still the case with Montenegro, for the success of domestic brands in the international market, it is necessary to carry out the national branding process firstly in order to establish the unique identity and positive national image. One of the positive association is, for example, preserved natural environment, so that: healthy food, clean water, coastal and rural tourism, then the music festivals, sporting achievements of our representatives, can be used and be a basis for brands, which have the ability to become global . In addition, we have the advantage that we are geographically located in Europe. Namely, in the Far East, European goods have a much higher status than the U.S. and are much more demanded and

5 Rakita, B., Mitrović, I., (2007) "Brend menadžment", Savremena administracija, Beograd, str. 269

6 Thus, for example, raises the question - does anyone doubt that the clock made in Switzerland is low quality or the wine from France is bad, that the car manufactured in Germany is bad made or that Italian clothing is poor quality?

7 www.brandchannel.com

sold. Since the Made in Europe has a special power of brand, that fact provides that in some cases our European location may be used with that basic aim.

Specificity of country of origin effect, as well as engine brand performance, is in fact that it has fully external nature, so it can not be controlled in any way by any single company. When it comes to positive perceptions, the company is not interested in controlling it. However, when the perception of country of origin brand is negative in a broad geographic scale, the company has a big problem - *how to build a positive brand image through the negative image of the country of origin?* French wines, American cars, Scotch, Italian clothing and footwear, Japanese TV, are all examples of how the company „draws benefits” at the global level, without any promotional efforts. We should not forget that Germany, Japan and Italy after World War II had, to say at least, a negative image in the largest part of the globe. But, what to do in the cases when the company is ahead of this problem?

There is no doubt that some countries and regions have created „strong” brands!⁸ The rule is that industrialized countries more consider both brand and „country of origin” which is not the case in developing countries! „Country of origin” may be an important element, because it gives credibility and it guarantees the quality of some product and service categories. In the following table are shown the characteristics of individual countries.

COUNTRY NAME	POSITIVE FEATURES	NEGATIVE FEATURES
Germany	Black Forest, polka, leather pants, well-designed cars	Hitler, fascism, divisions
SAD	business, freedom of thought and speech, democracy, Cowboys, New York, fun, show	global economic crisis, war, materialism, George Bush
Great Britain	London, Royal Palace, football	bad time, poor taste food
Italy	fashion, wine, art	fascism, prejudice on the mafia
Canada	hockey, leaf ash	police horse, the mortality rate
Holland	windmills, clogs, dams	same-sex marriage, legalization of drugs
Montenegro	food, wine, grape brandy, Sveti Stefan, Splendid, Tara, water polo, Petrovic dynasty, the arrival of the Rolling Stones, Madonna and so on.	standard of living, unemployment, institutions, and corruption, political division, some hotels, until recently a country with „high risk”

Table no. 1 Positive and negative characteristics of certain country brands⁹

Analyzing the above table we can conclude that the national brand determines both positive and negative dimensions of certain country. This rule applies not only to less developed countries, but also to those who are considered to be global leaders. Thus, for example, we can observe the case of the United States from the last decade of the twentieth century until today. The traditional image of the United States based on the „American values” (democracy, freedom ...) is „compromised” to the large extent. Thanks to the previous White House foreign policy, many U.S. companies suffered damage on some geographical destinations and faced with various dangers. Anti-globalization movements in the world are not directed straight to the U.S., but primarily on the largest global companies (of which the largest number comes right from the U.S.). They are (rightly) considered as the main „promoters” of the globalization process and one of the main causes of the so-called „global economic crisis”, which assumed global proportions in late 2008. and early 2009. On the other hand, despite the negative image that countries of Eastern Europe had in the West, some of their products are, however, managed to achieve good results in these markets. For example, Belarusian tractors have been being sold very well in Western Europe and the U.S. because they had the appropriate balance between the price and quality. However, the lack of proper distribution network has reduced the potential of Belarus companies to penetrate deeper into these markets.

⁸ Examples of “country brands” certainly are: Great Britain, Brazil, Mexico, Costa Rica, Australia, New Zealand, Ireland, Scotland, Portugal, Spain, Thailand, etc.

⁹ www.emagazin.co.yu

2.2. Geographical extensions strategy - Made in ...

The concept of applying the strategy of geographical extension enables that products in the international market get the country of origin label – “Made in”. Such as landscapes, cities and famous people represent their countries, holders are of the “Made in” attributes, and companies, products and brands represent the nation of origin. When the country and/or geographical location (region, city) is clearly co with the brand, then it reflects the image on the brand and has an impact on the perception and associations. Brand culture is related with the values of a country, region or city culture from which the brand is derived: *McDonald’s* - America, *Mercedes* - Germany, *Dolce & Gabbana* - Sicily, *Shiseido* - Japan and so on. For foreign market entering it is firstly necessary to determine whether potential buyers have favorable or unfavorable feelings about the country of origin products. That is why is very important to conduct a survey about the country of origin, in various countries, in order to understand what the „name“ of the country reminds them on. To this end, it is logical to set the question: what is it that that people from other countries „comes to mind“ when they see: *Made in USA, Made in China, Made in Japan, Made in Montenegro, etc.*¹⁰

The effect of country of origin will be more or less important in some market, depending on whether there is **consumer ethnocentrism**. Namely, the limiting factor in achieving relevance in international markets, there is a phenomenon of *consumer ethnocentrism* - the situation in which consumers prefer consumption of domestic products. (in our areas, it is still known as a „**economic patriotism**“). Consumer ethnocentrism means that customers of a local market tend to buy domestic products, because they feel that buying foreign products can hurt the local economy.¹¹ Thus, for example, Japanese consumers prefer to buy domestic brands, especially vehicles, electronic equipment, cameras and video games. However, this phenomenon is largely mitigated by developing of global communication and globalization of world markets in general. Therefore, it is noted that brands which have similarities with their country of origin penetrate foreign markets more easily.

It is important to emphasize that consumer’s knowledge about the country of origin and their affinity with it, mainly depend on the stereotypes that exist and usually represent the most simplified pictures of reality. People generally like to confirm their beliefs and fit all into the previously established framework of thinking, and they perceive product characteristics on the basis of „made in“ attributes. However, stereotypes can be changed over time (for example, if technical goods originate from Korea, it does not mean poor quality and low prices today). In fact, it is possible to build, position and maintain brands in a specific product category, because it does not necessarily have to relate only to one country (the wine is not related only to France but also Italy, Spain, Portugal, Argentina, etc).

How much is the rule of perception important shows the fact that many global branding campaigns in their early stages, firstly had the task to create a perception of the country from which the brand comes, and then followed phase of customers introduction to the brand.¹² Often, the global market should be „informed“ or „educated“ about the traditions of individual countries. For example, Sweden is a country where there is one of the best steel in the world produced. One of the keys of successful *Volvo* car branding for the promoters was to remind the world firstly on a fact that their steel is the best, and then to present the *Volvo* as the safest car in the world. Not like the most qualitative, because Germans are unique there and not as the most economical (price-quality ratio), because Japanese are the unique in that area. They have found a „market-brand niche“ which can be ideally adapted to the image of a country from which the car is imported.

¹⁰ Some studies show that in the overall perception is more important country of origin of that brand than the country of production products with the brand name.

¹¹ In 2005. The state union of Serbia and Montenegro, has carried out actions “Buy local”, at the time when there was a highly prominent consumer ethnocentrism. Research of Institute, “Strategic Marketing Research” in that period gave results that the third of consumers are ethnocentric. However, this did not prevent the entry and survival of foreign companies in our market (first of all, companies from neighboring countries), because the consumer ethnocentrism, in general, is more pronounced in older population, lower education

¹² www.superbrands.com.au

THE POSSIBILITIES FOR BRAND BUILDING IN MONTENEGRO

- THE CURRENT STATE AND PERSPECTIVES

Consideration of the importance of brands is important for all countries, especially for countries in transition and their enterprises, which more and more encounters with the problem of name, naming and rapid recognition of enterprises and/or their supply. In fact, at very mention of whiskey, almost all the world will think of Scotland; chocolate is an association for Switzerland; the general term „brand“ which refers to the meaning of the quality or a protective mark.

Countries in transition are, related to the investigated brand phenomena and in conditions of globalization „captured“ market positions, covering and strongly defending their presence in them by visible and invisible instruments. On the other hand, transition countries seek to accelerate their economic growth and development. Taking into account these two arms, in front of these countries several questions raises: What to do in such a constellation of competition and market relations? Where to start? How to build country brand and/or brand of individual companies? What are the priority business (and other) areas? What is the role of history and environmental factors? Etc.

The fact is that despite all the beauty that it has, a rich national cuisine, and many other historical and cultural details on which is definitely unique and so different from others, Montenegro still, with some exceptions, can not significantly boast with its „strong“ brands. Because of that it is ahead of a complex and responsible way, a lot of dilemmas and problems that has to resolve in the context of building its own (native) brands.

The concept of building recognizable brands in the Montenegro requires, above all, understanding of key natural, cultural, traditional and other factors which is characterized by. On the other hand, Montenegro is in the final phase of transition, which started in the early '90s of the last century and which gradually reforms and prepares the economic system for the upcoming phase of EU accession. The economic development of Montenegro is reflected through the relative increase of a total volume of transactions on the current account. Trend of increasing current account transactions, however, is followed by the trend of quite rapid deterioration of the balance of payments accounts. The current account is also dominated by the long-term foreign trade deficit. Financing the current account deficit is carried out, mainly through foreign direct investment (FDI) and loans. However, our opinion is that the long-term solution of the problem of growing current account deficit, balance of payments, viewed from the standpoint of the foreign trade deficit, is to **increase the competitiveness of the Montenegrin economy** and on that basis, to **accelerate exports growth!** The fact is that there is a huge imbalance between imports and exports. In addition, in the export structure, products of low-level processing are dominated. Increasing the competitiveness of the domestic economy is inevitable next phase of economic development of Montenegro, which will undoubtedly influence to the further exports increase and reducing foreign trade imbalance. Taking into account the specific features set out above general conclusion is that the particularly important areas for brand building in Montenegro are: 1. tourism, 2. agriculture and 3. »Traditional products«

1. **Tourism** development has a higher priority than all other economic sectors in Montenegro. From creation the opportunities to make this potential more accessible and from its sustainable use, public participation in private economy, depend on (and will depend on in the future) jobs and living standards of a significant part of the population in Montenegro, as well as development of »many tourist brands«. With regards to economic, environmental, social and cultural change, which bring with it the development of tourism industry, and with the complexity of all issues that have to be solved, as well as due to the limited natural resources, development of »tourism brands« have to be planned, harmonized and implemented, not only in the material sense,

but in close cooperation with the inter-ministerial, regional and municipal level. In addition, it is important to, following the marketing, which determines the position of Montenegro in accordance with its strategic objectives, place in the market, to build brand and to animate only those market segments which »wishes« in the country can be filled.

2. Special possibilities for the brands development in Montenegro are in the field of agriculture.¹³ For a relatively small area, the Montenegrin agriculture is very diverse - from growing the olives and citrus in the coast, through the cultivation of early vegetables and tobacco in the central part, to extensive livestock in the northern part. On the other hand, commercial production of wheat, maize, sugar beet and oil crops is practically not present, what significantly differentiates the Montenegrin agriculture, even from the nearest neighboring countries. Montenegrin agriculture has its advantages that are reflected in the unpolluted land resources, low use of chemicals, which gives the opportunity for organic production of most products (domestic brands)¹⁴. All of this enables the production of specific and traditional products, which can be placed through tourist spending, as well as through producing of specific and recognizable Montenegrin products (brands) for the markets beyond its borders. Competitiveness increasing of domestic agricultural and food products (brands) is not only reflected in the market of Montenegro, but also in the market of the region, in which Montenegrin products, from year to year, record sales growth. However, Montenegrin agriculture still can not meet the needs of the population in food, and food stability depends mainly on imports. The reason for this is not only in small volume of domestic production, but low merchantability of total manufactured products. Another problem is the placement of certain groups of seasonal products (vegetables, Mediterranean fruit, sheep) and the purchase of milk, because there is no contractual production.¹⁵
3. Potential construction and further strengthening of the recognized brands of Montenegro can be seen through the »traditional Montenegrin products« as well as products of the Montenegrin cuisine. In the list of national traditional products of Montenegro are: Crmnica wine, Njegusi ham, Pljevlja cheese, grape and plum brandy, olive oil, made from medicinal herbs, honey, etc. We think that on the basis of these products is possible to build the »strong brands« of domestic production, but also the brand of whole Montenegro! However, it is necessary to emphasize the fact that in Montenegro, there is still not any serious protection of domestic products as brands, in order to, as a fully branded, supply the foreigners and export to the world market. On the other hand, it must be borne in mind the fact that these products are mostly from rural areas! All of these products require **high-quality marketing concept and adequate promotional approach**, in order to have clear geographical origin (Made in Germany) and earned recognition in the market.

Experience with several significant projects represents a new basis for the further development of our national branding. There are several projects, such as „Made in Montenegro“, Good from

13 Primary agricultural production in Montenegro last year recorded a growth in most important branch, which is primarily the result of total support to private sector, development through the placement of funds committed with the agrarian budget and implementation of international projects in this sector. Compared with many countries of the EU, agriculture in Montenegro has a much greater economic importance, as the gross domestic product has a share of about 15%. When to primary production add processing sector, comes that over one-fifth of GDP generated in the sector of food and beverages, and the importance and participation of this sector indicates that investment by the state in this sector should increase. Agricultural areas occupy 38% (518,067 ha) of the total territory of Montenegro. Fund agricultural land of 0.82 ha per capita is an important resource because Montenegro was on this indicator at the top of European countries. However, in the structure of agricultural land the largest share are pastures and natural meadows (88%), which are extensively used. (Source: www.monstat.org)

14 Structural characteristics of agriculture, which are important for the development of "strong" brands, are very negative: small family farms areas dominated, they are fragmented and with a low productivity, which as the final result has a relatively low competitiveness of most agricultural products (brands). On the other hand, agriculture is still far the most important activity of the rural population. It is labor-intensive and plays an important role of "social amortize"- more than 60 thousand rural households partially or fully provide income in agriculture. It is particularly important in less developed, the northern part of Montenegro, where there is fully expresses multiple role of agriculture.

15 The main problem of brands building in the agricultural sector is the lack of financial resources for the intensification of production and exports. Major weakness is also a modest producer marketing performance in the international market, design, packaging, lack of adequate export brands, a large number of small exporters and so on. Very often products of our country are not competitive abroad with the price, because many business barriers, which hamper the product placement to the markets of CEFTA 2006 signatory.

Montenegro“ „Year of Good Food“ and others who opened the space to companies from Montenegro that they can individually develop their corporate and individual brands . These kind of projects are the basis for further institutional and promotional campaign in our enterprises. However, one should bear in mind the fact that these projects claims are not aimed at solving problems of individual **branding** and **brand management** in Montenegro. Enterprises from Montenegro have to do it by themselves, because no one can do it for them (and instead of them)! It is well known that, in essence, **branding is individual, not collective! National branding is an expression of individual brands power, with appropriate synergy effect. It „grows“ from the power of individual brands, not vice versa.**

It is undeniable that Montenegrin companies are ahead of the complex task of their products branding. In this work are listed some of the attractive field of branding. There are some positive experiences, and institutional projects can only be „broad framework“ for individual brands! The process of brands building in the Montenegro requires a series of activities, and one of the key is **ensuring quality protection of authentic local products**, in order to thus become „officially branded“, with the possibility of supply not only on domestic but also on the foreign markets! The second step is cooperation with foreign enterprises in the function of valorization of resources, affirmation of traditional products in the context of new technologies. All of this should be tied into corresponding national and international clusters, which will increase our overall competitiveness in the international market.

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CEFTA AND REGIONAL COOPERATION: MOVING CLOSER TOWARDS THE EU.

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ABSTRACT

The existing patchwork of 32 bilateral free trade agreements between the countries of South East Europe is being folded into the Central European Free Trade Area (CEFTA) agreement, which entered into force in the middle of 2007.

With the conclusion of the CEFTA 2006 free trade agreement among the Western Balkan countries and with trade of goods between them and the EU largely liberalized, regional integration has progressed significantly in recent years. As these countries seek to fulfill their European aspiration and to more effectively use trade a lever for domestic economic growth, attention is shifting towards behind-the-border policy reforms that are required to deepen regional integration and to permit the Western Balkan countries to successfully compete in the EU Single Market. On the one hand, this requires reforms in cross-sector policy areas such as public procurement, competition policy or rules of origin. On the other hand, it requires the liberalization of trade. Whereas this paper reviews the general policy issues associated with deeper integration and trade in SEE, the progress of the technical barriers to trade (TBT) and the opportunities for further co-operation.

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Key words

CEFTA, EU, Regional integration,

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INTRODUCTION, A HISTORICAL VIEW.

After years of mistrustful relations and lack of mutual coexistence, European leaders decided to eliminate wars and conflicts between them. Instead, they developed a new way of governing through a philosophy of cooperation and economic integration. Maybe it is indispensable for South East Europe Countries to see this as an option for their aspiration a right European Union.

Since the end of the Kosovo war in 1999 the European Union has sought to promote increased regional cooperation in the Balkans as a means to achieve the dual objectives of greater political stability and more rapid economic growth. Two new institutional arrangements were created to deliver this policy agenda:

- The Stability Pact adopted in 1999 between the countries of the region and the major Western powers which had formed a coalition to force Serbia to disengage its forces from Kosovo. It involved collaboration between the EU and the International Financial Institutions. It operated essentially as a coordination mechanism which brought together various international actors, governments and agencies in an increasingly comprehensive process of regional cooperation covering not just trade but infrastructure investment, environmental actions, the creation of a regional electricity market, social programs and other initiatives.
- The Stabilization and Association Process (SAP) launched by the EU seeks to address the broad issue of the European integration of these countries and, within this framework the problem of this new remoteness as well as weakness in economic.

The EU signed SAAs with Macedonia and Croatia in 2001 which eventually came into force in 2004. SAAs have also been signed with Albania in 2006, with Montenegro in 2007, and with Serbia, and Bosnia and Herzegovina, in 2008. Therefore Kosovo, which declared its independence in February 2008, is the only Western Balkan country which has not yet signed an SAA with the EU.

Over the past two years, the countries of the Western Balkans⁴ have moved closer to the EU. Still, our partner countries are confronting a number of challenges in 2008 which could have far-reaching implications for their security, stability and well-being.

The need to solve the status of Kosovo has focused attention on the region and its links with the European Union. It is important under present circumstances to maintain the peace and stability of the region. This can best be achieved by further enhancing the EU perspective and by making it as visible and tangible as possible for all the peoples of the region.

On the other side, Albania has continued to participate in a number of regional, political and economic for a an initiatives, including in a transition from the Stability Pact to a more regionally owned framework South East European Cooperation Process and Regional Cooperation Council.

However, societies remain divided on a number of key issues related to the co-existence and integration of different communities and, in some cases, constitutional reform. Further efforts are needed to achieve consensus on such issues, to avoid harmful displays of nationalism, and to press on with the necessary political and economic reforms.

Trade interdependence creates more factors as positive pressure toward economic integration. Not only trade efforts toward integration, but growing economic co-operation in order to soften the challenges of economic integration and largely improve diplomatic and further political collaboration.

⁴ Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia, as well as Kosovo under UNSC Resolution 1244/99.

TRADE PROGRESS AND ECONOMIC INTEGRATION

Western Balkans Countries: From ethnic conflicts to economic cooperation

The last twenty years for the Western Balkan Countries were full of tensions and mistrustful relations, where ethnic conflicts remain still problematic.

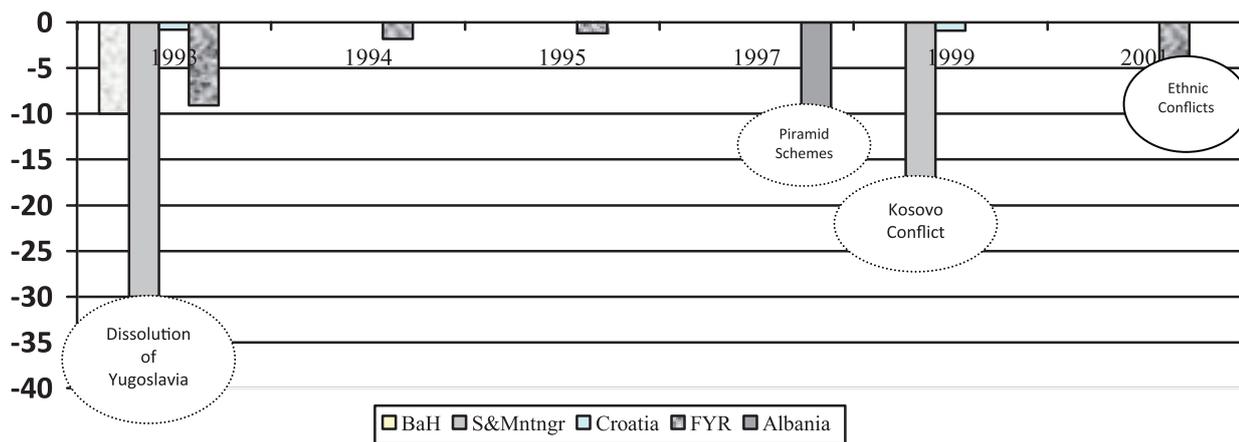
The Western Balkans has experienced high rates of economic growth since the 1991 recession. Referring to the data of economic growth the GDP⁵ of the region increased annually at 4% - 4.5% for the last 6-7 years. High growth rates are in part a feature of the Western Balkan's post-transition economies that have not yet reached steady growth levels. It has been very difficult for the region to reach at this point because of ethnic conflicts following the dissolution of Yugoslavia in 1990-1992 and the economic crises such as the fall of "pyramid schemes" in Albania in 1997. These events had a very negative influence to the growth path of the region's countries. The fall of pyramid schemes in Albania provides a clear example in this regard. Similar effects have been associated also with ethnic conflicts in Serbia and Montenegro or FYR Macedonia.

In our opinion this situation did not start during the Kosovo conflict, but reached its most problematic stage during the dissolution of Yugoslavia in 1993. The creation of new sovereign countries with ethnic differentiated populations like FYR Macedonia and Bosnia and Herzegovina has influenced the slow growing process of integration. The Kosovo conflict was the final step which signed the end of a negative period of the transition of Western Balkan Countries.

While the break-up of Bosnia and Herzegovina is not in prospect, in practice the state is divided along ethnic lines and an integrated internal single market has yet to be created. As shown in Figure 3, this conflicts has affected directly as a negative impact in terms of real GDP rates.

Figure 3

Negative impact of ethnic conflicts and tensions in the Western Balkans in terms of real GDP rates.



Source: EBRD

Most of the Western Balkan countries have similar income levels, although they are comparatively poor compared to European standards. Gross national income per capita in the region was \$ 4730 per capita in 2008, except for Croatia with \$ 13750.

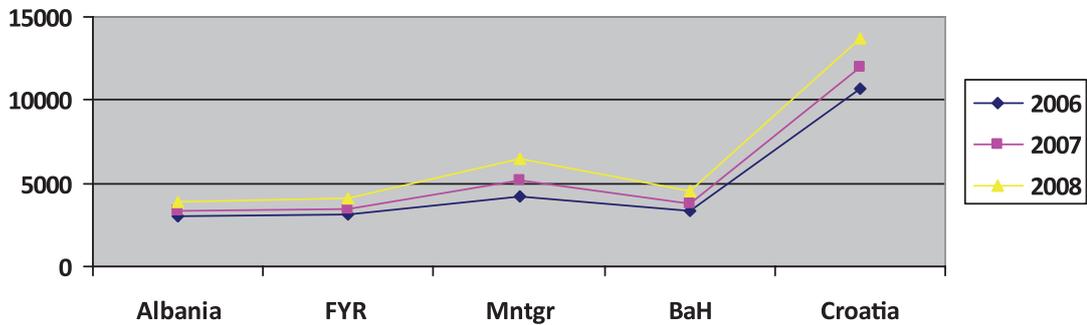
According to Figure 1, Albania has the lowest Gross net income per Capital growth during these years. It has known economic growth but still needs stronger efforts to reach the target of neighboring countries.

5 UN, Economic Commission for Europe, Economic Survey of Europe Nr.2

Considering the FDI inflow as shown in figure 2, Albania's indicators are not as they are expected. As a future member aspiring EU integration, it has to work harder in strengthening its economic position in the region.

Figure 2: GNP per Capital

Gross Net Income Per Capital \$



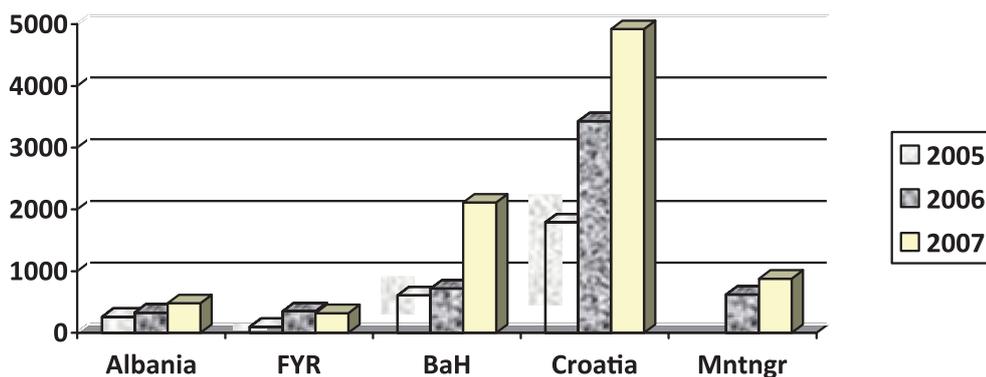
Source: World Bank Indicator 2009

The economic position of the Western Balkans remains weak also with respect to other indicators like current account, merchandise trade account and FDI. All countries have significant deficits of goods trade, and of combined goods and services trade, emphasizing the importance of improving their export performance. This can be detected not only through the comparison with the EU, but also with the 10-EU NMS as well as the two other members that joined the EU in January 2007 (Rumania and Bulgaria).

298 Currently, trade deficits are covered in several countries by large flows of remittances. In Albania for example, a significant proportion of the workforce has migrated to neighboring countries such as Greece and Italy and the inflows of remittances form a significant part of GDP. Remittance flows are also high in Montenegro and in Kosovo.

Figure 3: FDI

Foreign Direct Investment (million \$)



Source: World Bank Indicator 2009

Although the economic development of the Western Balkans lags behind that of the EU, the mutual trade exchange is significant. All of the region's countries have at least 40 percent of their import/export activity with the EU, which is their main trading partner. This trade interdependence provides a strong incentive for the region to integrate into the EU and adopt of the Euro.

Balkan countries need to effectively address the priorities set out in their Accession or European Partnerships. The pace of each country's progress is determined by its own achievements in this respect.

CEFTA 2006 and trade in the Western Balkan countries

A Trade Working Group (TWG) was established under the umbrella of the Stability Pact to coordinate and push forward the provisions of the MoU. Under the guidance of the TWG the Balkan members of the Stability Pact had all signed FTAs with each other by the end of 2004, creating a patchwork of 31 bilateral FTAs in the region. The system of bilateral FTAs was eventually replaced by a single free trade agreement through the simple expedient of extending the Central European Free Trade Agreement (CEFTA) to the Western Balkans in December 2006. Since this happened just as Bulgaria and Romania left CEFTA following their accession to the EU in January 2007, only Croatia remained as one of the former CEFTA members.⁶

One of the aims of creating CEFTA was to stop the rapid shrinking of European countries' foreign trade, its objectives were clearly directed for The CEFTA 2006 agreement will not only simplify the regional trade regime but also considerably deepen regional integration by including provisions on trade in services, intellectual property rights, public procurement, and investment.

One of the aims of creating CEFTA was to stop the rapid shrinking of Western Balkans countries' foreign trade, its objectives were clearly directed towards creating free trade. The overruling aim of the Western Balkan countries is to join the European Integration and improving regional relationships may be part of future economic development. Cooperation may help to get access to the more developed integration but CEFTA membership means no guarantee whatsoever for joining the EU. In the CEFTA countries economic growth exceeds the EU average, markets are growing, especially relationships within the CEFTA. The multilateral aspects of CEFTA 2006 need to be stressed through consolidating a common list of exemptions and reducing the extent of no tariff barriers and quantitative restrictions in agriculture. Tariffs on industrial products will be eliminated once CEFTA 2006 is effective in Albania, Bosnia and Herzegovina, and Serbia; FYR Macedonia, Moldova, and UNMIK/Kosovo have kept a few exceptions. Liberalization of trade in agricultural products remains similar to that which occurred under the bilateral FTAs, as CEFTA adopts a system of quantitative restrictions and maintains a series of differentiated exemptions by country. The parties have committed to reviewing these exemptions and concessions by May 2009.

An important result of the CEFTA cooperation is the broadening of the integration's subjects (e.g. competition policy, rules of origin, etc.) the establishment of regulations that make the admission of new members possible, and the improvement of operations. Measures have been taken to develop the trade in services, towards the liberalization of the conditions for the movement of capital and in the field of the common acceptance of the results of quality control examinations. All these results were achieved without CEFTA having an administrative apparatus, a seat. CEFTA is not an alternative to the EU but a facilitator of the European Integration. It is not the "entrance hall" but the "training room" of the EU, where we get ready for union membership through cooperation. The CEFTA is the motor of regional cooperation, and trade between member states is expected to grow further.

In the Balkans, there is little doubt that the key response to the challenges of improving and sustaining growth should involve a sustained increase in exports.

Refereeing to table 1 imports has reached higher levels of percentage on GDP during 2006-2008 periods. On the other side, exports seem to reach stable levels but low in comparison with import percentage on GDP. The data show clearly that Western Balkans growth has not achieved a satisfactory level; on the contrary, countries like Bosnia and Herzegovina, Montenegro and Croatia are attempting to keep previous level of their exports.

⁶ The initial intention had been to create a South East European Free Trade Agreement (SEEFITA) but Croatia objected and so the idea of an extension of CEFTA to the Western Balkan region was adopted.

However, despite the criticisms it attracted, the evidence presented in this paper suggests that the system of bilateral FTAs may have already been having some success in increasing the intra-regional trade flows among the Balkan countries even prior to the extension of CEFTA, and that the latter agreement may reinforce such positive trends.

Table 1: Imports and Exports of goods and services (%GDP)

	Import of goods and services %GDP			Export of goods and services %GDP		
	2006	2007	2008	2006	2007	2008
Albania	49.15	54.32	55	25.9	27.85	28.5
FYR Macedonia	66.76	72.24	77.25	48.14	53.16	56.04
Bosnia & H.	66.44	73.65	64.41	36.57	39.08	34.63
Montenegro	77.71	84.9	74.04	49.37	46.33	41.13
Croatia	50.41	50.35	50.28	43.4	42.79	41.91

Source: World Bank Indicator 2009

The benefits of deep integration go beyond those of merchandise trade. The benefits arise from the objective of creating a single economic space, and include greater contestability, a larger market, greater economies of scale, and so on. Benefits would manifest, for example, in intraregional supply chains and higher FDI.

THE ROLE OF CEFTA IN REGIONAL INTEGRATION.

Implementing CEFTA

While the SAAs offer prospects for attracting FDI, an effective implementation of CEFTA is necessary to reduce the potential hub and spoke effect. The decision to replace the complex system of bilateral FTAs with CEFTA, a regional FTA, is a critical step that needs to be consolidated. CEFTA is expected to reduce trade diversion and distortions and to serve as a springboard for eventual EU accession. Trade diversion could be reduced further if all CEFTA countries adopted the EU MFN tariff. It is also expected to reduce business transaction costs and the administrative strain on customs, enhancing the flow of exports and imports across SEE countries. It is important to ensure that CEFTA is well-implemented in order to ensure successful liberalization of trade among SEEs. Failure to do so could give rise to negative “hub and spoke” effects. The latter emerge because of distortions that provide EU firms (the hub) with better market access to other SEE markets (the spokes) than that provided to SEE firms. If this occurs, it could work against the objectives of increasing intraregional trade and investment.

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The role of CEFTA in regional integration

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One of the aims of creating CEFTA was to stop the rapid shrinking of Western Balkans countries' foreign trade, its objectives were clearly directed towards creating free trade. The overruling aim of the Western Balkan countries is to join the European Integration and improving regional relationships may be part of future economic development. Cooperation may help to get access to the more developed integration but CEFTA membership means no guarantee whatsoever for joining the EU. In the CEFTA countries economic growth exceeds the EU average, markets are growing, especially relationships within the CEFTA.

An important result of the CEFTA cooperation is the broadening of the integration's subjects (e.g. competition policy, rules of origin, etc.) the establishment of regulations that make the admission of new members possible, and the improvement of operations. Measures have been taken to develop the trade in services, towards the liberalization of the conditions for the movement of capital and in the field of the common acceptance of the results of quality control examinations. All these results were achieved without CEFTA having an administrative apparatus, a seat.

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Thinking of criticism.

The way in which the free trade area was implemented, through a patchwork of bilateral agreements, came in for some trenchant criticism. Kaminski and De la Rocha (2003a) argued that the resulting 'spaghetti bowl' of bilateral FTAs would become a barrier to mutual trade within the region.

A 'spaghetti bowl'⁸ of FTAs-term originally used to describe overlapping FTAs in Latin America that will emerge once all bilateral trade agreements are implemented may become a barrier to mutual trade. Two measures that can be introduced to avoid this outcome include the removal of provisions on contingent protection along the lines of 20 SAAs have been concluded only with Croatia and FYR Macedonia. Their trade component envisages asymmetrical pace in removing tariffs. The EU will dismantle all tariff and non-tariff barriers over a shorter period than SEE-5 partners.

⁷ The initial intention had been to create a South East European Free Trade Agreement (SEEFITA) but Croatia objected and so the idea of an extension of CEFTA to the Western Balkan region was adopted.

⁸ Stabilization and Association Process in the Balkans: Integration Options and their Assessment ' Bartlomiej Kaminski and Manuel de la Rocha'

The interaction of the EU's preferential trade on a bilateral basis with the system of bilateral FTAs between the countries of the region could create a perverse 'hub-and-spoke' syndrome. Firms located in the EU hub would achieve lower costs than those located in the Balkan spokes, due to greater economies of scale achievable in the hub, so that spoke firms would become less competitive.

Firms located in "spokes" are likely to have larger costs for two reasons:

- I. They face higher barriers than hub firms when importing inputs from the other spokes; and they tend to be penalized by lower demand from other spokes due to trade barriers.
- II. Second, in the absence of both multilateral liberalization and SEE-5 regional liberalization, suppliers from the EU may crowd out more efficient suppliers from countries subject to MFN tariffs as well as charge a higher price than in international markets.

Even though the Europe Agreements increased trade between the hubs (EU) and the spokes (the SEEs), there was still considerable room for increased trade between the spokes. In this respect the CEFTA agreements were a necessary condition for welfare gains from the Europe Agreements. Combined with rules of origin restrictions, firms located in the spokes would also be discouraged from importing intermediate goods from neighboring countries in the region for processing into exports for the EU market.

A DILEMMA OF INTEGRATION AND DISINTEGRATION

The dynamics and the structural of the trade relations in Western Balkan.

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Country profile: Albania

From the above data it is evident the fact that Albania relatively has a low economic integration level in the region than the other countries. This aspect is understandable ascertainment if we consider the fact of the isolation before the '90 and in the other side we are talking about countries that were part in the past of a one Federation (FRJ), with a higher level of cooperation and specialization of each republic.

Anyway for Albania, if we consider the dynamic of the export and import ratio in the region we will see that this weight has increased. (Table 2):

Table2: Change of ratio of Albanian's export and import with Western Balkan Countries

	Export			Import		
	2006	2007	2008	2006	2007	2008
Macedonia	1.6 %	2.3 %	2.6 %	1.6 %	1.9 %	2.0 %
Serbia	1.4 %	1.9 %	2.1 %	0.9 %	3.0 %	4.5 %
Montenegro		0.4 %	0.9 %		0.1 %	0.6 %
Bosnia & Herzegovina	0.5 %	0.4 %	0.5 %	0.3 %	0.3 %	0.3 %
Croatia	0.3 %	0.1 %	0.2 %	1.4 %	1.0 %	1.2 %
Kosovo	3.8 %	4.8 %	6.3 %	0.5 %	0.6 %	0.9 %
Total	7.6 %	9.9 %	12.6 %	4.7 %	6.9 %	9.5 %

Source: General Custom Directory

The increase of the ratio of the exports and also of the imports, although modestly, shows in fact the higher intensity of the Albania relations among the region countries. The main factors in this

increase will be: (i) the Free Trade Agreement signing with the region countries (CEFTA 2006) (ii) the increase in the competitions of the region economies in the global one. It shows that the biggest increase has had the specific weight in 2006 and 2007, years that belongs to end of FTA signing with the region countries.

Anyway, the period that pertain these data is relatively short and the change of this tendency in the upcoming years will give as a full view about the determinate factors of the change of this structure. From another part if we analyze the import export structure of Albania with the region countries, it is evident that the main products in exports and in imports are still raw material or rough materials. This characteristic of course reflects a important aspect of the integration nature of Albania with region economies.

Integration or disintegration.

Yet despite this progress, other arrangements cut across the region and threaten to fragment the growing mutual trade relations. The Accession with EU in April 2004 of Bulgaria and Romania and the membership of Croatia with the prospect of accession soon thereafter are the most recent activities who negatively affect the future prospective of CEFTA. When they accede to the EU, Croatia and Macedonia will exit from their free trade agreement with other non-member Balkan states in the expanded CEFTA. Thus, soon after having established a new mechanism of integration, the region will once again be split apart, leaving a rump association of five poverty-stricken and politically unstable countries (Albania, BaH, Kosovo, Montenegro, and Serbia) to pursue the vision of regional cooperation set out at the EU Balkan summit in Zagreb in 2000. Montenegro voted for independence in a referendum carried out in May 2006, thus bringing the fictitious state union of Serbia and Montenegro to an end. Kosovo declared itself independent from Serbia in 2008, although its independence is not universally recognized. Regional tensions periodically flare up between the indigenous Slav community in Macedonia and the large Albanian minority community in the western part of the country bordering Albania and Kosovo.

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Thus, paradoxically, a measure designed to promote regional economic cooperation may exacerbate tendencies towards political disintegration, at least as far as BaH is concerned. Turning to Albania, the critical issue here is Albania's relation with Kosovo and the large Albanian ethnic community in Western Macedonia. To the extent that free trade agreements foster economic relations between these partners it may promote the economic integration of their Albanian populations. Trade flows in the Balkans do not follow ethnic lines, and that the history of past linkages is a more dominant influence. However, the success of free trade agreements in promoting trade relations, even where there previously were none, may reinforce political relationships based on ethnic or other dimensions of political cleavage, and thus undermine the very process of regional cooperation which they are designed to support.

Nevertheless, the Balkan case indicates the complexities of regional integration, and that in a politically and ethnically divided region, policies designed to promote regional economic cooperation may in practice have contradictory effects, opposed to those that were intended by the their designers drawing on experience of more benign environments. Potentially, each bilateral agreement could be different and therefore this approach could create rather tangled, spaghetti-like trading relationships.

Critics of the free trade agreements also noted that many of the potential benefits of trade opening achieved through reductions in tariffs, quotas and duties were likely to remain unrealized so long as non-tariff barriers to trade persisted. The removal of non-tariff barriers required the introduction of complementary measures to accompany the basic policy of trade liberalization, including measures such as harmonization of laws, standards, licensing arrangements, and the removal of corruption.

However, measures such as these would depend for their success on 'deep integration', which in turn would require much more extensive political cooperation and policy coordination than exists at the current time in the region.

The potential loss of tariff revenue that can accompany trade liberalization could be especially damaging in countries that are trying to build capacity in their public sectors (Lamy 2002). This argument clearly applies to the Western Balkan countries which are still engaged in process of state building, and where the public sector is relatively weak. Declining tariff revenues could hit public expenditure programmes in these countries. Moreover the Western Balkan countries are under IMF conditionality and are struggling hard to meet targets to reduce the government public deficit as a share of GDP. Reductions in tariff revenue would not make this target any easier to achieve. In addition, most Western Balkan countries have now signed Stabilization and Association Agreements with the EU which require them to meet numerous commitments related to the *acquis communautaire*, which are likely to involve quite substantial increases in public expenditure. Reductions in tariff revenues following trade liberalization would clearly not be helpful in achieving these goals unless other sources of public revenue can be tapped.

CONCLUSIONS

The regional integration of the West Balkan countries shows important European integration countries of the region, it can be considered as a preliminary phase of the countries in its EU integration. A very important aspect of integration is concretized in economic collaboration with the region countries. Western Balkan countries have had a relatively fast development in the direction of the regional integration politics in the economic field. The process started in 1999 with the Stability Pact that was concretized at least with the CEFTA -2006 agreement.

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Macroeconomic stability of the Western Balkan countries and the openness of the economies are generally associated with the current account deficits and trade deficits increase. The positive correlation among the economy opening scale of the special countries and foreign direct investment of these countries, that it is not something accident. This correlation shows the fact that trade development is result of the increase in the economies competitions of the region countries, which from other part mostly depends in the foreign investment.

The trade intensity level among region countries is relatively high, especially among Former Yugoslavia Federation. The data shows that this intensity, despite with its decrease for the period 1996 - 2004, has risen for the period 2006 - 2008. The export and import part of the different countries with other region countries shows an increase tendency.

Albania relatively with other west Balkan countries shows a low level of economic collaboration, thing that is unexplainable with the country close before the '90. Anyway the characteristic is even for this country the increase tendency of the specific weight of the trade with other region countries.

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FINANCIAL MANAGEMENT IN BULGARIAN HOSPITALS

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ABSTRACT

The hospital is the most complex institution in the modern health system. The consumption of the hospital system represents 60% of the whole financial resource of the health sector. The reform of the hospitals and their development in the conditions of market economy require flexible, fast and adequate reaction of the management team in order to implement its mission effectively.

For the optimization of the results it is necessary to make an economic assessment which represents comparative analysis of alternative variants for action from the point of view of costs and results on different levels. The analyses cost – effectiveness, cost – utility and cost – benefit, are expedient for the purpose of the hospital management. Their putting into practice by health managers in Bulgaria will contribute for the optimization of these activities in the condition of a restricted financial resource.

There are possibilities to supply medical services on differential prices: for patients with mean living standard and for very solvent patients. In this way the access to health care for the needy wouldn't be restricted, and at the same time the hospital would realize additional revenues. The elaborated model for calculation of cost and prices in the hospital coupled with coding of patients by diagnostic-related groups under the condition of an active hospital information system is a solid base for hospital managers to conduct a positive financial policy.

The author studies the factors contributing to the increase of hospital costs. She analyzes the characteristics in the financial management of different kinds of hospitals. Health managers have to face the challenge named financial management. The utilization of its principles and tools will contribute to optimize the management, to reach a balance between resource – activity – results.

Key words

financial management, hospital, income, cost.

INTRODUCTION

Nowadays the health system in Bulgaria passes a very difficult period characterized by insufficient financial resources and their inefficient allocation and consumption. The hospital is the most complex institution in the modern health system. The consumption of the hospital system represents 60% of the whole financial resource of the health sector. The reform of the hospitals and their development in the conditions of market economy requires flexible, fast and adequate reaction of the management team in order to implement its mission effectively.

Hospitals have performed many different roles and functions over the centuries: as shelters for the poor attached to monasteries in the Middle Ages; as a feared last resort for the dying in the eighteenth century; and as shining symbols of a modern health care system in the twentieth and twenty first century. Hospitals have evolved over the centuries in response to social and political changes and changes in medical knowledge. (4, 10)

What, precisely, is a hospital? One definition is that it is “an institution which provides beds, meals, and constant nursing care for its patients while they undergo medical therapy at the hands of professional physicians. In carrying out these services, the hospital is striving to restore its patients to health” (Miller 1997). Although this captures its essence, a hospital can cover very diverse structures. A hospital might be a ten-bed building without running water in a little mountain village or a large specialized centre equipped with the most advanced technology in a western European city. (7, 19) Second, the type of hospital can be difficult to classify. For example, how does one classify a facility that links a small acute care service to a larger long-term care facility? What is the difference between a small community hospital offering mainly nursing care and a nursing home visited daily by a physician?

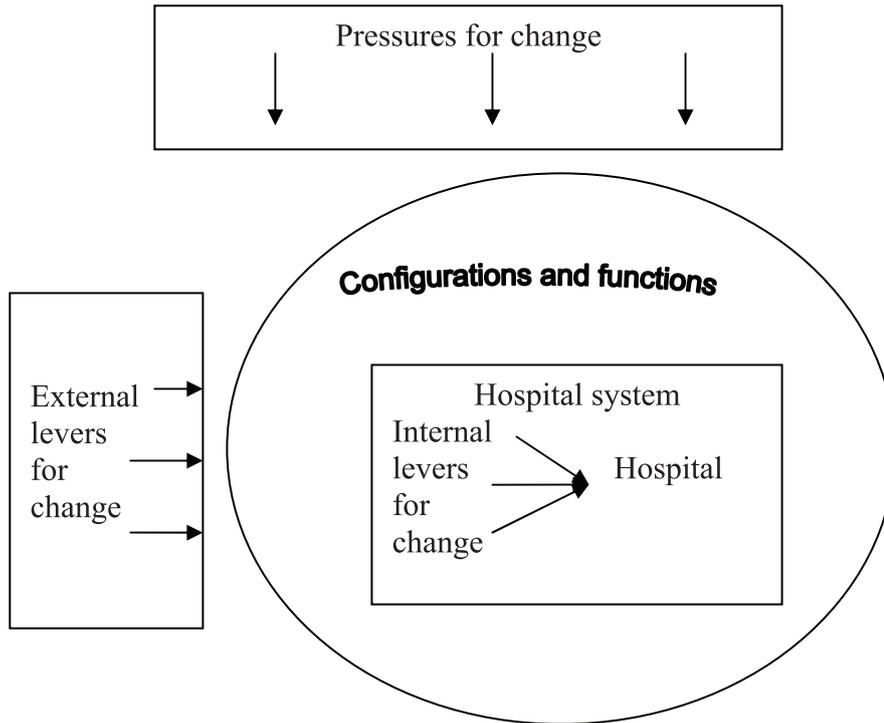
Third, a hospital may spread across many buildings, or hospitals on different sites may merge into one organizational structure.

Fourth, does the definition of a hospital cover only the activities undertaken within its walls? Hospitals in the United States have embarked on vertical mergers that incorporate other service types such as rehabilitation and post-discharge care. Schemes such as “hospital without walls” or “hospital at home” link the hospital to a wide range of outreach services. (7, 19)

CHARACTERISTIC OF THE HOSPITAL AS A PART OF THE HEALTH SYSTEM

The modern hospital is a complex open system which consumes a large number of human, material, financial and informatics resources. It produces medical services intended to protect and ameliorate human health. (fig. 1)

Fig. 1
THE HOSPITAL AS A SYSTEM: OPPORTUNITIES FOR CHANGE



Last years the number of the hospitals increases progressively from 244 in 2001 till 305 in 2008. In Bulgarian hospitals work 50% of all medical doctors (total number 27480); 63,2% of nurses (total number 32314). (17)

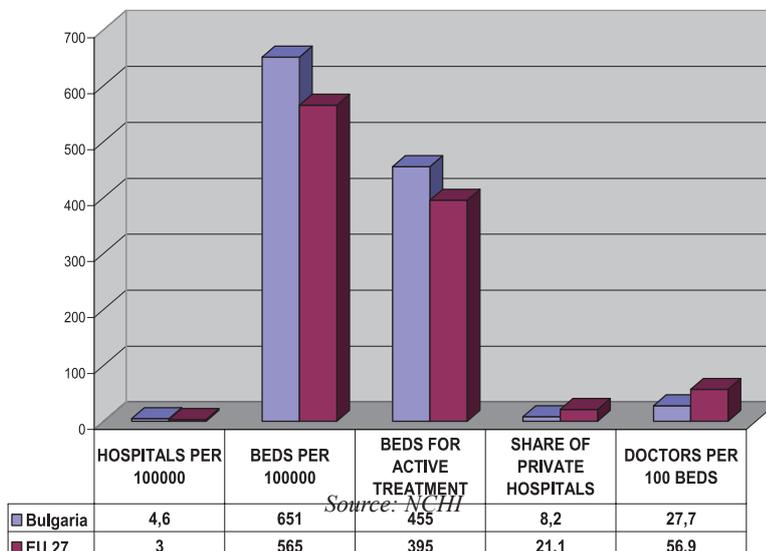
Table 1

	Bulgaria	EU 27
Medical doctors per 100000	361	322
Medical doctors per 100000 in hospitals	181	
Nurses per 100000	421	745
Nurses per 100000 in hospitals	269	

Source: NCHI

Some disproportions are outlined: between doctors and nurses as well as in comparison with EU data.

Fig. 2
HOSPITAL INDICATORS IN 2008



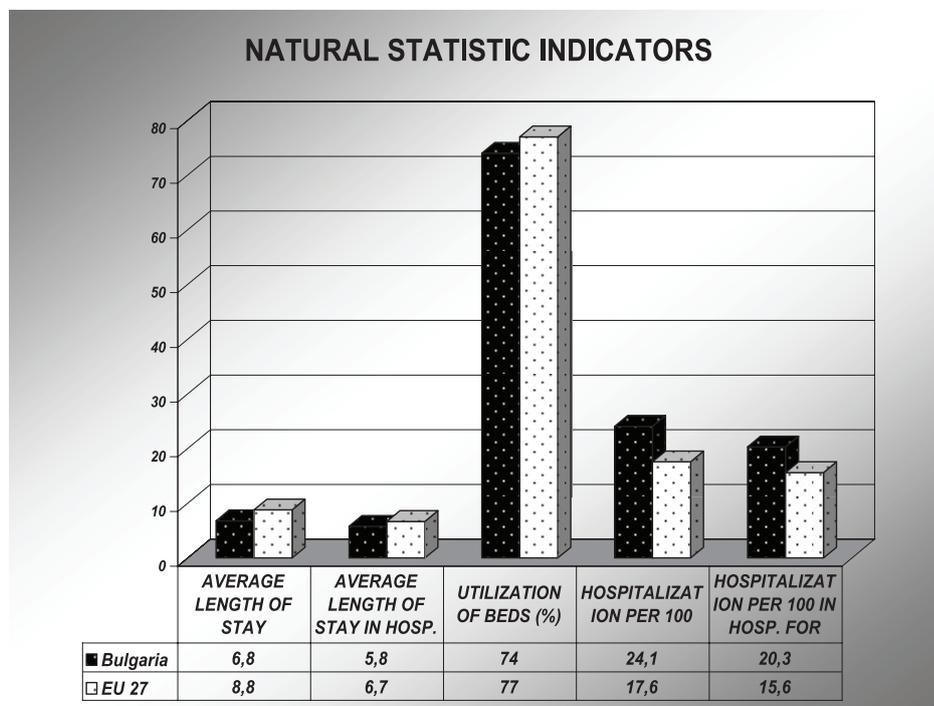
The analysis of presented data shows extensive type of hospital system with many hospitals, beds (including for active treatment), little share of private hospitals and twice less doctors per 100 beds than the average rate in EU 27. (16, 17)

The basic natural data for hospital activity are shown on the next figure 3. The utilization of beds in Bulgaria is lower than in EU 27, the average length of stay is shorter with 2 days. We have to notice that the model for financing of hospital activities by clinical pathways generate hyper hospitalization, shortening of hospital length of stay. (8, 16, 17)

In 2008 were hospitalized 1825488 persons (the total Bulgarian population is 7606551). This process generates increasing costs for the hospital system.

The financing sources for the Bulgarian health system are multiple: from the National Health Insurance Fund - 865468 Euro, Ministry of health - 356603 Euro, Municipality budgets – 108881 Euro, direct payment from the population – 1020000 Euro, others – 112245 Euro. As it was mentioned above financial flows for the hospital system represents 60% of total budget. (4, 18)

Fig. 3



Source: NCHI

The hospital costs vary in wide ranges. They depend on the specificity of the activity. The most expensive medical services are provided by University hospitals which follows the logic that in this type of institutions are treated the most complicated cases of patients. The highest costs per patients are in the psychiatric hospitals – 703 Euro because of the long average stay. At the same time it's a public secret that the conditions in Bulgarian psychiatric hospitals are too poor. The cost of food day is extremely low – from 1 to 1.53 Euro. With such a value it's impossible to provide good quality nutrition. (10, 17) (fig. 4, 5)

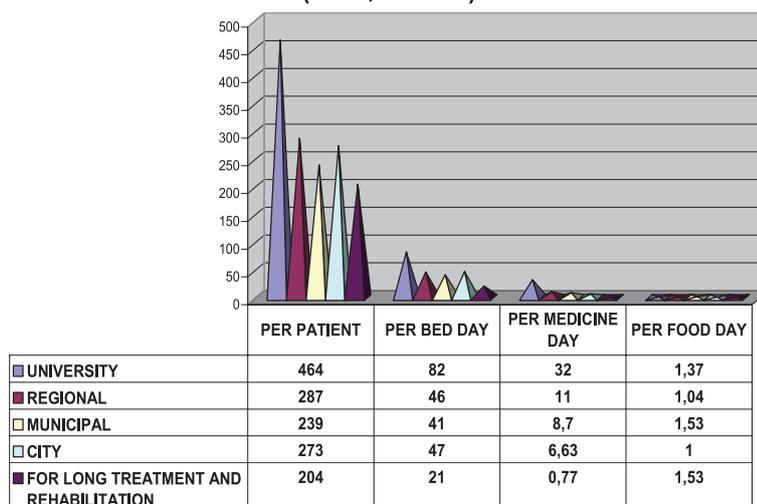
FINANCIAL TOOLS FOR HOSPITAL MANAGEMENT

For the optimization of the results it is necessary to make an economic assessment which represents comparative analysis of alternative variants for action from the point of view of costs and results on different levels. The analyses cost – effectiveness, cost – utility and cost – benefit, are expedient for the purpose of the hospital management. Their putting into practice by health managers in Bulgaria will contribute for the optimization of these activities in the condition of a restricted financial resource. (6, 9, 11)

We have studied the real cost of treatment in some hospitals and after comparing with the price of corresponding clinical pathway we found that some of them are underestimated (for example treatment of glomerulonephritis, gynecological diseases, rehabilitation for diseases of the musculoskeletal system and connective tissue), others are overestimated (treatment of diseases of the circulatory system, some surgical treatment).

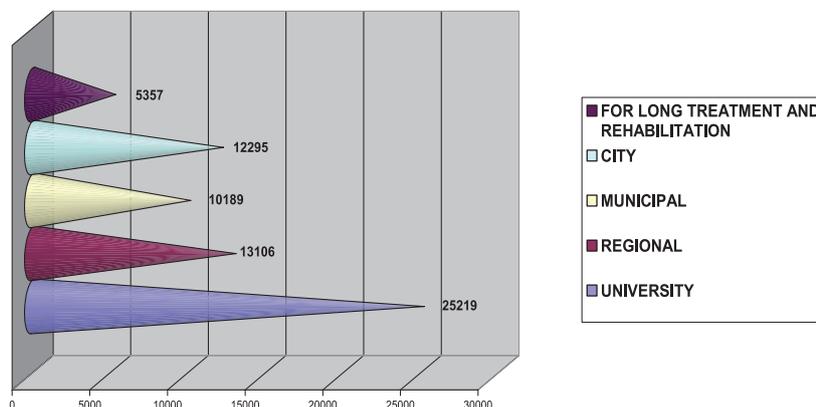
Besides the price of clinical pathways is the same for the treatment in every kind of hospitals: university, regional, municipal, city nevertheless in university hospitals are treated patients in grave condition with complications and attendant diseases. (3, 15)

Fig. 4
ECONOMIC INDICATORS OF THE HEALTH FACILITIES
(2008, in euro)



Source: NCHI

Fig. 5
COSTS PER BED OF THE HEALTH FACILITIES
(2008, in euro)



Source: NCHI

There are possibilities to supply medical services on differential prices: for patients with mean living standard and for very solvent patients. In this way the access to health care for the needy wouldn't be restricted, and at the same time the hospital would realize additional revenues. The elaborated model for calculation of cost and prices in the hospital coupled with coding of patients by diagnostic-related groups under the condition of an active hospital information system is a solid base for hospital managers to conduct a positive financial policy. (2, 5)

The diagnosis related groups (DRG) method assigns a numeric value to an acute care inpatient hospital episode of care, which serves as a relative weighting factor intended to represent the resource intensity of hospital care of the clinical group that is classified to that specific DRG. As a reimbursement system the DRG assignment determines the payment level the hospital will receive. Four guidelines were established as guiding principles for the DRG system's formation:

- The patient characteristics used in the DRG definition should be limited to information routinely collected on the hospital billing form.
- There should be a manageable number of DRGs that encompass all patients seen on an inpatient basis.
- Each DRG should contain patients with a similar pattern of resource intensity.
- Each DRG should contain patients who are similar from a clinical perspective (i.e., each class should be clinically coherent). (1, 3)

Grouping patients in this manner allows hospitals to evaluate and manage costs by DRG or groups of DRGs. Hospitals can also benchmark by groups for quality and resource measurement. The DRG system allows only one DRG assignment per patient stay, so payment includes all services that occur between hospital admission and discharge. DRGs are hierarchical. Major diagnostic categories (MDCs) represent the body systems. Originally there were 23 MDCs; now there are 25. The next level in the hierarchy divides each MDC into surgical and medical sections. The third level then assigns surgical patients into a DRG based on the procedure performed and medical patients into a DRG based on the principal diagnosis for which the patient was admitted. (1, 3, 4)

Hospitals, like other business organizations, issue financial statements. The three major hospital financial statements are:

- The income statement
- The balance sheet
- The cash flow statement

Financial analysis has become mandatory for important decision making and planning in government, non-profit and private health organizations everywhere. People may think that its primary result is a pro forma income statement. However, the fundamental metric is cash flow, not income. Health managers may include a projected income figure besides the expected cash flow if they want to know what the proposal will do for reported income per se. But cash flow, not income, is the clearest answer to the basic question: Is this a good business decision? (13, 14, 15)

Hospitals must spend money to function and provide patient's care. The main categories of costs include salaries, supplies, depreciation, amortization, interest, and bad debt expenses. Wages and salaries paid to employees are usually the largest category of expenses for hospitals. In many hospitals, salaries make up about 50 - 60 percent of total expenses. Supplies (medicines, consumers, foods) and overhead expenses usually make up the second largest category of hospital expense and typically account for 30 percent of a hospital's expenses. "Other" includes a range of expenses, but often represents contract labour and lease expenses. (15)

When any entity (including hospitals) buys equipment, buildings, or other fixed assets, it does not expense, or write off, the entire cost of purchasing that fixed asset in one accounting period. Instead, it recognizes the cost over the estimated life of the good, and records the appropriate portion as an expense during the current accounting period. Usually the amortization rate amounts to 5 – 8 %. Private hospitals accumulate a higher rate – 10 – 11 % in view of the necessity of renovation of the equipment and the building. (4, 15)

Hospitals often borrow money for mortgages and other large purchases. Interest expense is the amount a hospital must pay in the current accounting period for borrowing funds. This catchall category includes any other expense not listed above. Other expenses typically include amounts spent for employee pensions and general services, such as phone system repairs. Bad debt represents service charges for which a hospital expected to collect but does not receive payment. Bad debt is valued at charges. (15)

Next figures show the cost structure in three different types of hospitals in 2008.

Fig. 6

COST STRUCTURE IN UNIVERSITY HOSPITALS (2008, IN %)

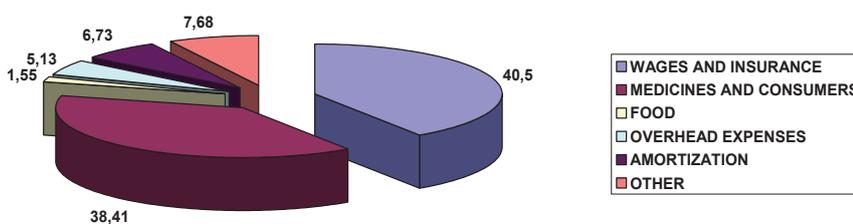


Fig. 7

COST STRUCTURE IN REGIONAL HOSPITALS (2008, in %)

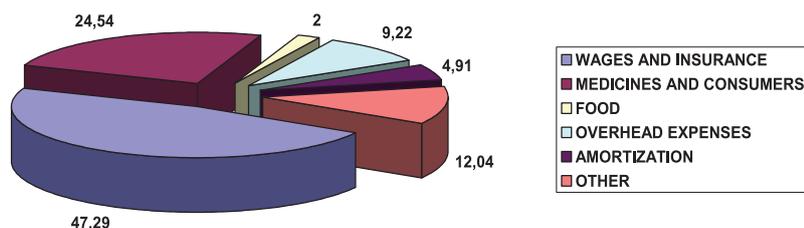
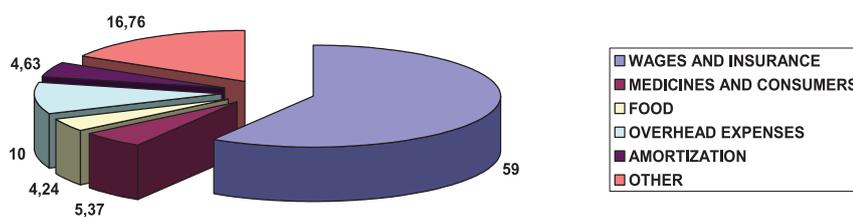


Fig. 8

COST STRUCTURE IN HOSPITALS FOR LONG TREATMENT AND REHABILITATION (2008, in %)

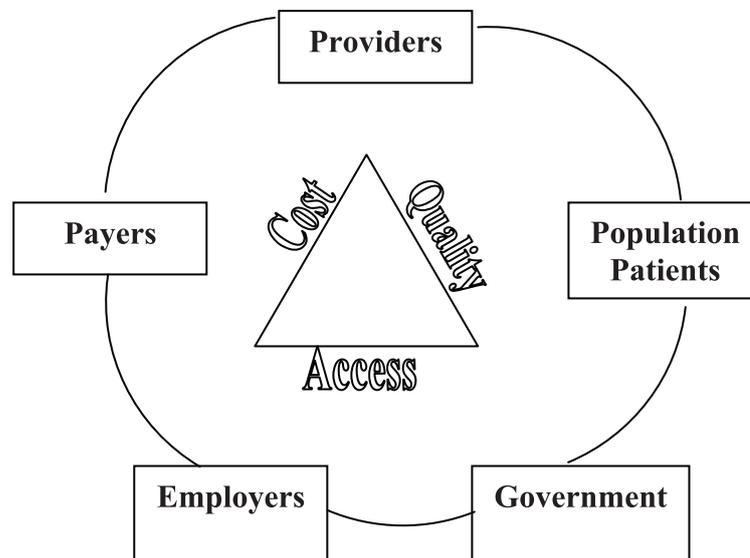


Source NCHI

The differences in the percentages are due to the specificity of different kinds of hospitals. The major part of hospitals costs is for wages and insurance of the personnel.

Because they are assuming more risk, providers must be able to measure their costs accurately. The three generally used approaches are: the cost-to-charge ratio, the step-down method and activity-based costing. The step-down method finds costs by allocating those that are not directly paid to produce medical services, but are necessary for these activities. It is useful for pricing and reimbursement-related decisions but should not be used to control costs. Activity-based costing (ABC) not only finds cost but also helps to control them. This is a bottom-up approach because it calculates the cost of each service at the point at which resources are used and then aggregates them upward into product. ABC is based on the paradigm that activities consume resources and processes consume activities. Therefore, because the use of resources is what causes costs, if activities and processes are measured and controlled, then costs will be measured and controlled too. The implementation of these approaches needs high qualified personnel and adequate hospital information system. (15)

Fig. 9
KEY ELEMENTS OF HOSPITAL PAYMENT SYSTEM



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CONCLUSION

The modern hospital has the primary responsibility for providing quality care. The first step is to provide appropriate facilities. These should be sufficiently flexible to adapt to inevitably changing circumstances. Increasing ambulatory surgery requires fewer beds but more operating theatres, and advances in anesthesia enable some routine surgery to be removed from the hospital altogether into free-standing ambulatory care facilities. Hospitals also need adequately trained staff. They must be able to adapt to changing circumstances, too. All health care providers must update their skills regularly, and the public increasingly will demand that health professionals demonstrate their continuing competence to practice. Hospitals must ensure that they have systems in place to monitor and enhance the quality of care.

The implementation of principles and tools of financial management will contribute to optimize the hospital activities, to reach a balance between resources – business – results.

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PUBLIC BURDEN OF SMOKING AMONG BULGARIAN POPULATION

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ABSTRACT

During the last years Bulgaria survives dramatic changes in the development of the society and the economics. Periods of crisis, revival, recession and expansion succeeded each other. As a result of the action of multiple factors was achieved the recent situation of failure in health, demography and economics. The historical human development demonstrates that there is a direct ratio between the health status of the population of a country and its economics.

According to the data of national statistics the gross domestic product (GDP) of Bulgaria was 34 mlrd Euro in 2008, which represents 4485 Euro per capita. The index GDP per capita for Bulgaria is 2.5 times lower of the average for the 27 countries members of the European Union.

Authors analyze the expenditure of the population for cigarettes and cost of treatment of tobacco related diseases. The efficient analysis is made difficultly because of lack of reliable information data. It was found that on the one hand Bulgaria pursues a policy directed to the restriction of tobacco smoking, and on the other hand production and consumption of tobacco and cigarettes grows up. In 2006 tobacco production amounts to 70,4 mil. Euro, in 2008 achieves 127 mil. Euro. The expenditure for alcohol drinks and tobacco products represents 4,6% of total household expenditures in October 2009 and show growth of 0,4 percent points towards the same period of 2008.

The control and the restriction of tobacco smoking is a prolonged process, for which success are necessary the efforts of the whole society. It is indispensable to use economic as well as educational and psychological tools.

Keywords

tobacco, health, disease, economic analysis.

INTRODUCTION

During the last years Bulgaria survives dramatic changes in the development of the society and the economics. Periods of crisis, revival, recession and expansion succeeded each other. As a result of the action of multiple factors was achieved the recent situation of failure in health, demography and economics. The historical human development demonstrates that there is a direct ratio between the health status of the population of a country and its economics.

The effects of human capital variables imply that the investment rate tends to increase the education and health rate. Because these variables evolve systematically according to economic development, such changes may be associated with increases in the investment rate. Thus, low levels of human capital represent a barrier to development, which impedes competitiveness. Any attempt to reduce the gap between the rich and poor worlds must therefore incorporate a better understanding of the mechanisms that underlie the process of human capital formation. (2, 12) The life long learning covers 11-12% of the population in EU, in Bulgaria – 2-2,3% (2008). (24)

Right up until the second half of the 1990s, the role of human capital was, in the main, linked to education, although a few authors had already recognized the importance of other factors such as health and nutrition. In a groundbreaking analysis, Mankiw, Romer, and Weil (1992) cite the importance of considering not only education, but also health and nutrition in a broader analysis of human capital. Yet there was a delay of several years before the relation between economic growth and health became widely accepted as a significant issue of economic inquiry. Fogel (1994), Barro and Sala-i-Martin (2004), and Barro (1996) were among the first in examining this problem, and their research has subsequently given rise to a substantial store of work focusing on wealth and health. (12, 17)

318 Good health is a crucial component of overall well-being. However, improvements in health status may be justified on purely economic grounds. Good health raises levels of human capital, and this has a positive effect on individual productivity and on economic growth rates. Better health increases workforce productivity by reducing incapacity, debility, and the number of days lost to sick leave, and increases the opportunities of the individual to obtain better paid work. Further, good health helps to forge improved levels of education by increasing levels of schooling and scholastic performance. (12, 15) There is also an important positive spillover effect of the resources that would otherwise be used for preventive health treatments are freed for alternative uses or in cushioning the effects of other negative externalities such as poverty within the nation. Nowadays the main demographic indicators for Bulgarian population give a proof for the bad health status: high mortality – 14,5‰ (EU 27 – 9,7‰), infant mortality rate – 8,6‰ (EU 27 – 5,7‰), life expectancy – 73 years (EU 27 – 78,9). (21, 24) The frequency of deaths caused by Diseases of the circulatory system and Neoplasms is one of the highest in the European region. The traditions in nutrition of the population are related with unhealthy habits: high salt, fat, alcohol and tobacco consumption, low rates of fruit and vegetable consumption.

To gain a more adequate understanding of the accumulation process driving health human capital and wealth, it is essential to ascertain how the causal relationship between the two works. The main difficulty in any approach to this task lies in the possible existence of endogeneity between health and wealth. Although good health may be considered a form of human capital that has a beneficial effect on productivity, income also influences health in a positive way. (11, 12) The capacity to generate higher earnings facilitates an increase in the consumption of health-related goods such as adequate food or medicine. There is also an indirect effect on individual health via the improvements inherent in changes in lifestyle, a more intensive participation at the work place, and higher levels of education, all of which promote better health and increase the income. The nature of this feedback would yield biased and inconsistent estimates of the structural parameters when it carries out the impact that health has on economic growth. (2, 9 12)

TOBACCO PRODUCTION AND SMOKING IN BULGARIA

The tobacco industry uses economic arguments to persuade governments, the media and the general population that smoking benefits the economy. It claims that if tobacco control measures are introduced, tax revenues will fall, jobs will be lost and there will be great hardship to the economy. But the industry greatly exaggerates the economic losses, if any, which tobacco control measures will cause. The producers never mention the economic costs which tobacco inflicts upon every country. Tobacco's cost to governments, to employers and to the environment includes social, welfare and health care spending, loss of foreign exchange in importing cigarettes; loss of land that could grow food; costs of fires and damage to buildings caused by careless smoking; environmental costs ranging from deforestation to collection of smokers' litter, absenteeism, decreased productivity, higher numbers of accidents and higher insurance premiums. (8, 14)

This paper represents a part of a scientific project to reduce smoking, funded by the Council of Medical Science in Medical University - Sofia

The areas planted with tobacco in Bulgaria are 25.3 thousand ha in 2008, which is with 4.6 thousand ha less than in 2007. The total produced raw tobacco is 42.4 thousand t. in 2008, with 1.3 thousand t. more than in 2007. There is a decrease only for Virginia tobacco. The average yield from hectare increases last years for all tobacco brands. The gross produced value is 64 million Euro, 1.4% of total produced agriculture value. (24)

According to national statistic data and our personal research the average days off sick per year are 6.16 for smokers; 4.53 for ex-smokers, 3.86 for never-smokers in 2007. (5, 23, 25)

The economic costs of smoking to smokers and their families include money spent on buying tobacco, which could otherwise be used on food, clothing and shelter, family holidays or a car. As smoking kills a quarter of all smokers in their working years, smoking deprives the smoker's family of many years of income. Smokers also suffer loss of income through illness. Following a smoker's premature death, a partner, children or elderly parents can be left destitute. Family members of smokers lose income through time taken looking after smokers when they are sick, and time lost taking them to hospital. Smokers also have to shoulder higher health insurance premiums, and many other miscellaneous costs, such as increased wear and tear on their home, as well as increased fire risk. (16, 20, 26)

Bulgarians are the third most active smokers among European members, and half of the pregnant women smoke. Active smokers are 1,9 million. Bulgarians smoke an average of a pack a day, and almost every third child between the age of 10 and 19 is an active smoker, the survey shows. In 1986, the women smokers were 19%, and now the percentage is 38. Active smokers among men are 52,4%. (7, 20, 23)

The Bulgarian households spend 1.5 milliard Euro for cigarettes per year which is more than the public health expenditures for the country, according to official statistic data. Smuggled cigarettes accounted for half of the total amount sold in Bulgaria. The increase in the cigarette smuggling perhaps was caused by the increase in the excise duty, which rose from 53 euro for 1000 cigarettes to 76 euro for 1000 cigarettes in January 2010. (10, 13, 21, 22)

Table 1
Expenditures for cigarette consumption per capita (inEuro)

	2000	2004	2009
Bulgaria	50,2	100,7	201.2

(Source 5, 24)

ECONOMIC AND HEALTH CONSEQUENCES OF SMOKING

Second-hand tobacco smoke is the smoke emitted from the burning end of a cigarette (side-stream smoke) or from other tobacco products, usually in combination with the mainstream smoke exhaled by the smoker, and has similar components to inhaled or mainstream smoke. However, it is three to four times more toxic per gram of particulate matter than mainstream tobacco smoke, and the toxicity of sidestream smoke is higher than the sum of the toxicities of its constituents. (4, 18) More than 4 000 chemicals have been identified in tobacco smoke, at least 250 of which are known to be harmful and more than 50 of which are known to cause cancer. People in places that allow smoking can be subject to significant levels of toxins, as pollution from tobacco smoke can reach levels that are much higher than levels of other environmental toxins, such as particles found in automobile exhaust. Studies have shown that pollution levels in indoor places that allow smoking are higher than levels found on busy roadways, in closed motor garages and during firestorms. (3, 18)

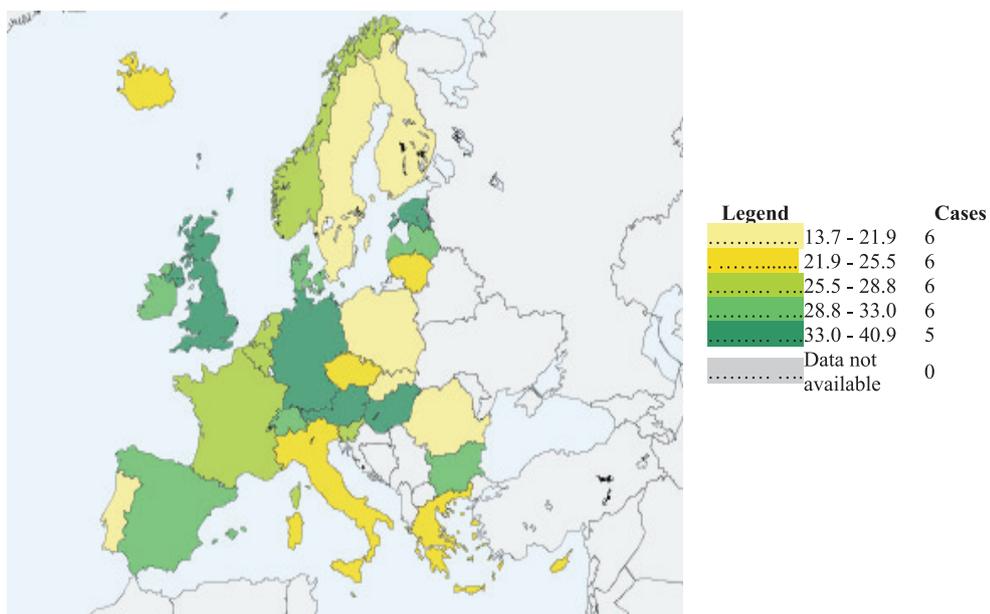
Second-hand tobacco smoke can spread from one room to another within a building, even if doors to the smoking area are closed. Toxic chemicals from secondhand tobacco smoke contamination persist well beyond the period of active smoking, and then cling to rugs, curtains, clothes, food, furniture and other materials. These toxins can remain in a room weeks and months after someone has smoked there, even if windows are opened or fans or air filters are used. Filters can become a source for deposited chemicals that are then recycled back into the air of a room rather than removed. Tobacco toxins that build up over time, coating the surfaces of room elements and materials and smokers' belongings, are sometimes referred to as "third-hand smoke". (4, 8, 18)

The tobacco dependence is a disorder classified by WHO. It is an open gateway to the next step of dependence – the drug. The children are the most endangered part of the population. (19, 26)

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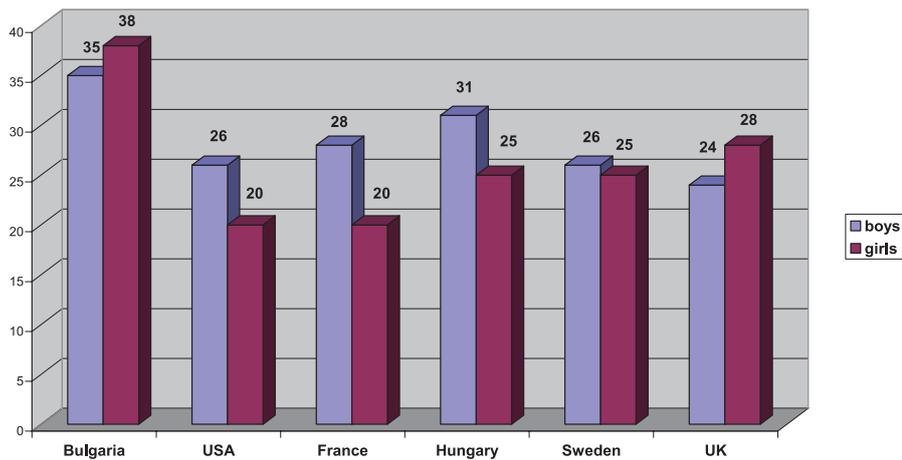
Fig. 1

SMOKERS BETWEEN 15 AND 24 (%)



Eurostat database

Fig. 2
PREVALENCE OF SMOKING AMONG YOUTH
(BOYS AND GIRLS 15-16 AGED) in %



Source NCHI, NSI

The injurious habit is among the main causes of 25 diseases, and is also a reason for their change for worse. Smoking is the main cause of death in the European Union, making its limitation a vital part of the European Community health policy. (6)

Cigarette smoking accounts for about one-third of all cancers, including 90 percent of lung cancer cases. In addition to cancer, smoking causes lung diseases such as chronic bronchitis and emphysema, and increases the risk of cardiovascular diseases, including stroke, heart attack and aneurysm. Smoking has also been linked to leukemia, cataracts, and pneumonia. On average, adults who smoke die 14 years earlier than nonsmokers. (1, 16, 26, 21)

Although nicotine is addictive and can be toxic if ingested in high doses, it does not cause cancer - other chemicals are responsible for most of the severe health consequences of tobacco use. Tobacco smoke is a complex mixture of chemicals such as carbon monoxide, tar, formaldehyde, cyanide, and ammonia - many of which are known carcinogens. Carbon monoxide increases the chance of cardiovascular diseases. Tar exposes the user to an increased risk of lung cancer, emphysema, and bronchial disorders. Smokeless tobacco (such as chewing tobacco and snuff) also increases the risk of cancer, especially oral cancers. (14, 16, 19)

Pregnant women who smoke cigarettes run an increased risk of miscarriage, stillborn or premature infants, or infants with low birthweight. Maternal smoking may also be associated with learning and behavioral problems in children. Smoking more than one pack of cigarettes per day during pregnancy nearly doubles the risk that the affected child will become addicted to tobacco if that child starts smoking. (19, 20, 22)



The families' producers of raw tobacco are exposed to double high risk (more than 65 000 people). Their life standard is very low; more than 70% of them are smokers. The cultivation of tobacco is related with toxic effects. The children in these families have to work from a very early age (6-7 years) for helping their parents. In addition we have to notice their mediocre educational level. This part of population needs special attention by municipal, health and governmental authorities. (5, 24, 25)

Cigarette smoking is the number one preventable cause of premature death. From a medical standpoint, smoking is one of the most hazardous health behaviors. Physicians routinely counsel their patients who smoke to quit. Practice guidelines for smoking cessation exist and have been widely disseminated. Similarly, from the vantage point of public health, smoking is the major cause of mortality and an important source of morbidity and long-term disability. Such concerns have led public expenditures on tobacco control programs, restrictions on access to cigarettes, especially to youths, bans on advertising of tobacco products, and increased excise taxes on cigarettes. To the extent that smoking is viewed as an absolute "bad", it seems unnecessary to quantify costs attributable to tobacco consumption. (17, 20)

322 An alternative view, shared by most of the economists, is that people are the best judges of the goods and services they consume. This view is incorporated in the doctrine of "consumer sovereignty". In determining what and how much of each good and service to consume, people weigh benefits accruing to them personally with the costs. Both benefits and costs are private. Costs include the price of the good or service, but also later consequences, such as effects on health in later life. At the same time, consumption contributes to the person's utility or well-being. In the context of cigarette consumption, people smoke because they enjoy it, for relief of stress, to display their maturity or sexuality, to satisfy an addiction, and for other reasons. If one accepts the doctrine of consumer sovereignty, only those benefits and costs from the person's consumption that are external to the individual are relevant for public policy decisions. There are few external benefits of tobacco consumption. (10, 16, 20) Some might list employment opportunities in tobacco growing, manufacturing, and sales as external benefits, at least in the short run until such resources can be allocated to alternative uses. There are two major types of external cost: adverse health effects and discomfort that smoking imposes on others and the financial burdens from smoking-attributable illnesses that are borne by others in addition to the smoker. A third, somewhat more controversial external cost, is loss in well-being that a nonsmoker suffers from just knowing that others smoke. This third type of external cost is inconsistent with consumer sovereignty. Its existence presupposes that smokers should know better or that they are simply too addicted to quit. (13, 14)

SOCIAL COSTS OF SMOKING

Social benefit is the sum of private benefits to each consumer of the product plus the external benefit. Likewise, social cost represents the sum of private costs incurred by individual consumers as well as the external cost. Economists consider costs borne by the household to be private. Household and individual decision making are viewed as virtually interchangeable. In the microeconomics of household behavior, the distinction has largely been a matter of mathematical notation. Implicitly at least, every family member is assumed to have identical preferences. Or, at a minimum, a smoker is presumed to have incorporated all preferences of other family's members in decisions about how much to smoke. (15, 17, 20, 22)



An important characteristic of tobacco consumption is the long latency period between the time of initiation and the onset of adverse events. Relatively few adverse health events occur before late middle age. To illustrate, at age of 35, the cumulative probability of survival is the same for those who have never smoked and smokers. At age of 45 the ratio of such probabilities increases considerably for men and less for women. The lower ratio for females may reflect an average higher age of onset of the smoking habit than males. Excess morbidity and consequently elevated cost occurs earlier, however, for some smoking-related diseases such as lung cancer; for this disease, the lag between initial treatment and death is less than a year on average. (8, 17, 20)

Tobacco taxes are an extremely potent policy instrument. The conceptual task of setting the optimal cigarette excise tax rate is quite complex. The optimal tax would force the potential smoker to consider the cost of all consequences smoking imposes on others. To the extent that smokers are irrational and myopic, the optimal tax would reflect private costs of smoking as well. Thus, to determine the optimal rate, one needs to both understand choices people make about smoking as well as quantify the external and perhaps the private costs of smoking. Private costs far exceed the external costs of smoking. Equity considerations add further complications, because an economically efficient tax may be viewed as inequitable. (10, 13, 20, 21)

CONCLUSIONS

1. Tobacco consumption in Bulgaria is high and rising. Consumption rates are higher than those of the EU countries. Consumption data are with limited accuracy due to the high rate of smuggling.
2. Smoking prevalence is high and shows an increasing trend. Men are smoking more.
3. Youth smoking is characterized with earlier onset of smoking. Girls show higher prevalence rates than boys, higher than the EU rates in children and adolescence.
4. The production and the trade with tobacco articles is a traditional branch. Its restriction in close future and even complete cessation in a more distant future necessitates the efforts of the government and the whole society. Both the production and supply of the tobacco articles are in a direct dependence on their demand and consumption.
5. The taxation policy follows the European directives.
6. The total economic burden represents the sum of the direct private and public costs and the indirect private costs. Household expenditures for tobacco products represent the largest burden within the total sum of the direct private costs and influence strongly upon the high values of the direct private costs.
7. Cigarette consumption occupies a significant part of the GDP – more than 4%.

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TAX SYSTEMS IN WEST BALKANS COUNTRIES – BETWEEN SIMPLICITY AND EFFICIENCY

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ABSTRACT

There are two main features characterized every tax system: simplicity and efficiency. These features converge not necessarily with each other. The simplicity of a tax system is related and implies the simplicity of tax calculation. In other site this characteristic is a very important element regarding tax collection and also affects the transparency among different economics activities. But how much these system are efficient?

The efficiency of a fiscal system is related particularly with the characteristic of a tax as an instrument for implementation of different economic policies, incitement of economic development, achievement of particular structural changes, etc.

In this framework the paper aims to perform a comparative analyze of fiscal systems for different West Balkans Countries. In this point of view, the main objective of the paper is to analyze how much the tax systems of these countries reflect the simplicity and transparency, and in the other site, how much those serve as a mechanism of economic development. In this approach the paper effort to explain, if the tax systems are considerate only as an instrument of budget revenue collection, or these system have considerate also as an incentives targeted economic development of these countries. In West Balkan Countries in this paper are included: Albania, Bosnia & Herzegovina, Croatia, Kosovo, Macedonia, Monte Negro and Serbia.

JEL codes: H21 – Efficiency; Optimal Taxation

Key words

Tax System, simplicity, efficiency.

INTRODUCTION

The fiscal system in West Balkan Countries has already been consolidated and they constitute one of the main pillars of the functions of these economies. Although being very fundamental, the fiscal reforms were carried out in a relatively short period of time. Despite of their problems and continuous corrections, these systems function in conformity with the objections and principles of each fiscal system. In this point of view the tax revenues actually constitute the main source of the budget revenues of West Balkan Countries.

On the other hand these achievements enable today those fiscal systems to be analyzed in a more qualitative way. The fiscal system in all West Balkan Countries has actually been seen mainly in the function of its most important objective: the realizing of budget revenues. Thus the setting up of these systems is based mainly on the fight against fiscal evasion, aiming at the extension of the tax payers. Beyond this important objective I think that these systems should be considerate in the aspect of their efficiency as well.

As far as the efficiency is concerned, it has a broader meaning. In a certain point of view it is related to the known economic principle on the “temporary neutrality” of tax. In other point of view, the efficiency of a system can take into consideration the fact how the fiscal system serves as an instrument to incite and realize certain economic policies. In fact none of fiscal system is totally “neutral” because each system has exemptions for special cases which aim to stimulate an activity or another.

Viewed in this framework this study aims to develop a comparative analysis among fiscal systems of West Balkan Countries. In addition to this introduction – first part, the paper deals four questions. In the second part is displayed the tax income dynamics in the budget of various Balkan Countries. The aim of this part is to show the weight of fiscal system on the income structure of this system. The third part will deal with direct taxes: personal income taxes, and the profit taxes (corporate income taxes), which systems have chosen the countries, and whether they are based on progressive tax or the flat tax. The fourth part deals with indirect taxes and mainly with value added tax; this part will treats with the level of consumption tax as well as the differentiations made in different countries. The five part, give a general competitive analysis of main taxes for separate countries, it is the aimed to reflect the policies being applied in Balkans Countries, both in the aspect of simplification of fiscal system and also of their efficiency. The study ends with the conclusions and references.

THE DYNAMICS OF FISCAL INCOMES AND THEIR STRUCTURE IN WEST BALKAN COUNTRIES.

The political changes in West Balkan Countries were accompanied with a lot of important institutional changes closely linked with the new system based on market economy. One of the most important changes was the one of fiscal reform. The dynamic of this reform has been determinate by the dynamics of the economic democratic changes and their opening toward the market economy. However, today all West Balkan Countries have set up a fiscal system similar to the one of the European Developed Countries. Actually these systems base on the three main kinds of taxes like: personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT)

The table 1 presents both the budgetary incomes and fiscal ones in proportion to the GDP of West Balkan Countries.

Table1: Budget revenue in GDP - 2008¹ (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Total budget revenue	24.3%	25.1%	33.7%	24.2%	36.4%	41.8%	18.4%
1. Tax Revenue	18.1%	14.1%	20.3%	20.7%	21.3%	28.9%	17.1%
2. Non - tax revenue and contribution	6.2%	11.0%	13.5%	3.5%	15.1%	12.9%	1.3%

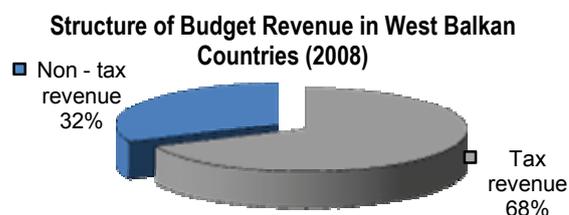
Source: Budget 2008 from respective countries, World Bank estimation of GDP, and author's calculations.

The budget revenue fluctuates according to the countries from 18,4% of GDP (Serbia) to 41,8% (Monte Negro). The weight of tax revenue is between 14,1% of GDP for Bosnia and Herzegovina and 28,9% for Monte Negro, while other countries have nearly the same fiscal burden, which fluctuates between 17-20% of GDP. For all the above mentioned countries the budgetary revenue constitute nearly 27,7% of their GDP. This percentage shows the declining tendency of the budget revenue in proportion with the GDP of these countries, which in the years 1991-1995 has been about 36,8% and in the period 1999-2002 was about 34,6%².

On the whole, the revenue taxes for the region constitute about 18,9% of GDP while the ones from other sources were 8,8% or respectively 68% and 32% of the totally budget revenue (graph 1).

In comparison with the previous periods of time there has been raised the part of the income taxes. If we would include the incomes from the social contribution in the part of revenue tax, in 2008 this part for Balkan Countries constituted about 93,4% of the budget revenue, while the revenue from other sources constituted only 6,6%. In the period 1999-2002 these parts constituted 86,2% and 13,8% respectively³. These data compared to the previous periods of the time in one side indicate the relative decline of the weight of the public sector in the economy and on the other side it indicates the role of the fiscal system within the public sector.

Graph 1



The analysis of the tax structure among different countries is important as well. The budgets of these countries do not have a standard presentation, a thing which makes difficult the accuracy of comparative data. However the analysis of the countries might be presented in the following table (table 2):

Table 2: Direct and Indirect tax in Tax Revenue - 2008⁴ (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Tax Revenue - total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
1. Direct tax	14.5%	11.1%	17.6%	NA	21.1%	19.7%	18.8%
2. Indirect tax	65.5%	75.7%	78.3%	NA	74.1%	63.2%	69.0%
3. Other tax	20.0%	13.2%	4.1%	NA	4.8%	17.1%	12.1%

Source: Budget 2008 from respective countries, World Bank estimation of GDP, and author's calculations.

1 "Non tax revenue and contribution" include also social contribution.

2 Grabowski, M. dhe Tomalak, M – "Tax System Reforms in the Countries of Central Europe and the Commonwealth of Independent States" – Special Study, pg. 260. In this paper in West Balkan Countries are included only Albania, Croatia, Macedonia, Bulgaria and Romania.

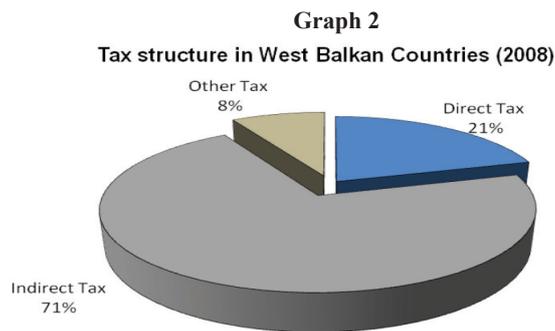
3 Grabowski, M. dhe Tomalak, M – "Tax System Reforms in the Countries of Central Europe and the Commonwealth of Independent States" – Special Study, pg. 263. Here social contribution are included in tax revenue.

4 Data for Kosova are missing.

The indirect taxes (63,2% - 78,3%) constitute the heaviest weight from the tax revenues. In Bosnia and Herzegovina the direct taxes constitute 11,1% and in Macedonia about 21,1%. In these percentages, beside the high rates of indirect taxes, influences the fact that indirect taxes on production can be simply management, so the informality here is smaller. On the contrary the lower percentage of direct taxes shows the informality of respective countries.

The data of the structure of direct and indirect taxes, for all countries together, are presented on the graph 2.

The indirect taxes (for example VAT) are considered to be taxes on consumption because they weigh down on the final consumer through goods prices. The high weight of these taxes generally shows that the West Balkan Countries implemented fiscal systems that are based on consumption.



The structure of direct taxes shows that various countries have different structures (table 3). Thus for both, Albania and Macedonia, the tax revenue towards personal income tax are almost the same with corporate income tax. While for Monte Negro and Serbia the personal income tax constitute the heights weight respectively 64,1% and 68,1%. In Croatia the corporate income tax revenue is very high 86,2%. The later is linked with the high rates that Croatia keeps on applying on corporate income tax 20%, in comparison with 9%-10% being applied in other countries.

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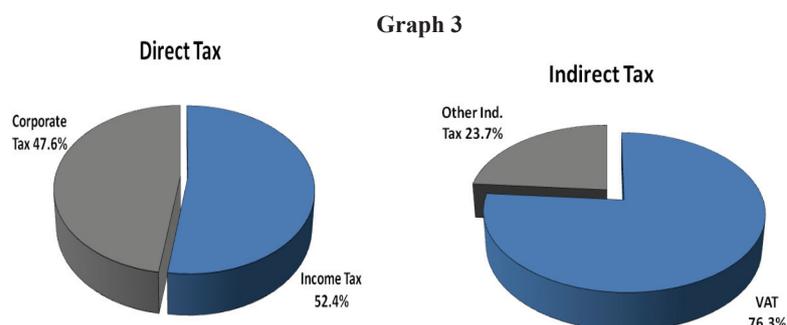
Table 3: Structure of direct and indirect tax - 2008 (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Direct tax	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
1. Income tax	53.0%	NA	13.8%	NA	49.7%	64.1%	68.1%
2. Corporate tax	47.0%	NA	86.2%	NA	50.3%	35.9%	31.9%
Indirect tax	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
1. VAT	72.2%	NA	75.8%	NA	61.6%	78.5%	75.0%
2. Other indirect tax	27.8%	NA	24.2%	NA	38.4%	21.5%	25.0%

Source: Budget 2008 from respective countries, World Bank estimation of GDP, and author's calculations.

As far as the indirect taxes are concerned the data show that the main tax is that of VAT.

For all countries together, the structure of direct and indirect taxes is presented on graph 3.



In general the budget revenue in percentage toward GDP for West Balkan Countries is presented on table 4. It strikes the eye the lower weight of the personal income tax and that of corporate income tax: about 1,9-2,0% of GDP. At the same time by VAT, percentages is about 10,2% of GDP. On this table “non tax revenue” constitute about 8,8% of GDP. In fact in this category are also included the revenues from social contribution, which constitute about 79% of non tax revenue, or differently about 7% of GDP. All these data show that the tax revenue is realized from those taxes that can be collected and managed easily.

Table 4: Budget and Tax revenue in relation to GDP- 2008 (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia	Total
Total budget revenue	24.3%	25.1%	33.7%	24.2%	36.4%	41.8%	18.4%	27.7%
A. Tax Revenue	18.1%	14.1%	20.3%	20.7%	21.3%	28.9%	17.1%	18.9%
1 Direct tax	2.6%	1.6%	3.6%	NA	4.5%	5.7%	3.2%	3.9%
1.1 Income tax	1.4%	NA	0.5%	NA	2.2%	3.6%	2.2%	2.0%
1.2 Corporate tax	1.2%	NA	3.1%	NA	2.3%	2.0%	1.0%	1.9%
2 Indirect tax	11.9%	10.7%	15.9%	NA	15.8%	18.3%	11.8%	13.4%
2.1 VAT	8.6%	NA	12.0%	NA	9.7%	14.3%	8.9%	10.2%
2.2 Other indirect tax	3.3%	NA	3.8%	NA	6.1%	3.9%	3.0%	3.2%
3. Other tax	3.6%	1.9%	0.8%	NA	1.0%	4.9%	2.1%	1.6%
B. Non - tax revenue and contribution	6.2%	11.0%	13.5%	3.5%	15.1%	12.9%	1.3%	8.8%

Source: Budget 2008 from respective countries, World Bank estimation of GDP, and author's calculations

DIRECT TAXES: PROGRESSIVE AND FLAT TAX

In the relation between simplicity of fiscal system and that of economic incitement, the first question to be analyzed is that whether this system is a progressive tax system or a system it is based on the flat tax.

The progressive systems are characterized by the increase of tax rates with the raise of income level. These systems aim to provide a more social level in the revenue distribution because the individuals with higher incomes are charged with a higher fiscal rate.

The systems based on the flat tax are characterized by the same tax rate, in spite of the level incomes. In this way these systems better serve both the simplicity and neutrality of the tax. Above all the flat tax systems are considerate to be more stimulating for the economic growth. In the progressive tax system, the increase of tax percentage with the raise income level in fact penalizes more saving than consumption. Thus, theatrically these taxes influence more negatively on the stimulation of the increase of incomes of subjects or individuals, because the more goods they realize the more taxes they are charged with. Starting with this it is accepted the fact that with the same level of governmental expenses, the progressive tax will have a more negative effect on the economic growth than the flat tax. The idea is: it is important not only the income tax level, but also the structure of their collection. Thus for years in Europe has been recommended, among others, the transition from progressive tax to the flat tax, in order to incite economic growth.

The main criticism toward the flat tax is the fact that this tax compared to the progressive one makes a softer distribution of the tax burden between the groups with higher and lower incomes, favoring in this way relatively the individuals with lower incomes. However, the economic analysis being broken down for years in countries where this tax is in force, indicates that the above mentioned phenomenon is gradually accompanied with the gradual income growth even for the groups of population with lower incomes. This occurs because the application of this tax for some years makes possible that its positive effect on the economic growth increases in general with lower incomes to the ones with higher incomes.

Most of the East European Countries have passed into flat tax in the last 10-15 years. Estonia was the first country in Europe which put into practice the flat tax of 26% both for the personal income and that of corporations. Later that system was followed by two other regional countries like Leetonia and Lithuania. The Russian case was very meaningful, where the flat tax was applied towards the personal income in a low considerable level, 13%. The tax income was doubled within three years considering this reform as one of the most positive one.

The fiscal system of West Balkan Countries in the aspect of progressive or not are presented in table 5:

The discussing on the progressivity of the tax or no to is more related to the personal income tax. In fact it is seen that corporate tax is the same. The differentiation of this tax has to do more with the incentives for separate activity.

Table 5: Direct Tax rate in West Balkan Countries (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Income tax rate	10%	10%	15% - 45%	4%-8%-10%	10%	9%-15%	10%-12%-15%
Corporate tax rate	10%	10%	20%	10%	10%	9%	10%

Source: Fiscal package in respective Countries 2010.

Personal Tax Income

Considering personal income tax, four countries like Albania, Bosnia and Herzegovina, Macedonia, and Monte Negro apply the flat tax. This tax for Albania has been applied since 2007 by replacing progressive tax which went up to 30%. At the same time Macedonia has passed into flat tax since 2007. Monte Negro applies the flat tax 9%, from 12% in 2009. But here it is applied also the surtax on personal incomes which is paid by historical cities, respectively 13% and 15%.

Two other countries, Croatia and Serbia, apply progressive tax. This tax is more characteristic for Croatia by escalating from 15% to 45%. In Serbia the basic rate is 10%, but the self-employed pay 12% and the individuals with incomes higher as six times than the approved average salary, pay 15% of their personal income.

Hence, a general characteristic of West Balkan Countries, with the exemption of Croatia and to some extend of Serbia, is the setting of the systems the flat tax.

The flat tax in West Balkan Countries has almost been the same for all kinds of personal incomes⁵. From its nature, as is emphasize above, the flat tax is considered like a tax which stimulates the saving and investment. But in fact for the Balkans Countries it hasn't been the main aim of implementing this tax. This tax has been used mare because of its simple calculation and administration.

Considering the personal tax income and if we compare the results of the flat tax with those of progressive tax, typical is the case of Croatia. As it is mentioned above this is the only country which used income progressive tax. Table 4 indicates that incomes from this tax are only 0,5%, which is at the same time the lowest percentage in the analyzed countries.

⁵ The mainly exemption are concerning with rent's incomes.

Corporate tax

The corporate tax (profit tax) is one of the most important one among the direct taxes. From this tax are realized about 47,6% of direct tax revenue, or 1,9% GDP for all Balkans Countries. Croatia has the highest rate tax 20%, and the revenue from this tax in comparison with GDP for is higher than other countries 3,1% (table 4). The comparative corporate tax analysis is important to see what stimulating policies use different countries for the inciting of separate economic activities.

Which are some of these policies which have been applied by different Balkans Countries?

- Albania stimulates small business. If the annual income of a company is between 2-8 million AL (about 14-57 thousand Euro), then the company pays so called “simple profit tax”. While if the turnover is less than 2 million AL, then business taxed in the same way as the personal income.
- Bosnia and Herzegovina through the corporate tax aims to incite both imports and exports in the country. Thus, the companies which reach 30% of their turnover from export are excluded from profit tax for that year. At the same time the companies which can invest for 5 years in succession 20 million BAM (nearly 1 million Euro) are excluded from profit tax for 5 years starting from the first investment year, (the investment in this year should be at least 4 million Euro).
- Croatia stimulated investment and employment. This depending on the size of investment and the number of workers, the firms can reduce profit tax from 10% to 0%. At the same time it is stimulated the scientific work for research and development (R&D), in this case the company has the right to reduce from profit tax the twofold of expenses made for R&D.
- Macedonia stimulates investments in the free market areas, “Technological Industrial Development Zone (TIDZs)”. Concerning the profit tax, companies which exercise their activities in these areas, are excluded from profit tax in a period of three years.
- Serbia intends to incite development in less development areas. Thus the new companies are excluded from the profit tax for 10 years of time, if they make an investment of about 6 million Euros and employ not less than 100 people. At the same time companies are also excluded from the tax in the case of investments for exploitation of certain natural resources (for 5 years), as well as investment in no developed areas (in this case they are excluded for 2 years).

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INDIRECT TAXES: VALUE ADDED TAX

Which are some of the main characteristics of fiscal systems of West Balkan Countries considering the aspect of indirect taxes and especially that of value added tax (VAT)? Which tax facilities are applying and what economic policies intend to achieve these systems?

Indirect tax on products and services play the most important role in the budget revenue of West Balkan Countries, they constitute on average 13,4% of GDP (table 4) where the VAT constitutes the greatest part with 10,2%. Table 6 presents standard tax rate of VAT for the West Balkan Countries:

Table 6: Value Added Tax in West Balkan Countries (%)

Value Added Tax	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Standard norm	20%	17%	22%	16%	18%	17%	18%
Preferential norm	NA	NA	10%	NA	5%	7%	8%

Source: Fiscal package in respective Countries 2010.

The value added tax is considered as a consumption tax because it is paid by the final consumer. Its advantage is a good way of administration, a thing which is explained also by the revenue levels being provided by this tax. In the point of stimulated of economics policies, the question related with escalation of the tax, whether that should be in the same level, or differentiated. View on this angle, VAT in the same level is theoretically criticized by considering it as a regressive tax because all the consumers pay the same tax rate. Thus individuals with lower incomes will relatively higher taxes than the individual with higher incomes. On the other side, the VAT with a level means the preserving of neutrality from the tax would not influence in the allocation of resources in supplementary way.

What kind of taxes applies different countries and what kind of exemptions do they predict?

- In Albania the tax rate is 20%. Except for the known cases like for exports, international transport and financial services, the legal exceptions are very limited. Such legal exceptions are for instance the ones that are related to medicines, books, magazines, newspapers; the research and exploitation of hydrocarbons. For some goods there are implemented special schemes of VAT payment, for example for the import of machineries and equipments, farmer's compensation, etc. As it is seen from table 6 tax rate (20%) is one of the heights of the region.
- Bosnia and Herzegovina applies the tax 17%. The exceptions from the tax payment, besides the known cases, are the ones for health services, social security's and sport and educational services. Special payment schemes are applied for the farmer's activities, touristic agencies, works of art, etc.
- Croatia applies standard rate 22%. A reduced rate of 10% is used for touristic services and respective agencies as well as the magazines and periodical newspapers. On the other side for the goods of the first need like bread, milk and a certain part of educative publications and some health services, the tax level is 0%.
- Kosovo applies the tax standard rate 22%. The exceptions from the tax (despite of general cases) are the ones of health goods and those of services in public education.
- Macedonia has the standard rate 18%. While the most preferable rate is 5% and it is applied in a wide range of products where the most important are: food products, various publications, agricultural machineries, pharmaceutical products and health services, machineries and programs that are related with automates processes.
- Monte Negro applies the standard rate 17% and the preferable one of 7%. The preferable rate is applied for food products like bread, milk, oil and sugar as well as the medicines, including the veterinary ones and for the health services.

Serbia applies the standard rates 18% and the preferable one of 8%. The preferable rate is used for goods and services of the first need and some food products like: fruits, vegetables, educational text books, medicines, personal computers, newspapers, etc.

In general, we can say that three countries like Albania, Bosnia and Herzegovina and Kosovo apply a unique rate of VAT. While other countries like Croatia, Macedonia and Serbia use two levels, the standard and the preferable rates. The preferable rates mainly intend to provide lower prices for the necessary goods of the primary needs, to help the strata of population with lower incomes. At the same time all the countries expel from the tax, medicines, periodic press and different publications.

Concerning the VAT, it is important the analysis of limit of registration of the subjects which should be included in the business that is submitted to this tax (table 7). Albania, Kosovo and Serbia have the highest level of VAT registration. Probably this is the reason of the lower percentage of the revenues from this tax in proportion to the GDP of these countries (table 4).

Table 6: Registration for Value Added Tax

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Turnover / Year (EURO)	57,225	NA	11,660	50,000	21,138	18,000	40,000

Source: Fiscal package in respective Countries 2010.

COMPARISON AMONG COUNTRIES: THE SIMPLICITY AND THE EFFICIENCY OF FISCAL SYSTEMS.

Firstly I would like to present shortly the evaluation of west Balkan Regions concerning the weight of taxes in economic activity of these countries. In fact this evaluation is based on the reports of World Bank “Doing business – 2010” for West Balkan Region. In these reports, the indicator which is related to the content of this paper is the one of the percentage of the total tax revenue, concerning profit of the firms⁶ (table 7).

Table 7: Total tax rate (% profit)

		Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Total tax rate (% profit)	2009	50.5	44.1	32.5	28.3	18.4	31.8	34.0
	2010	44.9	27.1	32.5	28.3	16.4	28.9	34.0
Rank	2009	145	155	33	49	28	139	126
	2010	138	128	39	50	26	145	137

Source: “Doing Business 2010” for respective Countries,- World Bank

From the table can underlined some features: First, Albania and Serbia have the highest tax percentages in proportion to the profit, while the lowest one is for Macedonia. Thus, while in Albania, tax payment is about 44% of the profit, in Macedonia this percentage is about 16,4%.

Secondly, some countries like Bosnia and Herzegovina, Albania, Macedonia and Monte Negro have decreased the tax load toward business in 2010, compared to 2009.

Third, many of the countries like Monte Negro, Albania, Serbia and Bosnia and Herzegovina, occupy a low place in the general order of 183 countries, concerning tax payment (according to three criteria taken in the study) –graph 3.

In the analysis of the role of taxes in the economic development of Balkan Countries we can refer to the survey of the enterprises performed by the World Bank in the economies in development (table 8).

Probably the data cannot be used to compare the countries with each other, but nevertheless they indicate that the percentage of firms which think that the tax rate is the main constrain for their business in West Balkan Countries, (except for Bosnia and Herzegovina), is smaller than the percentage of all 121 countries taken together in the study 36%, and it is absolutely lower than that of West and Eastern Central Europe, 40%⁷.

6 The rank is determinate taking in consideration also two other factors: number of tax payments per year and the hours for payment of the tax, spent from firm in the year.

7 In the Enterprise Surveys, West Balkan Countries are included in Eastern Europe & Central Asia Region.

Graph 3

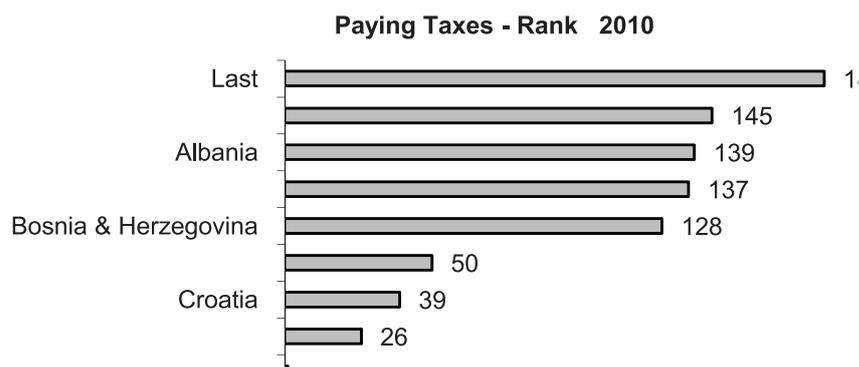


Table 8: Valuation of tax rate as major constraint (%)

	Albania	Bosnia & Herzegovina	Croatia	Kosovo	Macedonia	Montenegro	Serbia	Region	All Countries
% of Firms Identifying Tax Rates as Major Constraint	28.8	37.8	34.4	12.0	26.6	7.6	28.4	40.0	36.4

Source: Enterprise Surveys performed by World Bank and International Finance Corporation (IFC)

Beyond this general conclusion, we can pass to the comparison of fiscal system of the countries. Here we can base on three taxes, which we dealt with, PIT, CIT and VAT.

The level of these taxes according to the different countries is presented in issues 2 and 3 and the above in the table 7, is given the evaluation of fiscal weight towards the respective business. In this point of view, we will try to make an evaluation that how these taxes are related to the simplicity of their application, and on the other side, how efficient they are, which means what interference do they bring in the efficient allocation of economic resources. It should be underline that both these characteristics depend on the nature of the each tax.

Personal income tax (PIT). As criteria of the tax simplicity it would serve, whether the tax would be progressive or flat tax. As it was indicated above, a flat tax is simpler in administration. The criteria of efficiency can be seen in two aspects: first, how would the tax serve to the social aspect and secondly how the tax would support the economic growth. In social aspect, a progressive tax rate would be more positive (point A in table 9). While in aspect of economic growth, the progressive taxes favor more the consumption, and the regressive ones favor more the saving and investments, that is economic growth (point B in table 9).

Corporate income tax (CIT). Here as criteria for the simplicity of administration it would be taken if the tax rate would be the same or not with the tax rate of personal income tax. While as criteria of efficiency would be taken, first, tax level (point A in table 9) and second, how many exceptions are allowed for separate activities (point B in table 9). The tax level, if it is low or high, means how do the tax interferers not in the market mechanism for the efficient allocation of resources. The lower the tax level, exp. under 10%, the more efficient is considerate the tax. On other side, the exception and differentiations in tax application for various activities, although they distort the market mechanism they are instruments for application of certain economic policies. In this point of view, the tax rate differentiations to the corporate can be considered positive.

Value Added Tax (VAT). The simplicity here would be linked with the rate differentiation, so a tax with the same level (rate), would be easier to be administrated.

While the efficiency could be seen in two aspects: first, in the social aspect as tax of same level would favor the consumption of the products of primary needs, would be considered more efficient (point A in table 9). Second, even here the tax level would determine its efficiency. For example a lower level under 18% would normally incite the consumption, so the production, as well (point B in table 9).

Starting from these criteria, even the tax treatment in issue 3 and 4 according to various countries, there has been an evaluation which should be made for the West Balkans Countries concerning the simplicity and efficiency of be signed (+), if the tax meets the above mentioned criteria, and (-) if it does not meet these criteria.

Table 9: Simplicity and Efficiency

	Simplicity			Efficiency					
	Personal Income Tax (PIT)	Corporate Income Tax (CIT)	Value Added Tax (VAT)	Personal Income Tax (PIT)		Personal Income Tax (CIT)		Personal Income Tax (VAT)	
				A	B	A	B	A	B
Albania	+	+	+	-	+	+	-	-	-
Bosnia & Herzegovina	+	+	+	-	+	+	+	-	+
Croatia	-	-	+	+	-	-	+	+	-
Kosovo	-	-	+	+	-	+	+	-	+
Macedonia	+	+	-	-	+	+	+	+	-
Montenegro	+	+	+	-	+	+	+	+	+
Serbia	-	-	-	+	-	+	+	+	-

It is necessary to point out that the evaluation remains subjective, because the fulfillment of a certain criteria might be in different levels and can't be separated with (-) or (+). In this aspect the evaluation can be made only for one kind of tax and for a certain criteria and it would be meaningless to be made for all taxes criteria taken together.

CONCLUSIONS

20 years after democratically changes, the fiscal system in West Balkan Countries is stabilized and based on three main taxes: personal income tax, corporate tax and value added tax. Tax revenue provides about 93.4% of budget revenue, or 17.1% of GDP.

The main tax revenues are collected from indirect tax, and particularly from VAT. For all countries in West Balkans, indirect taxes provide about 69.0% of total tax revenue, where VAT takes about 75.0%, or 10.2% of GDP. Direct tax revenue provides only 2.0% of GDP, which means difficulties of administration of these kinds of taxes.

Most of the countries: Albania, Bosnia & Herzegovina, Macedonia, and Monte Negro, used a flat rate of personal income. That system offer more simplicity and neutrality of the tax. Above all, the flat tax systems are considered more stimulating of saving and economic growth. The flat tax of these countries is 10%, except Monte Negro with 9%.

Regarding corporate tax, except Croatia (20%), all the other countries applying a low standard rate 10%, (Monte Negro even 9%), which is the same as a flat rate of personal income. In this concern, the fiscal system in these countries becomes more transparent and simple to administrate. Whatever, the revenue from this tax is in the low level and take average only 1.9% of GDP, (Croatia 3.1%).

Different countries applying a different incentives regarding corporate tax. Most of them intend to stimulate new investment, employment and exports. It is also to underline that, as more as corporate tax provide exemptions and incentives, as more the system becomes a instrument to support different economic policy, but in the mean time the system loss its neutrality and simplicity.

Value Added Tax is a main tax, concerning tax revenue. As a consumption tax, VAT has a significant impact in social aspect in the taxation in general. In this point of view, most of the countries, as Croatia, Macedonia, Monte Negro and Serbia, applying different VAT tax rates, which take in consideration particularly needs for foods, health and education. On the other point, VAT with a single rate, as for example Albania preserves the neutrality of the tax, means it would not be influenced in the allocation of economic resources.

The impact of VAT in tax system in general, depends not only from the level of tax rate, but also from the limit of business registration in the VAT system. As example, Albania has the high VAT tax rate (20%, without a preferential rate), but the limit for registration in VAT system is also too high (about 57.225 Euro), therefore for this country the percentage of VAT to GDP is one of the lowest of the region (8.6%). On the other side, Monte Negro has a low rate of VAT (standard 17%), but limit of registration is also low (about 18.000 Euro); in this country VAT revenue takes about 14.3% of GDP.

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THE FACTORS THAT IMPACT THE SYSTEM OF SOCIAL SECURITY AND THE EFFECTS THEY HAVE IN THE ECONOMIC FUNCTIONS OF THE SOCIAL SECURITY SCHEME IN ALBANIA

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ABSTRACT

The study will focus on the demographic, economic, political and external factors. The analysis of these factors aims to demonstrate not only their impact on the functions of the system of social security, but also the potentials for the improvement of the system and the lives of the system beneficiaries.

The study will analyze in details the Demographic Factor, considering all its main elements such as the rate of births, the rate of deaths, emigration and migration and their impact on the social security system.

The demographic factor in this study will be viewed and analyzed based on the experience of our country, demonstrating in details the negative effects that the above-mentioned events have had on the social security scheme, generating obstacles and preventing the increase of the benefits for the system beneficiaries.

Furthermore the study will concentrate on the economic factor, as a main and very important element of the social security scheme. The analysis of this factor is mainly based on the economic development of our country, on number of jobs available, both important elements with direct impact on the scheme of social security.

The political factor will also be a part of this study, where the domestic politics will be analyzed and viewed in relations to social policies, pursued by the security scheme, and the impact they have had in the lives of beneficiaries.

Through analyzing the external factor, the study aims to find the impact that other countries or international bodies' policies and experiences have had in the social security scheme related to the further improvement of the system.

Key words

Social security scheme, Contribut, Economic factor, Demographic factor, Emigration, Immigration

FACTORS INFLUENCING THE SOCIAL SECURITY SYSTEM

The development of society, its individuals civilization, the relation between young and old, the ratio of births and deaths, the ratio between women and men, the change of the economic balances, the direct influence on every social and governmental body, playing an important role in the formation and development of social institutions.

The efforts to implement the social justice would be perfect, if there would not be impediments of:

- *Demographic character ;*
- *Economic character;*
- *Politic character.*

These impediments are considered very important for the social security system because they follow the demolition of the balances that compose it such as social insurance schemes, health insurance schemes, economic assistance scheme.

The demolition of the balances, plays an important role in some key moments of the functioning of social insurances and health insurance schemes, where we can mention: the process of collection of contributions, income distribution (payment) towards the beneficiaries of the scheme, moment of calculation of the costs based on the detailed analysis of the financial balances of the abovementioned schemes of insurance and its branches, the same also applies to those schemes which are funded by the state such as the assistance scheme. The deterioration of the economic balances reduces significantly the amount of income that are planned in the budget for social assistance (economic aid)

Let us analyze all these factors and their impact on the social system.

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DEMOGRAPHIC FACTOR

The demographic processes have a significant impact not only on the current situation of the social security system but also in his perspective. In many countries the demographic situation where they are is considered one of the most important problems faced by their systems of social security.

The instability of the demographic movements that have occurred in our country have brought difficulties to the functioning of the social security system in these directions:

- *Prediction and design of the finances of the social security systems for the future;*
- *Design of the fund towards the benefits and expenditures;*
- *Long term prediction of the social policies for the scheme.*

In order to avoid the above problems arising due to the demographic changes, the contributory systems composing the social security, must try not only the implementation but also the exceeding of the general fund.

But to achieve the realization or excess of the Social Insurances fund, it is necessary to consider three important phenomena:

- Aging of the population;
- Migratory movements within the country;
- Immigration movements.

Aging of the population (senility)

The senility is a natural phenomenon but many states approach this phenomenon as the result of the reduction of the number of births, non procreation, by reducing the average life expectancy or increase the period in which pensions are paid.

With the approach of senility, the individual begins gradually to lose the ability to work, which characterized him before. Elderly individuals cannot have the necessary stability and the ability of adapting with the technique, which is developing rapidly. The phenomenon of development prevents many of them to continue working when they have the age to retire or to be employed when they have the possibility, after retiring¹. The aging of the population is a problem throughout Europe. As a consequence of this phenomenon the countries are obliged to review periodically the age structure of population according groups of ages in order to reevaluate of the social insurance systems.

The present composition of the population ages is conditioned by the level and the trend of actual births and those planned in the future and from the number of deaths in the past.

If the number of the old population compared to the total active population grows, consequently it will increase the cost of social insurance in the social insurance schemes for the pension payments and other services necessary for their benefit². Also a cost increase would occur in the health insurance scheme, this because in most cases the elderly necessitate more health care than young people, and this will aggravate social insurance with extra costs. We should not forget to mention the assistance to take care of everyday activities. We have emphasized that the social security tents to establish opportunities of integration for all individuals affected by the social risk, therefore we must emphasize that: the need to clean the house, cooking, washing, are important elements as well as monetary incomes. If these options are not offered to an elder person, then we can say that we have not conducted properly the social tutelage. These services result in the identification of a new scheme of social insurance which cannot be ignored without being considered as a scheme with high levels of expenditure.

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We can say that an old population is considered an extra expense in the fund of social insurance.

In Albania, only 8.3% of the population is over 65-years old, almost one third of the total. This number ranks our country in the countries with a relatively young population compared to other European countries, like Bulgaria, Lithuania and Croatia which have approximately 17% of their population over the age of 65³. Not only in the countries with a well developed system of insurance, but even in those states with a fragile system, the good knowledge of the factors that lead to the aging of the population, assist in the prediction of the approximate costs of the social insurance system.

Besides the costs forecast, the recognition of these factors will help us to anticipate the implementation of the financial policies, social policies. and, above all, the prediction of long-term and short-term benefits.

Migratory movements

The migratory movements are another very important element affecting the social insurance scheme. Considering the large number of migratory movements that are carried out in Albania and the velocity and the scale of these movements, often chaotic and not officially recorded, from rural areas towards urban areas, arises as a primary obligation an accurately and correctly process of this demographic process

1 According to the Labour Code, it is allowed the employment of elder persons. The law about Social insurances also allows a pensioners to be employed by giving up from the pension.

2 When we talk about other necessary services we mean Expenditures for a trustee, expenditures for care by means of the respective bodies etc

3 Rapport of N.37594-A1 of the World Bank, page n 2

The organization of this demographic process is very sharp duty of the government. The government has not only the duty to highlight these movements, but these movements should be controlled, and when it is necessary well studied policies should be organized and developed, in order to eliminate negative phenomena deriving from these non – controlled movements in the life and the family economy, but also in the functioning of the social insurance scheme constituting a basic and indispensable element for the realization of long-term strategies that will involve all the social insurances system.

The demographic process is followed by a high degree of complexity. This high degree of complexity pertains to the ongoing efforts to avoid the current negative phenomena, but even those which can be followed in future in all the constituent elements of the social system.

In an attempt to simplify as much as rural contributors in our country are been designed social policies through which the government tries to soften the difference of payment between the contributors of the rural and urban areas.

The schemes of social and health insurances systems are built to function as a separate sector for the urban and rural sectors. Referring to this division mainly evident in the social insurances system, we can easily observe the disparity of the level of contributions as well as in the level of benefits. The number of the subjects who benefit a full pension of aging, was relatively small compared to the number of those who chose to benefit a partial pension. This was also the reason that many contributors, became the target of the branch of partial pensions, increasing not only the costs in this branch but also creating a relationship between the interchanges in the amount of pensions that are earned in rural areas and amount of pensions that are earned in areas urban. The number of contributors in rural areas has been identified that is greater than those in urban areas. **See table⁴.**

340 This disparity which is evidenced in the scheme in terms of expenses on pensions reflected in the following table comes due to the functioning of the social insurance system in the past.

The rural beneficiaries were not beneficiaries or covered by social security schemes up to 1972. To obtain full pension are required 35 years of contributions, so that the application of new law on social insurance, the rural subjects, who had achieved the age but who do not fulfill the limit of years of insurance, arise the right to benefit only partial pension. That is why the costs for pensions or for all other types of payments that are provided by the social insurances system are smaller in rural areas than in the urban ones. As a result of the favorable policies in terms of increasing the benefits for beneficiaries in rural areas today are not full pensions under \$ 100.

Therefore, to avoid the negative phenomena of the Social insurances system mentioned above, and to clearly identify the relationship between rural and urban population, or even the relationship between women and men there arises a necessity for a census. In our country there is realized a population census for a long time.

⁴ This table is taken from the Institute of social insurance, the directory of statistics

Indices	Urban	Rural	Total
Number of contributors	320,000	340,000	660,000
Number of benefiter	367,900	187,300	555,300
Expenses in million leke:	30,900	5,800	36,800
Age Pension	26,100	5,300	31,400
Inability	2,300	100	2,400
Widow persons	1,900	200	2,100
Orphans	700	200	900

The demographic process is a basic and indispensable element to achieve long-term strategy of social insurance.

The migratory movements of the population bring to the Social Security system negative consequences in terms of:

- Decrement of the number of contributors;
- Increment of costs,

Let's see actually the influence of those negative consequences.

✓ ***Decrement of the number of contributors***

The failure to pay the compulsory contributions consists in a powerful challenge for the social insurances system in many countries in Europe and mainly in the eastern and southern part of the continent. The decrement of the number of contributors is a phenomenon which may occur for a short term, but it may exist even for a long term. When we talk about a controlled migration which is based on finding a safe job and a secure housing then the scheme would be more easy to be predicted, because of the fact that one or more contributors in rural areas can often be in minimum insurance scheme, after the migration to the urban areas could turn / return to a compulsory contributor under the average wage. This will mean additional contributions for the scheme. While in the case in which a / some rural contributors do not find work in urban areas where they have migrated, then the contributions for the scheme will be reduced, but we have also the case in which due to lack of jobs the cost for payments are added to the scheme. This regards the fact that in cases of not finding a work, the subject is forced to go into partial pension scheme, thus exacerbating the pension scheme. But not only this, the scheme of assistance can be significantly affected by migration because due to unemployment the individuals can be directed to this scheme to assure their living.

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Referring to all the abovementioned, we can highlight the consequences of non controlled migration in the social insurance scheme linked to the lack of jobs, but also the non registered work. Often the migration conditions the finding of an employment. This for several reasons, which relate to:

- *Professional level;*
- *level of the economic development of the area in which is been migrated.*

Considering the fact that the migration in most cases is realized for all the family, so with all family members, the possibility to be employed becomes even more difficult.

So we can summarize that from the spontaneous and not studied migration as well as from the lack of jobs derive negative consequences on individual lives but also in social insurances schemes.

✓ ***Informal market of work (undeclared work)***

The phenomenon of informal labor market (undeclared work) is very popular nowadays not only in Albania but also in other developed countries.

As regards Albania, the informal market occurs for two reasons: the economic reason as consequence of the low salaries that do not respond to the high standard of living but also due to the mentality that the employees have inherited from the period of socialism. In this period of social insurances payments were not held by salary, it was planned in the 5-year plans of the government. After the emission of the new law on social insurances which worked on the basic principle pay-as-you go, keeping the rate of contribution was not understood as a good by itself, but as an injustice by the government. This mentality and the poverty have stimulated for a long time the informal labor market. As a consequence of the existence of informal market, the negative consequences will be drawn towards the existence of the social insurance system, and in terms of individuals who

avoid them⁵. This because all those individuals who avoid the payment of the contributions will be uncertain about their future when hit by social events⁶.

Increment of costs

When an individual immigrates from a rural area to an urban one, not always he is fortunate to be employed. In the terms of the economic development of our country getting a job is not very easy. It may occur that an individual, lose his jobs due to bankruptcy of the economic activity. This moment directs it to the branch of the benefit from the unemployment (assistance). The branch of the unemployment benefits (assistance) is considered a deficitary branch. The costs of this branch are higher than the level of contribution paid. This because of the fact that in this branch the employer only contributes with a lower percentage of contribution. For this reason, this branch is funded by the governmental budget. An increase of expenditures is recorded in the branch of assistance (economic assistance). Although this scheme is not related to the contributory fund of social insurances, it is directly related to the governmental budget.

Also, it may occur that due to unemployment, the individual is directed for benefits to the branch of pension⁷, increasing in advance the costs for this branch. So for the abovementioned, we can say: The more organized migration of citizens is the more easily will be for the sheme to manage the contributions and to control the expenditures.

In order to see more precisely the role of the migratory movement, we need to have accurate data about the number of population, the percentage of urban and rural population, the percentage of educated population and that with lack of education. These data are obtained through the census. Also, through a census, we can identify problems such as:

- *The rapport between the urban and rural population*
- *The rapport between the sources of new employment positions and the unemployed persons*

Rapport between urban and rural population

It is known that prior to the 90's in our country, the greatest number of people, was occupied by the population that lived in the villages. After the development of the economy, of the society, the increasing of the demand for a better life for themselves and their family members, the migration movements increased significantly. The migration movements were larger in the rural-urban direction, from rural areas to the urban ones, from the city to the capital.

As a result of these movements, it began a congestion of the cities in developing. The overcrowding of cities was accompanied by disturbances in social insurances schemes. This disorder brought negative consequences in the column contributions also in the expenses column.

Rapport between the sources of the new employment positions and the unemployed persons

A developed economy and a powerful government create opportunities to achieve the employment of the citizens. A regular employment of the citizens is followed by the regular payment of the contributions in favor of the system of social and health insurances strengthening it.

⁵ By hiding the employment the individuals do not pay contributes to the insurances scheme. While the consequence in the expenses scheme remains the same. The individuals that have an undeclared work benefit from the column of the assistance, thus we can say that, the undeclared employment is a very dangerous phenomenon in the insurances scheme.

⁶ In the social events will be included: illness, aging, unemployment

⁷ The branch of pensions that is more deteriorated is the one of the partial pension and of the reduced one.

In the current conditions of our country, the people seeking work, occupy a large number compared to the free work positions. The number of unemployed is significantly increased as result of several phenomena:

- *Privatization of the economy process;*
- *Decrease of the activities of the little business;*
- *Bankruptcy of the little business activities;*
- *Increment of the population;*
- *Migratory movements.*

Starting from the above phenomena, the governmental bodies, such as the Ministry of Labour and Social Affairs, the Institute of Social Insurances, have the duty to elaborate long-term strategies for the economic growth, the employment, by harmonizing them with the demographic developments and the projects for the poverty reduction.

Immigration movements

The immigration is an important element in the demographic movements as well as the migration, directly affecting the social insurances system. Referring to the experiences of various countries in Eastern Europe, it is noted that the immigration is not always controlled. In the study of this element we will refer exactly to the non controlled immigration and its consequences on the social insurances system.

The social insurances schemes, which have high sensitivity of the illegal immigration, are those of social insurances and health insurances, in the column of the contributions and in the column expenditures. This means that as a result of the illegal immigration, to both these schemes are created fluctuations in the system of contributions which effects are felt directly in the budget, in the level and continuity of benefits.

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The wide phenomenon of illegal immigration included the categories of pensioners, disabled, unemployed persons, as well as the employees. The immigration of the above categories negatively and positively impacted on the social insurances scheme. More specifically:

Immigration of pensioners and disabled. In the immigrations are included the pensioners and the disabled who have been beneficiaries of social security schemes. Apparently we understand that this kind of immigration, the social insurance schemes regarding the payment, or the health insurance schemes in relation to the free services and medicines, have a decrease of expenses. This refers to the fact that a regular immigrant is legally registered in the country where he emigrates and from here derive all the benefits for his needs. These categories will receive social assistance and health care services, from the social insurances schemes of the country where they have immigrated, giving up the social benefits of the scheme in their country. The exception to this case is the pension scheme when the pensioner immigrates for the union of the family and not for employment. In case in which the immigration has as object the union of the family the immigrant - pensioner continues to be entitled to a pension benefit, either personally or by delegation to other persons. And when the immigration is for employment, then this right is interrupted⁸. Also, the benefits for pension or for disability will be interrupted in the case of changing nationality. The case of disability differs from that of the pension. The disability is confirmed by the Forensic Medical Commission and therefore the immigrated individual must have all the medical records in his residence and should appear personally before the commission. Where the address has changed as result of immigration, he will receive social assistance and health care services in the country where he lives, based on medical test, not in the contributory one. Based on the principle of exportation of contributions, the benefits

⁸ This fact is very difficult to be evidenced because it lacks the accordation of information's between the institutions

for the pension and for the disability will be awarded in cases where there is a bilateral relationship between the governments for the payments from the contributory scheme, and therefore a aging pension and a disability pension.

What we explained above occurs when we have legal emigration, where an individual declares that he immigrated and as result of the immigration is awarded to quit the benefit.

But we should not exclude the illegal immigration, which is evidently more common nowadays. As a result of this emigration the individuals hide their current situation by taking advantage from the social schemes, although they do not live in their country.

Migration of unemployed people, has a “positive” role for the government budget and for the social insurances scheme. Specifically:

Regarding the government budget, the emigration of unemployed decrease the government expenses for the percentage of contribution in favor of the unemployed, for the the unemployment payment, and also reduces the costs realized for social assistance (economic aid).

The immigration of employees or of the contributors ruins the balance of the contributions scheme, regarding the payments provided by the social insurances schemes (pension payments, family payments, maternity payments, etc.). So, we conclude that the frequent and uncontrolled immigration movement causes negative consequences to the scheme, which is reflected in benefit of the payments offered by the schemes in favor of subjects.

As such we can mention;

- *The risk to non effectuate in time the payments in favor of the benefiter;*
- *The risk of the financial destabilization of the system⁹;*
- *The risk to impede the application of policies in the direction of the improvement of this system;*

During the ‘90s-’93s and during 1997, our country was involved in a “boom” of citizens emigrated abroad. The non registered iniquity of the inflow and outflow of individuals after 1994, reflected significant problems in the social insurance scheme, among which we can mention;

- *Impede the normal functioning of the social insurances scheme, in the column of the contributions and the payments columns;*
- *Impede the realization, distribution and calculus of the pensions (senility, disability, complete and partial).*
- *Impede the procedure of the collection of the contributions percentage.*

The contributions scheme knows the years ‘90-’93 and the year 1997-1998 as dark periods. This, because the payment of the contributions in those periods was very low, so low that:

- *Risked the benefit of payments from the Social Insurances scheme;*
- *Was used the Reserve fund;*
- *It became necessary the continuous financing from the government budget¹⁰.*

In order to minimize the negative effects of immigration in the new law on Social insurance was foreseen a new column of insurance coverage: the voluntary column¹¹.

9 As consequence of the no controlled emigration movements the system is disclosed to the risk of fund decrement.

10 A financing which went on up to 2000. From this year on the government budget subventions only.

11 In nowadays this column is very developed by increasing the number of the subject insured.

The voluntary column was appreciated as a practical solution in order to realize the collection of the contributions percentage for:

- The Emigrants;
- All those subjects who do not desire to be continuously insured;
- All those subjects who desire to make the contribution payments for the antecedent years.

At the beginning of its establishment, this column was not very developed, because of the fact that many subjects did not understand its significance. Keen after work and creation of a better life in a foreign country they were indifferent to this scheme, but gradually, many emigrants attended this system. A significant increase of the voluntary contributions was observed in the scheme after the Stabilization and Association Agreement. That's because of the facilities that this agreement provided for the payment of two pensions and the transfer of contributions.

ECONOMIC FACTOR¹²

A major impact on the rise, development and modernization of the Social Insurances system has the economy. As we said earlier, referring to economic relations in production, the period of socialism, the concept of social insurances in the contributory schemes, was unknown¹³. This concept began to rise gradually, at any stage of economic development until today. When we say that the economy has an important role in the development of the social insurances system, we can say that, in countries with a developed economy, the social insurances systems are financially more powerful, the domain of coverage of insurance is wider, the measure of the benefit is greater, and the inclusion of new events as social risk occurs earlier than in non-developed countries.

The opposite occurs in countries where the economic development is low. The bad economic situation is considered as the main threat to social insurances systems, especially for contributory systems. In many countries the economic situation is interpreted as negative cause in the GDP, in other national reports it is referred to the bad situation in the international market. It is important to note that: "The development of the expenses of social insurances should be in peace with the economic development.

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In many countries *the inflation* is considered another element of fear for the social insurances system. Also the introduction of the market mechanisms in the former commanding economy is seen as another threat to the social insurances systems in one state, while the inclusion of market-oriented reforms is considered risk in some other countries. The economic problem is a crucial factor for the existence of social insurances system. As such, each government makes its continued efforts and take various measures dealing with economic problems. Below we will treat these measures together with the reasons why they are implemented.

The administrative and managing purpose of the social insurance is an element to which we should pay attention in terms of economic situation of the social insurances system. The fight against fraud, abuse and the efforts to improve the control procedures are very important elements for the social insurances system. In those countries which realize an economic transition oriented towards a market economy, the administrative structure of the social insurances has been subject to changes. The need to make financially responsible administrative bodies has been felt in many countries. About this, in the future it should be considered an important orientation, giving more powers to the regional authorities, especially to the local ones. In some countries, the governments have addressed the idea of more powers between the administrative bodies of social insurances.

¹²The concept of this factor is been taken from the "Right of Social Insurances", Igor Tomesh. In the details of this part it is analyzed the economical issues of Albania scheme and society.

¹³ During this period the government predicated the principle of a government without levies and taxes. This mentality still exists. A lot of individuals, because of the nostalgia for that system are not awarded for the necessity of the contribution payment

Another measure aiming to strengthen the social insurances system is the *transfer of economic freedoms*. This measure is very evident in the economic area of Europe.

In this area there are efforts to strengthen the social insurances system in the bases of the fundamental principles of EU law as: *the equal and fair competition for benefits*, the *free movement of goods and services*. Regarding the implementation of these principles there is a growing interest of the European Community Commission and in the Council of Europe for the implementation of justice in the implementation of these economic freedoms in the area of national social insurances schemes.

The computerization of the social insurances system, is also considered an important measure for the management of social insurances system. The computerization and digitization are considered as tools anti-fraud that as we have already mentioned deteriorates the social security system with expenses and without rights, thus weakening the economy of various social schemes.

The expansion of the role of social partners, trade unions and employers' organizations. The role of abovementioned partners in the administration of social insurances is very important. These partners are related in national local level in order to show their common purpose about cooperation on social protection and employment¹⁴.

The indexing mechanism is adopted to make the recalculation of the benefits, to counteract the effects of inflation indexing

Although Albania is considered a country with economic growth in various sectors, on the social insurances has a lot to do compared to other European countries.

.....346 The insurance system for the number of services, as well as regarding the remuneration is poor. A major impact on the weakening of the social insurance system has played the 1997 crisis. In this period, up to 2000 the insurance system was financed by the state. The percentages of contributions could not cover the costs of the scheme. Nowadays the insurance scheme is functioning very well; it has a growing number of contributors but also an increase in the incomes in terms of beneficiaries. The government policies towards the reduction of the contributions for certain categories and increasing the benefits, have increased the vulnerability of individuals to this system. So, it should be noted that the government's role for the economic initiatives is very important, in order to perform system development and scheme Social Security in accordance with socio-economic level, that characterizes the country as well as through numerous studies state makes continued efforts to:

- The application of long-term strategies;
- The projects of the economic development;
- The studies for the decrease of unemployment;
- The study of exploitation of the economic resources.

So we can say that the economic factor has a direct and very large influence in the development of the processes in the domain of social insurances. This factor is one of the elements by means of which limits of opportunities are set for further development and perfection of the Social Insurances system.

¹⁴ A good example of the activity of those partners is Denmark.

POLICIES FACTOR¹⁵

Any party that comes to power elaborates a social program for the implementation of the favoring social policies and in particular, about how the aid will come in the development of the Social Insurances system, integral schemes and profit entities.

Often, on the eve of election campaigns, there is a small movement of the pension measure, but although small, it is a reflection of the impact of the politics on the scheme. By the side of the citizens there is always a mechanical choice. They tend to support that politic party, which promises a more developed social policy which protects the interests of a wide band of subjects, workers or pensioners. But what it should be emphasized about the influence of politics in terms of the social insurance scheme is the fact that all mitigation policies towards the individuals should be studied and long termed. These policies should not be undertaken for competition purposes. If such a thing would happen, then those who will be hurt are the individuals. Political parties are not the only determining factor affecting the development of social insurances system. An important role is played by the policies and the cooperation among professional organizations and labor organizations, for the discussion of the problems related to social care and primary financial sources. We cannot overlook to mention the role played by the representatives of the professional groups (trade unions) where the main purpose of these clusters is the identification and reduction of problems with economic and social character, which affect our society. Considering as important their participation in this system, they take initiatives and make proposals, through which they tend to affect directly the improving of the functioning of this system¹⁶.

At the conclusion we can say that the operation and development of the social insurance scheme is closely related to the above factors. The normal breakdown of them has negative consequences for the scheme and its beneficiaries.

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CONCLUSIONS AND ITRODUCTION

The social insurances system can not only be a purely theoretical system. The government must not forget that considering the demographic, economic and political factors is a very important element of this system. The volatility of these factors directly affects the financial equilibrium of the scheme, at the time of the collection of the contributions, of the income distribution, and at the time of calculating the costs of the scheme. But it also prevents fluctuations: Increasing the minimum wage; Increasing the minimum pension; Reducing the percentage of contribution

The government must be constantly under pressure to collect a better social insurance fund. A good administration means continuity in payments, increases benefits, decreases the percentage of contribution.

Considering the demographic factors, mainly in the immigration and migratory movements will help to prevent negative phenomena that may derive for the economy of social insurances system, namely the reduction of the contributors and instability of the budget between income and expense fund for payment.

The economic factor, it remains one of the most important and most delicate of the social insurances system. For the countries with a fragile economy, the presence of inflation, the development of

¹⁵ The definition of the politics factor is made in accordance with the definition of Igor Tomesh in the book "Right of Social Insurances". In the details of this part it is analyzed the economical issues of Albania scheme and society.

¹⁶ Among the most important initiatives we can mention; The right of disables to be excluded from the taxes. The right of the disables to have a lower fuel price.

the expenses of social insurances should make peace with economic development. The good administration and management of this system in terms of the economic situation remains an important element of the fight against fraud, abuse and efforts to improve control procedures. In those countries which realized an economic transition oriented towards a market economy, the administrative structure of social insurance has been subject to the continuous change. The computerization of the social insurances system, expanding the role of social partners, and employers' organizations, the mechanism of indexing, against the effects of inflation are considered important elements for the economy of the social insurance scheme.

The social policies are a very important element of the social insurance system. About the influence of politics to the social insurance scheme we should emphasize the fact that all mitigation policies in terms of individuals should be studied and long termed. These policies should not be undertaken for competition purposes. If such a thing would happen then those who will be hurt are the individuals.

Besides the social programs that are developed by the political forces an important role is played by the policies and the cooperation among professional organizations and labor organizations, for the discussion of the problems related to social care and primary financial sources. We cannot overlook to mention the role played by the representatives of the professional groups (trade unions) where the main purpose of these clusters is the identification and reduction of problems with economic and social character, which affect our society. Considering as important their participation in this system, they take initiatives and make proposals, through which they tend to affect directly the improving of the functioning of this system.

At the conclusion we can say that the operation and development of the social insurance scheme is closely related to the above factors. The normal breakdown of them has negative consequences for the scheme and its beneficiaries.

STRATEGIC HUMAN RESOURCES MANAGEMENT AND THE RELATIONSHIP WITH HUMAN RESOURCES TECHNOLOGY

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ABSTRACT

Organisation management strategies must consider the human resource too, so that can harmonize the orientation and the practices in these resources with actual conditions in which organization operate. The organisation human resources and their successful management are the key of the success of a business organization. There is a close relationship between organization management and strategic human resources management and, the other side, between strategic human resources management and human resources technology. Different studies have determined different strategies of human resources management, indicating the relationship between them and organization management.

The main aim of this paper is to demonstrate through an analysis and the study of concrete cases, just this relationship: organization management -strategic human resources management. In the crisis condition, this relationship becomes more evident and its function is essential. A very interesting part of the paper is research of the existence of this connection from a questionnaire realized in Gjirokastra. The analysis of this questionnaire indicates once more how important is the existence of this relationship: the organisation operates perfectly, in case its management and the strategic human resources management are coordinated in the right's way.

Key words

human resources, management strategy, organization, Gjirokastra

INTRODUCTION

Companies are dealing with a range of very complex issues today, as globalization, shifting demographics, economic instability and ongoing competitive pressures create a set of changes, challenges and opportunities. Human Resource Management is finding itself at the forefront of many of these challenges, with the mission to enhance change and improve effectiveness and organizational performance. Human asset is now ranked as the most important asset of a company; it is considered to be a chance for profit and success rather than as a cost to be avoided. The company, by its policies, must link plans and actions to its workforce. Based on the understanding of Organizational Behavior, Human Resource Management attempts to handle variations across culture, develop successful leaders, engender commitment, facilitate communication, reinforce team working and implement change. Through its functions (performance management, staffing, developing and evaluating employees and managers), Human Resource Management seeks to provide the company with the most skilled and effective workforce. Specifically Human Resource Development will probably give a competitive advantage, since it is about creating new competences, managing careers and enhancing creativity and innovation.

Strategic human resource management is designed to help companies best meet the needs of their employees while promoting company goals. Human resource management deals with any aspects of a business that affects employees, such as hiring and firing, pay, benefits, training, and administration. Human resources may also provide work incentives, safety procedure information, and sick or vacation days. Strategic human resource management is the proactive management of people. It requires thinking ahead, and planning ways for a company to better meet the needs of its employees, and for the employees to better meet the needs of the company. This can affect the way things are done at a business site, improving everything from hiring practices and employee training programs to assessment techniques and discipline. Strategic human resource management is a complex process which is constantly evolving and being studied and discussed by academics and commentators. Its definition and relationships with other aspects of business planning and strategy is not absolute and opinion varies between writers. Strategic HRM can be regarded as a general approach to the strategic management of human resources in accordance with the intentions of the organization on the future direction it wants to take. It is concerned with longer-term people issues and macro-concerns about structure, quality, culture, values, commitment and matching resources to future need. It has been defined as: all those activities affecting the behavior of individuals in their efforts to formulate and implement the strategic needs of business.

In the recent years, in Albania like in other countries, the enterprises have been concentrated on the development issues and organization of human workforce. The respective sectors are provided with qualified personnel, while their directors participate actively in defining the strategies of the enterprise. The Management of Human Resources represents a branch of a rapid development within the science of management, in Albania and other countries, as well. It is defined as the unity of all those functions of policies, practices and systems, which aim at an effective management of the enterprise personnel.

METHODOLOGY AND DATA

The methodology used in this article is descriptive and analyzing. My intention is to study the role and influence of the strategic management of human resources in the supervision and successful administration of the organization and also to indicate the close relationship existing between them and between strategic human resources management and human resources technology. This is realized through description and elaborate analysis concentrated on the process of the strategic

management of human resources, its positive sides and its influence on the main aspects of an organization operation.

The data has been obtained by various research carried out mainly by foreign scholars, who have investigated this problem. This material has been completed by a questionnaire, which was distributed in some enterprises in the district of Gjirokastra. Some of the main questions that compiled the questionnaire are as follows: What do you know about the strategic management of human resources? What role does it play in the activity of an organization? Is this management a necessity or a waste of time and value? Do you think that strategic management will increase the efficiency of an organization? There are also further questions relating the topic under study.

MANAGEMENT OF AN ORGANIZATION AND HRMS

Although, traditionally the personnel of an enterprise is considered as an inevitable expense, especially by the economic sciences, and not a source of capital gains for the enterprise, researches and practices have demonstrated that an organization generates high performance and results in case it provides the appropriate care and administrates its functions effectively.

The conception of management of human resources assumes that the employees represent: “the resources” of the employer and the enterprise. As a “resource” the human capital in proportion with the economic capital, characterizes the personnel of an enterprise and its features like (e.g. education, experience, intelligence, knowledge about the target of his work and the devotion to work), which can enhance the economic value of the enterprise.

This presupposes that the employees of an enterprise are not “consuming” elements of a system, but they compose a creative source, preservation and survival of an organization. Management of human resources has recently had a big growth, which is being manifested on the academic and business level, too. This is a conclusion drawn by the recurrent researches made in Greece by the European network CRANET and also there are similar investigations realized by big advisory companies in Europe and the world.

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The results of these researches can be summarized as follows:

- The Board of human resources has reached high standards of development for the majority of the enterprises, and specialized employees work in the respective sectors, mainly in large and multinational enterprises. Anyway, most of the small, medium enterprises and the public sector do not demonstrate the same tendency.
- The role of the advisory enterprises has been reinforced, particularly about problems concerning absorption, selection and the personnel qualification.
- Recently, there has been a considerable increase in the role and participation of the staff of human resources board with regard to the assignment of the strategy for the enterprise where they are employed.

Anyhow, there are still a lot of shortcomings in the harmonization and interrelationship of the enterprise strategy with the strategy of human resources. This perhaps constitutes the greatest challenge for the contemporary management of human resources:” its transformation” and development into the management strategy of the human capital, having a protagonist role in the formulation and development of the enterprise strategy through the development of its workforce. In order to have a successful realization, it is crucial for the enterprise or organization administrations to embrace the principles of human resources direction, concerning the style as well as the leading policies that they apply.

At present times, time after time the employer and academics of the enterprise emphasize the necessity of the relation of personnel direction with the procedure of achieving strategic decisions. Much importance is given to the role of human factor during the enterprise efforts to achieve the objectives and long-term aimed targets. Human Resource Management should bear a long-term vision: to cope with vital issues of shaping the appropriate business culture, the development and improvement of organizational necessary skills and technological competencies of every employee, particularly of the enterprise including also all the other employers. Thus it is an activity of preventive nature contrary to the old viewpoint of personnel leading, which essentially constituted an activity of specifying character: concentration on a short-term planning and mostly control even for the issues of functional leading, which seems to be out of question for the strategic management of the enterprises.

Instead of considering the workforce planning, as a simple procedure, it considers it as one of the most important procedures of development, improvement, the skills of important resource of the enterprise; the human capital.

Nowadays, enterprises operate within a very competitive and complex outer climate Adoption of the strategic management systems and the rating of the output by the enterprise, may apparently influence the improvement of their skills to compete successfully on a national and global scale, naturally if they are appropriately developed and used (Sink & Tuttle, 1989) .

Neither subsystem is as important as the strategic planning (or “programming” according to H. Mintzberg, 1994: pp. 333), during the process of continuous improvement of the enterprise results. Most of the strategic programs do not lead to practical application of the strategies, and consequently, a gap is created between the goals of high level leadership, formulated within the strategic plans and the results achieved through the application of the concrete strategy. (Sink & Tuttle, 1989: pp.28).

On the other side, the assessment of the total output should be directly related to the system of strategic management (and the strategic program), in order to have a considerable influence on the enterprise success. Only in cases when the efficiency rating is found at the center of the strategic management, the enterprise can attempt to reach continuous enhancement.

Through the procedures of strategic management and the assessment of the general efficiency, the enterprises should set goals and clear objectives, in a way that they can enable the employees to understand as much as they can the method of the operational system of their enterprises, which might be improved even if this system might be controlled or out of control.

The high executives of the administration in the majority of enterprises today, believe that the important competitive priorities are quality, rapid launching of new products in the market and the fulfillment of the clients needs. Anyhow, no one denies the fact that the main competitive priorities mentioned above, compose a condition for the enterprise existence. Meanwhile, the strategy of their exclusive selection, as occurred in ‘80-ies, is not enough for the materialization of the vision, which should characterize the executives of the leading enterprises.

It is clearly understood that the suitability of the enterprise with the outer environment, by imitating the procedures and selections that different enterprises follow, transfer it into “traveler” that follows the “pilot traveler” of the branch. Also, the “traveler” enterprise may be improved, but can never become “different” or achieve superior qualities in the market. In short, the most important point for an enterprise nowadays, is its ability to enable in any moment the analysis of its own progress and to come up with such new strategies that bring about new core competencies and “special skills”. As a result, this introduces new “competitive priorities” completely different from those of other competitors, with such affirming dynamics in the market leading to fundamental changes in the branch they operate.

The managers of the enterprises should understand that the competitive problems they face do not stem from the “word competition” due to internationalization of the market, but rather by the “untraditional or paradoxical” competition. Thus Europe can not compete with USA and Japan. The real competitive problem is present with the traditional enterprises that progress slowly and those with a vision for the future, between the enterprises that follow the other examples and those which continually rationalize in the procedures and products, between the enterprises that seek to maintain their own leading position within the branch and those which attempt by their own fantasy to create the premises to be at the top of this branch. (Hamel and Prahalad, 1994).

The future leader of a branch is considered the enterprise which undertakes the duty of structuring the whole branch or the market and continues towards “a deep reorganization of the procedures” including the whole branch and not only the enterprise.

As a result, the important duty of the executive administration of the enterprises nowadays, is the attempt to regenerate the branch, generally by reassignment of their strategic choices. Within this frame the enterprise should change through the significant initiatives that are to be undertaken, the rules and the competitive conditions of the branch. Moreover, it should expand the field of branch activity and stimulate the creation of new markets within this respective branch or either open up new branches. Thus the possibility of creation of new markets or branches as well as restructuring of old ones constitutes the single premises for the enterprise survival and the core condition for the establishment and preservation position as the branch leader.

Practically the leading role in the branch comes to light in cases when:

1. *Firstly*: it is possible to predict the expected changes of the competitive game and this enables the enterprise to have an influence on the main parameters in line with the desired aspect.
2. *Secondly*, it seeks and exploits the future opportunities.
3. *Thirdly*, the future aims are clearly understood and fully approved by all members of the enterprise. In order for the enterprise to acquire the above mentioned points it is necessary to define the notion “strategy” differently, compared to the traditional definition. So in details:
 - It should not be based on past knowledge and experience
 - It is not sufficient to aim at further perfection of its strategic position within the frame of the actual condition in the markets or branches. On the contrary, the challenge for every enterprise lies in the possibility to influence the progress and management of the branch and markets for the years to come.
 - It is required an “architectonic strategy” with the help of which, the enterprise identifies the skills and competencies necessary for the dominance of the future markets or branches.
 - The meaning of the fact that the competition is already developed towards the “strategic allies” of the enterprises and not between the separate units.
 - Now the issue is not the minimization of the time of new products launched in the concrete market, but the minimization of the acceptance time of these products, originating from new “basic concepts”.
 - The enterprise intends to set the formulated objectives in general, (such as obtaining the leading position in the branch, fulfillment of the client’s needs which will continuously “challenge” all human beings in the enterprise and value their materialization,) rather than the close relationship between the aims and means available.

The way enterprises operate in making the decisions is outdated like the ways of inner organization. Even the most prosperous enterprises, on the organizational aspect, need to employ workers which explore the future. There should be a common effort made by all employees.

Due to these occurrences, the management of human powers is undergoing the big changes through its history. Although for years running, the directors of the personnel were concentrated on “management of employment conditions”, now they should further cope with the: management of achievement”. This change indicates difference even in the terminology used. So the term “personnel management” is used to express a short-term approach to the issues related to the personnel of an organization. The term “management of human resources signals the confronting systematic and long-term attempt of the entirety of the working force, which is confronted as a “source”.

The activity of human resources management goes beyond the borders of inner surroundings of the organization and it shifts to the multinational and international level. In parallel, its link to outer issues and the strategic nature of organization, leads to the gradual change in the objectives of management of human resources. While the objectives of personnel management were: absorption, employment and employees stimulation: in the management of human resources the objectives concentrate essentially on the competitive ability, output), survival, creation of competitive skills and agility at work.

The objectives of absorption, employment and stimulation remain important and they make up the basic and critical means to be efficient and improve the recommended objectives mentioned above. This fact implies the moving away from a functional orientation, where the interest is concentrated on the development of products and “human” services, and not on the importance of human resources for the enterprise.

As far the employees are concerned, the sector of human resources was transformed from philosophical orientations of confrontation and distinctions, into an orientation of equality and harmony. The term “resource” includes terms like “ability” and “competence”. Meanwhile, the origin of a strategic program has to be focused on development and protection of employees in every organization, who should be considered as “collaborators” and not “subordinates”. (Wainwright, 1997: pp.13)

HRMS AND HUMAN RESOURCES TECHNOLOGY

The term Technology of (Management) Human Resources (HR Technology) describes any technological application that is used for recruitment, hiring, retaining and evaluating employees as well as retention of talent and support of workforce.

The modern Human Resource Management focuses too much on technology, the efficient use of which helps to reduce cost and time of execution of standard functions, thus providing the opportunity for HR managers to undertake the construction, management changes etc. Technology improves the Human Resources Management in 4 modes:

- a.) Self-service employees (Self-service),
- b.) Support centers (call centers),
- c.) Productivity Enhancement (productivity improvement),
- d.) Assignments outsourcing (outsourcing).

Investigation revealed that the 2 / 3 of business plan in the near future, either to increase or accelerate investment in technological applications were related to Human Resource Management.

Objectives of Technology (Management) Human Resources intend to diagnose the company’s technological impact on personnel management, select or develop appropriate systems to settle, adapt and integrate seamlessly to the company, facilitating the work of Management of Human

Resources and meet the business goals and needs.

The successful establishment of the Technology Administration of Human Resources passes through the following three phases:

1. Adoption Phase

The driving forces essentially determine whether the company will use all the possibilities of modern technology (Administration) of Human Resources. For example, the need to reduce their costs, improve service quality, knowledge management and culture change.

The needs analysis essentially answers the question of what basically needs to be made to install the technology. The available time and quality analysis essentially determines the depth of analysis.

To select a key role that technology plays such an approach is made for the company: Companies believe that the procedures are so established that do not change, make an approach based on the processes and companies that prefer a technological approach geared towards standard (off-the-shelf) packages. However, even if you select the first approach, sometimes revamp certain business processes are inevitable.

2. Implementation Phase

Service providers can not provide quality services if they do not understand the expectations of their customers. At one level, it is the staff of HR and IT (Information Technology) that provides services to internal customers, or employees and managers of their own organization. At another level, there are the suppliers and external consultants who provide services to major clients: the HR and IT staff who bought the technology and provided the service to them. For example, to clarify the above statements, if a large hotel company wants to install an Information System for Human Resources, it may contact a company providing IT solutions such as SAP or People Soft or Oracle. Here's the software installation, which should be aligning with the Human Resources Management of the company, was bought to transfer all the data in an integrated and verified database.

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The problem is that not everyone agrees with everything about this establishment. Many people resist the changes brought about by new technology. Thus, such inhibitors can prevent the transition to third phase. Indeed, according to some estimates, 75% of businesses a wide range of technological applications, like ERP (Enterprise Resource Planning) systems are stranded (not pass the institutionalization phase).

3. Institutionalization phase

Many believe that large-scale technological applications fail due to administrative and not technical reasons. The passage in the final stage then is left in Management Change, which should create a climate for innovation support to refute the inhibitors described and leading to the successful institutionalization of cost savings, facilitating decision making, and giving an opportunity for engagement of Managers Human resources strategy (as it will increase their time through the automation of various functions). The above described phase does not include the *phase of the initiative*, in which the company recognizes the need for change is confronted with internal or external factors and has already decided to move in Technology (Management) Human Resources to meet the operational needs. The role of new information and communication technologies is crucial for the effective management of knowledge. The new systems, such as intra-networks (intranets), document management technologies and workflows (document and workflow management), systems for cooperation

(collaboration systems, groupware), the intelligent agents (intelligent agents), stores data (data warehouses) and enterprise information portals (enterprise information portals), are critical factors that facilitate administration knowledge. These systems are useful in various operations management knowledge, as support collaboration in virtual teams (virtual teams), analysis of data from previous transactions of its customers in finding the right database of the company management, etc. The balance between technological and human factors are the most crucial elements in successful knowledge management. While technology alone is not the solution, without that, knowledge management is often doomed to become a theory without practical applications

CONCLUSIONS

The leading of human resources signals an attempt for a systematic and long-term confrontation of the entirety of human resources in an organization, which should be faced as a “resource”.

While the objectives of personnel management were absorption, employment and workers stimulation; the management of human resources includes as basic objectives competition, rivalry, survival, creation of competitive advantages and competence at work.

Methods of the management of personnel are linked with the short-term objectives and are focused on the individual, whereas the methods of human resources management are various and they focus on the group work. Presently, the majority of the leaders of different organizations (private and public), have realized that the single effective way to create and apply a development strategy which can lead to successful strategic decisions, is the way used by the executive administration, in order to stimulate its personnel in relation to participation in the process of compilation and application of business strategic programs. Under these new circumstances, the management of human resources and actually the programming of these resources may be better understood and applied through the conceptual proposed framework.

In every organization, there should exist a continuous attempt to create and coordinate different systems, which shape the behaviors, necessary abilities and competencies of the personnel; with the ability of the organization for applying successfully the settled strategies. This coordination leads to the change of behavior on the personal level of every worker, even to the entirety of the organization, as an important key to success for all strategies. Administration and the executives of an organization can not control directly, but they can only influence the personnel activities during the procedure of a strategy application. They have the possibility to obtain the direct control on the strategy compilation and action plans, as well as those organizing systems that affect the personnel behavior.

Management of human resources entails a source of competitive advantage for contemporary enterprises. The enterprises and organizations constantly acknowledge that the factor which helps the enterprise to be distinguished, are the people and they are treated as a source of asset.

The study of psychology and organizational behavior gives the possibility to understand that the low results of an employee may not be necessarily linked with the lack of its characteristics, but with the lack of motivation or dissatisfaction in some situations. Thus the most part of opportunities of a worker will be evaluated. With the help of qualification programs of economic interest, which are organized after the identification of training needs, the company can improve the workers communicative skills, informing them about the new problems coming along, e.g. new technologies, enable them to gain confidence, mobilize, being “open” to other cultures, encourage cooperation and communication, etc., whereas if they manage their career, they may be secure about their devotion and stability in the enterprise.

During the successful application of the international management of human resources, the enterprise should be very careful about the establishment of leading mechanisms in another country, due to the existence of cultural, economic and legal distinctions.

The effective and continuous communication is very necessary for the integration of world culture by the workers, but the company should differentiate its methods when it is necessary, not its criteria (e.g. personnel selection)

The issue of repatriated executives requires a special treatment. The enterprise should assure them and their families to be prepared to live in the new country, on the contrary they will be loaded with excessive expenses and what is the most important thing, it risks the success of world renowned works where workers are implicated.

A considerable part of the contemporary companies' budget is meant for technology application. The system of management of human resources, which is necessary for multinational corporations, has gained importance and is essential for all enterprises big or small ones. In order for this system to be more effective and valuable, it should be carefully selected. In most of the cases, it is of interest to include it in the system of leading information, and analyze the parameters that cover the enterprise needs; on the contrary it might turn out as an unnecessary expense. Naturally, the users of this system should have the appropriate qualification in order to use the maximum of possibilities this system offers.

Finally, it is most likely that tomorrow's dominant companies will base their success on the combination of Strategic Human Resource Management and International (or Global) Human Resource Management, the first aligning HR policies to the company's strategic aims or forming company's strategy regarding to its human resources and the second enabling the company to compete efficiently on a global basis. Of course, by implementing Technology and especially Human Resource Information Systems, modern Human Resource Management is much more likely to save time, reduce cost and increase productivity and performance. The balance between technological and human factors are the most crucial elements in successful knowledge management. While technology alone is not the solution, without that knowledge management is often doomed to become a theory without practical applications

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STATUS OF THE PEOPLE EMPLOYED IN THE PRIVATISED COMPANIES IN MONTENEGRO

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ABSTRACT

This work elaborates the status of the people employed in the privatised companies in Montenegro. The main objective is to stress the privatisation effects with respect to status and role of those employed in the privatised companies.

Analytical statements are based on empirical material coming from primary and secondary sources, whereby the emphasis was put on perception of the target group. The research team has conducted a survey on a representative sample of 110 privatised companies. The survey covered the following areas: awareness of the employees on the privatisation process, social program, employment status of the employees, employment, wages and financial status of the employees in the privatised companies. Each of these areas has been separately analysed and the conclusions in each segment arising from the mentioned researches are given in the end of this work.

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Key words

employment, unemployment, wage, employees, privatisation, social program.

INTRODUCTION

Implementation of the research “Analysis of the status of people employed in the privatised companies” derived from the need to collect reliable data which could provide a clear image of the privatisation impact on the status of employees.

In this research the data collected according to the questionnaire comprised the following area:

- Awareness of the employees on the privatisation process,
- Social program,
- Employment status of the employees,
- Employment,
- Wages and
- Financial status of the employees.

The survey on the privatised companies was based on the sample of 67 active companies. The survey was conducted in the period from 20th June 2006 until 15th July 2008. The main researching tools are two, individually designed questionnaires, one for employers and the other for the representatives of employees – trade union trustees. The questionnaires are not completely independent; their contents match in the part of their joint interest and served as the basis for the comparative analysis. Total number of employees within the surveyed companies is 15.680. Total number of the surveyed employers and employees is 134.

The rest of the questions covered certain specificities of significance for employees and employers. With this approach we tried to achieve a deeper insight and point out some specific problems faced by these two categories.

The research has shown that in most cases replies of the employers and those of employees have matched, i.e. the surveyed employees have been very well informed about the developments in their company. Due to overlapping in answers of the surveyed group, the following analysis will be presented as per the average values, except from the cases where there are significant discrepancies in the replies of the employers and the employees.

The structure of the sample is as follows:

Table 1. Number of the surveyed privatised companies by region

REGION	NUMBER OF THE SURBEYED COMPANIES	SHARE (%)
CENTRE	34	50.75
SOUTH	19	28.36
NORTH	14	20.90
TOTAL	67	100

Table 2. Number of the surveyed privatised companies by activity

TYPE OF ACTIVITY	NUMBER OF THE SURVEYED COMPANIES	SHARE (%)
CONSTRUCTION	4	5.97
FOOD INDUSTRY	6	8.96
TRADE	7	10.45
TOURISM AND HOSPITALITY MANAGEMENT	13	19.40
WOOD AND METAL INDUSTRY ¹	14	20.90
OTHER	23	34.33
TOTAL	67	100.00

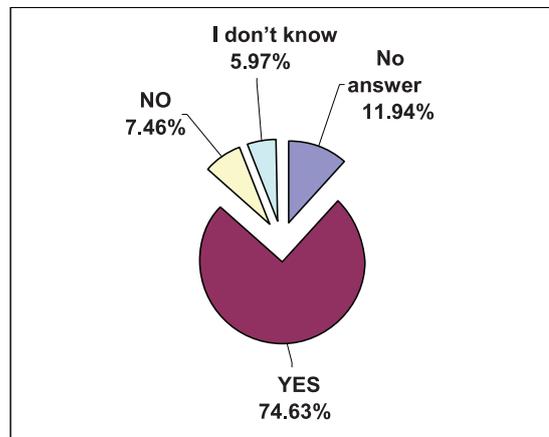
Table.3. Number of the surveyed private companies based on different privatisation methods

PRIVATISATION METHOD	NUMBER OF THE SURVEYED COMPANIES	SHARE (%)
MVP	26	38.81
PUBLIC TENDER	19	28.36
STOCK TRADE	6	8.96
PRIVATISATION THROUGH THE BANKRUPTCY PROCEDURE	5	7.46
PURCHASE OF THE CONTROL PACKAGE FROM THE MANAGEMENT	2	2.99
TRANSFER OF SHARES TO THE STATE FUNDS AND EMPLOYEES	2	2.99
AUCTION SALE	7	10.45
TOTAL	67	100

AWARENESS OF THE EMPLOYEES ON THE PRIVATISATION PROCESS

Awareness of the employees on the privatisation process was rather good which is confirmed by the distribution of answers to the question: “Were the employees in your company informed about the privatisation process?”. 74.63% replied YES, while 7.46% gave negative answer.

**Graph 1. Answers of employees to the question:
“Were the employees in your company informed about the privatisation process?”**



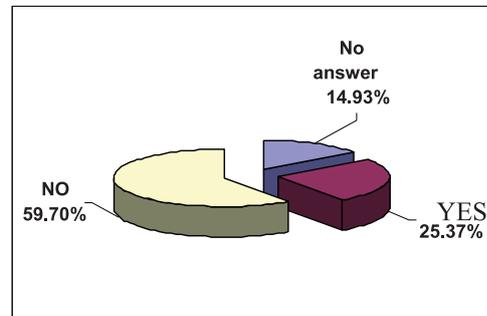
The main source of information for the employees on the privatisation process came from the trade union. Even 58.21% of the surveyed employees received information on the privatisation process from the trade unions, 14.93% were informed through individual conversation and 10.45% were informed via announcement board.

² Covering companies in the area of: mining and stone taking, production of basic metals, production of metal products, wood industry and production of explosives.

SOCIAL PROGRAM

To the question: “Was the social program adopted in your companies prior to the privatisation“, employers and employees gave the same answers. Out of total surveyed people, 17 (25.37%) replied YES. Negative answer to the same question was given by 40 (59.70%) surveyors. 10 people (14,93%) gave no answer.

Graph 2. Answers of employers and employees to the question:
“Was the social program adopted in your companies prior to the privatisation ?”



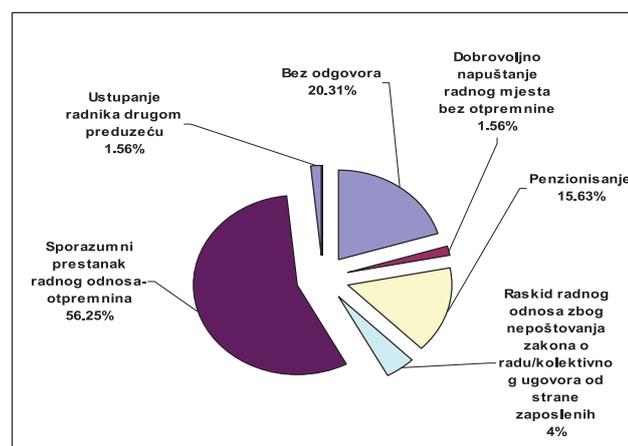
Based on the answers received by the surveyed, a conclusion may be derived that prior to privatisation process in most of the privatised companies there was no program adopted to take care of the employees whose qualification were not needed anymore.

The best privatisation method, from the social aspects was public tender. The companies where social programs were adopted were mostly privatised by public tender, 56.25%, then by MVP (31.25%), stock trade (6.25%) and by auction sale (6.25%).

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The most frequent lay offs in the privatised companies implied an agreed termination of the employment along with the severance pay (56.25%), then retirement (15.63%), cancellation of employment due to violation of the Labour Law by employees (4%) and trade off to another company (1,56%).

Graph 3. Answers of employers and employees to the question:
“What are the most frequent lay off methods in your company?”



Trade offs to another company – 1.66%

No answer – 20.31 %

Voluntary leave – 1.66 %

Retirement – 15.63%

Cancellation of employment to violation of the Labour Law by employees

Agreed termination of employment

EMPLOYMENT STATUS OF THE EMPLOYEES

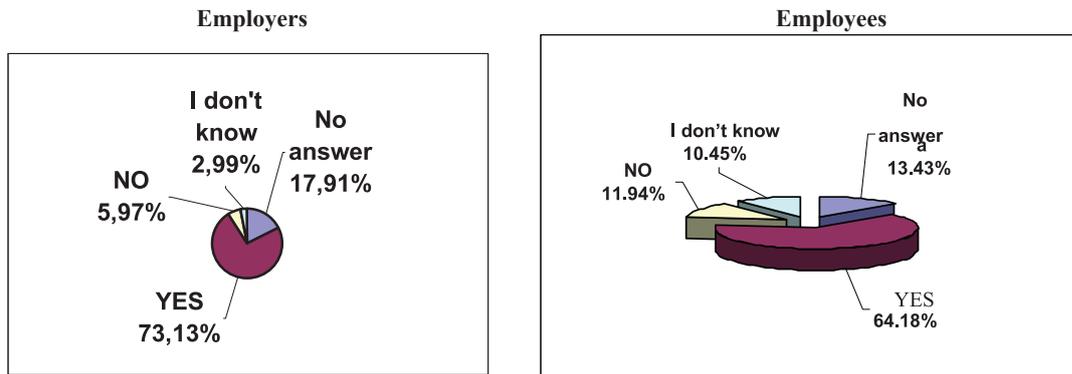
Issues in this section comprise the trade union organisation within the company, collective agreements between employees and employers, so as the most frequent lay off methods in the company.

Employers and employees gave the same answer to the question: «Are the employees in your company organised in trade union»? In even 82.09% of the surveyed companies there are trade union organisations, while in 10.45% there is no trade union as a kind of organisation of the employees. Out of total number of the surveyed, 7.46% did not reply to this question.

Collective agreement between employees and employers has been concluded in 91.32% of the surveyed companies.

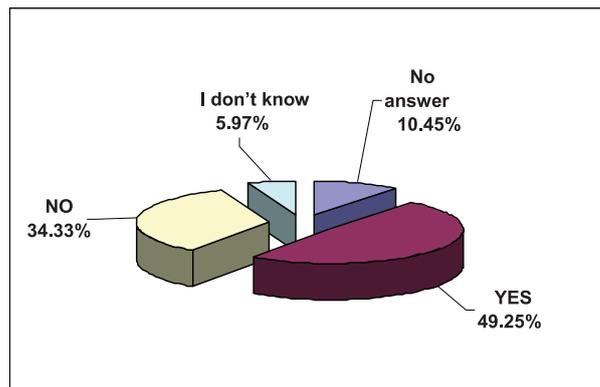
Opinions of the employers and employees differ on the question: “Is the collective agreement being completely complied with in your company?”. Employees in 64.18% of the surveyed companies gave positive answers, while the same answer was given by employers in 73.13% of the surveyed companies. According to the employers, the collective agreement is not complied with (in 5.97% companies), whilst the employees are inclined to think that it is not adhered to in 11.94% cases. It can be concluded thereon that the rights of the employees arising from the collective agreement are respected in most of the privatised companies.

Graph 4. Answers of employers and employees to the question: “Is the collective agreement being completely complied with in your company?”



New collective agreement has been concluded in 49.25% of the surveyed companies. Negative answer to the question: “Has the new collective agreement been concluded with the syndicate of the company?” was given by 34.33% of the surveyed. Therefore, it can be concluded that the privatisation process imposed the need for the new method of governing relations between employees and employers in the company.

Graph 5. Answers of employers and employees to the question: “Has the new collective agreement been concluded with the syndicate of the company?”

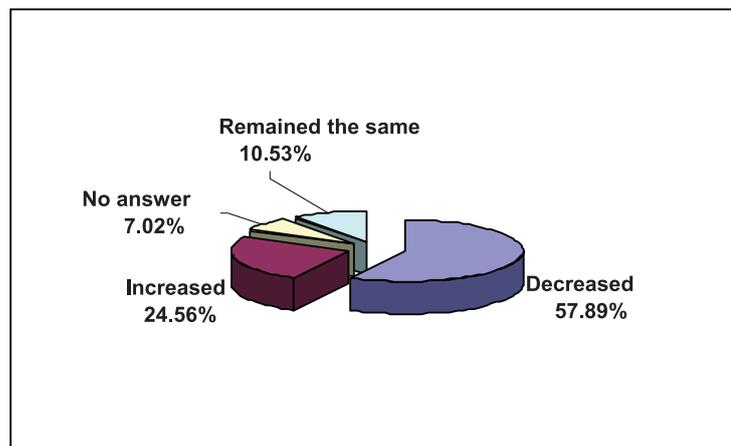


In most cases privatised companies fulfil their wage-related obligations to both state and employees. To the question: «Does your company contributions to the Pension and Disability Insurance Fund and the health insurance for the employees pay on regular basis », 70.15% of the surveyed gave positive answers, while 15% replied negatively.

EMPLOYMENT

To the question: “Has the number of the employees been decreased or increased after the privatisation process”, 57.89% of the surveyed replied that the number had been decreased and 24.56% replied that the number of the employees had been increased in their companies. Frequency of answers to the previous question shows that the **privatisation of companies in most surveyed cases was followed by the decrease in the number of employees.**

**Graph 6. Answers of employers to the question:
“Has the number of the employees been decreased or increased after the privatisation process”?**



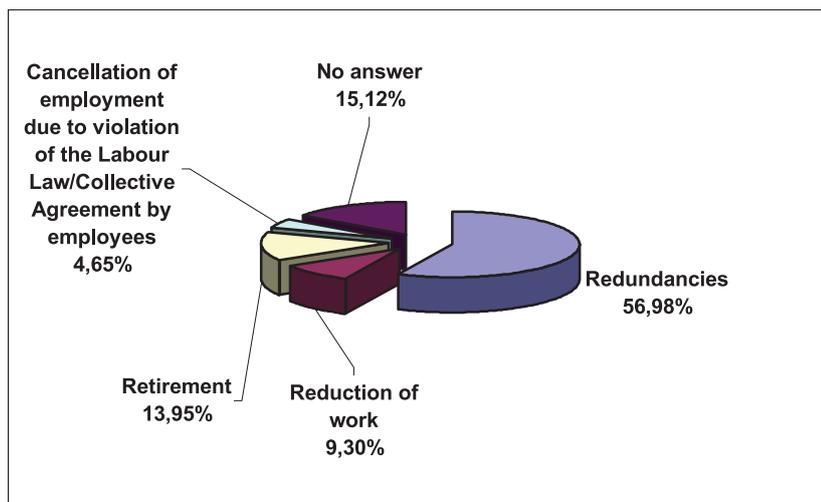
In the companies where employment rate has been decreased, the average decrease of the employment rate was 37.54% against the number of employees before the privatisation

Effects of the employment rate decrease in the privatised companies were the most unfavourable in the north region. The employment rate in the north region has been decreased by 45% on average, against the situation before the privatisation

Average decrease of the employment rate regarded by sectors has been the following: civil engineering (63,17%), wood and metal industry (44,48%), food industry (32,54%), tourism and hotel management (27,27%) and trade (28,32%). In terms of employment rate decrease, the privatisation mostly affected the sector of civil engineering and wood and metal industry, and the least effect had on trade, tourism and catering sectors.

The consequence of the privatisation of the companies without prior restructuring implemented were layoffs of the redundancies which was present in most of the surveyed companies. The main cause of the decrease of employment rate in the privatised companies have been technological and economic redundancies (56,98%), followed by: retirement (13,95%), decrease of the workload (9,30%) and termination of work due to the disrespect of labour law by the employees (4,65%).

**Graph 7. Answers of employers and employees to the question:
“What are the main reasons for the decrease of the employment rate in your company?”**



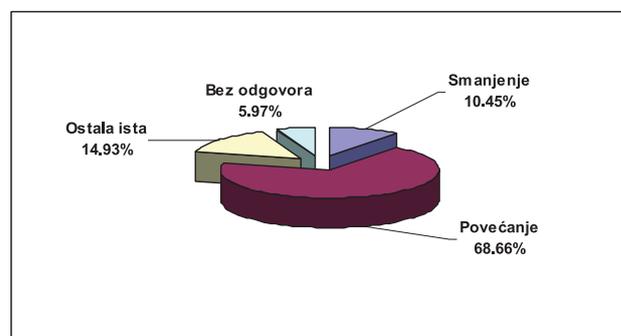
Average increase of the employment rate has been 13.70% in the companies where the employment rate increased after the privatisation.

Regarded by sectors, the highest average increase of the employment rate has been recorded in tourism and catering sector (23,43%) and trade (20,66%), and the lowest increase in the civil engineering sector (2,17%). The increase in the food industry sector has been 12,42%, and in the sector of wood and metal industry 9,48%. It may be concluded that privatisation effects, in terms of number of employees, were the greatest in tourism and trade sector, and the smallest in the sectors of civil engineering and wood and metal industry.

WAGES

According to the research, the increase of wages has been recorded in 68,66% of the surveyed companies, while the decrease of wages has been recorded in 10,45% of the companies. It may be concluded that majority of surveyed companies **had the increase of wages.**

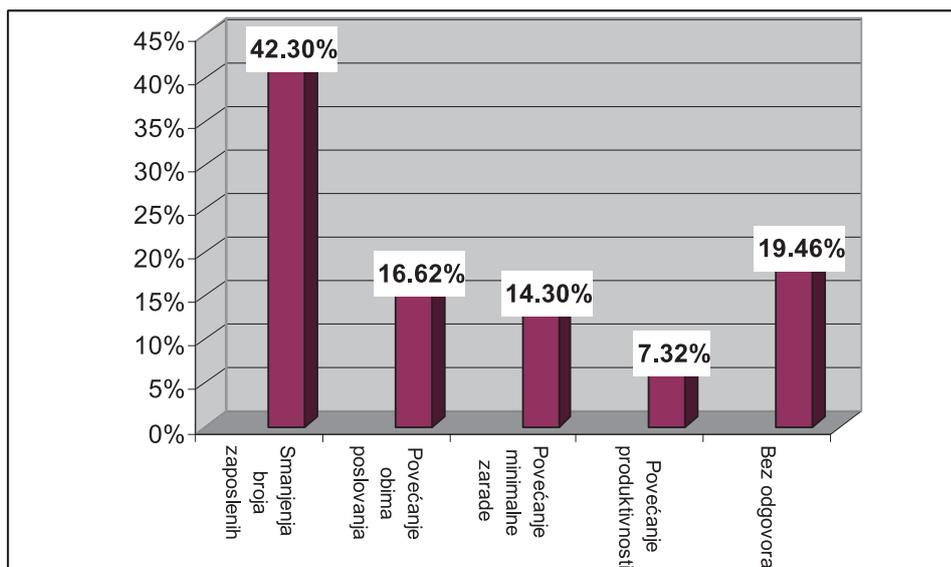
**Graph 8. Answers of employers and employees to the question:
„Was there an increase/ decrease in wages after the privatisation of your company?“**



Remained the same, No answer Decrease, Increase

Surveyed employers identify the decrease of the employment rate (42,3%) as the main cause of the wage increase. Apart from the decrease of the employment rate, as the cause of wage increase, surveyed employers also identified: increase of the workload (16,62%), increase of the minimum wage (14,3%) and increase of the productivity (7,32%).

**Graph 9. Answers of employers to the question:
„What are the main reasons for the change in wages after the privatisation of your company?“**



1. Decrease in number of employees
2. Increase in the workload
3. Minimum pay rise
4. Increase in productivity
5. No Answer

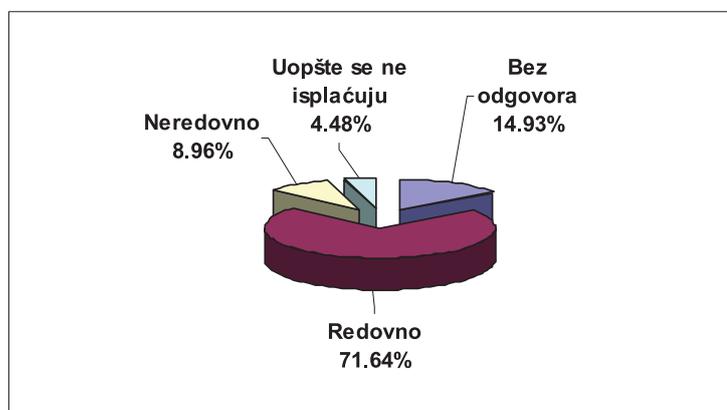
Average increase of the wage increase against the wages in companies before the privatisation has been 30,36%.

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The highest average wage increase has been recorded in the tourism and catering sector (34,33%) as well as the trade sector (33,45%). The lowest average increase of the wages has been recorded in the civil engineering and (20,50%) and food industry sector (26,13%).

Wages of the employees in the privatised companies have been in most cases regularly paid. Please find answers to the following questions in the graphic: “Are the wages regularly paid in your company after the privatisation“.

**Graph 10. Answers of employers and employees to the question:
“Are the wages paid out on regular basis in your company?“³**

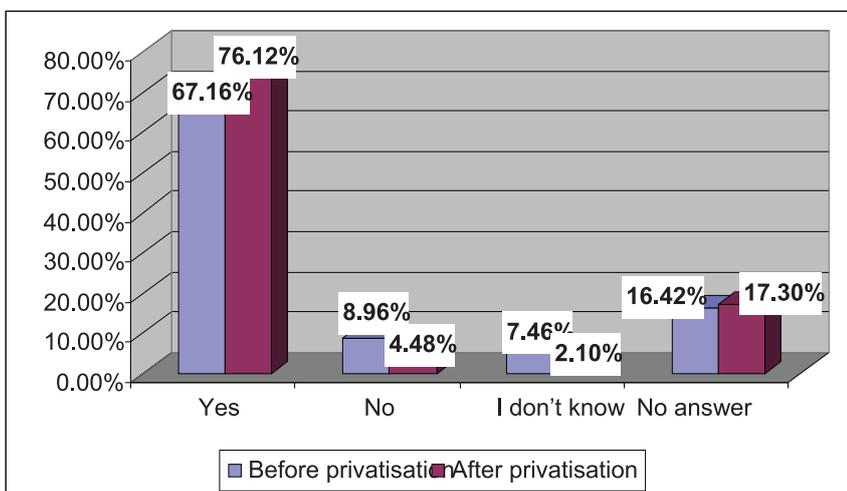


1. Irregularly
2. Not at all
3. No answer
4. Regularly

³ Frequency of answers to the question about the situation in the company before and after privatization was almost the same.

Payment of compensations on the basis of wages has been improved by the privatisation of the companies, which will be testified by the frequency of the answers provided in the following graphic. It is evident that the number of positive answers increased by 9% after the privatisation of the companies.

Graph 11. Answers of employers and employees to the question
 “Are the lunch, transport, leave and allowance regularly paid out in your company?”

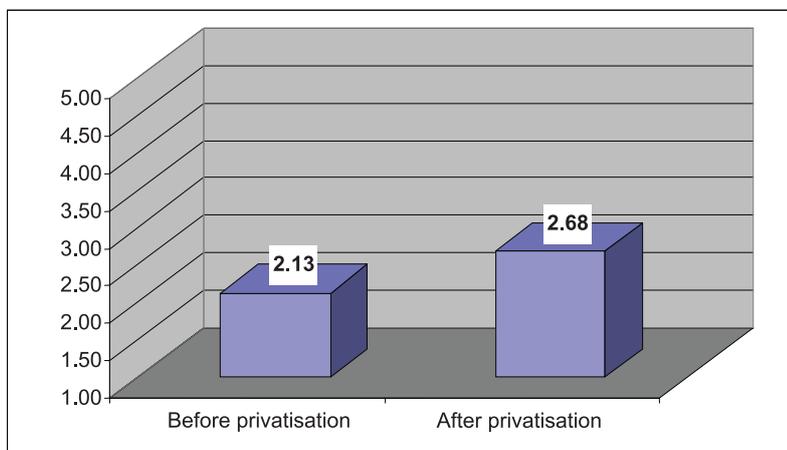


After the privatisation, there was a significant increase in the workload of the employees during non-working days (weekend, holidays) and overtime.

FINANCIAL STATUS OF THE EMPLOYEES

Financial status of the employees of the privatised companies has been positively assessed by the surveyed. **Average mark of the employees status before the privatisation was 2,13 (satisfactory), and after privatisation 2,68 (good). The privatisation has led to the improvement of the financial status of the employees (increase of 0,55 points) in the privatised companies.**

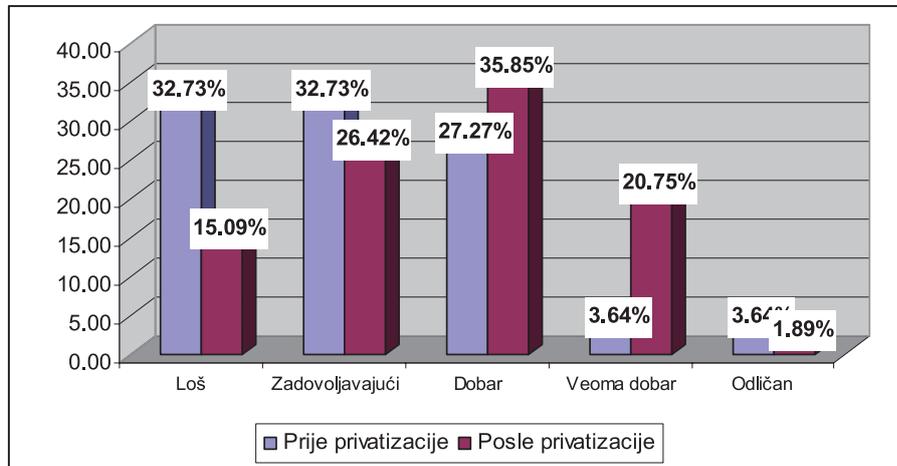
Graph 12. Answers of employees to the question
 “How do you rate financial status of employees before and after privatisation (on the scale from 1 to 5)?”



4 1- insufficient, 2-sufficient, 3-good, 4-very good, 5-excellent.

Out of the total number of the surveyed, 35,85% thinks that the financial status is good, 26,42% assessed the status as satisfactory, while only 1,89% of the surveyed assessed the financial status as excellent after the privatisation. Financial status after privatisation was assessed as bad by 15,09% of the surveyed.

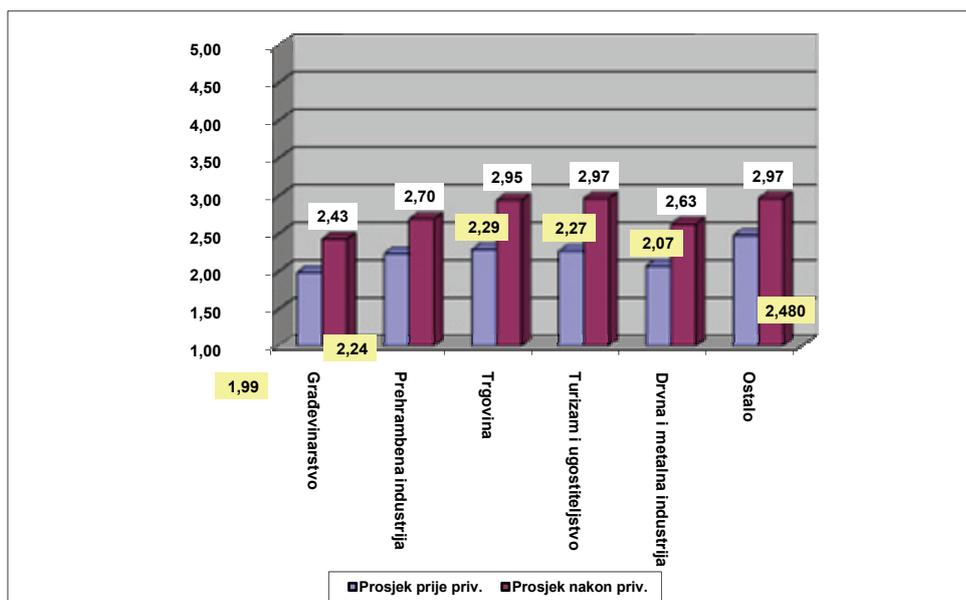
**Graph13. Answers employees to the question
“How do you rate financial status of employees before and after privatisation?”**



Financial status of the employees regarded by the regions shows the growth trend after the privatisation in each of the mentioned regions. Before and after privatisation, the financial status of the employees was the best in the south region, and the worst in the north region. The north region had the greatest effects of the privatisation in terms of improvement of the financial status of the employees, increase of 0,64 points, but it remained under Republic average (2,28).

368 Privatisation in the tourism and catering sector had the best effect on the financial status of the employees (increase of 0,70 points), and the worst in the civil engineering sector (increase of 0,44 points). Improvement of the financial status of the employees after implemented privatisation in other analysed sectors has been in the following: trade sector (0,66), wood and metal industry sector (0,56) and food industry sector (0,52).

Graph 14. Assessment of financial status of employees in different sectors before and after privatisation



Construction, Food industry, Trade, Tourism and hotel management, wood and metal industry, other

CONCLUSIONS ON THE EFFECTS OF THE PRIVATISATION ON THE POSITION OF EMPLOYEES IN THE PRIVATISED COMPANIES.

Summarizing the results of the conducted research on the position of the employees in the surveyed privatised companies, we may conclude the following:

- Knowledge of the employees on the privatisation process was very good.
- The main information source on the flow of privatisation process was the trade union.
- In most of privatised companies before the privatisation, there was no adopted programme for taking care of the employees whose work is not needed anymore.
- In the companies where social programme is adopted, employees participated in its creation.
- In most of privatised companies where social programme is adopted, the most frequently applied way of taking care of employees whose work is not needed anymore, was the severance pay.
- In the companies in which the privatisation process was faster implemented (MVP, stock exchange sale), the position of the employees in terms of their future status was the most certain against the employees in companies in which the privatisation process was more slowly (sale through public tender).
- Trade union organizing in privatised companies is present at the majority of these companies.
- Valid collective agreement, employees' rights from the work and on the basis of work have been observed in most of the privatised companies.
- Wages of the employees and compensations on the basis of wages, as well as fiscal duties upon them have been regularly paid in most of privatised companies.
- The number of employees decreased in most of privatised companies, against the situation before the privatisation, on average by 37,54%. The greatest decrease has been recorded in the civil engineering sector (68%) and in the sector of wood and metal industry (44%), and the smallest in the trade sector (28%) and tourism and catering sector (27%).
- The consequence of the privatisation of the companies without prior implemented restructuring was the layoff of the majority of employees present in most of surveyed companies.
- Majority of the surveyed employees, whose work is not needed anymore, regardless of the fact whether the social programme was adopted or not, left the company with the severance pay.
- Wages of the employees in most of privatised companies have increased by 30,36% on average. The highest increase of the wages has been recorded in tourism sector (34%) trade sector (33%), wood and metal industry sector (28%) and food industry (26%).
- Decrease of the number of employees after privatisation has been identified as the main cause of the increase of wages in privatised companies.
- Additional work engagement of employees is paid in most of privatised companies.
- Financial status of the employees has been improved in majority of privatised companies by 0,55 points on average. Prior to privatisation, the status of employees has been assessed as satisfactory (2,13 points), and after privatisation it has been assessed as good (2,68 points).
- Financial status of the employees has been the best in the south region (2,85), then in the central (2,73), and the worst in the north region (2,28). Although the north region had the greatest improvement of the financial status of the employees according to the assessment of the surveyed, it has remained (satisfactory) below Republic average (good).
- The best effects on the financial status has had the privatisation in tourism and catering sector (0,70) and in trade sector (0,66), and it had the worst effect in civil engineering sector (0,11 points).

General conclusion which could be made at the majority of surveyed companies is that the privatisation resulted in the necessity of human resource restructuring, reflected in the decrease of the number of employees. Decrease of the employment rate in most of privatised companies was monitored by the

programmes of securing employees, defined by the valid legal regulation (Labour law, Collective agreement). The consequence of the decrease of employment rate was manifested on the increase of workload of those who continued to work in the privatised companies and the improvement of their financial status, especially of those employed in the sectors of tourism and catering and trade, regarded by the sectors. Regionally regarded, the decrease of the employment rate resulted in the improvement of the financial status of the employees in all three regions, while the financial status of the employees in the north region has remained below the Republic average.

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MULTI-CRITERIA DECISION MAKING – FOUNDATION OF AN OPTIMAL BUSSINES DECISION

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ABSTRACT

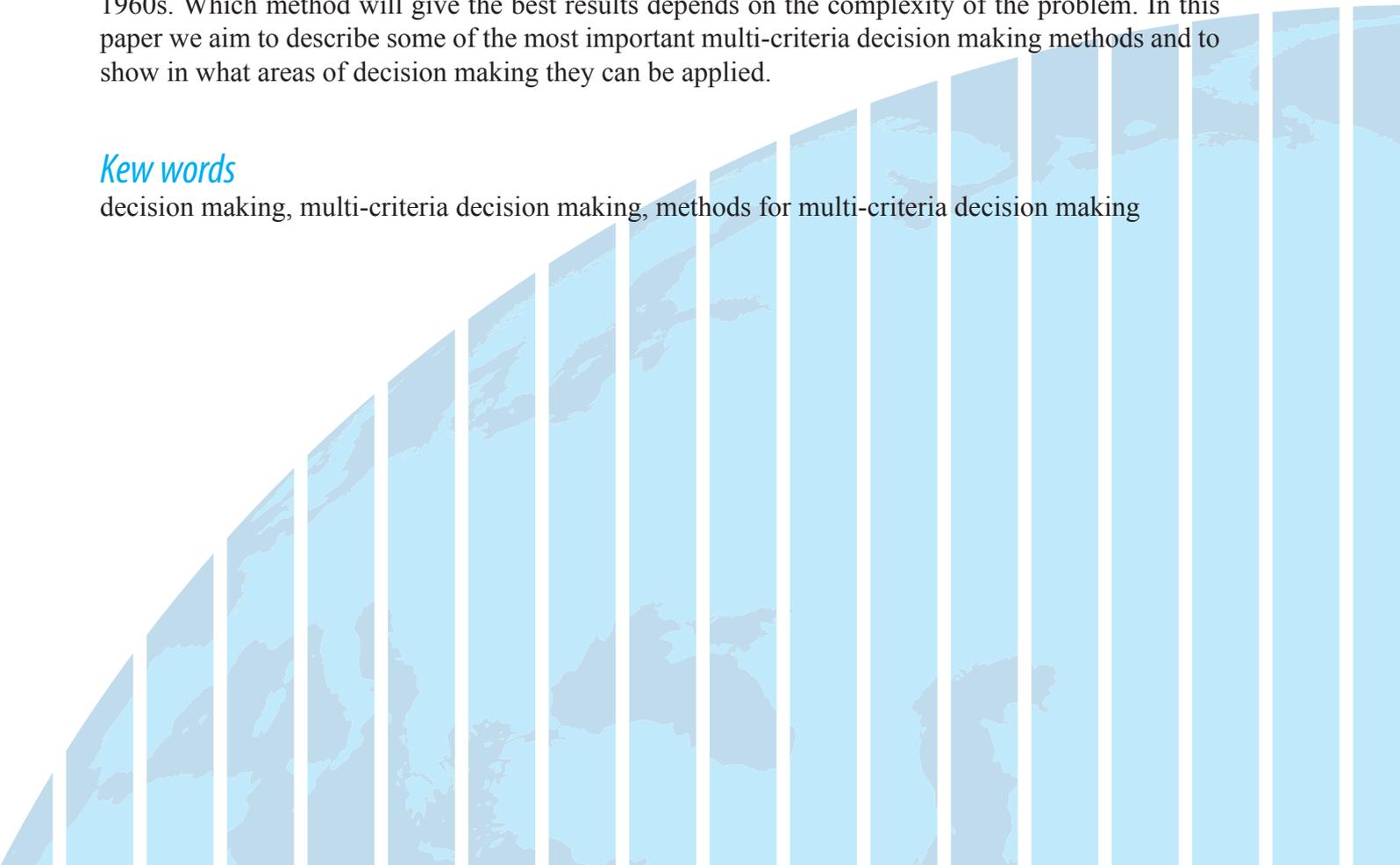
Multi-criteria decision making (MCDM) is one of the most important branches in the theory of decision making. It refers to situations by which there are a number of, most often conflicting, criteria on the grounds of which the optimal decision is to be made. Unlike single criteria- optimization models where only one criterion in decision making is used, thus significantly reducing the actual problem to be solved, the presence of a greater number of criteria in decision making models represents an important step towards actuality.

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Many various methods of decision-making problems solution have been recommended since the 1960s. Which method will give the best results depends on the complexity of the problem. In this paper we aim to describe some of the most important multi-criteria decision making methods and to show in what areas of decision making they can be applied.

Kew words

decision making, multi-criteria decision making, methods for multi-criteria decision making



INTRODUCTION

Most frequently, only one criterion for decision making is used in classical optimization methods, consequently resulting in minimization of their significance in solving actual economic problems. Unlike these methods, decision making situations with a greater number of most frequently conflicted criteria, belong to the multi-criteria decision making (MCDM) problems. However, although useful, the existence of a greater number of criteria in decision making models has negative characteristics as well - because the models become significantly more complex in a mathematical sense there is a risk that a solution to the problem covers only some of the placed criteria.

Range of problems which belong to the multi-criteria decision making problems is extensive. Still, common characteristics to all the problems can be isolated. These are: a) Existence of a greater number of criteria; b) Conflict among the criteria; c) Incomparable measurement units for different criteria; d) A greater number of alternatives, e) Selection of one final solution – which could be the projecting of the best alternative, or a selection of the best alternative from the set of previously defined final alternatives.

Following classification of multi-criteria decision making is made to: multi-objective decision making (MODM) and multi-attributive decision making (MADM), or multi-criteria analysis, although the expressions ‘multi-objective’ and ‘multi-attributive decision making’ are often used as the synonyms for multi-criteria decision making.

Problems of decision making having a continual process of decision making are explored through multi-objective decision making. Typical example is a mathematical programming problem with multi-objective function. On the other hand, multi-attributive decision making is focused on problems which do not have the continuity in the process of decision making. With these problems, the set of alternatives is predetermined.

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NOTION AND TYPES OF ATTRIBUTES

Selected characteristics which determine differences among the alternatives are called attributes or criteria, and the direction of the attributes’ movement is defined as the objective we want to achieve.

Differences among the attributes can be perceived through many features, and the most significant are: a) precision with which they can be measured and b) direction of correlation between the value of the attributes and the effectiveness they provide.

According to the level of measurability, the attributes can be classified as quantitative and qualitative.

Quantitative attributes are the characteristics of the alternatives which can be measured with precision on the so called cardinal scales, while the **qualitative attributes** are the characteristics whose modalities cannot be numerically expressed.

Second criterion according to which the attributes differ is the direction of correlation between their value and effectiveness they provide. If the effectiveness increases with the increase of the value of attribute, we have an attribute called income attribute; and if the effectiveness decreases with the increase of the value of attribute, we have the attribute called expenditure attribute. Non-monotonic attributes are those which have a direct correlation with the effectiveness in one segment of their values, and an inverse correlation with the effectiveness in the other segment.

CLASSIFICATION OF THE METHODS FOR THE MULTI-CRITERIA ANALYSIS

Multi-criteria decision making has been representing a rapidly developing area for the last two decades. However, not only in theory do the changes happen. Decision making is changed in practice also - from one person (the director) and one criterion (profit) to a greater number of persons and decision making criteria.

Since the sixties, a number of methods which can solve the majority of actual problems of the multi-criteria analysis with more or less success have been developed. According to the type of information, all the methods of the MCDM are classified in two groups:

1. Methods without the information on attributes: Domination method, MAXIMIN method and MAXIMAX method.
2. Methods which require certain information on attributes, and the most important of these methods are: Conjunctive method, Disjunctive method, Lexicographic Method, Linear allocation method, Simple additive weight method, Analytic Hierarchy Process, ELECTRE, CAMELS and PROMETHEE.

SOLVING THE MULTI-CRITERIA ANALYSIS METHOD

In order to solve the models of MCA, one must first transform qualitative attributes and adjust them to the needs of some methods. Several methods of attribution transformation are frequently used in practice, and most frequently used are: a) transformation of the attributes to the interval scale; b) normalization of the attributes; c) allocation of the adequate set of weights.

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For the *transformation of the qualitative attributes to the /interval scale*, the so called bipolar scales are used often. This implies selection of a scale which consists of, for example, 10 points, where 0 is allocated to the lowest level, and 10 to the highest level which can be physically realized. It is of an utmost importance to determine the middle of the interval precisely, because it represents the border between the desirable and undesirable.

Normalization of the attributes can be two-sided:

a) **Vectorial normalization** – each row vector decision making is divided by its norm, where the normalized value n_{ij} of the normalized decision making matrix \mathbf{N} is obtained from:

- with the 'max' type criterion

$$n_{ij} = \frac{f_{ij}}{\left(\sum_{i=1}^m f_{ij}^2\right)^{1/2}}, \quad i = 1, 2, \dots, m, j = 1, 2, \dots, n.$$

- with the min type criterion

$$n_{ij} = 1 - \frac{f_{ij}}{\left(\sum_{i=1}^m f_{ij}^2\right)^{1/2}}, \quad i = 1, 2, \dots, m, j = 1, 2, \dots, n.$$

This type of transformation advantage lies in the fact that all criteria could be expressed with measurements which have their own unit.

b) Linear scale – exit (result) of a criterion is divided by its maximum value, and then the transformed exit f_{ij} is obtained on the account of the following expression:

$$l_{ij} = \frac{f_{ij}}{f_j^*} = \frac{f_{ij}}{\max_i f_{ij}}, \quad f_j^* = \left\{ f_j \left| \max_i f_{ij} \right. \right\}, \quad i = 1, 2, \dots, m, j = 1, 2, \dots, n.$$

Values of the l_{ij} are within the interval (0,1) and the result is more favorable when closer to 1.

With the min type criterion, the elements of the linearized decision making matrix are calculated as follows:

$$l_{ij} = \frac{f_j^{\min}}{f_{ij}} = \frac{\min_j f_j}{f_{ij}}, \quad f_j^{\min} = \left\{ f_j \left| \min_i f_{ij} \right. \right\}, \quad i = 1, 2, \dots, m, j = 1, 2, \dots,$$

Allocation of the adequate set of weights is a transformation used in cases when the problems of multi-attributive decision making demand information on actual significance of certain attributes. For the n criterion, the set of weights is:

$$t^T = (t_1, t_2, \dots, t_j, \dots, t_n), \quad \text{where} \quad \sum_{j=1}^n t_j = 1.$$

CAMELS METHOD

CAMEL(S) method is one of the first methods developed by the Federal Deposit Insurance Corporation (FDIC) for the purpose of the early detecting and solving of problems in banking business. The title of the method is comprised of the letters deriving from the six components according to which the accomplishments of the banks are being valued. These components are: Capital adequacy, Asset quality, Management quality, Earnings quality and income level, Liquidity management and Sensitivity to market risk. The fourth component is variously treated and some authors¹ use the term ‘equity’ instead of ‘income’.

Core of this method implies evaluation of the banks’ accomplishments according to the abovementioned five (six) components. Each component, with the exception of Management, has developed quantitative methods for their measurement, but, for the purposes of this method, these values are transferred to qualitative, according to the subjective evaluation of the reviewer or the manager on the complexity of the problems identified. All values are ranked on a scale from 1 to 5, with 1 as a measure for the best rating. Instead of the numerical scale, alphabetical scale can be used, for example AAA, AA, A; BBB, BB, B; C; D, etc.

When assessing capital adequacy, the reviewer tries to determine a bank’s capability to sustain its present and planned levels of assets’ risks. Quality of the assets is assessed through the control of credits. Credits which indicate some failings or excessive risk are classified as non-standard, suspicious, or as deficit. Quality of management is assessed through technical and steering skills, leadership etc.

Reviewer must assess internal control, business operating procedure and implementation of laws

¹ Hunjak, T., Jakočević, D.: “Višekriterijski modeli za rangiranje i upoređivanje banaka”, Zbornik Ekonomskog fakulteta u Zagrebu, godina 1, broj 1, 2003; Brockett, P.L., Charnes, A., Cooper, W.W.”Data transformations in DEA cone ratio envelopment approaches for monitoring bank performances”, European Journal of Operational Research, Volumen 98, 1997, pp. 250-268.

and bank regulations. Earnings adequacy is assessed through terms and level of contributions of the shareholders, cash flow in relations of standard requirements of the borrower and the basic bank capital contributions as well. Liquidity is ranked according to the capability of the bank to settle a demand for deposits and credits without any excessive effort.

Individual ranks are synthesized into a unique rank, so, at the end of assessment, each observed bank gets its CAMEL(S) rank position from 1 to 5. However, cumulative rating does not represent their arithmetic mean. In the procedure of determining cumulative rating of a bank, starting point is the level of component ratings, their mutual connection and extension of certain components' influence to a situation in a specific bank. Lack of this method relates to nonexistence of a finished model on the grounds of which a unique rank would be derived, but it is upon the subjective assessment of the persons responsible to deal with this problem.

Report based on the CAMEL(S) method is not for the public usage, that is, rating of a bank is a classified information which stays between the evaluator and the manager and is used only for the purposes of surveillance over banking business. According to the achieved rating, the frequency of banking business revision is determined. Banks with CAMEL(S) 3, 4 and 5 rating must be supervised annually, while banks with 1 and 2 rating are supervised once in every two years.

ELECTRE METHOD (ELIMINATION AND (ET) CHOICE TRANSLATING REALITY)

This method was among the first methods of multi-criteria ranking of alternatives. It is widely implemented in practice when the problems concerning the impossibility of determining the strict domination of one alternative over another are being solved. In such cases, there is a necessity to introduce so called higher order connections, that is, defining the criterion for “mechanical” allocation of the rank is necessary. Most frequently found in practice is the ELECTRE I method, but several variations of this method have been created, such as: ELECTRE II, ELECTRE III and ELECTRE IV. Similarity of all the modalities of this method can be observed through same initial steps, and certain differences start from the moment the most acceptable alternative is isolated. For the purposes of this paper, only the basic type of this method will be displayed.

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ELECTRE method is based upon comparison of the alternatives in pairs. Two conditions are to be met: a) agreement condition – defined through desired level of compliance and actual index of agreement; b) disagreement condition – defined through the desired level of disagreement and actual index of disagreement.

Indexes of agreement and disagreement represent quantitative indicators of agreement or disagreement that the alternative “a” can be ranked ahead of the alternative “b” according to all criteria at the same time. First, degree of agreement between the preferences weights and paired domination connections is examined, and then the degree of disagreement according to which the evaluations of weights of certain alternatives mutually differ. For these reasons, this method is also called Agreement Analysis.

Procedure of implementation of the method is iterative and it is manifested through the procedure comprised of 9 steps.

Step 1: *Calculation of the normalized decision making matrix* . Normalized elements of the decision making matrix are calculated as follows:

- with the max type criterion:

$$n_{ij} = \frac{f_{ij}}{Norma_j} = \frac{f_{ij}}{\sqrt{\sum_{i=1}^m f_{ij}^2}}$$

- with the min type criterion

$$n_{ij} = 1 - \frac{f_{ij}}{Norma_j} = 1 - \frac{f_{ij}}{\sqrt{\sum_{i=1}^m f_{ij}^2}}$$

Step 2: Calculation of the weighted normalized decision making matrix. In this step, the decision maker must show his/her preferences towards the attributes according to which he/she chooses one of the offered alternatives. Then, weighted normalized decision making matrix is being calculated. The chosen weighted coefficients matrix is:

$$TN = N * T$$

Whereby the following implies

$$T = \begin{bmatrix} t_1 & \dots & \dots & 0 \\ \dots & t_2 & \dots & \dots \\ \dots & \dots & \dots & \dots \\ 0 & \dots & \dots & t_n \end{bmatrix}$$

And N is the normalized decision making matrix. Total of the elements of diagonal matrix of allocated weights to certain attributes must be equal to 1,

that is $\sum_{j=1}^m t_j = 1$

Step 3: Determination of the sets of agreement (S) and disagreement (NS). Here we compare the pairs of alternatives. The alternatives we compare shall be marked with p and r (p,r = 1, 2, ..., m and p≠r). First we form a set of agreements (S_{pr}) for a_p i a_r alternatives which is consisted of all criteria (J = j | j = 1,2,...,n) for which the alternative a_p is more desirable than the alternative a_r i.e.

$$S_{pr} = \{j | x_{pj} \geq x_{rj}\}$$

In case we have a criterion of the type minimum, inequality sign is opposite (≤).

After that we form a complementary set of disagreement for which the following implies:

$$NS_{pr} = \{j | x_{pj} \leq x_{rj}\} = J - S_{pr}$$

If we have the type minimum criterion, inequality sign is opposite (>).

Step 4: Determination of the agreement matrix (MS). Agreement matrix is calculated according to the sets of agreements which were calculated in the previous step. Elements of this matrix are comprised of agreement indexes. Their value is calculated as the sum of preferences (weighted coefficients) which correspond to the belonging elements of the sets of agreement. Agreement index S_{pr} for a_p and a_r alternatives is calculated as follows:

$$MS_{pr} = \sum_{j \in S_{pr}} t_j$$

Value of S_{pr} is within a range of an interval from 0 to 1. When the value of this index is more closer to 1, a_p alternative is more desirable than a_r alternative (according to the criterion of agreement). Agreement indexes form the agreement matrix, which has elements equal to zero on the main diagonal, because the comparison of the alternative with itself cannot be executed.

Step 5: *Determination of the disagreement matrix (MNS).* Elements of the disagreement matrix are comprised of the disagreement indexes which are calculated using TN matrix (weighted normalized matrix) as follows:

$$MNS_{pr} = \frac{\max_{j \in NS_{pr}} |t_{pj} - t_{rj}|}{\max_{j \in J} |t_{pj} - t_{rj}|}$$

Disagreement index is within interval from 0 to 1 and it shows to what extent a_p alternative is less desirable than the a_r alternative. With the higher disagreement index (closer to 1), according to the disagreement criterion, a_p alternative is less desirable than a_r alternative. Disagreement indexes are calculated according to weighted normalized decision making matrix (TN) and a set of disagreements for the observed alternatives (NS_{pr}).

Step 6: *Determination of the agreeable domination matrix (MSD)* .Elements of this matrix are calculated according to the values of a treshold of agreement index. Treshold of agreement index is defined as an average agreement index calculated as in the following formula:

$$PIS = \sum_{\substack{p=1 \\ p \neq r}}^m \sum_{\substack{r=1 \\ p \neq r}}^m \frac{MS_{pr}}{m(m-1)}$$

According to the given value of the average agreement index, it could be said that a_p alternative has a chance to be more desirable than a_r alternative, only if her corresponding agreement index MS_{pr} exceeds the value of an average agreement index. Agreeable domination matrix is formed according to the following criterion:

$$\begin{aligned} MSD_{pr} &= 1 & \text{za} & MS_{pr} \geq PIS \\ MSD_{pr} &= 0 & \text{za} & MS_{pr} < PIS \end{aligned}$$

Step 7: *Determination of the disagreeing domination matrix.* Similar to the previous step, for the calculation of the disagreeable domination matrix, we first calculate the average disagreement index through the following relation:

$$PINS = \sum_{\substack{p=1 \\ p \neq r}}^m \sum_{\substack{r=1 \\ p \neq r}}^m \frac{MNS_{pr}}{m(m-1)}$$

We form the disagreeable domination matrix according to the following criteria:

$$\begin{aligned} MNSD_{pr} &= 1 & \text{za} & MNS_{pr} \leq PINS \\ MNSD_{pr} &= 0 & \text{za} & MNS_{pr} > PINS \end{aligned}$$

Step 8: *Determination of the aggregate domination matrix (MAD).* This matrix is received as a product of positions of the elements of the agreeable domination matrix and disagreeable domination matrix (the calculation in a classical sense is not in question here) as follows:

$$MAD_{pr} = MSD_{pr} * MNSD_{pr}$$

Step 9: Elimination of the less desirable alternatives . If the value of $MAD_{pr} = 1$, in that case a_p alternative dominates over a_r alternative according to both criteria (of agreement and disagreement). It does not necessarily imply that there is no other alternative which dominates over a_p . This is the reason why another condition is to be met:

$$\begin{aligned} MAD_{pr} &= 1 && \text{for at least one } r, \quad r = 1, 2, \dots, m \text{ i } p \neq r \\ MAD_{pr} &= 0 && \text{for all } i, \quad i = 1, 2, \dots, m \text{ and } p \neq r \text{ and } i \neq r \end{aligned}$$

In order to determine which alternative is the dominant one, it is necessary to examine the state of domination for the possible combinations of the alternative pairs. Alternative with a greater number of elements $MAD_{pr} = 1$, dominates over other alternatives. In a situation when a number of such elements is equal, it is not possible to determine the state of domination. One can come to a conclusion about inexistence of domination among some alternatives when all the elements $MAD_{pr} = 0$ for a certain alternative. Since the situations where the impossibility of defining the state of domination through the implementation of this method are frequent, ELECTRE method belongs to a group of methods which determine the sequence of partial preferences.

PROMETHEE METHOD (PREFERENCE RANKING ORGANIZATION METHOD FOR ENRICHMENT EVALUATION)

PROMETHEE method is one of the earliest methods in the area of multi-criteria analysis, created in 1984 by several authors of the Brussels School (J. P. Brans, B. Mareschal, P. Vincke). Advantages of this method in comparison to other methods of multi-criteria analysis can be perceived through its simplicity. Parameters which are used have their economic interpretation and significance and associated effects of ranking are completely eliminated. Problems which can be solved using this method are related to the ranking of alternatives and a selection of the most acceptable alternative, according to the defined number of criteria.

Mathematical model for solving the problem can be set out as follows:

$$\begin{aligned} \max [k_1(a), k_2(a), \dots, k_n(a)], \quad n \geq 2 \\ a \in A \end{aligned}$$

Where: A – is a final set of alternatives
 $k_1 - k_n$, n of criterion, defined by the decision maker.

So far, four types of this method have been developed. PROMETHEE I helps decision maker to rank alternatives partially, PROMETHEE II makes complete ranking possible, the third type carries out the ranking in corresponding intervals, while the fourth type considers the uninterrupted line of alternatives. In this paper we will show gradually, through three steps, how one can choose the best alternative using PROMETHEE methods. Basic steps of this method are:² a) expansion of the preferences structure and introduction of the general criterion; b) construction of a higher rank graph; c) exploitation of the graph acquired.

We will assume that comparison of the two alternatives, a and b , is necessary to be carried out, for one criterion $k(a)$ of the maximum type:

$$a, b \in A \Rightarrow k(a), k(b)$$

² Čupić, M., Rao Tummala, V.M., Suknović, M.: "Odlučivanje: formalani pristup", FON, Beograd, 2003, str. 312.

It is necessary to define the preference P function as a degree of significance of one alternative over another as follows:

$$P(a, b) = \begin{cases} P[k(a), k(b), \text{if } k(a) > k(b)] \\ 0, \text{if } k(a) \leq k(b) \end{cases}$$

That is:

If: $k(a) > k(b) \Rightarrow a P b$ (a preferable to b)

If: $k(a) = k(b) \Rightarrow a I b$ (a is indifferent to b)

Step 1: *Expansion of the structure of preferences and introduction of the general criterion.* Value of the preference function is within the range of interval between 0 and 1, where higher preference is expressed with a higher value of the function (closer to 1) and vice versa (closer to zero). In order to apply this method, it is necessary to determine the general type of criterion for each criterion $k(a)$. Authors defined six types of general criterion with which the majority of actual cases can be comprehended. During creation of a specific model, it is necessary to determine the parameters for each type of the general criterion. In Table 2, general types of criteria are displayed with borders for the corresponding parameters.

Step 2: *Construction of the higher rank graph.* Here, it is necessary to determine the indexes of preferences (IP) of the alternative a in relation to alternative b for each pair of alternatives from the set A. Index of preference is calculated by the means of the following relation:

$$\forall a, b \in A: IP(a, b) = \sum_{j=1}^n t_j P_j(a, b); \quad \left(\sum_{j=1}^n t_j = 1 \right)$$

If all the criteria would have the same weight, for example $t_j = 1/n$, then:

$$IP(a, b) = \frac{1}{n} \sum_{j=1}^n P_j(a, b)$$

Characteristics of the index of preference are as follows:

1. $0 \leq IP(a, b) \leq 1$; $IP(a, a) = 0$
2. $IP(a, b) \sim 0$, weak preference a in relation to b for all criteria
 $IP(a, b) \sim 1$, strict preference a in relation to b for all criteria
3. $IP(a, b) \neq IP(b, a)$

The estimated higher rank graph is called a graph whose cores are permissible alternatives and for each pair of alternatives a and b the respective bow (a,b) has a value of their index of preferences $IP(a,b)$.

Step 3: *Usage of relations of a higher rank as aid in decision making.* Here the entering, exit and net flow of each alternative or core are calculated, taking into account the preferences of the core a with other cores x.

Exit (positive) flow is calculated as follows:

$$T^+(a) = \frac{1}{(p-1)} \sum_{x \in A} IP(a, x)$$

Where p is a total number of alternatives in the model

Entering (negative) flow is calculated:

$$T^-(a) = \frac{1}{(p-1)} \sum_{x \in A} IP(x, a)$$

Difference between the entering and the exit flow is net or clear flow, that is:

$$T(a) = T^+(a) - T^-(a)$$

Such defined flows are interpreted as follows: the larger exit flow for alternative a is, the more dominant over other actions it is, that is, the smaller the entering flow is, the smaller the number of other alternatives which dominate over action a is. With a larger net flow, alternative a has a higher place in order (higher rank).

The next step is defining a partial and complete order. It is necessary to define order of preference and order of indifference $[P^+, I^+]$ and $[P^-, I^-]$:³

$$\begin{aligned} a P^+ b & \text{ only and only if } T^+(a) > T^+(b); \\ a I^+ b & \text{ only and only if } T^+(a) = T^+(b); \\ & \text{and} \\ a P^- b & \text{ only and only if } T^-(a) < T^-(b); \\ a I^- b & \text{ only and only if } T^-(a) = T^-(b). \end{aligned}$$

Comparing the intersection of these two orders, partial order can be determined (P^I, I^I, R) as:

$$a P^I b \text{ only and only if } \begin{cases} a P^+ b & \text{and} & a P^- b \\ a P^+ b & \text{and} & a I^- b \\ a I^+ b & \text{and} & a P^- b \end{cases}$$

$$\begin{aligned} a I^I b & \text{ only and only if } a I^+ b \text{ i } a I^- b \\ a R b & \text{ in other cases.} \end{aligned}$$

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This partial order offers to a decision maker a graph in which some alternatives are comparable, and some are not. In order to remove this shortcoming, a new version of PROMETHEE II method which offers a complete order of alternatives has been developed.

CONCLUSION

For the more complex problems of the multi-criteria analysis for which the most acceptable alternative should be selected and complete order of importance of the alternatives should be defined in a model, the following methods of multi-criteria ranking of alternatives are proposed:

- AHP method, if it is necessary to define objective vector of weighted coefficients of criteria and relations of the values of pairs of alternatives, whereby nine-points scale is used. Also, when there is a small number of alternatives which are to be compared, this method is convenient.
- PROMETHEE method, if it is necessary to compare the observed criteria with the six types of general criteria.
- ELECTRE method, if the isolation of a complete order of importance of alternatives in a model is requested.

³ Suknović, M., Čupić, M: "Višekriterijumsko odlučivanje: formalan pristup", FON, Beograd, 2003, str. 157.

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ACCOUNTING FOR DEFERRED TAX ASSETS AND LIABILITIES BASED ON THE BULGARIAN EXPERIENCE

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ABSTRACT

In the 1990s and in the very beginning of the new millennium numerous changes were made in accounting and taxation laws in Bulgaria towards harmonization of our legislation and existing practices in order to set them in compliance with legal framework established in the European Union.

The financial reporting standards just outline a common framework for accounting of income taxes, while their particular implementation is in close relation with the provisions of the Corporate Income Tax Act (CITA): in order to establish the taxable profit the accounting profit/loss is adjusted by permanent and temporary tax differences.

In most cases the accounting profit/loss diverges from the tax base since distinctive rules exist to determine each one of them. Financial reporting standards play a role of methodological guidance for treatment and presentation of information in the financial statements, whereas the CITA determines how the taxation base is calculated.

In frequent situations permanent and temporary tax differences are as a result of incomes or expenses that were recognized for tax purposes in a period distinct from their accounting period. In general, the accounting standards adopt recognition of the future recovery or settlement of the tax, in consequence of the difference between the amounts due and paid, as deferred tax assets or liabilities. In such a way, the profit tax is presented as a sum of two elements: current tax and deferred tax, instead of being a product of the effective tax rate multiplied by the accounting profit.

The paper discusses some aspects of the accounting standards applicable in Bulgaria as regards the income tax. Answers are given to the questions of the implementation of full provisioning for deferred tax, required use of a balance sheet approach, computation of deferred tax based on temporary differences between the tax values of assets and liabilities and their carrying amounts and practical aspects related to the specific accounting and disclosure of the income tax information.

Key words

tax system in Bulgaria, accounting standards, deferred tax assets and liabilities, financial reporting

INTRODUCTION

In the 1990s and in the very beginning of the new millennium numerous changes were made in accounting and taxation laws in Bulgaria. The membership in the EU since 1 January 2007 raised the obligation for full alignment of national accounting and taxation legislation with the Directives of EU. To fulfill this commitment, the Council of Ministers endorsed in the beginning of 2007 a new law on corporate income taxation and in the autumn of 2007 the respective amendments in the National Standards for Financial Reporting of Small and Medium Enterprises were made. All above-mentioned factors have given strong momentum towards harmonization of our legislation and existing practices in order to set them in compliance with legal framework established in the European Union.

In most cases the accounting profit/loss diverges from the tax base since distinctive rules exist to determine each one of them. Financial reporting standards play a role of methodological guidance for treatment and presentation of information in financial statements, whereas the Corporate Income Tax Act (CITA) sets up the order for determining and taxation of the profit/loss.

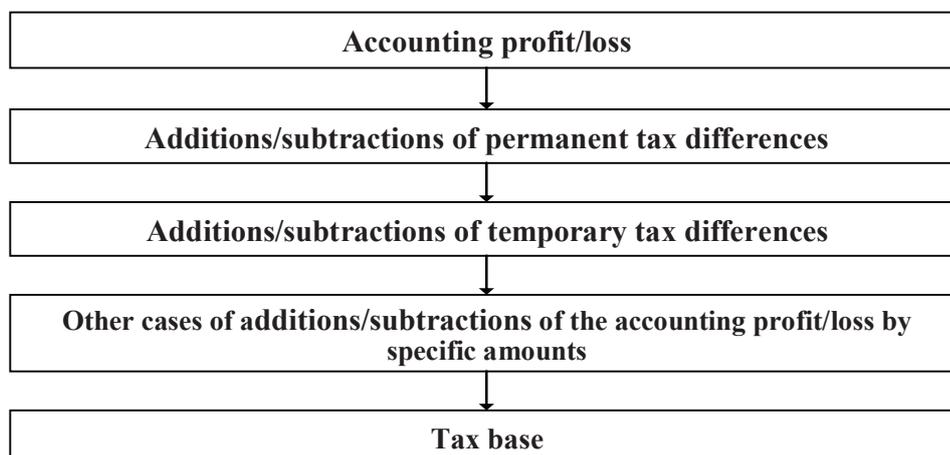
Differences come out between the accounting profit/loss and the tax base that are known as: permanent tax differences, temporary tax differences and special cases, which are also included in tax base calculation. In frequent situations differences are as a result of incomes or expenses that were recognized for tax purposes in a period distinct from their accounting period. In general, the accounting standards adopt recognition of the future recovery or settlement of the tax, in consequence of the difference between the amounts due and paid, as deferred tax assets or liabilities. In such a way, the profit tax is represented as a sum of two elements: current tax and deferred tax, instead of being a product of the effective tax rate multiplied by the accounting profit.

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TRANSFORMATION OF THE ACCOUNTING PROFIT/LOSS FOR TAX PURPOSES

The following approach of determining the tax base is adopted in the Bulgarian legislation: all data are recorded in the accounting systems of the companies; as a next step the incomes and expenses not-recognized or recognized for tax purposes are added to/subtracted from the calculated accounting profit/loss with the aim to determine the tax amount. As per CITA, in establishing the tax base some expenses and incomes are not recognized fully or partially though they are posted and included in the company's financial statement.

Figure 1 Profit/loss determining process



When income or expense is treated equally for accounting and tax purposes, no transformation of accounting profit/loss is done. However, once diverse accounting and tax treatments exist, transformation is needed since there is distinction in comparing tax bases with accounting values. The differences exhibited in one and the same reporting period are called permanent. According to the tax law, those differences are irrecoverable: they are included in the transformation of the accounting profit/loss, but they are not reversed in the subsequent reporting periods.

The similarity of temporary and permanent differences lies in the fact that in both cases the accounting incomes and expenses are not recognized for tax purposes in the year of their accrual. The distinction is that the temporary differences are reversed in general in the next accounting periods, when they will influence again the tax base. The accounting outcome of the temporary tax differences is exhibited in their tax effect.

The following rules could be derived to serve in determining of the tax base when temporary tax difference occurs:

- in case of an expense, out of recognition in the year of the accounting record, which will be recognized in consequent periods, when the relevant condition will take place, the accounting profit/loss will be increased by the same expense in the year of expense posting, and will be reduced in the year of the occurrence of the recognition event (reversal of a temporary tax difference);
- in case of an income, out of recognition in the year of the accounting record, which will be recognized in subsequent periods, when the required condition will be met, the accounting profit/loss will be decreased by the same income in the year of income posting, and will be boosted up in the year of the occurrence of the recognition event (reversal of a temporary tax difference)

The expenses and incomes enlisted in Chapter 8 of CITA, in fact, are or might be transformed in temporary differences. Hence, on the basis of the effective legislation, some temporary differences are given in Table 1.

In summary, the regulation of the Corporate Income Tax Act, being in force, is applied for the due taxes computation, where one can also find the definitions of the tax differences. The applicable accounting standards clarify the nature of the differences from an accounting point of view.

Accounting standards on income taxes contain the basic directive and they are applied by enterprises subject of the corporate income tax (CIT). The standards provide the rules of accounting for the CIT, the temporary tax differences and their taxation effects. The recognition, measurement and presentation of tax assets and liabilities, as well as the presentation and disclosure of the amount of the due tax are also considered in these standards.

The main issues in income tax accounting are linked with the current and future consequences of the transactions and events that have been reflected in the income statement and with the future recovery (settlement) of assets and liabilities presented in the balance sheet. As regards the deferred taxes, the applicable standards are based on the balance sheet liability method, in which the emphasis is moved from the income statement to the balance sheet, i.e. no incomes and expenses are carried out, but deferred tax assets and liabilities are included in the balance sheet instead.

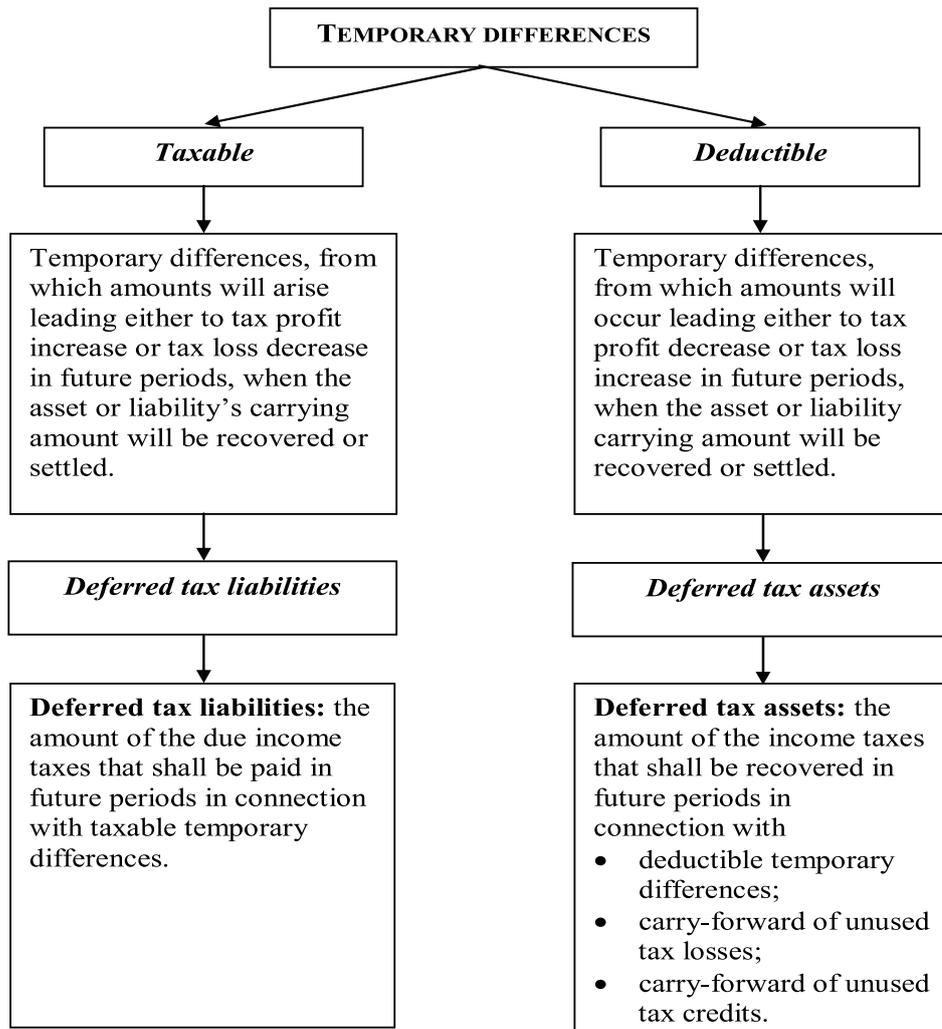
Table 1 *Temporary tax differences*

Temporary difference origination	Temporary difference reversing
➤ expenses from subsequent evaluations of assets and liabilities	⏪ in the year of the corresponding asset/liability's disposal
➤ expenses exceed incomes from initial recognition and subsequent re-evaluation of biological assets and agricultural production	⏪ in the year of the corresponding asset's disposal
➤ expenses as a result of receivables' impairment	<ul style="list-style-type: none"> ⏪ upon expiry of legal limitation ⏪ in transfers of receivables ⏪ when, after activation of the bankruptcy procedure, the receivable is discounted, as a result of an approved recovery plan – up to the value of the discount as per the recovery plan ⏪ in case the receivable is declared undue by court decision ⏪ upon receivable's repayment before legal limitation expiry, in accordance with the law ⏪ if the debtor is discontinued
➤ expenses for provisioning of payables	⏪ in the year of the provisioned payable repayment
➤ expenses for accrued, but unused paid leaves	⏪ when the remuneration is paid and the social security payable is deposited
➤ expenses, which constitute incomes of a domestic individual, except the incomes from main and additional labor contracts defined in a legal act and the incomes of sole proprietors.	⏪ when the incomes are paid and up to the amount remunerated
➤ interest expenses whenever thin capitalization is applicable	⏪ within 5 years timeframe from the recognition

The income tax standard lays down rules, according to which on the date of financial statement preparation (31st December), the amounts on deferred tax assets/liabilities accounts should be reconsidered and corrected to calculate precisely the income tax expense. These assets and liabilities are measured at the tax rates that are expected to apply when the temporary differences will be reversed. In practice, this could be done by multiplying the expected tax rate and the tax base total of the non-reversed temporary differences and the ones occurred in the current period.

Figure 2 shows the relationship between the carrying amounts of assets and liabilities, their tax bases and the origination of deferred tax assets and liabilities.

Figure 2 Types of temporary tax differences



Taxable temporary difference can arise in the following cases:

1. The carrying amount of an asset is higher than its tax base
2. The carrying amount of a liability is less than its tax base

Deductible temporary difference can occur, as follows:

1. The carrying amount of an asset is less than its tax base
2. The carrying amount of a liability is higher than its tax base

Table 2 Relationship 'Asset/liability amount – deferred tax recognized'

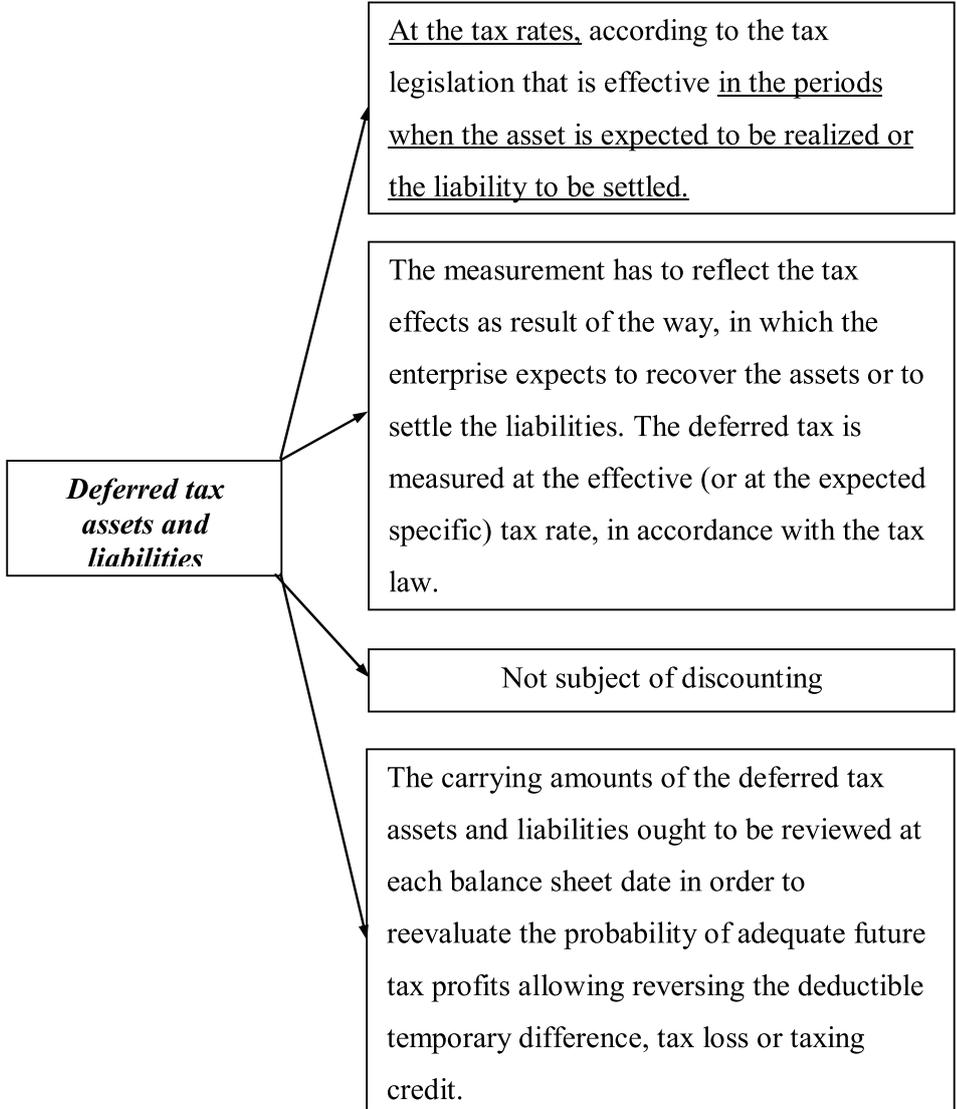
Asset/ Liability	Carrying amount compared to tax base	Temporary difference	The deferred tax is recognized as:
Asset	Higher	Taxable	Liability
Asset	Lesser	Deductible	Asset
Liability	Higher	Deductible	Asset
Liability	Lesser	Taxable	Liability

The rules applied with regard to the measurement of the deferred tax assets and liabilities are explained on Figure 3.

In case of temporary differences one has to determine deferred tax. The taxable differences require recognition of deferred tax liabilities, while the deductible differences necessitate recognition of deferred tax assets, according to the following guidance:

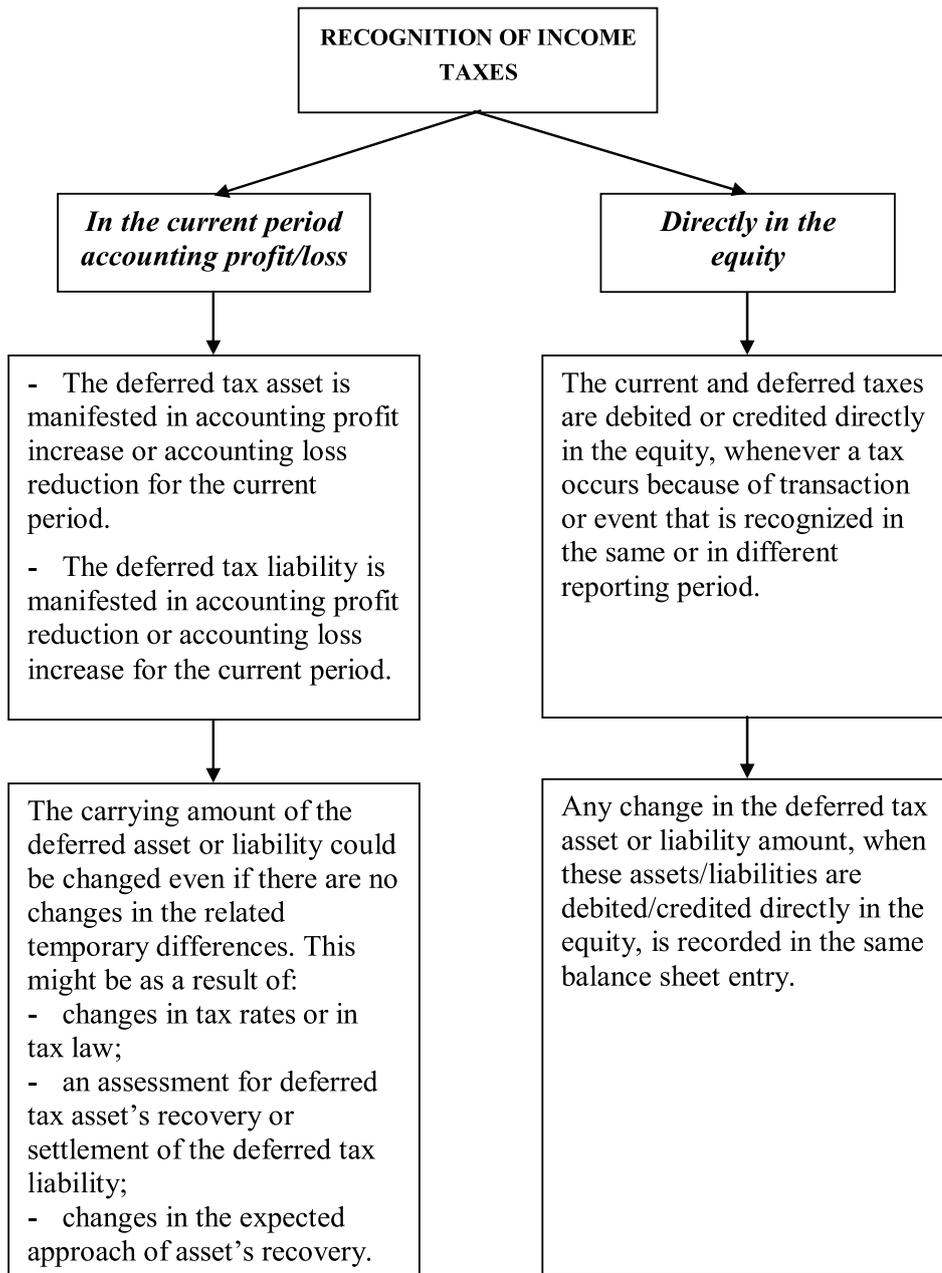
- the deferred tax liabilities must be recognized for all taxable differences occurred;
- when recognizing deferred tax assets, one should estimate the probability of their reversing and the extent to which the enterprise would be able in the future to generate sufficient profit that would be used to offset them.
- unrecognized deferred tax assets and the carrying amounts of recognized deferred tax assets are reviewed at the date of each yearly financial statement, in order to assess the probability of enough future tax profit, which will allow to reverse the deductible temporary difference, tax loss or tax credit.

Figure 3 Rules for measuring of the deferred tax assets and liabilities



Two approaches exist to recognize deferred income taxes, which are depicted on Figure 4.

Figure 4 Approaches to recognize income taxes



ACCOUNTING FOR DEFERRED TAX

In order to indicate the tax effect of the temporary differences, two separate balance sheet accounts usually exist in the charts of accounts of Bulgarian companies: account for deferred tax assets and account for deferred tax liabilities, both of which are included in a common group.

Deferred tax recognized in the accounting profit/loss for the period

The following accounting entries are made to record the transactions with deferred tax assets:

- Deferred tax assets occurred in the period as a result of deductible temporary differences:
 - Dr a/c Deferred tax assets
 - Cr a/c Tax expenses and incomes

2. Deferred tax assets are reduced when the deductible temporary differences are recognized / reversal/:
 Dr a/c Tax expenses and incomes
 Cr a/c Deferred tax assets

Similar accounting entries are made when temporary differences are transformed in permanent.

The accounting entries to reflect the transactions with deferred tax liabilities are, as follows:

1. Deferred tax liabilities occurred in the period as a result of taxable temporary differences:
 Dr a/c Tax expenses and incomes
 Cr a/c Deferred tax liabilities
2. When deferred tax liabilities are recognized /reversal/, the determined tax amount is accounted as an increase of the current period profit. The deferred tax liabilities settled in the period are reversed, as follows:
 Dr a/c Deferred tax liabilities
 Cr a/c Tax expenses and incomes

In case of a change in the tax rate, new evaluations of the deferred tax assets/liabilities' carrying amounts are needed as of the balance sheet date. The difference is recorded as current period tax expenses/incomes.

The following accounting entries are carried out, when there is a tax rate cut:

- *Deferred tax assets*
 Dr a/c Tax expenses and incomes
 Cr a/c Deferred tax assets
- *Deferred tax liabilities*
 Dr a/c Deferred tax liabilities
 Cr a/c Tax expenses and incomes

Deferred tax recognized in the equity

The deferred tax assets and liabilities could be directly debited or credited in equity in the subsequent case:

- *Re-evaluation of long-term tangible and intangible assets after their initial recognition.* According to the latest amendment in the Accounting Standards for Small and Medium Enterprises, in force since 1 January 2008, this re-evaluation was revoked, i.e. after the asset's first recognition it has to be accounted at acquisition price net of accrued depreciation and the impairment losses.

When the corporate income tax is posted for the period of the re-evaluation, the part corresponding to taxed re-evaluation reserve can be directly debited on the Deferred tax liabilities account. At the time of these liabilities reversal, the entry is, as follows:

Dr a/c Deferred tax liabilities
 Cr a/c Long-term assets re-evaluation reserve

Recognition and accounting of current period income tax

The current period CIT is a total of the taxes that are determined as due /recoverable/ with regard to the taxable profit /loss/ for the same period. The sum of this tax takes shape in the tax return, after which corrections are made by considering the recognized and reversed deferred tax assets and liabilities. The current income tax is recognized as a liability to the extent of the unpaid amounts in the reporting period. If the amount paid exceeds the tax due, as per the tax return, the surplus is recorded as a receivable from the state budget

Financial statement presentations for the deferred taxes

The deferred tax assets and liabilities ought to be distinguished from the current ones. Deferred corporate income tax is specified by applying the balance sheet liability method, by which their amount is computed, as of the balance sheet date. A particular position “Deferred taxes” exists in section B, group IV of the asset side of the balance sheet, in which deferred tax assets are presented. In the same time, deferred tax liabilities are put in position “Tax provisions, incl. deferred taxes” in section B of the liability side of the balance sheet.

The deferred taxes as a result of taxable and deductible temporary differences are showed separately only in consolidated statements. Companies that do not prepare such statements present them at net value by adhering to the following rules:

- excess of deferred tax assets over the deferred tax liabilities is presented as deferred tax in the asset part of the balance sheet;
- excess of deferred tax liabilities over the deferred tax assets is presented as deferred tax in the liability part of the balance sheet;

Evolution of deferred taxes in the period is equal to the difference between their initial and closing balances calculated as per the balance sheet method. This evolution is also presented in the Income statement, as an element of position 11 “Income tax expenses”, i.e. the tax expense (income) is reported in one position. Despite of the fact that p.21.7 in *AS-1 Financial statements presentation* stipulates the income tax expenses, determined on the basis of *AS-12 Income taxes*, are included in position “Income tax expenses”, the presentation of the tax, as per tax return, and of the deferred tax is not specified. The Income statement presentation can be separated into current tax expenses and deferred tax expenses by establishing of two positions: “Current tax” and “Deferred tax evolution”.

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The deferred tax that originates from cases of direct recognition in equity (e.g. re-evaluation reserve) has no effect on the Income statement.

Financial statement disclosures

The amounts of the following main components related to the deferred tax are required to be disclosed in the Notes to the financial statement:

- taxable temporary differences and the related deferred tax liabilities, as of the financial statement date;
- deductible temporary differences, unused tax losses or credits and deferred tax assets, as of the financial statement date;
- deductible temporary differences, unused tax losses or credits, for which deferred tax assets were not recognized, including the reasons;
- recalculations of the prior periods' income taxes that are recognized in the current period;
- current and deferred taxes debited and credited directly in equity;
- deferred tax correction as a result of changes in the tax laws;

In summary, a conclusion can be drawn that the present paper reveals some particular and practical aspects of accounting for deferred tax assets and liabilities, presentation and disclosure based on the Bulgarian experience. The latest amendments in the National Accounting Standards and the CITA have set up rules that are harmonized with the legal framework established in the European Union.

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HARMONIZING THE ACCOUNTING STANDARDS IN THE FUNCTION OF OBJECTIVE FINANCIAL REPORTING IN THE COUNTRIES OF SOUTHERN AND EASTERN EUROPE

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ABSTRACT

Financial statements are a direct product of the accounting reporting system. Financial reports are the most important instruments of informing interested stakeholders about the performance of the company for a certain period of time. Analysis of accounting reform and accounting reporting was conducted in several countries of Southeastern Europe. This analysis shows that the level of harmonization of financial reporting with international accounting standards is different in region of Southeastern Europe. Some countries are at the beginning of the process, while other countries in the region are at the end of the process of implementing the EU *acquis communautaire*. In order to harmonize financial reporting to IAS, it is necessary to implement the following activities:

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1. extension of the normative and institutional framework in accordance with the EU *acquis communautaire*,
2. develop the capacity of institutions for the implementation of IAS,
3. development of mechanisms of regulation and supervision,
4. development of accounting-auditing function,
5. establish mechanisms of action of market discipline in financial reporting,
6. establish a regional technical cooperation,
7. establish the appropriate form of external consultancy support in the financial reporting,
8. establish centers for training of accountants and auditors,
9. ensure reporting by segments of the company in accordance with IAS 14th.

Key words

*International accounting standards, financial reporting, the global financial crisis, corporate governance, *acquis communautaire*, reporting by segments of the company.*

INTRODUCTION

International accounting standards are a further development of IV and VII of the Directive. For the purposes of financial reporting, it is especially important to apply: IAS 1 - Presentation of Financial Reporting and IAS 14 - Reporting by segments. The process of implementation of IAS 1 in most countries of Southeastern Europe is very intense, or is completed in certain countries.

However, the implementation and harmonization of IAS 14 in most countries is at the very beginning, without any concrete results. This is a very bad effect on the efficiency of managerial activities of enterprises in countries of Southeastern Europe. This particularly affects large, multiproductual, diversified and dislocated companies.

Implementing international accounting standards more and more is a necessary condition for the effective functioning of international financial market. This especially applies to the efficiency of capital market. Without harmonization of IAS, there is no accelerated circulation of capital from investors to potential debtors. Impact of harmonization of accounting standards on the development of capital markets is analyzed with the following financial intermediaries: banks, insurance organizations, stock exchange and investment funds.

Reliable accounting system is the basis of the market economy functioning. The financial statements provide relevant information on the financial position, performance, capitalization and cash flow business. The financial statements present the economic substance of transactions and events. The need for improved financial reporting is a general trend in all financial systems. This is primarily caused by the emergence of the financial crisis and the crisis of corporate governance, which are present since the eighties of last century in many countries. Today the financial crisis has a global character.

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ANALYSIS OF ACCOUNTING REPORTING IN THE COUNTRIES OF SOUTHEAST EUROPE

Regulations on accounting and auditing in most countries of Southeast Europe, are not fully compliant with the relevant fundamental elements of the *acquis* on financial reporting and auditing (fourth, seventh and eighth Company Law Directive). Regulations on accounting and auditing are not aligned with the *acquis* mainly concerning:

1. preparation of management reports (fourth, seventh and Transparency Directive).
2. preparation of semiannual reports for listed companies (Directive on transparency),
3. electronic publishing of financial statements (First Directive),
4. approval and registration of audit companies (Eighth Directive),
5. preparation of consolidated accounts (Seventh Directive).

The importance of the *acquis communautaire* for the countries of Southeastern Europe is twofold:

1. it is a high quality model for improving accounting and auditing, and
2. the adoption of the *acquis communautaire* in the field of accounting and auditing, supports the goal of most countries of Southeast Europe to join the EU.

The countries of Southeast Europe need to show that they not only implement the *acquis communautaire* in the law, but they also take concrete measures of implementation in practice (institutional

framework). In this regard, the countries of Southeast Europe can rely on the experience of existing EU member states. Creating high quality regulatory and institutional framework for accounting and auditing requires reforms in the sphere of legislation.

The importance of auditing increases in the market economy. Audit reports create interest with shareholders, business partners, creditors, employees, state, stock market and the general public. Audit reports should be publicly available. The auditors confirm that the financial statements are real and true. This enables the management of companies and shareholders, to make proper decisions in the field of management activities of the company.

Basic accounting and auditing guidelines are:

1. Fourth Directive,
2. Seventh Directive, and
3. Statutory Audit Directive.

1) Fourth Directive is aimed at harmonization of national regulations of the members of the EEC on taking the accounts and financial reporting. The particularity of the legal system in EEC member countries has caused considerable differences in national regulations. This had resulted in the impossibility of comparing the financial statements of the EEC countries. However, it was a precondition for free movement of capital. Hence arose the need for equalization of principle of assessment, control, and publication of annual accounts. The subject of equalization are as follows:

- a) an annual summary, which consists of a balance sheet, profit and loss account and annex,
- b) report on Business.

2) Seventh Directive on consolidated accounts, coordinates national laws on consolidated accounts and defines the circumstances under which consolidated accounts are produced.

3) Statutory Audit Directive is known as the eight new EU legal directives of the Company. It explains the responsibility of statutory auditors and sets certain ethical principles to ensure objectivity and independence. Directive introduces a requirement for external quality assurance, ensures public oversight over the audit profession and improves cooperation between oversight bodies in the EU.

Transparency and disclosure of data is essential for effective corporate governance and functioning of capital markets. Quality and comparable financial statements allow investors to evaluate performance and prospects of growth and enterprise development. Adoption of reliable investment decision involves a regular and timely access to reliable and comparable information. Transparency and data publication is the basis for market-oriented supervision over the work of the company. This allows business owners and the public to evaluate the performance of enterprise management.

A crucial role in the quality of financial reporting has the support of education and development of accounting and auditing profession. In the process, institutions for the creation and transfer of accounting knowledge have the main role, as well as professional associations of accountants and auditors. Their role is continuous education and training of accountants and auditors. It is a dynamic process that relies on the harmonization of accounting education with relevant international professional accounting regulations. The quality of financial reporting is primarily caused by the quality of creation and transfer of accounting knowledge and professional education of accountants and auditors.

THE OBJECTIVES OF HARMONIZATION OF FINANCIAL REPORTING

The main goal of harmonization of financial reporting is to improve the quality of the application of international accounting and auditing standards to a level that will increase the usefulness of accounting-auditing activities and ensure compliance with the *acquis communautaire*. Based on this goal, a whole system of goals has been developed, which in fact is only the elaboration of the primary goal.

The system of goals includes the following objectives:

1. The legal framework for an internationally recognized financial reporting.
2. The high degree of compliance of financial statements with the EU *acquis communautaire* and internationally accepted practices.
3. The legislative framework for the audit of financial statements in conformity with the EU *acquis communautaire* and international practice.
4. Financial and accounting institutions have the capacity to implement and develop a framework for the implementation of international standards of accounting and auditing.
5. Mechanisms of supervision and control in performing accounting and auditing jobs.
6. Development of Accounting and audit profession and the application of ethical standards and codes of conduct.
7. Mechanisms of action of the market discipline to the quality of financial reporting.
8. The development and introduction of new forms of international cooperation in the implementation of technical assistance.

In terms of information provided, the financial statements must meet the following requirements:

1. Intelligibility is the most important characteristics of financial statements. Request for understandability of financial statements means that the information in the financial statements can be understood now, that is, at the moment to introduce users to them.
2. Relevance, assumes that, the usefulness of information is evaluated on the basis of how they are relevant to the decision making of users. According to the 26th paragraph of the Framework for the preparation and presentation of financial statements, the information is relevant when it influences the economic decisions of users by helping them to evaluate past, present or future events or by confirming or correcting the previous estimate of users.
3. Reliability, according to paragraph 31 of the Framework represents the information that has no material error and bias, and users can rely on it in order to truly represent what information is or what might be expected that it represents.
4. Comparability is the requirement that financial statements of the company in successive periods are comparable. The request includes the possibility of comparability of financial reports comparing different companies. In connection with the comparability requirement is also the concept of materiality, which includes a separate display in the financial statements of any materialy significant item.

The financial statements are the product of a large number of transactions and events in the company. The data are grouped according to their nature and function of a particular group or class, and are indicated as elements of financial statements. The elements that show the financial position of companies are property, equity and liabilities, and the elements on which to determine the success of business include income and expenses.

3. Implementation of the company's law Directives

Specific activities to be implemented in order to harmonize accounting reporting, refer to the following:

1. extension of the normative-institutional framework,
 2. development of monitoring mechanisms, and
 3. effect of market discipline.
- 1) Upgrading the normative framework includes statutory completion of application of the International Financial Reporting Standards, International Auditing Standards, ethical standards and rules of operation of the accounting and auditing profession.

The institutional framework involves strengthening the capacity of institutions that contribute to achieving those objectives. This primarily refers to the Ministry of Finance, Central Bank, the Commission for the Securities, the Agency for Deposit Insurance, Tax Administration and others.

- 2) Oversight mechanism involves the development of corporate, self-regulatory and administrative oversight. Corporate supervision means the introduction and development of forms of internal audit, the introduction of a higher degree of top management responsibilities for financial reporting, the introduction of audit committees and procedures for the preparation of financial statements. Self-regulatory oversight assumes strengthening of the motives and capacity of accounting and auditing profession.
- 3) As part of market discipline there are those mechanisms that provide access, comparability, active action in terms of analytical and proofreading on the basis of information from financial statements of the company. Everything that contributes to an active relation of market towards financial reporting of certain company, can be treated as the impact of market discipline. Reliance on market discipline provides the following benefits:
 1. raises the efficiency of action,
 2. raises the accountability system,
 3. easier to connect with investors,
 4. development of market discipline in other industries.

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Implementation of specific activities, in order to harmonize financial reporting, it is assumed to define an action plan and time frame for development and implementation of a plan. Making of an action plan is based on an analysis of compliance of Accounting and audit practices with the framework provided by the *acquis communautaire*. Each of the defined actions in the action plan is aimed at achieving one or more pre-set goals. All actions are interactively linked to each other, but they are defined as separate entities. It is necessary to specify for each defined action the institution responsible for its implementation and adequate budget and resources related to:

1. Appropriate external consultancy support, in order to meet international best practice.
2. Appropriate internal consultancy support, which can be provided in each country in Southeast Europe.
3. Regional technical cooperation, in order to exchange relevant knowledge and experience.
4. Funding of operational support to relevant stakeholders and projects for the realization of one or more of the planned activities.

REPORTING BY SEGMENTS OF THE COMPANY

According to International Accounting Standard 14 - Reporting by segment of the company can be in:

1. criterion of activity (business segment), and
2. geographical criteria (geographical segment).

Business segment is a clearly different part of the company, which creates certain effects or groups of related products and services. Diversity of return and risk is a criterion for identifying business segments. In determining whether a particular product or service are related, it is necessary to bear in mind the following:

- a) the nature of the products or services,
- b) the nature of related processes,
- c) the type or class of customers for effects,
- d) methods used for the purpose of effects distribution,
- e) the nature of the regulatory environment.

Geographical segment is a clearly different part of the company, which operates in the special economic environment. Geographical segment is subject to risk and yield different from other parts of the company. Identification of geographical segments is based on the following factors:

- a) similarity of economic and political conditions,
- b) the relationship between operations in different geographical areas,
- c) proximity of doing business
- d) special risks associated with doing business in a particular area,
- e) exchange control, and
- f) highlighted currency differences.

Segment, on which the report is being made, is a business or geographical segment for which information is required to be disclosed by International Accounting Standard 14th. Under this standard, the segments should be understood as:

- a) Business segment: Part of the company that produces a product or group of products, as well as part of the company that provides service or group of related services.
- b) Geographical segment: Parts of companies that are geographically separated, regardless of whether they produce the same products or group of products or provide the same services or group of services.

Business or geographical segment should be identified as a segment on which the report is being made, if the majority of its revenues is earned from sales to external customers, although, one of the following conditions is achieved:

- a) if its external revenue and income from transactions with other segments is 10% or more of total revenues of all segments,
- b) b) if the result of the segment is 10% or more of the joined results of all segments,
- c) c) if the property of the segment is 10% or more of the total assets of all segments.

Income segment is the income of which is reported in the Income statement of the company. Income can be directly attributed to the segment or allocated to the segment on a reasonable basis, whether through sales to external customers or from transactions with other segments of the same

company. Segment revenues exclude special items, income from interest and dividends, gains from investments and extinguishing debt, unless the segment is not primarily financial. Income segments are: operating incomes from effects sales to external customers and incomes from transfer of effects to other segments within the company, extraordinary incomes, financial incomes and participations in the joint venture.

Expenditures of segments derive from operating activities that can be directly attributed to the segment or on a reasonable basis, allocated to the segment, regardless of whether the expense is related to selling effects to external customers or transactions with other segments of the same company.

Expenditures of segments do not include extraordinary items, interest expenses, losses on the sale or termination of investment, expenses of participation in enterprise losses of associated companies, joint ventures and other investments, expenditures for taxes on income and general administration costs for the company as a whole. Expenditures of segments are: business expenses from the costs of sold effects to external customers or internal expenses on from the costs of transfer effects to other segments of the company, the general costs of administration and common functions of companies for the segment account, extraordinary expenses, financial expenses and costs of the segments based on the joint venture.

The result of the segment is segment revenue less segment expenses. Segment result is determined before any adjustments for minority interests. Segment result consists of internal and external financial results.

The funds of the segment are part of the company's business assets that are employed in its business activities and that are directly attributable to the segment or t can be allocated to the segment on a real basis. If the segment result includes income from interest or dividends, the funds include the appropriate credit, investment loans and other parts of the assets that bring revenue. The segment assets do not include the funds paid by the income tax.

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Obligations of the segment are those business obligations that arise from business activities of the segment and that are directly attributable to the segment or can be allocated to the segment on the real basis. Obligations of the segments are also liabilities for interest and obligations under the participation in joint ventures. Obligations of the segments do not include liabilities for income tax purposes.

Segment assets and liabilities are part of the company's Balance sheet. This means that there is no gender balance of assets and liabilities in the Balance sheet of the segment, as is the case with the company's Balance sheet. This is because capital and resources that segment is not using and liabilities that didn't arise from segment's business, are not allocated to the segment.

Segment's funds usually consists of inventories of effects. It refers to goods and material, under the condition that each segment has its own warehouse. Receivables from customers can be expressed by segments only if the certain segment sells its effects to customers, under the condition that there is no sales from other segments of the company. Fixed assets may be expressed by the segments based on analytical evidence from the accountancy.

The condition is that the fixed assets are not used for several segments of the company. Obligations to suppliers may be expressed by segments only if a supplier isn't ate the same time a supplier for several segments. Only the obligations to employees can be expressed by segments without any problem. Obligations under Interests may be balanced by segments, only if the segment is organized as an investment center.

In practice there are two types of segments of the company:

1. profit centers, and
2. investment centers.

Profit centers are:

- a) rounded production and sales segments,
- b) part of the company that has the necessary critical mass of direct costs and revenues that are under the control of segment's management,
- c) part of the company where the determination of income and expenditure has been transferred from company's administration to the segment's management, which is controlled and motivated by the company's administration with the help of business results.

Investment centers are segments of the company in which managers make decisions about resources and sources of funds related to the investment center, in addition to decisions on costs and revenues. With investment centers there are expenses of financing, and revenues from funding may also appear. Control and motivation of managers in investment centers is done by the rate of return on funds employed.

The aim of reporting on segments of the company is to help users of financial statements to better:

1. understand the performance of the company,
2. evaluate the risks and incomes of the company,
3. judge the company as a whole.

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Many companies produce groups of products and services or operate in different geographical areas with different rates of profitability, growth opportunities and risk. Information about the different types of products and services of company and its operations in different geographical areas are called the information by segment. All segment's information of the company are important for assessing the yield and risk of diversified and multi-product companies. Such information can't be obtained from the aggregated data at the company as a whole.

Reporting by segments of the company is basically a tool for profit maximization in the long run, which is the ultimate goal of company's business. Balancing financial results by company's segment, management of the company gets information of how each segment contributes to the achievement of company's profit. Based on this information, company's management undertakes the following:

1. Encourages growth and development of those segments of the company whose contribution to the achievement of profit is the most significant.
2. Segment of the company which has unsatisfactory result is the subject of special attention to the company's management.

Management of the company analyzes and tries to eliminate causes of unsatisfactory financial results of the the certain company's segment. If the causes of bad results can not be resolved, management cancels the segment of the company, unless the concerned segment is connected to other segments of the company, so his disappearance jeopardizes the success or survival of other segments.

Another important reason for segmentation of the company is building the motivation mechanism of the company. The construction and operationalization of motivation mechanism is related primarily to the managers of company's segments, who represent the middle layer of company's management.

Motivational mechanism for the middle layer of company's management can't be built and operationalized without balancing the financial results of company's segments. Motivational mechanism of segments lies in the determination of standards for measuring the success of managers through the special procedures of accounting planning. Achieved results of managers are compared with the standard, and separate contracts are concluded with managers.

International Accounting Standard 14-Reporting by segment, obliges companies with proprietary or debt securities which trade on the stock exchange, to report by segments. This is one of the requirements for inclusion of company's securities to the stock exchange list. Requirements that a company must meet in order to its securities were included in the stock exchange quotations list are prescribed by stock exchange or national legislation. One of the conditions for large companies is the obligation of reporting by segments. Companies whose securities are not traded on the stock exchange are recommended to report by segments, because the returns and risks of company's segments are different. The practice of the large companies in developed market economies is reporting by segments, regardless of whether their ownership or debt securities are traded on the stock exchange.

In most countries of Southeastern Europe Statutory accounting regulation is not in line with International Accounting Standard 14-Reporting by segment. This is the case with many countries that are in the transition phase. This has negative influence especially on large, multi-product, diversified and dislocated companies. This situation negatively affects those companies that were sent to the foreign market, whose ownership and debt securities are traded on the stock exchange. All this imposes a priority commitment of harmonization of the internal accounting reporting with the requirements of MRS14.

The request for the consistent application of IAS 14 includes regular financial reporting by business and geographical segments of the company, with disaggregation of the elements of income, expenses, assets, capital and liabilities on narrow homogeneous groups. In this way, company's management, as well as external users, come to the quality and detailed information. This increases informational power of accounting information system and requires adequate solutions in the field of cost accounting. Quality information on business of company's segments provide adequate and depth analysis of company's performance.

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CONCLUSION

Quality financial reporting helps avoid and resolve financial crises and have a positive impact on overall economic trends. Enhanced financial reporting enables:

1. attracting foreign direct and portfolio investment
2. intensification of domestic savings,
3. safety performance of financial markets,
4. adequately assessing the performance of the company by investors,
5. availability of financial resources to small and medium enterprises
6. improving corporate governance,
7. shareholders and the public to monitor the management of the company,
8. transparent process of privatization of enterprises that are owned by the state.

Over time, financial reporting is gaining in importance. Number of financial reports is increasing, the number of users and institutions for the quality control of financial reporting. The modern concept of quality involves the introduction of quality standards of financial reporting. Standards must be

based on the principles of total quality management. This includes observing and evaluating the success of education of the accounting staff in the countries of Southeastern Europe. Improving the quality of financial reporting, in addition to accounting and auditing, includes approval and fulfillment of the relevant parts of the *acquis communautaire* and international best practices and standards. Strengthening regulatory and supervisory framework for financial intermediaries and financial markets in line with EU law and practice, is a priority for the countries of Southeastern Europe in the sphere of financial services.

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SOCIO-ECONOMIC ASSESSMENT OF TREATMENT AND REHABILITATION OF BREAST CANCER

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ABSTRACT

Statistical and epidemiologic data show increase in morbidity and mortality of breast cancer both in Bulgaria and globally. The decreasing age of patients is another alarming trend. By breast cancer are affected mostly mid-age women, in their most productive period, which endangers to a great extent the social and economic wellness and development of the individual, their family, and the whole country.

By breast cancer are affected mostly mid-age women, in the most productive period of their lives, which endangers to a great extent social and economic wellbeing of the individual, their family and the whole country. The first-for-Bulgaria rehabilitation program for breast cancer prevention and recovery was initiated in 2003.

This study aims at an economic assessment of the rehabilitation program through cost-utility analysis (CUA). The emphasis is on the health-based quality of life, which is represented by improvement of mental, emotional and physical health, and a satisfactory level of social functioning (professional and community).

The following methods are used in the specific study: CUA of the rehabilitation program; modified (adapted) Health Utility Index mark 2 – HUI; psychodiagnosics of the level of anxiety, depression, self-assessment, stress; medical records, statistical analysis. The study covered 320 women of 25-65 years of age, following breast cancer diagnosis, who took part in the rehabilitation program.

Study results and conclusions: the data from the cost-utility analysis define the socio-economic benefit from and the therapeutic effectiveness of the rehabilitation program as to long-term prevention of disease recurrence, improvement of overall survival, health-based quality of life. The study demonstrates the need of such a further treatment. Rehabilitation of cancer patients is the final therapeutic stage of the overall treatment process which has a positive effect in health, social and economic aspects. In 2008, each individual from the population of working age generated an average of BGN 15,000 from the GIP (BGN 67 billion in 2008; 7.606.551 population of Bulgaria in 2008; 62% of working age, 8% unemployment rate). The data analysis studies the losses of patients, their relatives, and the entire society, in the form of both missed working activities and treatment and rehabilitation costs.

Keywords

cost-utility analysis, health-based quality of life, rehabilitation, breast cancer.

INTRODUCTION

Statistical and epidemiologic data show increase in morbidity and mortality of breast cancer both in Bulgaria and globally. The decreasing age of patients is another alarming trend. By breast cancer are affected mostly mid-age women, in their most productive period, which endangers to a great extent the social and economic wellness and development of the individual, their family, and the whole country.

Unfortunately, epidemiologic data places cancer diseases among the leading socially important diseases in Bulgaria. Recorded malignant neoplasm cases in the last four years per 100,000 population, according to data provided by the National Center of Health Informatics /8/.

Table 1

	2005		2006		2007		2008	
	Total	Incl. new cases						
Total	3069,9	379,3	3229,0	393,3	3330,7	413,9	3437,6	426,0
Breast	1038,3	83,2	1093,1	85,9	584,5	44,9	601,3	46,6
Fem. breast	538,8	43,5	567,9	44,8	1124,8	86,0	1156,6	89,2

The measures to reduce the high morbidity and mortality rates need to have as main focus a quality and effective primary prevention. Bulgarian women still do not undergo prophylactic examinations on a regular basis, and they need to change their lifestyle in order to leave those unhealthy habits and behaviors which induce the disease (over 85% of all cancer diseases in the world occur as a result of risk factors), /1/. With regards to treatment, what still needs an improvement is the access to therapy and medicines. There is no possibility either for an effective rehabilitation following the main treatment to reduce recurrence episodes and enhance the quality of life for the affected individuals. Therapeutic practice in cancer diseases in Bulgaria is still focused on a merely medical treatment.

World practice of fight against cancer has prioritized a composite approach aiming at ensuring a quality of life for patients and their families. And this is for a reason. **All oncologists agree that recovery of patients' psychological state after they have been diagnosed with cancer, is a leading protective factor to increase patients' life span, and, of course, the quality of their lives.**

World Health Organization (WHO) recommends all member states that their national programs on cancer control should be comprehensive, which means preventive activities, screening activities, access to effective diagnostics, treatment and subsequent complete rehabilitation. The main objective of rehabilitation is to decrease the medical, psychological and social complications resulting from the disease, and to create a proper attitude and a healthy lifestyle which is adequate to the consequences of the disease /1/.

In 2003, the first for Bulgaria rehabilitation program for prevention of and recovery from breast cancer was initiated. Therapeutic activities are focused on recovery of the physical state and maximum regaining of working ability; adaptation to the post-surgery physical changes and the psychological stress they generate; a complete influence on patients' psychical and emotional health, and mobilization of their personal resources to overcome the disease; formation of a proper attitude and a healthy lifestyle adequate to the consequences of the disease; family consultations /5/.

This program, unfortunately, has limited resources since it has been organized by private persons, and the government does not provide financial or material support. The number of people who have taken part in the program is much less than those who wanted to because of financial reasons. This paper will present some of the results of this rehabilitation program.

This study **aims** at an economic assessment of the rehabilitation program through cost-utility analysis (CUA). The emphasis is on the health-based quality of life, which is represented by improvement of mental, emotional and physical health, and a satisfactory level of social functioning (professional and community).

The following **methods** are used in the specific study: CUA of the rehabilitation program; modified (adapted) Health Utility Index mark 2 – HUI; psychodiagnostics of the level of anxiety, depression, self-assessment, stress; medical records, statistical analysis. The study covered 320 women of 25-65 years of age, following breast cancer diagnosis, who took part in the rehabilitation program.

Study result analysis. Conclusions.

Health-adjusted quality of life has already become an important part of medical practice, and it is becoming clearer and clearer that medical assistance and care are not limited to just elimination of symptoms and recovery of functionality, but are also aiming at helping the patients to achieve maximum health levels and satisfaction of their personal strivings and expectations. By studying the quality of life, professionals intend to find out users' necessities, because they understand that in addition to symptom management, there are a number of social, psychological and other factors which affect patients' state.

In WHO's opinion, quality of life is an individual, subjective evaluation of each person on their own place in life, in accordance with their surrounding culture and values, and their personal aims, expectations, standards and convictions .

Quality of life of a cancer patient is the final important, but difficult-to-assess index. In Oncology, the concept of quality of life also arises as a natural criterion of increased survival with an improved quality of life.

Health-adjusted quality of life in cancer patients assesses the impact of the disease and the treatment on patient's life, and it provides information on the extent of changes in three areas – physical, psychological (emotional), and social functioning and well-being /3/.

Physical well-being includes physical comfort as perceived by the patient, disease symptoms, and side effects from treatment.

Functional well-being includes the ability to perform activities related to personal necessities and social roles (daily activity, out-of-home responsibilities).

Emotional well-being is to a great extent depending on the physical well-being. It is connected with the psychological state (cognitive and affective state).

Social well-being plays an important role in patient's adaptation to the disease and its overcoming. Social well-being depends on the social support from patient's family and community, on patient's opportunities for professional activity and social functioning, on the changes in patient's dynamics and rhythm of life occurred since the disease has been diagnosed.

Maximum results in these areas of a cancer patient's life could be mainly achieved through an effective and disease-specific rehabilitation.

Rehabilitation of cancer patients is the final therapeutic stage of the overall treatment process which has a positive effect in health, social and economic aspects /5/.

The rehabilitation program which is the subject of our study and analysis was conducted at the facilities of a sanatorium which offered proper conditions for the purpose of rehabilitation. The program included: control medical examination, a specifically developed psychotherapy program – individual, group, and family; physiotherapy and kinesitherapy; individual dietary regimen, therapeutic physical activity, yoga, relaxation methods and techniques; a number of recreational activities (musical therapy, dances, therapeutic art activities, etc.) to choose from. At the end of their stay, each participant in the rehabilitation program was given an individual program (psychological, dietary and exercise) to apply at home.

The data from this research give information on the somatic, psychological, physical and social status of the women who took part in the program. Diagnostics and data collection were performed both at entering into and on completion of the program (at a person's inclusion and at the end of program).

The cost-utility analysis is a form of economic assessment focused on the quality of health outcome expressed in terms of health improvement as a result of health programs or therapeutic approaches /3/. In the cost-utility analysis (CUA) a comparison between differential costs of a program and differential health improvements is made from a certain perspective, and health improvement is measured by *quality-adjusted life-years* (QALY), or the other variant of that index – *health year equivalents* (HYEs). The cost-utility analysis (CUA) and the cost-effectiveness analysis (CEA) are similar in the cost part, but they differ about the outcomes. In the beginning, this approach was called generalized cost-effectiveness analysis (Torrance 1971), and later it was known as utility maximization (Torrance et al. 1972), and the health status index model (Torrance 1976). The name of 'cost-utility analysis' was first used in 1981 by Sinclair et al., and the Bush group in 1982.

There are three health utility index (HUI) systems - HUI1, HUI2, HUI3. Each of them consists of a health status classification scale, and one or more scoring formulae. In all cases the scores are preference-based, interval-scaled, and on the 0,0/dead/ to 1,0 /perfect health/. Scores are derived from preferences of members of the general public. These systems have been developed over time, each being partially based on the previous one /3/.

For the purposes of our research, we used a modified (adapted) Health Utility Index mark 2. The Health Utility Index mark 2 system was expanded to include **6 attributes**. Initially, the HUI2 system was applied in childhood cancer. Later, the HUI2 system was modified to be used in adults. The attributes that represent the essence of the health-adjusted quality of life measure sensation and mobility; emotions, feelings; self-care; cognition, pain. Recipients' (patients') health, psychological and physical states are measured according to the HUI classification system and then, the score is calculated by using the appropriated formula /3/.

Utility in our research gives information on the value given by the participants in the rehabilitation program. By using control tests at the end of the program, participants define (evaluate) various states they had developed as a result of certain interventions and activities. The objective is to quantify participants' preference to and the utility from certain rehabilitation activities.

PHYSICAL AND FUNCTIONAL WELL-BEING

As a result of the disease and the treatment, physical state changes, activity and capability decrease. Depending on the severity of disease, some of the affected are assigned a disability rating.

Pain, fatigue, sleep disorders, eating disorders, nausea, vomiting have been observed, varying in severity and duration. Surgical intervention causes restricted everyday activity, difficult upper-limb movements, reduced ability of physical endurance, mobility, carrying a bag; driving and longer walks require a greater effort. The physical comfort is disrupted.

Attribute 1 – mobility

Table 2

Attribute	Level	Description of Level
Mobility	1	Ability to walk, bend, lift, jump and run normally for age; able to use and load arms normally.
	2	Some problems in walking longer distances; some limitation of the upper limb movements, but does not require the help of another person
	3	Difficult to get around and use the upper limbs, requires the help of another person and/or mechanical equipment.
	4	Unable to control or use arms and legs

Results	Level 1	Level 2	Level 3	Le Level 4
Data at entering:	47 /15% /	273 /85%/	0	0
Data after rehabilitation:	126 /39,37%	194/60,62%/	0	0

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Attribute 2 self-care (self-hygiene and dressing)

Table 3

Attribute	Level	Description of Level
Self-care	1	No problem of taking care of themselves
	2	Some problems of taking care of themselves
	3	Needs a moderate help
	4	Entirely dependent on other people's help

Results	Level 1	Level 2	Level 3	Le Level 4
Data at entering:	287 /89,6% /	33/ 10,4%/	0	0
Data after rehabilitation:	309 /96,56%/	11 /3,44%/	0	0

Attribute 3 - Pain

Table 4

Attribute	Level	Description of Level
	1	Free of pain or discomfort
	2	Occasional pain. Discomfort relieved by non-prescription drugs or self-control, without disruption of normal activities.
	3	Frequent pain. Discomfort relieved by oral medications, with occasional disruption of normal activities.
	4	Frequent pain, frequent disruption of normal activities. Discomfort requires prescription of narcotics for relief.
	5	Severe pain that can not be relieved by medicines, and constant disruption of normal activities.

Results	Level 1	Level 2	Level 3	Level 4	Level 5
Data at entering	294/91,8%/	26/8,2%/	0	0	0
Data after Rehabilitation	316 /98,75%/	4/1,25%/	0	0	0

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Rehabilitation includes various activities to recuperate physical indices, activity and capability.

Yoga is presented as a way of reinforcing immune system and motive system by means of improving circulation and muscle tone, reducing tiredness and nervous stress.

Other used techniques include therapeutic physical exercises, terrain therapy, lymphatic drainage massage, water treatment, SPA. These aim at reducing and calming down the pain and nerves. The result is faster patient's recuperation and mitigation of certain concomitant side effects in cancer treatment (chemotherapy). These techniques activate and stimulate a part of the immune system and help the body in fighting more effectively cancer, infections and stress situation.

At the end of the program patients' assessment of these therapeutic activities is positive, and the program is considered as necessary and highly effective for physical recuperation.

EMOTIONAL WELL-BEING /PSYCHOLOGICAL STATE/

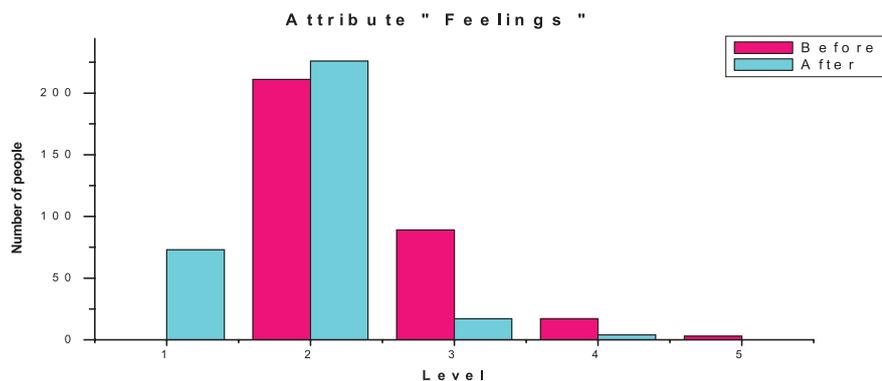
A cancer diagnosis causes shock, stress, fear, and often denial and desperation followed by a sudden change of life. Every woman has her own way of accepting of and reacting to the disease, and this depends on many factors, mainly, on their psychological and emotional stability and maturity, life experience, family and community support and relationships. Cancer and its treatment, the process of overcoming the crisis about the disease cause some reactions – transient in some women, and more persistent in others – of fear, anxiety, sadness, depression, rage, anger. Many women share that they think of the future with a sensation of doom, fear of a lethal outcome or disease recurrence.

Attribute 4 'feelings' – emotional state.

Table 5

Attribute	Level	Description of Level
Feelings	1	Generally happy and free of worry
	2	Occasionally fretful, angry, irritable, anxious, depressed or suffering night terrors
	3	Often fretful, angry, irritable, anxious, depressed or suffering night terrors
	4	Almost always fretful, angry, irritable, anxious, depressed or suffering night terrors
	5	Extremely fretful, angry, irritable, anxious, depressed or suffering night terrors

Results	Level 1	Level 2	Level 3	Level 4	Level 5
Data at entering	0	211 65,93%	89 27,81%	17 5,31%	3 0,93%
Data after rehabilitation	73 22,81.%	226 70,6/%	17 5,31%	4 1,25%	0 0%



Attribute 5. self-assessment 'has the disease affected my self-esteem'

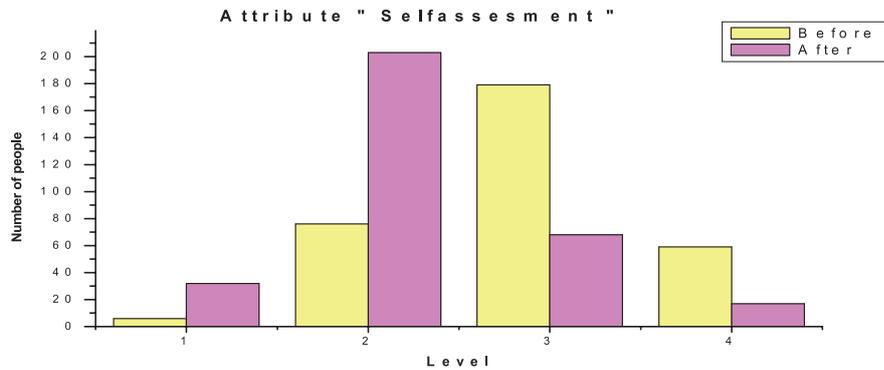
The psychotherapeutic program aims at balancing the psychological state, controlling the emotions, managing the stress. The work is focused on self-liking, self-assessment, the ability to love and appreciate one's own personality, despite the disease and the consequences; building a positive, realistic thinking to help recover mental and emotional health.

It is very important to help the women in accepting the physiological changes after the surgery. Women share a feeling of inferiority in being a complete marital partner. Unfortunately, in some families relationships between family members get disrupted, sexual life disrupts too. It is not uncommon that couples get separated. Patient's relatives have to face new responsibilities and duties. They need to manage their own feelings of fear, confusion, sadness, so they can provide the support the patient needs for a successful treatment and recovery. In such cases, psychological help and consultations are offered to the family or certain members of the family or the closest circle.

Table 6

Attribute	Level	Description of Level
Self-assessment	1	Physical change has not affected my self-esteem
	2	Physical change has slightly affected my self-esteem
	3	Physical change has significantly affected my self-esteem
	4	Physical change has affected my self-esteem to a great extent

Results	Level 1	Level 2	Level 3	Le Level 4
Data at entering:	6 /1,87% /	76/23,75%/	179/55,93%/	59/18,44%/
Data after rehabilitation:	32 10%	203 63,44%	68 21,25%	17 5,31%



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In order to get over the stress, anxiety and worry caused by the fear of disease recurrence and lethal outcome, patients learn techniques of positive thinking, belief of successful therapy and overcoming the disease. Various relaxation techniques, autogenic training, breathing techniques are applied. The work is focused on building a sustainable positive attitude toward the future and new cognitive models.

SOCIAL WELL-BEING /SOCIAL ACTIVITY AND SOCIAL SUPPORT/

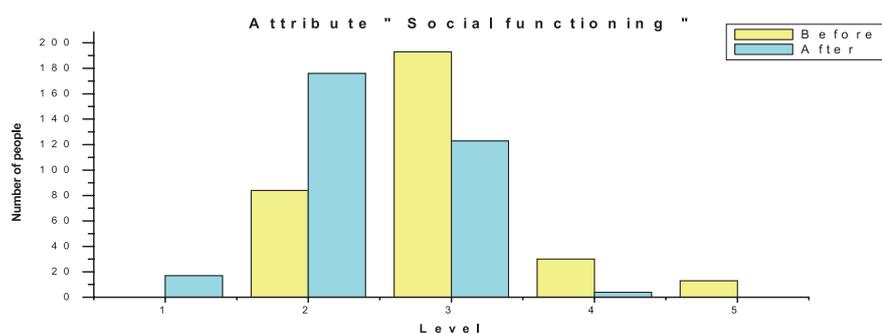
Another effect of the disease is the change of intensity and quality of the relationships with the familiars and friends. The reasons are different, but there are isolation, withdrawal and limitation of activity and contacts as a result. Patients share about disrupted social functioning, limited social contacts, reduced working abilities or impossibility to cope with their professional duties; abandoned or reduced entertaining and pre-disease activities.

Attribute 6. Social functioning /Social contacts and Social activity/

Table 7

Attribute	Level	Description of Level
Social functioning	1	No change in the intensity of relationships with and support from familiars and friends, and no change of the level of activity in the usual activities and occupations
	2	Slightly restricted contacts with and insufficient support from familiars and friends; slightly limited level of activity in the usual activities and occupations.
	3	Somewhat restricted intensity of relationships with and support from familiars and friends, significantly limited level of activity in the usual activities and occupations.
	4	Extremely restricted relationships, no support from familiars and friends, a highly reduced level of activity in the usual activities and occupations.
	5	No relationships (isolation), no support from familiars and friends, no social activity

Results	Level 1	Level 2	Level 3	Level 4-	Level 5
Data at entering	0	84 26,25%	193 60,31%	30 9,37%	13 4,06%
Data after rehabilitation	17 5,31%	176 55%	123 38,43%	4 1,25%	0 0%



One key feature of the conventional cost-utility analysis of the rehabilitation program is that it uses the QALY concept and the results measure health improvement in quality-adjusted life years (QALY).

When calculating the scores with the Health Utility Index it is assumed that health utility is 1.00, and death utility is 0.00. Each of the 6 attributes studied (and each attribute level) has its own coefficient.

Obtained results of due to the disease (in 320 recipients):

Economic losses before rehabilitation program	Economic losses after rehabilitation program
Attribute 1– Mobility 282 555 lv.	Attribute 1– Mobility 200 790 lv.
Attribute 2 – Self-care 51 480 lv.	Attribute 2 – Self-care 17 160 lv.
Attribute 3 - Pain 47 970 lv.	Attribute 3 - Pain 7 380 lv.
Attribute 4 – Feelings 332 430 lv.	Attribute 4 – Feelings 317 010 lv.
Attribute 5 - Self-assessment 1 103 850 lv.	Attribute 5 - Self-assessment 693 720 lv.
Attribute 6 - Social functioning – 339 570 lv.	Attribute 6 - Social functioning – 243 465 lv.
Total economic losses – BGN 2 157 855	Total economic losses - BGN 1 479 525

* according to modified Health Utility Index mark 2.

Economic assessment shows significantly lower financial losses after the addition of rehabilitation as the final treatment stage for 320 cancer patients – BGN 678,330.

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The analysis demonstrates that temporal work disability, worsen health, treatment costs result in significant financial losses.

The losses resulting from the temporal disability for up to 6 months paid by the National Social Security Institute (NSSI) should be also added to the above losses. NSSI has paid sick leaves to the amount of BGN 3,256 per person. A total compensation of BGN 1,041,920 has been paid to 320 persons (for 6 months).

Financial losses from a cancer disease and the subsequent health (physical and mental) worsening in 320 individuals amount to BGN 3,199,775.

*This amount does not include the treatment costs (surgery, conservative treatment).

In 2008, each individual from the population of working age generated an average of BGN 15,000 from the GIP (BGN 67 billion in 2008; 7.606.551 population of Bulgaria in 2008; 62% of working age, 8% unemployment rate), /7/. Thus, instead of producing BGN 15,000 a person will produce BGN 8,580.

CONCLUSION

Rehabilitation treatment costs BGN 600,00 per person (BGN 192,000 per 320 persons, respectively). Currently, the program is not being funded by any health or social-security institution, but by the patients themselves. The data analysis studies the losses of patients, their relatives, and the entire society, in the form of both missed working activities and treatment and rehabilitation costs.

The data from the cost utility analysis determine the social and economic benefits and therapeutic effectiveness of the rehabilitation program with respect to long-term prevention of disease recurrence, improvement of the overall survival, health-adjusted quality of life by means of a set of various services. The need of such a further treatment has been demonstrated.

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FOREIGN DIRECT INVESTMENT AND THE INFLUENCE OF THE BUSINESS CLIMATE ON THE STRATEGIC CHOICES OF FIRMS IN MONTENEGRO

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ABSTRACT

The Balkan market has been showing to be, for some years, one of the most dynamic and active ones thanks to the reforms implemented by local governments, aimed at opening up to foreign companies in order to acquire the technology and know-how needed to comply with Western development standards, in view of a future entry into the EU.

In particular, among the countries in this area, Montenegro is now playing an important role, due to the high degree of attractiveness achieved by improving the business climate, which is increasingly directing Foreign Direct Investment (FDI) towards this country.

Following a brief analysis of the main forms of Foreign Direct Investment, the present work is aimed at examining what fields have experienced an improvement in the business climate in Montenegro and how this has influenced the development strategies of foreign companies (particularly the Italian ones), thus yielding any economic benefit to corporate investors as well as to the country itself.

In this aim, an analysis was carried out following the data collected from interviews with the managers of the companies located in Montenegro, based on ten indicators: Starting a Business, Dealing with Construction Permits, Employing Workers, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, Closing a Business. The final results were then compared with those obtained, on average, in the Balkans.

Key words

FDI; Business Climate; Strategies; Montenegro.

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INTRODUCTION

The increasing globalization of the world economy has made the business decision-making process much more complex than before, because of the number of variables coming into play, that the top management of a company should carefully weigh up to avoid unfortunate business choices.

The growing need for internationalization, involving the search for strategies (direct or indirect export, partnerships with local investors, or foreign direct investments) allowing competitive advantages, leads entrepreneurs wishing to choose the most attractive market, to analyze such factors as: the extent of the market itself, the economic and political stability of the country, the existing skills and know-how in the area, the existence of skilled human resources, labour costs, the quality of transport and logistic infrastructures, contained energy costs, a favourable tax and regulatory framework.

The Montenegrin market seems to be the most interesting one in the Balkan area, because of the numerous reforms implemented, aimed at improving the business climate, in order to attract those foreign investors who, thanks to their technologies and know-how, are able to accelerate the process of harmonization of the country with Western standards, in view of a forthcoming entry into the EU.

Thus, the process of liberalization of the country, started with the privatization of large local companies such as Niksic steelworks, Telekom Montenegro, Podgoricka Bank, Montenegrin Railways, Montenegro Airlines, represents just the beginning of an ambitious project that, following the Government intention, aims at making the country play the role of the new “Balkan Switzerland”. Therefore, starting from an analysis of the reforms implemented and of the main indicators dealt with, the present work aims at assessing, first, whether those reforms have brought about a real benefit in the business climate of the country; secondly, at evaluating their economic, social and strategic impact on businesses and finally, at examining the impact that such reforms have had on the Italian presence in the country as well as how the latter has strategically changed from a sectoral perspective.

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In order to carry out the present study, the starting point for the methodology adopted was the survey carried out by the World Bank and elaborated in the annual report drawn up by the team of Doing Business in collaboration with experts from academia and involving 183 countries.

The report has been drawn up by interviewing more than 8,000 local experts (lawyers, accountants, business consultants, government officials, shippers) who answered questions about legal and tax issues, either in writing or by holding conferences or visiting personally the country involved on a standard case business (analysing the legal status of the businesses, their size, their market position and the nature of the operations carried out); the final results, properly revised, have the advantage of being compared, over the time, between the countries as well.

Ten indicators,³ considered as valid for all countries, were selected for the survey but, in particular, five of them, those being mainly the object of reforms by the Government, will be taken into consideration by the present study, namely: Starting a Business, Employing Workers, Getting Credit, Protecting Investors, Paying Taxes.

For each indicator selected, the main reforms implemented and their impact on businesses were treated briefly, comparing the above-mentioned indicators with the average data collected from the area which the country belongs to.⁴

³ The indicators analysed are the following: Starting a Business, Dealing with Construction Permits, Employing Workers, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, Closing a Business.

⁴ The country is part of Eastern Europe and Central Asia area involving the CEFTA member countries (Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Moldova, and Serbia) and the EU members (Bulgaria, Slovenia, Romania and Poland), the Baltic Republics (Estonia, Lithuania,

For the sake of informational accuracy, it has to be specified, that a major requirement for the methodology adopted is that the company is aware of any information needed about how to operate and how to complete the procedures, that the statistics relate to the most economically important towns in the country and concern limited liability companies (or similar); in addition, the standard case analysed only considers some specific issues and not all the problems affecting a company and the indicators issued represent the average of the various answers by the interviewees.⁵

REFORMS

As already noted in the introduction, the Montenegrin Government is distinguishing itself for the reforms implemented, aimed at improving the business climate in the country, in order to attract foreign investors.

- Following the analysis of the indicators which were the object of reforms in recent years, the first indicator examined is related to starting a business (Starting a business).

1.

In this context, the Government has taken important steps to attract foreign investors, offering them the same treatment as local companies, reducing time and costs of starting a business, allowing investors to transfer or reinvest profits if they comply with the Revenue system, and abolishing tax on the profits gained by the companies.

In this respect, start-up firms (limited companies or joint-stock companies, partnerships with local investors, as well as local branches or representative offices) will be exempted from paying tax on the profits gained: for a year, in the case of commercial, financial as well as insurance investments; for three years, in the case of new firms engaged in other activities; for five years, concerning either companies located in deprived areas or those firms involving total foreign investment or investment exceeding 50% of the capital; for ten years, concerning those companies located in duty free zones (such as the Port of Bar).

These regulations will not apply to those companies which stopped carrying out an activity similar to the new one, during the three years preceding the starting up of the new company.⁶

Analysing the data relating to this indicator, it can be noticed that the development of new businesses has been encouraged by the streamlining of bureaucratic procedures (Time, days) in terms of number of days needed to complete them, that, compared to 2008, has been practically halved, namely 13 days against 24, turning to be lower than the average of the area by 17.4 days in 2009; despite this, the procedures number (Procedures, number) (the main ones being the decision of starting up a business, filling a form and a statutory declaration)⁷ still remains high, being twice the procedures needed in the other countries belonging to the eastern Europe and Central Asia area, i.e. 12 procedures against an average of 6.7.

Another factor favouring business starting up in the country is represented by the low initial costs to be born by the partners (Cost, % of income per capita) which are about 1/3 of the average ones in the area (2.6% of income per capita against 8.3%).

Latvia) as well as another 12 countries belonging to the area: Armenia, Azerbaijan, Belarus, Cyprus, Georgia, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan, Turkey, Ukraine, Uzbekistan. For further information see: <http://www.doingbusiness.org/EconomyRankings/?regionid=2>.

5 For further information about the methodology adopted see: **World Bank, (2010)**. <http://www.doingbusiness.org/MethodologySurveys/MethodologyNote.aspx>.

6 For corporate and tax-related aspects see: **Mondimpresa, (2006)**. **Union of Serbia and Montenegro**. <http://www.mondimpresa.it/infoflash/scheda.ASP?st=94>.

7 These documents are available on the central register of the Commercial Court, responsible for all registration practices. See: **INFORMEST, (2008)**. **Business Guide Montenegro**. <http://www.servizi.informestconsulting.it/abbonamenti/bg/Montenegro/estratto.pdf?rnd=ikvgxmibm3wnezb5v0eay3m3>.

In addition, the minimum capital needed to start up Ltd companies (Min. capital, % of income per capita) is, actually, symbolic, (1 Euro), while, on the other hand, the percentage of the minimum capital that previously had to be compulsorily paid in advance, before the establishment and registration of the company, was abolished.

Such reforms have led the country to progress in the rankings, as to this indicator, from 107th, in 2009, to 85th, in 2010, out of the 183 economies examined (World Bank 2010).

- The second indicator considered, was the one relating to hiring workers (Employing workers), for which, the Government object was to make work as flexible as possible, compared to the past, with both open-ended contracts and time contracts whose length ranges from a minimum of 6 up to a maximum of 10 years, involving 3 kinds of contracts (general, sectoral and individual).⁸

Moreover, in order to promote employment, 50% reductions of the taxable base were provided for, concerning those companies employing local temporary staff, as well as tax exemption on corporate profits, following the number of needy people hired by the companies and calculated by considering the total staff of the companies themselves. The positive results of such reforms are supported by indexes. In fact, as an example, considering the rigidity of employment index (Rigidity of employment index)⁹ ranging from 0 (maximum flexibility) to 100 (indicating the maximum rigidity of regulation), it scores just 13 points (i.e. less than half the average in the countries of the area scoring 29.2 points), confirming the high flexibility of work in the country.

Finally, as to dismissal costs, calculated according to the number of weeks to be paid to the dismissed employee (Redundancy costs, weeks of salary), they amount to 28 weeks, thus turning to be in line with the 27.8 weeks average concerning the countries of the area (World Bank 2010).

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Thanks to such positive indexes, this indicator got the best annual performance among the 10 indicators examined, so that to make the country progress again from 93th, in 2009, to 46th, in 2010, allowing it to rise of 47 positions in the rankings and to rank 2nd, following after Macedonia alone, among the CEFTA (Central European Free Trade Agreement) member countries.

- The indicator relating to getting credit (Getting credit) records very good results as well, thanks to the reforms implemented.

In fact, the introduction of the Euro, the Law on banks and on the Central Bank as well as that regulating bankruptcy, liquidation and the protection of deposits are just some of the most significant reforms.

More recently, a new credit public registry has been established, providing detailed information on the amount of loans granted both to individuals and businesses, as well as the first guarantee fund for SMEs in the country, namely the Montenegro “Confidi”,¹⁰ both of which allowing the country to rank 43th in the general list (World Bank 2010).

In particular, among the most significant indexes, two of them are worth noticing. The first one describes the effectiveness of security and bankruptcy laws that would facilitate getting loans

⁸ The general contract is made between the employers’ associations and trade unions, the sector one is valid for certain industries and the individual one is stipulated between the union representatives of the employer and of the manager.

⁹ This index is the result obtained from the average of 3 sub-indexes: the index of difficulty in recruiting staff (Difficulty of hiring index) examining the existence of fixed-term contracts even for permanent work and their expiration, the rigidity of hours index (Rigidity of hours index), checking the existence, in the contract, of work at night or at weekends as well as the number of weekly hours of work and finally the one measuring the degree of difficulty in dismissing employees (Difficulty of redundancy index) signalling whether or not the dismissal of an employee or a group of nine employees, needs a public body to be informed and to issue authorization for it. See: **World Bank, (2010).** <http://www.doingbusiness.org/ExploreEconomies/?economyid=210>.

¹⁰ The “Confidi” will have an authorized capital of 5 million Euros. See: Balkans and Caucasus Observatories, (2008). Montenegro: The First Guarantee Fund for the Country. <http://www.balcanicaucaso.org/ita/Cooperazione/Dalle-regioni/Montenegro-Primo-fondo-di-garanzia-per-il-paese>.

(Strength of legal rights index), showing an optimal value being equal to 9 on a scale of values of 0 to 10, well above the average of 6.6 of the countries in the area; the second relates to the percentage of businesses and private individuals surveyed in the public registry (Public registry coverage, % of adults) providing data on the unpaid debts or credits in the last 5 years; the above index reaches a value of 27.6% of the adult population (aged over 15 years), thus tripling the figure concerning the average of the countries in the area, i.e. 9.7%.

However, as it can be noted, no private credit registry (Private bureau coverage, % of adults) exists in the country yet; on the other hand, the index relating to the degree of accessibility and quality of information about credit (Depth of credit information index), that can be found in private or public registries, is to be improved, showing a value which is equal to 2, on a scale of 0 to 6, thus turning to be lower than the area average of 4 (World Bank 2010).

- Another indicator that benefited from the reforms implemented is the one relating to protecting investors (Protecting investors).

The government has in fact, finally, guaranteed that the investor has the certainty of his right of ownership, which will be lost just in case of public security, upon a compensation, however, equalling the value of the expropriated property; in addition, the investor will get interests at LIBOR rate, calculated according to the temporal interval between expropriation and compensation; moreover, the proportional rates fixed by the Government range from 0.08% and 0.80% and can be applied to various kinds of property.¹¹

Thanks to these reforms, the investor protection index (Strength of investor protection index)¹² scores 6.3 points, on a scale of 0 to 10, and turns to be higher than the average value of 5.5 in the area, thus ranking the country 27th in the list, in 2010, (the best position reached by the country among the ten indicators examined) and 3rd, following after Albania and Macedonia alone, among the CEFTA countries (World Bank 2010).

- Even the indicator measuring the payment of taxes (Paying taxes) benefited, in some way, from the reforms implemented, in order to give greater impetus to foreign investment.

In fact, the “Agreement against Double Taxation” signed by Montenegrin authorities with some countries among which Italy, turns to be very important for foreign investors, as it aims at fixing the rate of tax payment in relation to the real financial potentials of the tax-payer, favouring stability and economic growth in the country, creating suitable conditions for compatibility with other tax systems as well as equal conditions for tax-payers operating within the same market, through the free movement of goods, services, people, and capital.

As to tax rates, the most important changes concern the following: the personal income tax amounting to 15% in 2007, was reduced, first, to 12% in 2009, equalling the corporate income tax in 2010, reaching 9%,¹³ VAT amounting to 17% both for products and services and to 7% in order to promote tourism, the abolition of customs duties on 95% of goods that, thanks to this, can circulate freely.¹⁴

11 The rates apply to property, as well as to inheritance and donations and to real estate market, while as regards payment, this may include not only the ownership and usufruct, but also the right of user and of occupancy, the right of long-term lease as well as ownership of shares held within the company.

12 This index is the result obtained from the average of 3 sub-indexes: the one concerning transparency and disclosure of information (Extent of disclosure index), the one involving the degree of directors' responsibility for abuses on the company's property (Extent of director liability index) and the one measuring the company's members ability to sue directors for corporate mismanagement (Ease of shareholder suits index). See: **World Bank, (2010)**. <http://www.doingbusiness.org/ExploreEconomies/?economyid=210>.

13 See: Italian Chamber of Commerce for Serbia and Montenegro, (2005). Serbia and Montenegro Legal Informative Guide. <http://www.ic.camcom.it/eic/GUIDE%20LEGALI%20CE/Serbia%20e%20Montenegro%20CCIAA%20LC.pdf>.

14 Only a package of agricultural products are excluded from liberalization, which are considered as strategic for the country and for which, Montenegro reserves the right to agree upon special tariff rates.

In fact, having a look on indexes, it can be noticed as the reforms implemented led to a real reduction in the tax pressure in the country, as the profit tax (Profit tax) represent 8.3% of the profits themselves and is lower than the average value of 10.9% concerning the countries of the area; similarly, other taxes (Other taxes) have an impact on profits only for 1.8%, compared to the average value of 9.4%.

Even welfare contributions (Labour tax and contributions) are kept below the average value of 18.8% against 23.1% and help keep tax percentage acceptable, compared to gross profit equalling 28.9% against the average value of 43.4%.

However, what consigns the country only to 145th place in the rankings, in 2010, and that the Government should aim at improving is, on one side, the reduction in payments number per year (Payments number, per year), amounting to 89, almost double the average value of 46.3 concerning the countries of the area, and on the other one, the streamlining of payment-related bureaucratic procedures (Time, hours per year), equalling 372 hours per year, well above the average of 336.3 hours (World Bank 2010).

The analysis of both the indicators and the indexes examined, clearly shows that Montenegro has undoubtedly become one of the most active countries, not only in the Balkan region, but worldwide. The policy aimed at improving the business climate, to attract foreign investors, was greatly appreciated by both the European Union and several international bodies, such as the World Bank and the International Monetary Fund (IMF). The reason for their appreciation is that, despite the current international financial crisis, the country can boast a GDP which is still positive, (2.2% in 2009),¹⁵ as well as a consolidation of the market economy and an increased flow of foreign investment into the country itself, although some unsolved problems, such as corruption, still exist.

420 However, the country has progressed remarkably in the world rankings drawn up by the team of Doing Business, from 77th to 71st, in 2009 and 2010 respectively, out of the 183 economies examined, placing it above such an industrialized country like Italy, ranking 78th (World Bank 2010).

ECONOMIC, SOCIAL AND STRATEGIC IMPACT OF REFORMS ON BUSINESSES

In the light of the apparent improvement of business climate, the impact of reforms on businesses will be checked from an economic, social and strategic point of view.

First of all, it turns out that, the streamlining of bureaucratic procedures and the reduction in costs to start up new businesses, not only increased their number but also improved their performances, compared to the past, due to both a reduction in entry costs and an increase in productivity per employee.¹⁶

¹⁵ For the analysis of the data see: ICE, (2010). Notice on the Economic Trend of Business. http://www.ice.gov.it/paesieuropa/montenegro/upload/SP10/Congiuntura%20MNE%20marzo2009%20_2_.pdf.

¹⁶ In fact, the study indicates that, on a sample of 97 countries included in the Doing Business rankings, a cost reduction of 80% of per capita income has increased the total productivity of businesses of about 22%. In addition, following an analysis made on 157 countries, the same reduction in entry costs results in an increase of approximately 29% of productivity per employee. See: Barseghyan, L. (2008). "Entry Costs and Cross-Country Differences in Productivity and Output". *Journal of Economic Growth*, 13 (2): 145-67.

From a strategic point of view, this result is explained as a consequence of abolishing barriers to entry, resulting in increased competition, thus leading to, as it is the case in Mexico (a developing country like Montenegro), a reduction in prices of approximately 1%, which corresponds to a reduction in the income of the existing businesses amounting to about 3.5%; a situation that, in fact, induces the least productive firms to withdraw from the market. See: Bruhn M. (2008). "License to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico". Policy Research Working Paper 4538, World Bank, Washington, DC.

Another consideration, in this respect, is that relating to the movement of labour and capital from one sector to another, which greatly increases at times of financial crisis like the present one, due to the streamlining of formal procedures and reduced costs associated with starting up a business (Ciccone and Papaioannou 2007).

Strategically, in fact, when the fixed costs to start up a business are high, it is more complex for entrepreneurs to work a transformation of the firm's range of activity from one sector to another offering, at that moment, better prospects of opening up to foreign markets, reducing, as a matter of fact, the interest of the firm in entering a new market (World Bank 2009).

As to the hiring of workers, it can be stated that, a labour legislation making work more flexible than the present one, will undoubtedly allow further benefits in terms of increasing commerce and industrial production as well as of reduction in the unemployment rate.¹⁷

The creation of the public registry on credit was very important as well, for businesses that, now, have access, particularly in transition countries, twice as fast as large firms (Brown and Zehnder 2007), due to the increased number of loans repaid by entrepreneurs to their financial backers, compared to the past.¹⁸

In addition, it is to be noted that, the reform highlighted, among other things, makes it harder for some businesses to manage illegal income, due to a more careful monitoring than before (Claessens and Perotti, 2007).

The importance of implementing a reform guaranteeing investors has certainly helped attract foreign investors that, with their technologies and know-how can help reduce the existing gap between a developing country like Montenegro and industrialized countries.¹⁹

With regard to tax cuts, the introduction of both personal income tax and corporate income tax, amounting to 9% (among the lowest in Europe), has allowed, finally, expedited bureaucracy and greater respect of the law and transparency in the enterprise accounting, thus giving new impetus to private investment and to the development of new businesses in the country.

In fact, it was noted that, a lower internal revenue often makes the procedures for payment of taxes easier (Diankov, Ganser, McLiesh, Ramalho and Shleifer 2008).

In the light of the impact of the reforms on business strategies, it can be noted that, in recent years, entrepreneurs have oriented their choice towards a direct presence on the territory, under various forms (trade and production subsidiaries, equity joint-ventures between Italian and local entrepreneurs, agreements on technology and know-how transfer, etc.).

¹⁷ This consideration is supported by the results of an investigation carried out on 1948 retail businesses in Indian metropolises, according to which a legislation making work more flexible would lead to a 22% increase in trading activities. See: Almeida, R. and Carneiro P. (2008). Forthcoming. "Enforcement of Labor Regulation and Firm Size". *Journal of Comparative Economics*.

In fact, evidence of what stated above is supplied by another investigation, carried out in Brazil, showing a reduction in employment due to high rigidity of labour legislation.

In addition, further benefit, brought about by work flexibility, is represented by a 15% increase in industrial production as well as by the reduction in unemployment in Indian towns, while, on the other hand, a 20% decrease in production is witnessed in western Bengala, because of high rigidity in the country. See: Philippe, A., Burgess R., Redding S. and Zilibotti F. (2008). Forthcoming. "The Unequal Effects of Liberalization: Evidence from Dismantling the License Raj in India". *American Economic Review*, 94 (4): 1397-1412.

¹⁸ Generally, there was an increase in the use of credit equal to 4.2%, mainly due to a higher percentage, compared to the past, of loans repaid by entrepreneurs to their financial backers (about 80% in developing countries like Montenegro), because of advertising, on the register, about their degree of solvency that, if negative, would prevent them from being granted new loans, in the future. See: Brown, M., Jappelli, T. and Pagano, M. (2008). "Information Sharing and Credit: Firm-Level Evidence from Transition Countries". Finance Working Paper 201, European Corporate Governance Institute, Brussels.

¹⁹ In fact, recent studies show that as many as 73% of the investment strategies of a company are influenced by whether or not there is adequate protection of investors. See: Doidge, C., Karolyi, A. and Stulz, R. M. (2007). "Why Do Countries Matter So Much for Corporate Governance?". *Journal of Financial Economics*, 86 (1): 1-39.

This consideration is supported by observing the growth in FDI (Foreign Direct Investment), rising, in recent years, from 10.6 million Euros, in 2001,²⁰ to 895.2 million Euros, in 2009 (ICE 2010).

Going deeper into the analysis, the question is whether this increase is due to inflow or out flow FDI.²¹

The analysed data about the unemployment rate in the country, showing a remarkable decrease between 2001, equalling 31.5%, and January 2010, equalling 11.4%, make us understand that FDI can be considered as inflow, which is typical of an open economy, able to attract foreign investment into the country (ICE 2010).

As to their evolution over time, a distinction has to be made. Until 2007, they were mostly of the brownfield kind, due to privatization of the main sectors in the country, while the Greenfield ones played, mostly, a secondary role, being mainly made by local investors having limited capitals. In recent years, thanks to the improvement of the business climate, new activities have experienced growth, carried out by foreign investors, even in the form of SMEs (Small and Medium Enterprises), mainly of the Ltd kind, needing just a symbolic authorized capital (1 Euro) to be started up.

It is worth noticing that entrepreneurs consider this kind of investment as less risky than acquisition because of the possibility of deferring the investment over time and of operating gradually in the foreign country, (starting, for example, with a sales department, then followed by a warehouse and a first phase of assembly, up to completing the whole production process) as well as of benefiting from the competitive advantages of the parent company and from their cultural homogeneity.

As to the strategic orientation adopted by companies, it can be inferred, supported by the data available,²² that it is mostly oriented towards the global one, specifically favouring greenfield investment, rather than the multidomestic one.

The global strategic orientation is indeed realized, when local authorities stimulate the entry of foreign companies, if the latter have sophisticated technology secured by patents or the know-how of the company owner, in the presence of significant economies of scale and if they have plants producing beyond the absorption capacity of the country demand, as well as a high value-added transport of goods which is considered not to be economically disadvantageous for the company. Considering the data supplied from a strategic point of view, various reasons account for the development of FDI in the country.

A first motivation is accounted for a better adaptability of the product to the specific needs of the local market, because of easier collection of information and better contact with customers.

It was noted, in fact, how companies (the Italian ones, for example) that can achieve a cost advantage resulting from their own resources (in such sectors as fashion and food where better technology and know-how than the developing countries are available), tend to outsource the research and development function as well as the commercial one, leaving their business in the country of origin if the cost of transport particularly affects the total cost.

A second reason is due to the need, especially for the industrial sector, to provide a high quality pre and post-sale service, that not only allows customers to interface directly with the manufacturer,

20 For data about FDI and the unemployment rate see: CIRPET, (2007). Economic Relations between Italy and ex-Yugoslavia. Contribution from Mallone, F. (chapt. 7), University of Turin. [http://www.cirpet.unito.it/ricerca2/CIRPET%202007%20Testo%20completo%20\(p.1-154\).pdf](http://www.cirpet.unito.it/ricerca2/CIRPET%202007%20Testo%20completo%20(p.1-154).pdf).

21 On the relationship between FDI and work market see: Napoli, A. (2007). Foreign Direct Investment and Work Market. <http://files.meetup.com/475175/IDE%20e%20Lavoro%20in%20Italia.pdf>.

22 The empirical investigation was carried out on 287 subsidiaries companies working in 22 countries and related to 104 international companies. See: Bertoli, G. and Valdani, E. (2006). *International Markets and Marketing*. Egea, Milano.

but also allows the latter to avoid the bull wip effect²³ by eliminating the stocks-in-trade which are typical of indirect export involving a broker.

Another important reason is getting around barriers concerning tariffs or other items through operating directly abroad. It must be said, however, that those barriers were abolished for 95%, in Montenegro.

In addition, SMEs are often driven by the opportunity of achieving a better control of the market niche in which they operate that, mostly through a direct presence in the territory, allows them to be more efficient in a given segment.

A motivation affecting the choice of some entrepreneurs to invest abroad is, surely, that of being able to influence the buyers psychologically, by the mere fact of belonging to a leading country in a specific field (as it is the case with the Made in Italy in the field of fashion, food, etc.).

Therefore, the main customer of a company often decides to internationalize, compelling, in fact, the supplier as well to follow, in order to operate in a just-in-time perspective involving continuous flows of goods between the forward firm and its suppliers, as to reduce the waiting downtime and leftover stocks in the warehouse.

Finally, the opportunity, for a firm, to benefit from international contracts providing for the transfer of technology and know-how, acquiring a stake, though a minority interest, in the developed country company (as it is the case for Montenegro), can represent a good opportunity for investment.

In fact, that transaction has two advantages for the buyer company.

On one hand, it has not to pay the full amount for the transferred technology (which are paid through a stake) and, on the other one, the company secures itself the necessary support, by the other party, to start up and operate the new plant.

ITALIAN PRESENCE IN MONTENEGRO AND FUTURE PROSPECTS

In 2009, Italy became the main partner of Montenegro, for FDI, outdoing Serbia. As to the trade balance, in 2008, it was, for the first time, favourable to Italy, approaching 19 million Euros, a trend that rose, in 2009, up to almost 55 million Euros, with exports representing 6.73% of the total (ICE 2010).

The strong presence of Italian SMEs, which began around the mid 90s, is certainly explained by a number of factors favouring entrepreneurship, such as: a growing economy, a kind of political stability, a secured and reformed investment climate, the market opportunities supplied by a transition country, the introduction of the Euro, a favourable tax system, geographical proximity, the spread of Italian language as well as a low cost of manpower (with an average salary of 463 Euros, in 2009). The sectors in which the Italian presence has been further strengthened are those of the traditional Made in Italy (clothing, knitwear, foot-ware), as well as such sectors as aluminium, radio and TV sets, car fittings and wood.

As regards the most significant investments, they were concentrated mainly in such sectors as energy, engineering, infrastructure and tourism.

²³ By this term, it is meant the deviation of demand in logistics. See: Mariotti, S. and Mutinelli, M. (2003). *International Growth for SMEs. II Sole 24Ore, Milano.*

In particular, in the energy sector, Italian groups (A2A, TERNA, Duferco and Enel)²⁴ are worth noticing, with important investments; as regards engineering, the Gatti firm has purchased the Livnica Foundry in Niksic; in the tourist sector, the Bolici group is going to make an important investment with the construction of a hotel in the centre of Podgoricka.

Looking ahead, interesting business opportunities may arise from the Government's wish to strengthen two sectors: the railway system, on one side, for which they obtained loans from the EIB and the EU up to 40 million Euros;²⁵ tourism, on the other one, which, though contributing 15% of GDP,²⁶ thanks to the efforts made by the Montenegrin Ministry promoting the natural and artistic beauties of the country, needs, however, redeveloping as regards its hotel facilities and the related services (with greenfield investments),²⁷ in order to ensure high quality standards as well as developing alternative forms of tourism whose demand is increasingly growing, as it is the case for farm holidays.

CONCLUSIONS

The present work showed that Montenegro is one of the Balkan countries that implemented the highest number of reforms in recent years, aiming at attracting those foreign investors that are needed to harmonize the country with the standards of the most industrialised European countries, in view of a forthcoming entry into the EU.

In particular, such reforms, aimed at promoting business starting up, favouring workers' employment, improving information about credit, strengthening investors protection and reducing taxation, would lead the country to improved business climate, so that to rank it 71st in the world list, out of the 183 economies involved in the survey.

This improvement would be favoured, among other things, by the reduced rates of income tax (9% for both personal and corporate income tax) and customs (95% of the industrial products exchanged with the EU), as well as by the symbolic authorized capital (1 Euro) needed to start up Ltd companies, tax exemption on profits from 1 to 10 years according to the situations, streamlining bureaucratic procedures, a higher flexibility of work, greater banking transparency, a new public registry on credit, a guarantee fund for SMEs and by a real protection of the investments made.

The main benefits of the reforms, having an impact on the development of the economy in the country, would be as follows: the starting up of new businesses in a shorter time, greater productivity of the existing ones as well as of the employees within the companies, increased employment and movement of labour and capital, increased use of credit, greater protection of minority shareholders, lower internal revenues and visibility of corporate shadow income.

At this point, the aim of the present work was to determine whether this regulative change would affect business strategies, apart from its beneficial effect from an economic and social point of view.

24 In particular, A2A electrical energy group has acquired, for 436 million Euros, 43.7% of the State electrical energy body, the EPCG, thus becoming, at present, a very important strategic partner, in view of acquiring, in the future, a majority stake in the firm, thanks to the agreements made with the Montenegrin Government.

"TERNA" Italian company has made a collaboration agreement with EPCG, concerning the project of a 1000 MW high voltage submarine cable allowing interconnection between the electro-energy Italian system (Pescara) and the Montenegrin one (Tivat).

Finally, Duferco company is going to build an incinerator for urban waste, yielding 85 MW of power, while Enel is going to develop a coal plant yielding a power of 800 to 1200 MW.

25 In order to strengthen the country's railway system, a trilateral agreement was reached between Italy, Montenegro and Serbia to build the railway line Bar-Belgrade allowing Serbia to have direct access to the port of Bar and playing a primary strategic role within the Corridor 10, starting from Salzburg, crossing Belgrade and stopping at Salonika. See: ICE, (2010). European Loan for the Development of the Railway System in Montenegro. <http://mefite.ice.it/CENWeb/ICE/News/ICENews.aspx?cod=15596&Paese=97&idPaese=97>.

26 For an analysis of the country's prospects see: Angelici, F. (2009). Economic Development in Serbia and Montenegro. The Doors of the Balkans n° 3, Editore Moire s.r.l. Roma.

27 The largest beach in Montenegro (Velika Plaza) has been put up for sale by the State, from which they expect to cash from 5 to 10 billion Euros. See: Finotello, S. (2009). Montenegro: a Leading Role for a Dynamic and Sustainable Development. <http://www.italiarealestate.it/web/public/index.php?action=detail&id=267>

The answer is positive, since the most widely used mode of internationalization seems to be that of FDI, rising from 10.6 million Euros in 2001, to 895.2 million Euros in 2009.

These investments would be mainly inflow, which are typical of an open economy, allowing foreign investment into the country, mainly due to a reduction in unemployment rate from 31.5%, in 2001, to 11.4% in January 2010.

In addition, as regards the evolution of FDI, according to the research carried out, the Greenfield kind, once used only by local investors, is now the one preferred also by SMEs investing abroad as it is considered to be less risky than the brownfield kind, thus driving firms to develop their internationalization process through a global strategic approach rather than a multi-domestic one.

The reasons why entrepreneurs would opt for FDI could be explained as follows: the opportunity to have access to export markets reducing either costs of transport or communication time (market seekers businesses), the acquisition of inputs (i.e. labour) at a lower cost than those available in the Internal Market (resource seekers), ease of access to information and strategic knowledge to innovate products and processes (strategic seekers), or the opportunity to centralize dispersed activities in terms of space, in the presence of economies of scale and scope (efficiency seekers).

The benefits, brought about by the development of FDI in the country, would be identified in an increased level of expertise and training of human resources, the transfer of innovative technologies in the territory, the country's integration in the global economy and international trade as well as in creating the right conditions for higher competitiveness, thus allowing business development.

However, FDI also shows a negative side whose effects could be detected in the following: the worsening of the balance of payments in the country, in case of the profits coming back into the country of origin, a change in the social fabric affecting mainly the developing countries, due to trade globalization as well as a reduced political sovereignty of the community to benefit multinationals.

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The last point of the research was meant to analyze whether the evolution of the business climate in Montenegro had weakened or strengthened the position of Italy as a main investor in the country.

In this case as well, the answer is positive, considering that Italy has become the main partner of the country for FDI and that foreign trade with the country was on the credit side, for the first time in 2008, approaching 19 million Euros, with further growth in 2009 up to about 55 million Euros.

The high local entrepreneurial dynamism is being mainly addressed to the high-technology sectors (telecommunications, electrical energy, information technology, infrastructures etc.), such sectors in which Italy is not historically in the forefront.

As a consequence, as clearly shown by the sectoral analysis, Italian companies are increasingly focusing their strategic orientation towards high technology sectors (telecommunications, electrical energy, information technology, infrastructures) in order either to keep or to increase their market share.

Looking forward, major employment opportunities for Italian companies could be those related to large infrastructure projects such as those for the tenders supplying the Port of Bar, AD Marina Bar, AD "Montecargo Podgorica" as well as to the privatization of the State Railways (Zeljeznice Crne Gore), of Tobacco industry "Duvanski Kombinat, of "Plantaze" alcoholic wines producer and of Velika Plaza Beach (ICE 2009).

From the scenario shown, it can be assumed that the winning strategy for start-up companies, in the future, will be to entry first into these highly technological sectors that bear, as well, a high potential of growth, by using for their huge initial investment, not only conventional financing but also the Venture Capital and Business Angels in particular (EBAN 2006).

The local Government, on their side, are expected to continue the process of reforms aimed at improving the business climate as well as to solve such problems as corruption, in order to allow the country to be increasingly involved in the global flows of investment and to make the ambitious dream of becoming the “Balkan Monte Carlo” come true.

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E-SERVICES MODEL IN BUILDING AN EFFICIENT GOVERNANCE CAPABILITY

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ABSTRACT

Services sector has moved the businesses in an internationalization society, which act and work globally having strong direct impact in the economies of all those countries that support this system. Services differentiation achievements compose is a competitive advantage which creates not only a sustainable market share and a strong position of the proper business.

The economic growth, higher disposable incomes, and technological advances have contributed to the rapid growth of service sector enterprises. This trend is predicted to continue. The general rule is: the more highly developed the economy of a country, the higher the contribution of the service sector to GDP creation, aiming in this way a national model which is based on efficient governance unique capabilities. E- Services play a major role in Albanian Governance in terms of growth and development. 70% of the total value added in EU economies is created in service sectors. It appears that 50% of the value added is generated by “market services” and 20% by public services.

This paper aims to show how Albanian government is trying to be an effective- costumer and efficient-cots through adapting and using e-services model, as a proper way to create unique capabilities for the governance.

Keywords

e-service, government, marketing, efficient.

INTRODUCTION

Service industries hold an increasingly dynamic and pivotal role in today's knowledge-based economies. The importance of services can hardly be exaggerated. Market services alone account for between 45% and 55% of total value added in most advanced economies. For this reason in the European Union great importance is given to the strategy in support of innovation in services. Nowadays many instruments are created to promote innovation in service sector. New European Union member states have a lot to accomplish to reach the level of service innovation policy recommended by European Commission.

THE ROLE OF SERVICES IN THE ECONOMIES EU COUNTRIES

In 25 EU member countries, services make the greatest contribution to the Gross Value Added (GVA). In 2008, the share of services in the gross value added was 71.9%, or 7 percentage points higher than in other countries. Sectors I and II played a much smaller role in the EU than in our country. In 2007, the key components of the service sector in Albania were trade, the catering industry, transport, warehousing and communication; in the European Union, on the other hand, business and financial services dominated the service sector.

An analysis of the role that services and various service sections played in the creation of the GVA in individual countries indicates that in 2007, the share of sector I decreased significantly in all countries of Western Europe and in Albania. With the exception of France, the share of sector II in the GVA also fell. On the other hand, business services and financial services became more important. This tendency was particularly clear in Ireland, the UK and Italy.

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The contribution of the service sector to the creation of the GVA in France and the UK was higher than the average for 25 EU countries. In Italy and Germany this contribution was slightly lower than the EU average. Only in Ireland the share of sector III in the creation of the GVA was lower than in Poland.

TECHNOLOGICAL INNOVATION IN THE SERVICE SECTOR

For many years the architects of EU innovation policy focused on technological innovation in production. Services were perceived as less innovative. As a matter of fact, services are innovative, but the path of progress is different in their case than in the case of production.

This is a good place to discuss some basic issues concerning the concept of innovation. The purpose of this concise review is not to deal with the very broad and multidimensional problems of innovation exhaustively, but to introduce a few topics connected with innovation that are of particular relevance to this paper. And also the reasons for which we are dealing with services sector and innovation is because they are considering in our viewpoint as paths for undergoing to e-services model as an effective and efficient base for governance and development of our country.

Adoption of IT and the global computer networks for conducting business activities is known as e-business. The phenomenon of e-commerce is simply, the driving force of the new economy where everybody is connected everywhere and anytime. It overcomes the geographical and time constraints and serves as a great equalizer by creating a single competing field for all (small and large firms, experienced and inexperienced, domestic and foreign). In a word, e-business or e-commerce drives globalization.

E-commerce is not just buying and selling of goods and services, but also servicing customers, collaborating with business partners and conducting electronic transactions within an organization (Turban and King, 2003). As e-commerce matures and its tools and applications improve, greater attention is being given to its use to improve the business of public institutions and government (country, state, county and city).

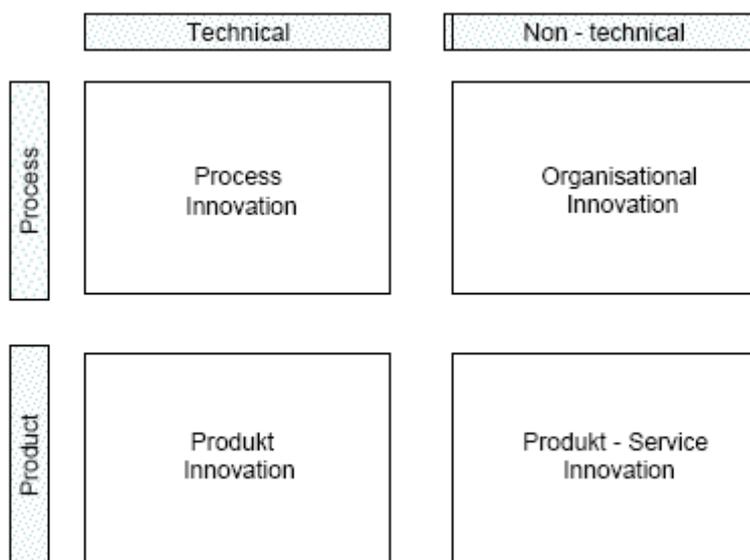
Innovations types

There are plenty of ideas what innovation means, especially in the business context. Goffin and Szejczewski distinguish four types of innovation:

- new products,
- new services,
- manufacturing processes, what means improving manufacturing or service delivery processes and
- business processes, that facilitate doing business with the organization.

Accordingly to Kinkel, Lay and Wengel there are product or process innovations and technical and non-technical innovations. Product and process innovations are defined as technical innovations. Product- service and organizational innovations represent non-technical innovations. Service – product innovation is defined as delivery of new services alone or combined with physical products (e.g. maintenance or operating services). Process innovation is aimed at finding new process technologies that make it possible to produce more cheaply, faster and in higher quality.

Figure 2. Types of innovation based on Kinkel, Lay and Wengel



Source: Armbruster H., Korner E., Lay G., at all, Patterns of Organisational Change in European Industry (PORCH), Final Report, Karlsruhe, August 2006, p.22

ALBANIAN MODEL OF E-SERVICES AND INNOVATION POLICY

As yet, Albania's economy does not qualify as knowledge-based, since the sectors that drive a knowledge-based economy are not sufficiently developed in our country. Nevertheless, the rate of development processes testifies to its high potential. Factors that limit the level of innovation in Albania include:

- Low employment in services sectors
- Insufficient cooperation between business and research institutions,
- Small number of new technology implementations,
- Small number of enterprises founded on new technologies

Public services and their effective distribution have a great impact on the economic and social development of a country. During the transformation process into a knowledge based society that a country undergoes, it is very important to offer those services effectively, promptly and in a transparent manner in line with the needs and demands of the citizens and businesses. Also, another step of good phase in the model is regarding to the fact that Albania is working on the healthcare field (e-health), on the Culture Sector (e-culture) and on the employment sector as well. But the latest development in the offering of electronic public services (e-services) indicate that Albania is still in the early stages of creating an Information Society, as it is still lacking in the offering of electronic services in healthcare, agriculture, employment, culture etc. Making those services available by means of electronic communication is of particular importance to accomplish better governance that is transparent, efficient and conducive to cooperation with the citizenry as well as with the business community.

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CONCLUSION

Albania has been undergoing radical changes and transitions since the dissolution of communism at the beginning of the 1990s. Although still comparatively isolated from international cooperative initiatives and lacking adequate institutions and support structures, the main actors carrying out research and development projects are the Academy of Sciences and higher education institutions. Higher education and science are mostly treated separately, and PhD programmers are often disorganized. Further progress in the reorganization of research institutes, the creation of national research centers, the introduction of standards and performance indicators, and the improvement of the infrastructure and legal framework are absolutely necessary. All this has on the center the process or even creating a model which will base on e-services. This e-services model will aim creating adding value in this way an *efficient e-based economic model*, as a system which is:

- provide support for all public finance operations,
- collect accurate, timely, complete, reliable and consistent information on all financial events,
- provide adequate management reporting,
- support government-wide and agency policy decisions,
- provide complete audit trail / auditable financial statements

The latest development in the offering of electronic public services (e-services) indicate that Albania is still in the early stages of creating an Information Society, as it is still lacking in the offering of electronic services in healthcare, agriculture, employment, culture etc. The government must explore strategies related to each of the e services.

Conclusions going to the services sector improvement necessity e-services in particular as a vital

motor of Albanian society. The conclusions to be described in the final paper are as follows:

- Albania must comply marketing policy with the main aim to be classified as knowledge based economy;
- *there is a huge gap between the European Commission recommendations towards marketing innovation policy in services, and Albania's current innovation policy in this sector*
- *a set of policy frameworks and mechanisms should be considered to more effectively harness service innovation to stimulate growth and competitiveness of Albania's economy*
- *the typology of systemic features that causes disadvantages in e-services model (capability failures, failures in institutions, network failures and framework failures) should be used to examine the reasons of poor results of Albania's innovation policy in services*
- *Educational programs should be introduced to promote the idea of marketing in services both in business and government circles.*
- *Some actions at the government level should be undertaken to facilitate the financial support for innovation and marketing in services.*

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AN ASSESSMENT OF AID MANAGEMENT & DONORS'S HARMONISATION: THE CASE OF ALBANIA

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ABSTRACT

This paper explores some of the issues, lessons, difficulties and current thinking within the aid management and donor harmonization and traces the evolution of these issues through contextualized examples on Albanian case.

Albania has benefited from substantial donor support and it has implemented liberalization and structural adjustment programmes, yet it still has economic and social problems. Even though till now it is so much spoken on the external financial aid, still not much attention has been paid to how donor behavior has impacted on the quality and effectiveness of aid.

Through this paper we want to identify how the uses of aid are affected by the extent and character of donor coordination. The ultimate question we would like to answer is what impact donor coordination can have on aid effectiveness in terms of development outcomes of Albania.

At the end we conclude that donor coordination can be improved when partners at both ends -- the recipient and the donor-- discharge their respective responsibilities and interact in good faith as good partners. Interaction, transparency, and functioning communication among the donors and the recipient government as well as information networks at country level are requirements for aid to work and donor coordination to exist.

The methodology used was followed with phenomenological research philosophy through literature review on the topic as well as by using qualitative techniques (interviews). These methodological issues will be used to provide sufficient in depth and detailed information when researching such complex issues on aid management and donors' coordination. It was further believed that the case study approach would be useful in researching this area where there has been little theory available.

Key words

Donors' coordination, External financial aid, Transparency

INTRODUCTION

Bilateral and multilateral donors began to discuss the problem of donor fragmentation, duplication of effort and lack of absorption of donor assistance in early 2003. The European Commission, UNDP, OSCE and the World Bank were given stewardship of the coordination process by the donor community in-country, supported by efforts of a number of bilateral donors and international organizations. The Government thereafter responded with similar action.

The main features of the Albanian coordination system are:

- Donor Architecture of 2003: an agreement of the donor community to allow 4 multilaterals to lead the process reporting to all donors on a regular basis, based on the work of a large number of sector working groups
- The twin steering and logistical functions since 2004: mirrored donor community and Government bodies that are able to operationalise the will of both to improve aid effectiveness
- New Government planning and budgeting mechanism Integrating Planning System (IPS): a State-of-the-Art internal coordination system to transform vision and policy into multi-annual budgeting, programming, implementation and monitoring/evaluation

BRIEF HISTORY

During years of 1992-1996, referring to the fact that Albania was one of Central European Countries in transition to market economy many donors considered Albania as a potential country which did really need an external assistance. The instruments of this external assistance were comparable to those offered to Hungary and Poland. In 1997, Albania woke up the international community to the fact that Albania had a unique modern history that required more traditional external assistance country programming. The Pyramid Scandal and ensuing Governmental collapse demanded strong international involvement which lingers on today.

In 1999, the Brussels-based donor coordination created through Friends of Albania was tested soon after with Kosovo Crisis, and one million refugees poured into neighboring Albania. Albania not only suffered from the influx but its poverty was revealed bringing even more donors to Albania. Being now seen more as a traditional external assistance recipient, in 2000 Albania began the poverty reduction strategy paper (PRSP) process in 2000 to access International Donors Assistance's credits.

The international effort produced a uniquely Albanian result, its National Strategy for Socio-Economic Development (NSSED) document in January 2001. The NSSED became widely accepted by the Government, donors and even civil society as the country's key strategy to be followed. At the same time the Government decided that 3 different ministries would coordinate donors depending on the type of assistance offered, created a deepening confusion and lack of coordination. It was also at this recovery/early reconstruction phase when donor coordination under the Friends of Albania group was disbanded, seen as have played out its role.

In March 2003, the end of Friends of Albania and the high point of donor fragmentation coincided with the emergence of an in-country donor initiative to create a coordination mechanism more suited toward long-term social and economic development. In March 2003 a donor retreat in Durres, sponsored by DFID, led to a 9-month intense discussion.

In December 2003 the final compromise resulted in the “Donor Architecture”, which was approved by the December 2003 Roundtable. Basically the compromise asserted that the four lead multilaterals are able to represent their members, the bilateral donors and most of the International Finance Institutions: directly or indirectly. The four multilaterals have as well four distinct mandates that complement each other, allowing for a thematic division of sector responsibility. Sector Working Groups began their functioning.

The Technical Secretariats, created in 2004, did ensure that progress was made in the preparation of the Integrated Planning System’s proposal launched by the Government in May 2005. The IPS proposal in itself has been a catalyst for renewed donor and Government interest in coordination. In March 2005, the donors approved an annual work plan for the Donor Technical Secretariat and announced plans for staffing it starting in May 2005 and a Harmonization Action Plan (HAP) design by December 2005. In November 2005, the new Government approved a reworked IPS and established/moved a number of structures to implement the IPS and to effectively coordinate donors. The Government clarifies that it will no longer need donors to co-chair the Government-Donor Quarterly Roundtables.

THE CURRENT DONOR COORDINATION SYSTEM IN ALBANIA AND LESSONS LEARNED

The “Donor Architecture” of Albania is led by regular Quarterly Donor-Government Roundtables chaired by the Deputy Prime Minister. This Quarterly Roundtable of Government and Donor Heads of Mission addresses strategic issues of coordination, monitors major progress in improved aid effectiveness and provides a forum for Government-Donor dialogue on critical issues. There are reports on coordination efforts in the sectors at the roundtable. Development Counselor Meetings are convened by the Donor Technical Secretariat in order to prepare and coordinate the donor community prior to the ambassador-level Roundtables.

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The Quarterly Roundtable of Government and Donor Heads of Mission is currently supported by 17 Sector Working Groups, facilitated by the lead multilateral within its thematic responsibility or by another donor volunteering to become a Focal Point and delegated with the task by the multilateral. The groups meet mostly on a quarterly basis.

Since early 2005 line ministries have been encouraged to co-chair or chair these groups. The groups initially concentrated on information exchange of on-going projects but slowly and unevenly now are concentrating more on forward-looking, upstream planning of assistance, joint actions and strengthening of the line ministry’s capacity and overview of the sector.

To manage the coordination process, the four lead multilaterals formed the Donor Technical Secretariat (DTS), and the EC as the largest donor became the permanent Head of the DTS.

Initially the DTS was a working committee of high-level official representatives of the four lead multilaterals. In May 2005 the DTS was transformed into having a physical office at the Delegation as well as retaining the original DTS steering committee. The four Heads of Mission of the multi-lateral stewards of the DTS have also met occasionally. The DTS has been responsible for logistical and advisory support to the Roundtables, Development Counselor Meetings, the Sector Working Groups and other donor events.

As the Government now begins to build up its parallel functions, the DTS Office transferred these tasks to the Prime Minister's Office. The DTS keeps contact with the Government through the Prime Minister's Office and facilitates wider information exchange with donors and Government by e-mail, web site and through its physical office.

In January 2005, the Government matched the DTS with the Government Technical Secretariat (GTS). This committee consisted of representatives of the core ministries – Finance, Economy, European Integration, Interior and Council of Ministers under the leadership of the Prime Minister's Office. The GTS was vital in drafting the Government's Integrated Planning System, a new integrated policy, planning and budget system that builds on existing components such as the Mid-term Expenditure Framework, the National Strategy for Socio-Economic Development (NSSD), the Public Investment Function and the Monitoring Information System. The GTS and DTS met regularly as the Joint Technical Secretariat during the period of the IPS design phase.

The Joint Technical Secretariat coordinated Government and donor cooperation on the IPS reform and facilitated roundtables. Since the 10 November 2005 decision of the Council of Ministers, the coordination work has become more institutionalized and the ad hoc GTS seemed to have played out its role.

As of December 2005, the Department for Strategy and Donor Coordination (DSDC) was established within the PM's office with responsibility for the NSDI (National Strategy for Development and Integration), the Integrated Planning System (IPS), and aid coordination. Since its creation, this Department has been the counterpart for the DTS. The DSDC was created to:

- Co-ordinate the implementation of the Integrated Planning System (IPS), which will ensure that the Government's priorities, including the requirements for EU and NATO integration, are fully reflected in the core Government policy and financial planning processes
- Co-ordinate the formulation and monitoring of the National Strategy for Development and Integration in which the Government's priorities will be articulated;
- Ensure that external assistance effectively supports implementation of the Government's priorities

DSDC has designed the donor coordination functions in order to take over the responsibility from other Government agencies and offer the first port of call for donor partners; in addition, it is responsible for organizing the major coordination activities such as the donor-Government roundtable and the IPS support group, which is a policy level advisory board; it is expected that during 2007, the DSDC will develop an external assistance strategy tied to the National Strategy for Development and Integration.

The DSDC has played an active role in the preparation of the Integrated Planning System Trust Fund, which starting from 2007 pooled donor community contributions. DSDC helps as well in coordinating the technical assistance in streamlining the support line ministries to receive on the core Government policy and financial planning processes.

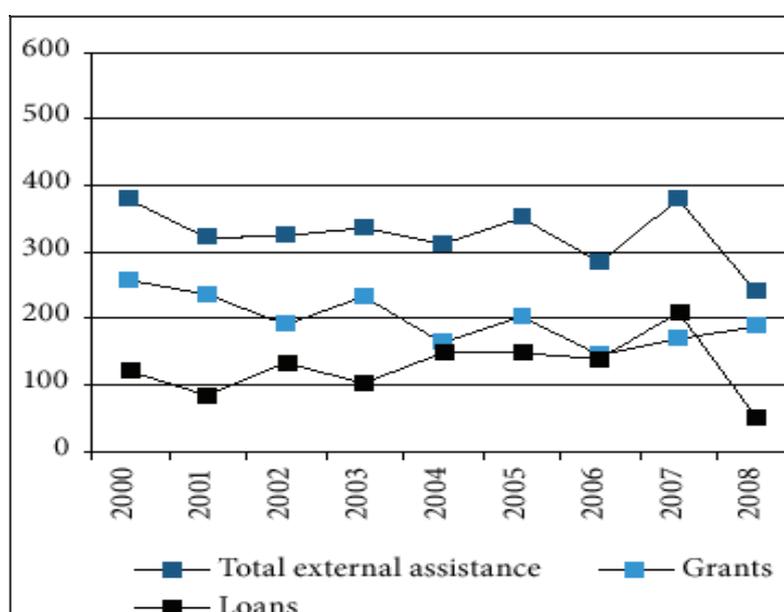
OVERAL TREND AND COMPOSITION OF EXTERNAL ASSISTANCE

Total external assistance during the period 2000 – 2008 has amounted to around € 2.93 billion, of which roughly € 1.79 billion (approx. 61%) has been in grants, € 1.13 billion in loans (approx. 39%)³. Since 2000, external assistance levels have remained between € 250 - 380 million per year.

Figure 1 shows the distribution of external assistance over this time period (2000-2008). Compared to other countries in the region, Albania has received lower levels of external assistance in per capita terms (Table 1).

Since 2000, the ratio of external assistance to gross domestic product (GDP) has declined. This is mainly due to the increase in GDP (which has increased to € 8.7 billion in 2008 compared to € 4.6 billion in 2001), rather than a decline in external assistance levels. In 2008, the estimated ratio of external assistance to GDP was 3.65 %.

Figure 1: Total external assistance, grants and loans 2000-2008 (€ million)



Source: Council of Ministers, Republic of Albania 2000-2008

Table 1: External Assistance (€) per capita per year, average 2000-2008

	External assistance per capita (€)	Population (million)
Albania	100	3.2
Bosnia-Herzegovina	144	3.8
FYRO Macedonia	114	2
Serbia	164	7.4

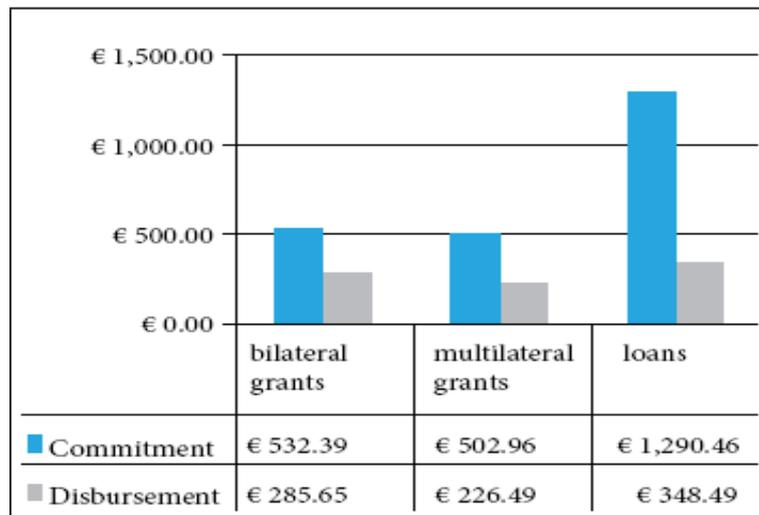
Source: OECD (2008) and World Development Indicators (WDI) (2008)

By type

During the period 2000 – 2008 the external assistance has been provided in the form of bilateral grants, multilateral loans, multilateral grants, non-concessional loans and bilateral loans (Figure 2). In 2000, grants represented 68% of total foreign assistance commitments, while during the following

years, this type of financing decreased substantially. Bilateral grants have decreased in the last four years, and further decrease is anticipated as a number of bilateral donors are gradually phasing out. Most of the loans are provided by multilateral donors oriented mainly in infrastructure, energy, health, education and social reform sectors. The increase in the level of loans, as well as the transit from soft loans (in concession terms) in commercial term loans, is closely related to Albania moving from a low income country to a middle level income.

Figure 2: Commitment vs Disbursement of Bilateral and Multilateral Grants and Loans 2000-2008



Source: Donors' Data Base 2000-2008

The division of commitments, grants and loans, for the period 2000-2008 by multilateral and bilateral donors is given in the Figure 2. From the charts, it is obvious that the biggest part of the assistance offered by multilateral donors is in the form of loans, while bilateral donors' assistance is in the form of grants. The largest source of non-concessional loans remains EBRD which has a portfolio of around € 195.6 million, mainly in energy and transport.

The European Investment Bank (EIB) has total approved projects of € 268.5 million, covering energy and transport, though including also water supply and sanitation and, more recently, education. The Central European Bank (CEB) has approved projects worth around € 74 million and supports health, education and social housing.

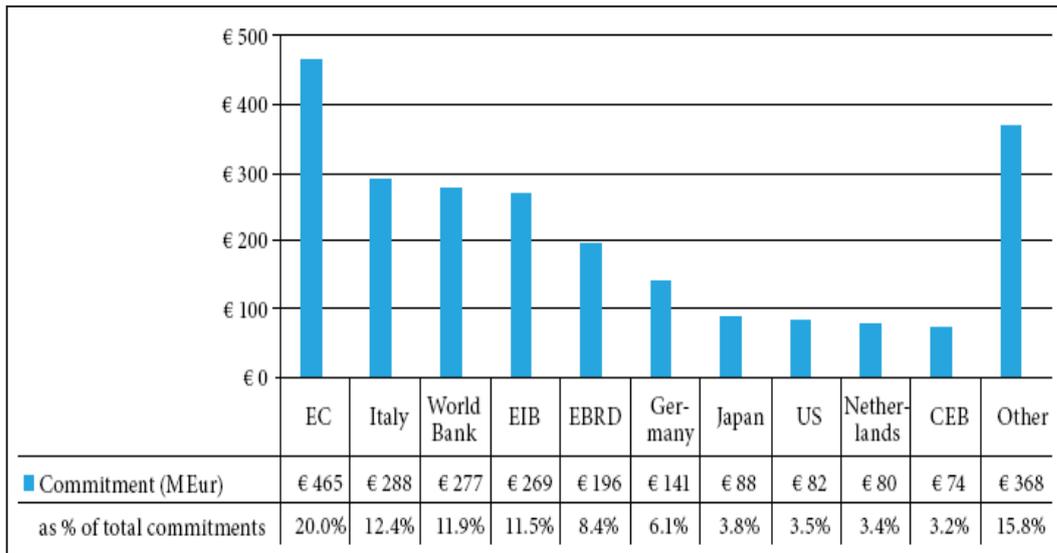
Assistance provided by these banks is considered as valuable for the government because of their ability to support longer term investments, and for the cooperation with bilateral and multilateral donors, other commercial banks and the private sector.

By donor

Eleven multilateral donors (whose assistance constitutes approximately 58% of the foreign aid) and 23 bilateral donors operate in Albania. The two largest multilateral donors during the period 2000-2008 have been the EC (providing grants with over € 465 million) and the WB (providing mostly loans with over € 277 million), together accounting for 32% of external assistance.

As for bilateral, the five largest donors, over the same period, have been Italy (providing both grants and loans with over € 288 million), Germany (providing grants and loans with over € 141 million), Japan (with almost € 88 million), the US (providing grants with over € 81 million), and the Netherlands (providing grants with over € 79 million), together accounting for slightly more than 29% of total external assistance during the period 2000-2008.

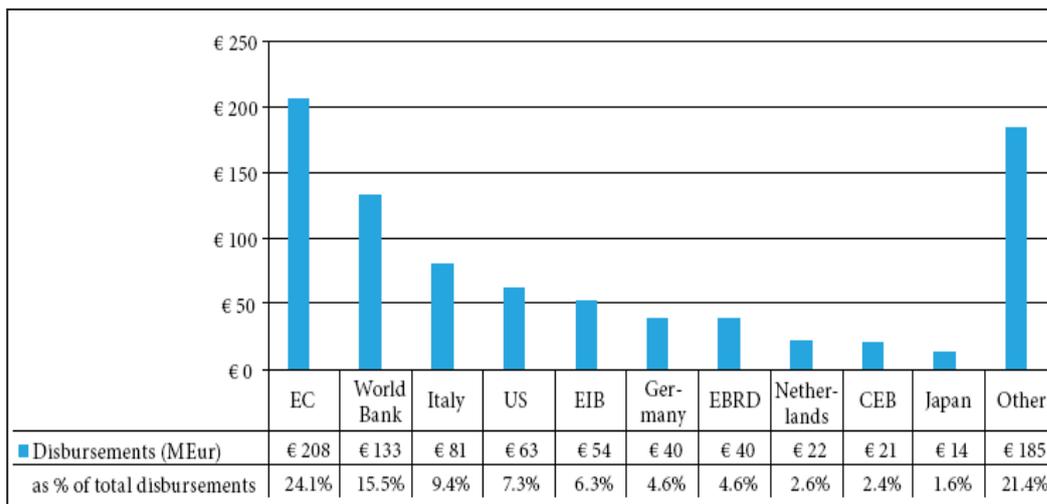
Figure 3 Commitments by Donor 2000-2008 (in € million)



Source: Donors' Database

Note: Only key donors are represented separately in this figure. Donors with a contribution of less than 3% of total assistance are grouped under "other".

Figure 4: Disbursements by donor, 2000-2008



Source: Donors' Database

Note: Only key donors are represented separately in this figure. Donors with a contribution of less than 3% of total assistance are grouped under "other".

Multi-lateral Donors

European Commission. Over the period 1991-2007, the European Commission assistance to Albania has totaled about € 1.3 billion. About € 635 million were delivered through the Phare programme from 1991 to 2000. Between 2001 and 2006 Albania benefited from around € 330 million of CARDS assistance.

CARDS assistance targeted four broad reform priorities: justice and home affairs (about 40% of the funding), administrative capacity building (about 20%), economic and social development (about 35%), and democratic stabilization (about 5%). Since 2007 the Instrument for Pre-accession Assistance (IPA) supports Albania as a potential candidate country, replacing the former CARDS programme.

Albania benefits from two components out of five, specifically from Component I – for Transition Assistance and Institution Building and Component II - for Cross-Border Cooperation. IPA objective

is to ensure full decentralized management. The indicative allocations to Albania under the Multi-annual Indicative Financial Framework (MIFF) for 2008- 2010 amount to € 245.1 million.

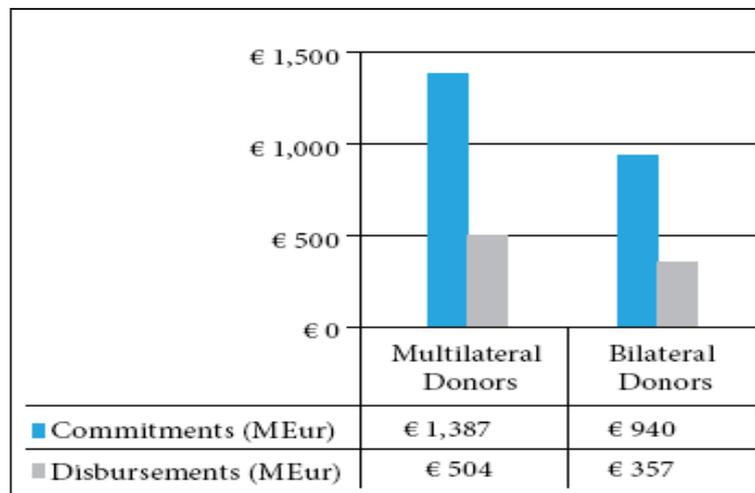
Main directions leading the EU assistance for Albania under IPA component shall be focused primarily on these fields: (i) strengthening of democratic institutions and the rule of law; (ii) promotion and protection of human rights; (iii) public administration reform; (iv) reform in justice and home affairs; (v) support to economic reform through private sector assistance, restructuring of industry and modernization of strategic sectors; (v) environmental protection policy; (vi) civil society development and social inclusions etc.

The World Bank’s support program aims to contribute to poverty reduction and improvements in living standards, job creation, government accountability, and infrastructure and social services. Since the inception of the World Bank’s program in Albania, 67 projects for a total amount of \$997.5 million have been approved by the Board of Directors.

In 2008, on account of its strong achievements in economic growth, Albania has achieved middle income status and graduated from IDA (International Donors Assistance) concessional flows to IBRD lending, sending a positive signal to investors and the financial markets about the economic prospects of the country.

The country is now credit worthy for IBRD. The main sectors that are benefiting from the World Bank’s assistance can be mentioned: (1) Transport; (2) Private and Financial Sector; (3) Water and Sanitation; (4) Agriculture, Rural Development and Environment; (5) Governance, Administrative Reform and Anticorruption; (5) Human Development.

Figure 5: Multilateral and bilateral commitments and disbursements 2000-2008 (in million Euro)



Source: Donors' Database

Bilateral Donors

Italy.

The Italian Cooperation has been active in Albania since 1991 and, with a financial commitment of approximately € 650 million, it represents the first bilateral partner and the third donor after the European Union and the World Bank. Through the allocated resources, Italy has supported the development and stabilization of the country, aiming at pursuing a democratization and socio-economic development, juridical and institutional reinforcement and integration in the international context.

Among the most consistent interventions to be mentioned: assistance for the electric power supply; Interventions for the rehabilitation of the water and sewage system of Tirana; programmes in the transport sector, aimed to reinforce the north-south axis (Shkoder - Hani Hotit Road) and the enhancement of the Balkan Corridor VIII (Lushnje - Fier - Vlore Road); The support to primary, secondary and higher education system; the development of Albanian SME, through credit line, guarantee fund and technical assistance; The support in the agriculture sector (through the support to FAO programmes, the improvement of food control systems, the rehabilitation of the pumping stations in floodable agriculture areas, etc.); and the support in the environmental, cultural, institutional, social and vocational training fields.

Germany.

The development cooperation between the Federal Republic of Germany and Albania began in 1988. The overarching objective of this cooperation, along with improvement of the conditions and the quality of people's lives, is to support Albania's increasing alignment with the European Union.

The priority areas agreed between the two countries since 2001 are: (1) Drinking water supply, sanitation and waste management; (2) Energy; (3) Sustainable economic and social development. The Technical and Financial Cooperation is implemented through GTZ and KfW offices in Tirana. Japan. Japan International Cooperation Agency (JICA) is the agency that provides bilateral aid on behalf of the Japan's Government in the form of technical cooperation, Japanese ODA loan and grand aid.

The main sectors that are benefiting from the Japan's assistance can be mentioned: (i) the support to the private-sector development - supporting human resources development for promoting SMEs and providing policy support to enhance trade and investment. (ii) Consolidation of peace - Japan has dispatched Project Formulation Advisors and project formulation study teams, and provided assistance in areas of education, agriculture and medical care, while paying careful attention to balance shared benefits among the various ethnic groups. (iii) Tackling Environmental Problems in the region.

USAID

The U.S. Agency for International Development (USAID) is an independent agency that provides economic, development and humanitarian assistance around the world in support of the foreign policy goals of the United States. USAID has been operating in Albania since 1992. During this time, USAID/Albania has delivered more than \$414 million in assistance to support Albania's transition and long-term development. USAID/Albania is implementing programs in four areas: (i) Promoting Economic Growth and Prosperity; (ii) Governing Justly and Democratically; (iii) Investing in People; (iv) Achieving Peace and Security. USAID's development program strengthens governmental accountability and transparency, reduces corruption, increases the competitiveness of Albania's private sector, improves the delivery of quality healthcare, helps ensure a reliable and affordable energy supply, and reduces trafficking in persons. The Stage II Millennium Challenge Corporation (MCC) Threshold program is addressing additional anti-corruption-related reforms in the country's public administration and justice sectors.

By sector focus

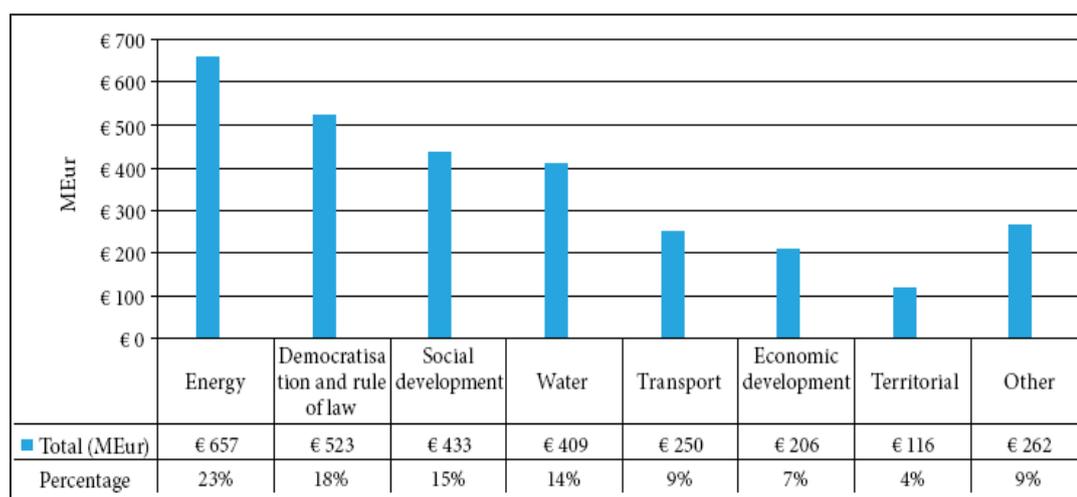
There has been wide variation from year to year in the sectoral allocation of support with no clear trends during the period 2000 – 2008. But based on evaluations and analysis conducted, the aid has been allocated in accordance with the priorities stated in the strategic documents for the development of the country.

Table 2 External assistance (commitments) by sector focus, 2000-2008 (Euro million)

Sector	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total 2000-2008	%
Democratisation and rule of law	85	61	49	67	64	89	36	41	31	523	18%
Economic development	30	32	36	17	11	15	16	23	26	206	7%
Transport	16	16	26	32	20	16	20	29	75	250	9%
Energy	33	51	83	61	94	88	107	107	33	657	23%
Water	99	53	22	37	47	53	40	48	10	409	14%
Social development	67	47	37	102	46	46	26	37	25	433	15%
Territorial	10	11	13	5	12	15	19	14	17	116	4%
Other	38	47	59	15	17	28	19	14	25	262	9%
Total	378	318	325	336	312	351	284	314	240	2858	100%

Source: Donors' database for 2006, 2007 and 2008.

Figure 6 Commitments by sector focus 2000-2008 (Euro million)



Source: Donor Database 2009

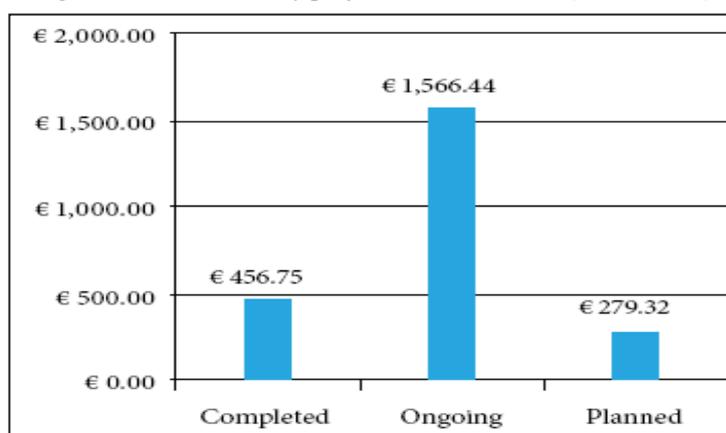
A large share of support has been focused on governance, including democratization and rule of law. Economic development, including agriculture, industry, trade, business/finance, and tourism, has expanded rapidly in the last two years, which can be explained by the recent focus of several donors in this area.

Social sectors have featured strongly in the past, but the indications show that the share of external assistance devoted to them has been declining in recent years. The support for infrastructure has remained stable in total (except for 2001), but there have been large swings between transport, energy and water.

The recent growth in non-concessional loans means that over 50% of external assistance to infrastructure now comes from concessional loans, with the majority going to the energy sector.

The donors' database includes projects that are ongoing or are planned with firm commitments. It also includes a record of completed projects and some notes of indicative programming. For the 2000-2008 period, this picture is illustrated by the following graph.

Figure 7 Commitments by project status 2000-2008 (Euro million)



Source: Donors' database 2009

Note: The graph shows that roughly 279 million Euro are planned by donors in future projects. This low figure results partially from the uncompleted information that is given by donors about their expected commitments in the coming years.

Table 3 shows the level of external assistance and domestically funded investments in different sectors, as registered by the Albanian Treasury.

In 2008, domestic funding accounted for 54% of public investments. Transport (56%), Environment (56%), Justice (56%), and Economic Development (54%) are sectors where the share of externally financed investment is higher than total of domestically financed projects.

The rest of sectors are significantly dominated by domestic funding share. It should be noted the relatively very low level of externally financed investments in Education (11%) and Health (17%).

Table 3 Public investment by sector and source of financing, 2008

	Domestically funded Euro million	Externally funded Euro million	Externally funded as share of total (%)
Justice	3.15	3.8	55%
Home Affairs	9.0	0.03*	3 %*
Education	38,4	4.6	11%
Health	16,8	3.4	17%
Employment	2,0	2.6	57%
Energy	7.2	32.9	22%
Water and sanitation	25,8	22.8	47%
Transport	215,8	271.5	56%
Economic development	1,1	1.3	54%
Agriculture	8,1	7.9	49%
Environment	1,8	2.3	56%
Other	52,4	0.5	1%
Total	381.6	356.7	48%

Source: GoA Treasury 2008 and 2008 Budget (MoF).

* Data for Home Affairs are obtained from the donors' database

Note (1): Both domestically and externally funded investment is taken from 2008 factual budget figures (MoF); It should be noted that some externally financed projects (especially grants) are captured with difficulties from the treasury system and in reality the figure of externally financed investment figure should be higher.

Note (2): The value of the domestically funded investments for Energy in 2008 does not include the investments of the public electrical energy corporation (KE SH) due to the fact that the budget does not finance the investments of the KE SH.

A relatively high concentration of external support in the above sectors will continue for some years. Several of the sectors receive high external assistance because they need strong TA (Technical Assistance), in addition to investment.

However, there will be a tendency for differences between sectors to decline. In addition, some of the sectors that are benefiting from semi-commercial borrowing, e.g. energy, will benefit from commercial borrowing, following the trends started by graduation from IDA and the use of loans by bilateral.

GOVERNMENT- DONOR POLICY DIALOGUE

Implementation of the Paris Agenda

Greater alignment of external assistance to the national strategic priorities and budgeting process is a key objective of the Government's Integrated Planning System (IPS), adopted as a set of operating principles to ensure that government policy, planning and implementation take place in a coherent, efficient and integrated manner. The effectiveness of external assistance management has been a concern of the Government and donors operating in Albania for many years and attempts to address this have gone through cycles of institutional architecture and process improvements.

Government has been increasing ownership and its role in coordination of external assistance since the establishment of the DSDC in 2005. DSDC central coordination role is to ensure organic links between external assistance and main policy and financial processes of the government. DSDC works very closely with the Donor Technical Secretariat (DTS).

The DTS was established in 2003 with the objective to facilitate a structured donor-to-donor and donor-government dialogue. The DTS, initially composed of four multi-lateral donors (EC, OSCE, UNDP, World Bank), is expanded since 2008 with two bi-lateral donors (Germany and the Netherlands), whose membership is rotated annually. Austria and Switzerland will be the two bilateral members of the DTS beginning in November 2009.

Strengthen coordination mechanism through Sector Working Groups. From 30 working groups established so far only a limited number of them (mainly Justice and Home Affairs, Gender Equality and Domestic Violence and Health) have been meeting regularly. A considerable number either never met or proceeded sporadically. Emphasis over the past six months have been put on further operationalisation of the functional SWGs or vitalization of the dormant ones, which will be crucial for a coherent policy coordination and monitoring process at the sectoral level. The aim is to give an active role to SGWs in policy co-ordination and in monitoring of sector strategies, Medium-Term Budget Programme and external assistance.

Also the SWGs (Sector Working Groups) will be utilized as for a to discuss potential joint programming between Government and donors where the future needs of the Government institutions, as well as sector potential to implement Programme-Based Approaches (PBAs) and SWAp (Sector Wide Approach) could be identified and agreed.

The "Donor Co-ordination Architecture" of Albania is led by Government-Donor Roundtables (DRT). This Roundtable of Government high officials and Donor Heads of Missions addresses strategic issues of coordination, monitors major progress in improved aid effectiveness and provides a forum for Government Donor dialogue on critical issues. At the roundtable, there are reports on coordination efforts in the sectors.

During 2008 two Roundtables were organized. The first one was held in May 2008 and focused on the specific issue of the donor financing to mitigate the impact of Gerdec explosion.

The second regular DRT was held in November 2008. It presented an overview of the progress towards the EU and NATO integration, implementation of the IPS and the results of 2008 DAC Survey on Monitoring the Aid Effectiveness in Albania. It pointed out issues related to the process of donor co-ordination and further steps to be taken for the implementation of Paris Declaration on Aid Effectiveness and Accra Agenda for Action. It concluded about the need to adopt a joint strategy and a harmonized action plan for improving donor co-ordination and aid effectiveness.

Harmonization Action Plan

The Paris Declaration has established 12 indicators and targets that need to be met by 2010. To achieve this, the Government and donors have been undertaking substantial efforts to improve use of country systems, make aid more predictable, use SWAp and PBAs and results-oriented frameworks. The need of having a joint strategy and a Harmonized Action Plan (HAP) for improving the donor coordination and aid effectiveness in Albania was raised at the Government- Donor Roundtable in November 2008.

An opportunity for both the donor community and the Government to mutually agree and deepen engagement in key areas of the Accra Agenda for Action and the joint efforts to implement the Paris Declaration on aid effectiveness was acknowledged in this meeting. A small working group composed by donors (DTS- Donor Technical Secretariat) and government representatives (DSDC -Department of Strategy and Donor Coordination and MoF) was set up to entail priority areas and identify the areas for progress.

The group has worked together over the period January – June 2009 and the draft of an Harmonization Action Plan (HAP) has been the result of this joint work. The aim of the HAP is to improve the efficiency and effectiveness of the management of aid, and is centered on the principles of supporting country ownership, aligning donor support behind government policy priorities, using government systems where feasible and where possible harmonizing and simplifying donors' own procedures. The HAP is not simply concerned with harmonization in the narrow sense of the adoption of common procedures and sharing of analytic and review findings between donors, but with a whole range of measures that will bear on aid effectiveness.

The HAP is specific to the circumstances of the countries, but it is based on the five partnership commitments set out in that Declaration: (1) Ownership, (2) Alignment, (3) Harmonization, (4) Managing for Results, (5) Mutual Accountability. The preparation of the plan is going through negotiations between development partners (represented by the DTS) and the government (DSDC) on the precise principles and policies to be used as the basis for the HAP itself and its implementation. It is critical to the effectiveness of the HAP that both the government and donors are fully committed to what is agreed. The HAP will set out the agreed domestic targets of the Government and donor community for the 12 indicators. The HAP will work in conjunction with the IPS to form a vice-like mechanism which slowly will reduce the space available for donor fragmentation.

Promote of use of national procurement systems by donors, in view of implementation of Paris Declaration Agenda. One of the achievements of the joint DSDC/DTS work in preparing the HAP relates to Public Procurement and application of the OECD/DAC methodology to assess its quality. The need for an opportunity to promote the use of national procurement system by the donors, by means of assessing the current national procurement quality and identifying areas that require further capacity development is identified as one of important areas for improvement.

Over the period May-June 2009 the OECD/DAC methodology was presented to key stakeholders (donor and government representatives) in Albania by the UN Procurement Capacity Development Centre (based in Copenhagen). Consensus between the Government and donor community emerged to fully implement this assessment and to use the assessment as a basis for discussion in order to increase use of country procurement system as agreed in the Paris Declaration and the Accra Agenda for Action.

The actual assessment is foreseen to start in November with financial support from UNDP. Government and donors have also agreed that the assessment team will be a joint assessment team led by Government with support from external consultants and development partners.

The general consensus among Government and donors is that the public procurement system has improved significantly since the last assessment and all stakeholders are in favor of carrying out a new comprehensive assessment with objective to: report on the Paris Declaration indicators related to public procurement; identify weaknesses in the public procurement system and develop a capacity development plan based on the assessment and; use the assessment as the basis for discussions on increased use of country procurement systems as agreed in the Paris Declaration and the Accra Agenda for Action.

CONCLUSIONS AND RECOMMENDATIONS

Based on all this experience of donors in Albania it was learned that:

1. The Government's inability to plan/budget the necessary resources to take over and maintain Official Development Assistance investments revealed the Government's inability to properly absorb even its own public investments. This realization made by the Government, in discussion with the donors, was the main impetus to design the IPS.
2. Soon after launching, the Government's National Plan for the Approximation of Legislation and SAA Implementation the same Government realized that it had not been linked to the state budget and thus would not automatically be implemented. Therefore, the IPS has exposed the need to integrate all donor assisted processes in the national planning and budgeting system.
3. There were a number of the political processes which put resource demands on the Government eg European Integration, NATO membership, decentralization, anti-corruption. Albania balanced these and make its own national prioritization through a new Integrated Medium Term Strategy in 2006 based on the full spectrum of approved sector strategies with domestically-set targets. This participatory process was crucial for Government leadership of donor coordination.
4. The key to joint funding is firstly to agree between the donors for the basic principles of the joint funding and implementation including how to proceed with financial arrangements before starting drafting papers. Many donors have already agreed on common guidelines and templates for these occasions such as those of the Nordic + group. In-country understanding of these new ways of working is limited and there is a need to organize more sessions of common training.

All of these lessons learned were concluded with the composition of HAP, which has been the result of a joint work.

The aim of the HAP was to improve the efficiency and effectiveness of the management of aid, and is centered on the principles of supporting country ownership, aligning donor support behind

government policy priorities, using government systems where feasible and where possible harmonizing and simplifying donors' own procedures.

But still Albanian Government is facing a challenge: how to properly absorb the external assistance and even its own public investments.

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THE ROLE OF FINANCIAL DERIVATIVES IN FINANCIAL CRISIS

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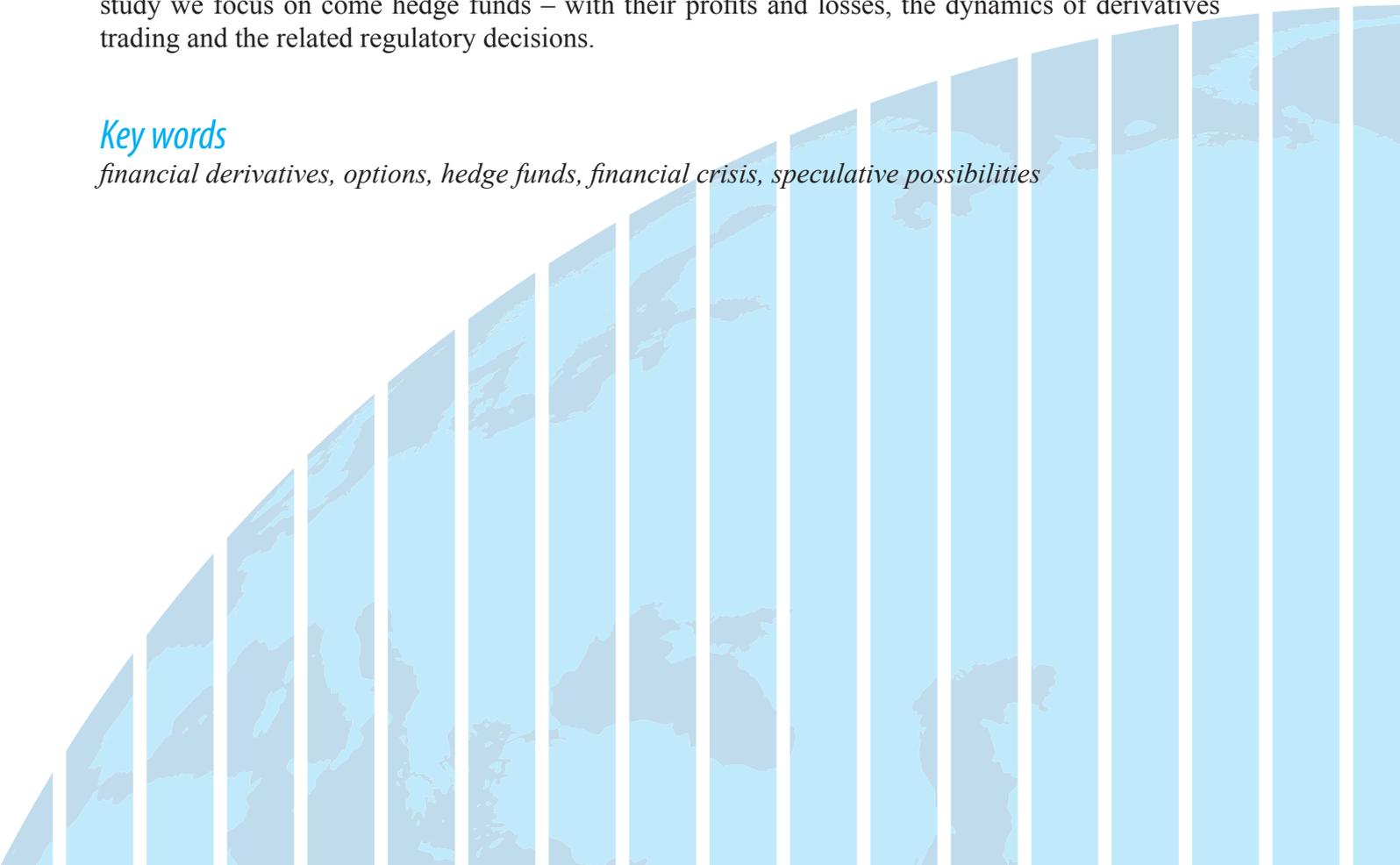
ABSTRACT

The current paper is focused on financial derivatives as an instrument for risk management. We frequently come across marginal opinions blaming financial derivatives for big losses of different market players and especially for the current world financial crisis. Having in mind the rich variety of different types of derivative contracts and underlying assets, synthetic possibilities and a large spectrum of strategies, we may say the options, the futures and the other derivatives have unlimited implementations. With this paper, we aim to outline the real behaviour and actual role of financial derivatives for financial crisis. We make an attempt to show the use of financial derivatives in normal (positive) economy, in the very beginning of financial crisis and total instability. To this end, in our study we focus on some hedge funds – with their profits and losses, the dynamics of derivatives trading and the related regulatory decisions.

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Key words

financial derivatives, options, hedge funds, financial crisis, speculative possibilities



INTRODUCTION

At the dawn of exchange trade, far before the modern regulation of stock exchanges, at the time of grain exchange, the traders in the American states Kansas and Arizona created the so-called “buying a pig in a poke”, realizing the risk of a serious imbalance between demand and supply. The future obligations - forward transactions lay the foundation of the forward trade, and later, of financial derivatives. Instruments of immeasurable speculative opportunities, unique arbitrary potential, but above all – of incomparable hedging opportunities. Opportunities which have been used for decades by the investors on all contemporary markets, who driven by the potential which the derivative instruments offer, continuously developing new groups of instruments and numerous their varieties. Nowadays the most dynamically circulating capitals are on the financial derivatives markets. The daily turnover of an instrument (e.g. swaps or *FRA*) exceed in times the annual state budget of the Republic of Bulgaria and the volume of all derivative instruments at the beginning of 2010 is six times more than the gross product of the entire world economy. (The reasons the Bulgarian practice lacks behind in this investment field are a subject of another thorough discussion).

At the same time, some prominent world and national financial experts express in their analysis and comments acute and even deprecating opinion regarding the “danger of the trade with financial derivatives”, its “blame for the world financial crisis” and other.

Based on the above, the present analysis focuses on financial derivatives and the subject of study is their application during periods of different financial and economic activity and substantial instability. The purpose is to highlight the actual significance of these financial instruments for the investment activity and for the vigor and stability of financial markets.

452 In our quest for these answers, we start with a brief review of contemporary financial derivatives; we examine market data, comment on few emblematic examples for use of derivatives on the eve of world crisis and comment on the statement of public market bodies which actively use derivatives –such as investment banks and hedge funds.

FINANCIAL DERIVATIVES – brief look from 2010

Varieties of Financial derivatives;

The systematization of financial derivatives presupposes the defining of several criteria for their correct and full presentation, the more important of which are: conditionality (unconditionality); method of trade (stock-exchange/not at the stock exchange); basic instruments, term, time of origin, etc.

A) According to basic criterion **CONDITIONALITY**:

<u>Conditional derivatives:</u>	<u>Unconditional derivatives:</u>
<i>Options;</i>	<i>Futures;</i>
<i>Rights;</i>	<i>CFD;</i>
<i>Warrants.</i>	<i>Swops;</i>
	<i>FRA;</i>
	<i>SAFE;</i>
	<i>Credit derivatives;</i>
	<i>Insurance derivatives.</i>

Each of these instruments includes several varieties depending on the basic elements of the particular contract. The richest and the most many-sided derivative – the options, has dozens of varieties (especially as exotic options are concerned).

Although this is a brief outlook on financial derivatives, we have to highlight the utter importance of securitization for the development of new instruments. Here we can give as an example the credit derivative, still topical nowadays.

B) ACCORDING TO THE TRADE METHOD it is important to have in mind the market - **exchange or OTC (over-the-counter) is traded** particular derivative instrument. The main reason is, from one hand - the liquidity of exchange trading, and from the other – the variety of OTC-instruments, “exotic” contracts, etc.

C) UNDERLYING ASSET, this element offers the biggest variety of derivative instruments. After the traditional contract types:

- capital instruments: *stocks; bonds; shares in funds;*
- commodity: *exchange traded goods;*
- currency: *convertible exchange traded;*
- credit positions;
- insurance positions;
- financial instruments (not assets): *exchange rates; exchange indices; interest rates; volatility index (VIX); dividend index; fictitious credit positions;*
- derivatives (compound derivatives): *options; swaps; futures ...*
- climate: *“Celsius”, temperature ..*
- quotes for pollution - permissions for *noxious emissions, so called “Carbon”, “oxides”; hothouse gases ..*

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The innovative solutions in the option industry, permanently introduced by CBOE, support its importance and leadership position since it has been established, for over 37 years.

Since 2006 CBOE has been offering the new VIX option. VIX is a variability index and reflects the attitude of the investors regarding the variability of the share prices on the stock exchange within the next thirty days.

*An interesting news for financial engineering: CBOE **launched trading in options on the S&P 500® Dividend Index** (ticker symbol - DVS), on March 5, 2010. The first contract of its kind in the U.S., S&P 500 Dividend Index options are listed exclusively at CBOE.*

D) MATURITY TERM – there exist traditional standardized expiration periods and dates. Plain-Vanilla Options and futures are short term - up to 12 months. Warrants and Swaps have traditional terms of 8 - 10 years.

*CBOE proposes **WeeklySM Short-Term Options**, or listed index and equity options - that match all other terms of standard options except that they are **listed for trading for only one week and expire on Fridays (not Saturdays) other than the third Friday of a month.***

***LEAPS (Long-term Equity Anticipation Securities)** are long-term option contracts that allow investors to establish positions that can be maintained for a period of up to three years. CBOE lists LEAPS on Equity and Index products.*

Market data

The Chicago Board Options Exchange (CBOE) reports:

CBOE March Volume Averages 4.5 Million Contracts/Day

March 2010 ADV: Down 8% from March 2009,

up 7% from February 2010

First-Quarter 2010: CBOE Volume Up 2%

Chicago, April 1, 2010 -:

- average daily volume (ADV) of 4,5 million contracts;

- in March for a monthly total of 104,4 million contracts.

March's average daily volume reflects: an eight-percent decline from March 2009 and a seven-percent increase from February 2010 ADV. For the first quarter of 2010, average daily volume at CBOE rose two percent from the same period one year ago. Quarterly index option ADV rose 26 percent, while equity option and ETF option volume declined by two and ten percent, respectively.

Table 1.
Option trading volumes

(trades in thousands)	Current Month				
	March 2010	March 2009	% Chg.	February 2010	% Chg
Trading Days	23	22		19	
Total Exchange	104,431.7	108,888.8	-4%	80,670.8	29%
Total Exchange ADV	4,540.5	4,949.5	-8%	4,245.8	7%
Equity Options	56,230.0	58,137.9	-3%	39,529.0	42%
Equity Options ADV	2,444.8	2,642.6	-7%	2,080.5	18%
Index Options	25,096.0	21,310.0	18%	21,263.9	18%
Index Options ADV	1,091.1	968.6	13%	1,119.2	-3%
ETF ¹ Options	23,105.7	29,439.6	-22%	19,877.8	16%
ETF Options ADV	1,004.6	1,338.2	-25%	1,046.2	-4%

(trades in thousands)	Year-To-Date		
	March 2010	March 2009	% Chg
Trading Days	61	61	
Total Exchange	277,263.1	273,103.4	2%
Total Exchange ADV	4,545.3	4,477.1	2%
Equity Options	146,171.1	148,665.2	-2%
Equity Options ADV	2,396.2	2,437.1	-2%
Index Options	67,670.3	53,689.9	26%
Index Options ADV	1,109.3	880.2	26%
ETF ² Options	63,421.4	70,744.8	-10%
ETF Options ADV	1,039.7	1,159.8	-10%

Chicago Board Options Exchange ³

Having in mind the **Market Share** - during the first quarter, CBOE's market share is 30.0 percent of total U.S. options industry volume. This means, above **15 billion contracts average daily volume for U.S. options industry. In money measures it is about 15.000.000.000.000 (trillion) US dollars.**

1 ETFs - Exchange Traded Funds.

2 ETFs - Exchange Traded Funds.

3 www.cboe.com/data/monthlyvolume.aspx.

From the relative figures given in the table we may also see a tendency for increasing interest of market instruments (index options) and respectively decreasing trade with particular business instruments (equity options), which shows an extending *risk-avoiding aptitude* (in the “risky” investments).

- The top five most actively traded index and ETF options at CBOE were the S&P 500 Index (SPX), Standard & Poor’s Depository Receipts (SPY), CBOE Volatility Index (VIX), PowerShares QQQ Trust (QQQQ) and iShares Trust-Russell 2000 Index Fund (IWM).
- The top five most actively traded equity options at CBOE were Citigroup (C), Apple (AAPL), Bank of America (BAC), Ford Motor Company (F) and General Electric (GE).

However the U.S. are not the entire world economy. Let us take a look at Japanese derivative market.

Diagram 1.
TOPIX Futures Trading Volume & Open Interest

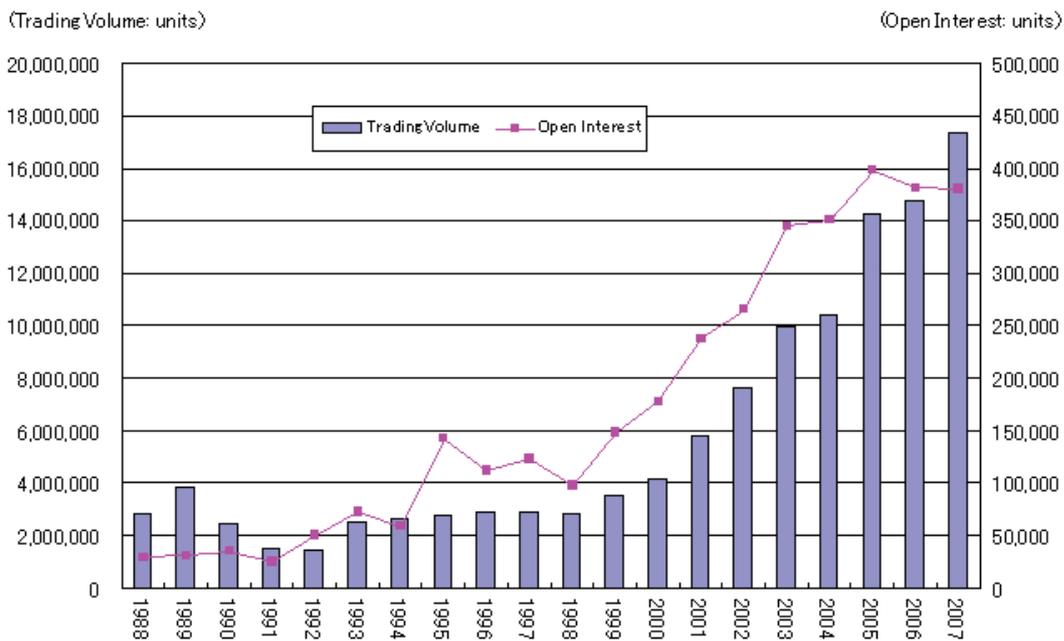
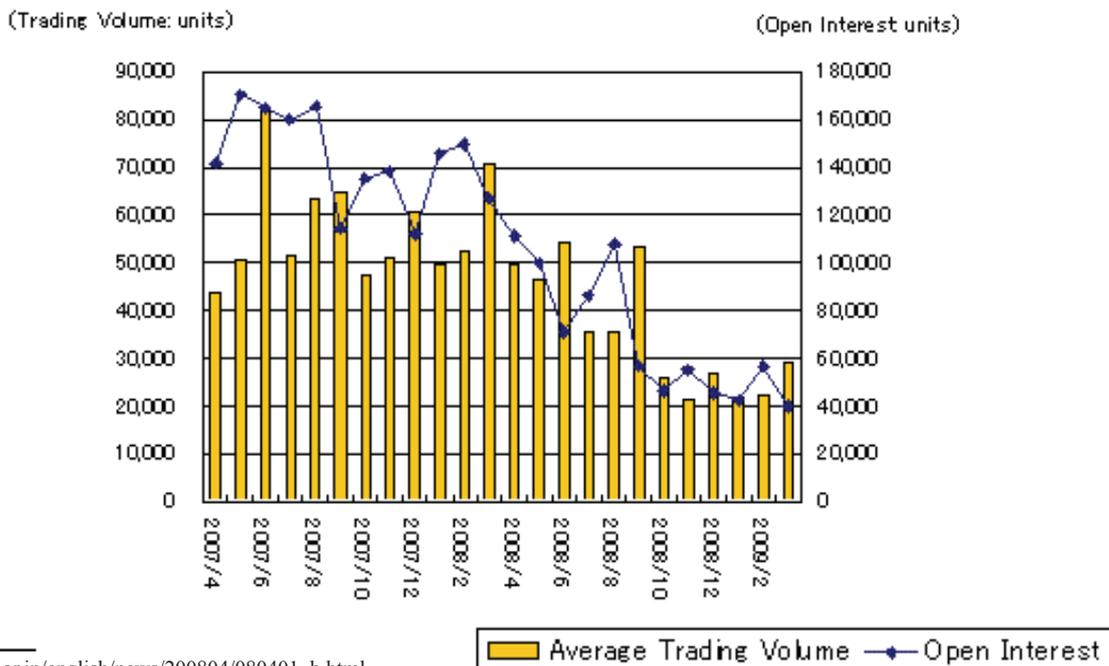


Diagram 2.
JGB Futures Trading Volume & Open Interest⁴



⁴ http://www.tse.or.jp/english/news/200804/080401_b.html

The data given in diagram 1. clearly shows a rising trend in TOPIX futures, which are representative for the Tokyo stock exchange. The trading volumes and open interest⁵ produces 10 times growth for 20 years, between 1988 and 2007, and mainly during the last 10 years.

Diagram 2 emphatically represents generally parallel tendency for growth till the beginning of 2008, followed by a one-year correction - till the beginning of 2009, and a recovery during the last year. We may also see another interesting data – when the market activity in transactions number rises, at the same time open interest is relatively low. When transactions go down – open interest is rising. ***It allow us to deduce that derivative market activity follows more modest fluctuations in trends.***

As we see at Diagram 2. the market activity in **Japan** is not very different (compared to U.S.). The trading volumes and open interest with futures (which are enough sensitive instrument for market tendencies) in Tokyo fell down four times from June 2007 till January 2009.

Diagram 3.



London stock Exchange⁶

In the British capital market recession extended a few months more, till the beginning of March 2009.

Summarized data for world derivatives trading

Table 2.

Amounts outstanding of OTC equity-linked and commodity derivatives counterparty in billions of US dollars

Jun. 1998	Jun. 1999	Jun. 2000	Jun. 2001	Jun. 2002	Jun. 2003
1.273,86	1.510,79	1.645,42	1.884,31	2.213,52	2.798,87
Jun. 2004	Jun. 2005	Jun. 2006	Jun. 2007	Jun. 2008	Jun. 2009
4.520,86	4.550,63	6.781,83	8.589,65	10.177,25	6.618,90

Committee of European Securities Regulators⁷

⁵ The number of active positions.

⁶ <http://finance.yahoo.com/q/bc?s=^FTSE&t=5y>

⁷ Report on trends, risks and vulnerabilities in financial markets. Committee of European Securities Regulators. Date: 26 March 2010, Ref.: CESR/10-310..

For the last ten years, including 2008, we see a ten times growth in derivatives trading volume. During the 2008 there is a dramatic decrease in range of 35% in trading volumes.

A much greater awareness of the risks of OTC derivatives – for banks, for other financial corporations and for non-financial firms – has led to a significant reduction in the size of gross positions.

Total OTC outstanding positions declined by almost 15% during the second half of 2008 (Table 2).

Credit Default Swaps only are down by more than 25%

There has also been a general increase in the price charged for market-making as well as an overall scaling-back of positions across markets by banks. The impact of such developments has been very visible in **foreign exchange swap** markets, where it has reduced the ability of borrowers to swap currency exposures. Both the managements of banks and the regulators have moved towards stricter capital adequacy rules, both for counterparty risks and for trading book market risks. In the case of CDS contracts, these contractionary forces have been reinforced by policy efforts to terminate outstanding CDS contracts which offset each other.⁸

In the quoted report of the Committee of European Securities Regulators we may outline two concrete measures of precaution:

- to improve the management of counterparty risk, primarily in the credit default swap (CDS) market and
- to increase transparency by making information on volumes and exposures available to the public and to regulators.

Having in mind current data, the sum of **open positions total in all derivative instruments is 6 times more than total sum of the world GDP** (gross domestic product), which is about 60 trillion US dollars for 2009⁹. This makes **360 trillion USD in derivatives open positions**.

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These 360 trillion USD are rights to buy and sell risk. Risk from: exchange volatility, credit default, interest and currency rates changes.

UTILIZATION OF FINANCIAL DERIVATIVES:

Speculative Reasons;

The speculative potential of the term instruments, expressed in the benefit from the difference between the expectations of the market players regarding the exchange rate (of a particular instrument, index, etc.) is a valuable source of income. A very important and practically imminent condition is the high liquidity of the derivative instruments. However, very often it is considered a sufficient prerequisite for success. This self-confidence leads to underestimation of the necessary competences and qualities, which often is a “mine” leading for serious losses.

In 2007 the biggest European hedge fund company „Brevan Howard Asset Management” LLP withdrew from „arbitration” with convertible securities. In 2008 this strategy brought 33,6% losses for traders. Alan Houerd stated that his task as well as the task of his eight managers is to spot and nip problems in the bud. ”The smaller the fire, the faster it will be put out”.¹⁰

⁸ Ibid

⁹ 2009 by the International Monetary Fund 57.937,460 billion USD,

2008 by the World Bank 60.587,016 billion USD.

http://en.wikipedia.org/wiki/List_of_countries_by_GDP

¹⁰ Commentary of Richart Taitelboum and Thom Kahil for Allen Houerd – manager and cofounder of the biggest European hedge fund company „Brevan Howard Asset Management” LLP.

http://info.varchev.com/index.php?request=index&subquest=publish&p_id=57

Speculative base is practically unlimited. Derivatives based over: currency; stocks; interest rates; indexes; commodities; dividends; weather ... allow all the time suitable possibilities for gains.

After the devastating, hurricanes in US in 2005 and damages for gas industry, there were big unexpected dynamic in gas and petrol futures prices. The next years the speculative game was also not lower, although the smaller damages than expected scales.

leverage effect. All Futures and options contracts have higher risk than equities as a result of the leverage given to futures traders. In comparison, in the equities market, a trader must come up with at least 50% of the volume of the trade (in short position). While in the futures markets, traders are able to enter a position with only 10% of the money up front.

Many large hedge funds also borrow money through credit lines from banks to add even more leverage, which increases both risk and the potential size of the return.

The case with Bear Sterns

- *Who to blame?*

Another bright example for extra speculative use of derivatives gives us the case with failure of Bear Sterns and Lemman Brothers. In the face of the scheme we see the key role of derivatives - especially put options. Which allow to an American professional trader to realize a grandiose short sell with the stocks of Bear Sterns at totally unexpected prices. This trader invested 1,7 million dollars, and in 9 business days he (they) hit profit of 270 million dollars. What happened in fact?

At march 11, 2008, an unknown trader buys put options at exercise price 25 and 30, based on the honourable bank Bear Sterns stock, when the course is \$ 62,97. There still no visual problems. But only during the next day Bear Sterns looses all liquidity and become dependent from the US government. There conduct active negotiations between current and Ben Bernanke and Thimoty Guitner - Fed presidents and bosses of the biggest financial corporations, instead of Bear Sterns - J.P Morgan, Goldman Sax, Morgan Stanly, Lemman Brothers, Meryl Linch and some hedge funds .¹¹

Hearing overspread. Here the speculators benefit for the crash with big size (uncovered) short positions. Arise out sharply the question – Were is the SEC? (Securities and Exchange Commission). But still there is not answer .

Finally there is understanding for 2,70 per stock.

For a less than tow weeks the trader realize the gains of 159 times then invested sum. And the biggest financial whales, in this case J. P. Morgan, gets in present Bear Sterns plus millions government subsidy.

Are the derivatives guilty?

Practically derivatives multiply the financial results and shorten a lot the time of markets reaction, thus rising the spreads.

¹¹ Taiby, Matt. "The big fraud of the Wall street", Rolling Stone, December 2009.

Hedge versus speculations

Some facts related to what is to “BLAME” for the start of the financial crisis in the USA – the credit derivatives.

The mass application and utilization of CDS (credit default swaps) in big transactions is related with J. P. Morgan and the team led by Demchak. These experts mix the exposure to risk of J.P. Morgan against over 300 gigantic corporations, creating an off-balance structure which later they sold in parts to the investors. This structure later protected J.P. Morgan from delays, poor creditability and bankruptcy of the respective big credit customers. Against this “comfort” J.P. Morgan pays insurance premiums to investors which now will cover the consequences if some of the customers of J. P. Morgan goes bankrupt. “The innovativeness not to be tied to specific credits or bonds made the derivative-credit market as it is today”, says Romita Shetty, who was a part of the Demchak team at J.P. Morgan.

Thanks to the creation of the team of Demchak „**Bistro**” (Broad Indexed Secured Trust Offering) in December 1997, (the biggest credit derivative transaction by then) J.P. Morgan managed to avoid risk to the amount of over 9,7 billion dollars. The new product was sold out at good price.

Very soon it became clear that the first risk “layer” of the product will not withstand the insolvency of one of the biggest companies and as a result a great part of the investors suffered serious losses. Logically CFD are a genius creation of financial engineering. Thanks to them the credit risk of big companies and bank institutions widely spreads over the financial sector, affecting all investor categories, but mainly the big ones.

Where is the blame?

The case with Greece

Greece government puts into practice one shifty technique - Cross currency swap. This happens with the help of Goldman Sachs (in the beginning of 2002), who contracted through a swap an unrealistic currency rates. In the case this technique (with not market currency rates) helps to Greek government to increase foreign financing. This way Goldman Sachs additionally and underhand credits Greece with a billion US dollars.

But the swap has maturity, and the price have to be paid. According to Spiegel the first of expected back payments have to be done in 2012.

In assessment of the role of financial derivatives we also must have in mind the role of rating agencies, which valuations form the markets bearing.

HEDGE FUNDS CONDITION –

Hedge Funds – financial derivatives prosecutor or advocate regarding the “benefit, necessity or harm and danger” of financial derivatives.

Hedge Funds - Main Characteristics

Depending on the level of the accepted risk in parallel with the expected earnings, hedge funds vary considerably – as any other private or collective investment plan. However, hedge funds can be characterized by **several main common features which originate from the application of term and derivative instruments**. They are as follows:

- A common feature of the management of hedge funds is the aim to achieve the highest earnings. In particular the aim of the investment managers is to increase the value of the property they operate with over a fixed market value. (benchmark).
- **They are more stable than the traditional investment funds.**¹² In fact the second part of this assertion has contrary maintenance.
- The greatest **advantage of the hedge funds is, that they may and that they usually bring profit independently whether it is a bull or bear market, i.e. they manage the system risk** (in difference to the rest investment schemes). The merit of this exclusively important opportunity is of the application of the term and the derivative instruments.
- Different styles of investment behaviour of the hedge funds can be outlined depending on the particular purposes. Traditionally they **apply serious technical and fundamental analytical models** based on historic, statistical and econometrical instruments. They quantitative calculations of the expected profitability and risk give the popular name K quantitative funds – накратко quants.
- The management costs, which are as can be expected higher in comparison to the traditional collective schemes, are directly transferred to the investors that form the capital of the fund.
- The critics of the application of the derivatives, especially in public investment funds, underline the higher risk potential, which usually bear the positions in options, futures, swaps, credit derivatives and other derivatives.

Hedge Funds - Status in crisis conditions

It is considered that in 2007 the assets of the hedge funds exceeded over 1 trillion dollars.

Realization of Hedge Fund It is the first time since the beginning of 2009 when the hedge funds with investments in Eastern Europe show growth in their annual profitability, according to the data from Eureka hedge consulting agency.¹³

According to Eureka hedge the profitability of the hedge funds from Eastern Europe only for September is over 10%. This makes the region the most profitable in the world for third month in turn. For example the global index of the profitability agency recorded under 3% for September. Eastern Europe and Russia are leaders in profitability and from the beginning of 2009 over 52%, with which the region significantly outran other regions in the world.

The positive profitability of the hedge funds, moreover calculated on annual basis, is another index for growth of the industry and quick recovery of the capital market.

When commenting on the financial derivatives it is important to underline the dependability of underlying instruments – **the influence of the derivatives on the trade with the underlying instrument.**

The growth of the financial derivatives market is considered to be basis for the activation of the world currency market after 2001 (growth in of the average daily turnover 2004 to 1,9 trillion USD, compared to 1,2 trillion in 2001 and in 2007 – it reached 3,21 trillion).

¹² Stateva Jo., The world currency market – characteristics and development in contemporary conditions”.

¹³ http://www.dnevnik.bg/pazari/2009/10/26/805253_hedj_fondovete_

CONCLUSION

The several emblematic examples described here for the multi-sided applications of financial derivatives in contemporary conditions of insecurity, growths and deep recessions are only a tiny part of the rich activity of the option, swaps and other derivatives industry. Despite the different instruments, market conditions, participation and actions of the market players, we can outline the following conclusions:

- 1) The wish for prohibition of derivatives trading is like an illusion to stop the technology progress;
- 2) If the instruments and trading system don't allow speculations, the market participants will lose the hedging opportunity;
- 3) Daily speculations are necessary for adjusting prices. Otherwise the market volatility, respectively losses will be far bigger;
- 4) The manifestation of danger for system trading – are related with unconscionable or illegal activities;
- 5) Human avidity and inclination to quick and easy money are not a problem while they are related with personal risk exposure;
- 6) In fact the market participants need regulations that prevent losses for public participants, not such that stop trading. Managing the derivative market have to be like tuning a Swiss watch – precise and seldom, probably once;
- 7) The working regulations have to be able to prevent spreading of market risk (credit, default risk) over the entire system. That means right “controllers” (precise risky indicators) and limits. In particular, it is:
 - to improve the management of counterparty risk, primarily in the credit default swap (CDS) market and
 - to increase transparency by making information on volumes and exposures available to the public and to regulators.

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Finally: Financial derivatives are not an accidental creation. They are an integral part of the financial system. Our look ahead has to direct their natural development.

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MANAGING THROUGH CONTRACTS BY THE LOCAL AUTHORITIES

(Case study Municipality of Elbasan, Albania)

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ABSTRACT

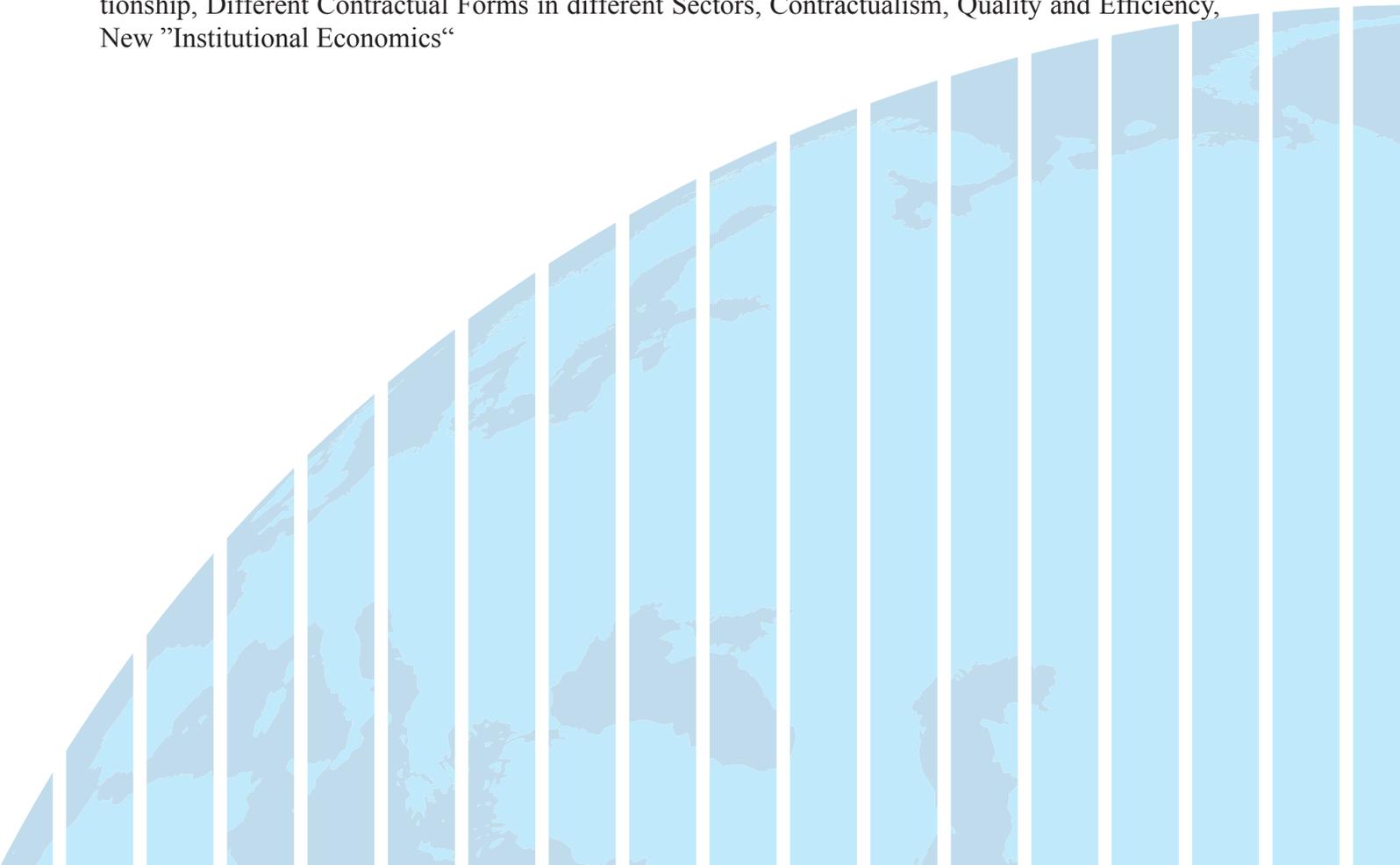
The main objective of this paper is to help the Local Authorities in Albania realizing analyses according to the Contracts they have for delivering of the public services. We will look in the Municipality of Elbasan, Albania how the Contracts have developed and how they affect the delivery of services.

For these we use a framework developed by Mari Sako, who looked at business-to-business contracting in the United Kingdom and Japan. She analyses contractual relationships according to a series of dimensions and proposes two archetypes, an Obligational Contractual Relationship and an Adversarial Contractual Relationship. Her dimensions are used to compare public sector contracts. As well as the nature of the contract, we then consider the nature of the specification, what it contains and who writes it. At the end we come to two Conclusions that hopefully will help the Local Authorities to identify benefits and to avoid mistakes from the contractual relation in public service delivering.

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Key words

Local Authorities in Albania, Obligational Contractual Relationship, Adversarial Contractual Relationship, Different Contractual Forms in different Sectors, Contractualism, Quality and Efficiency, New "Institutional Economics"



INTRODUCTION

The many of the services provided by the public sector are delivered through contracts, which are either internal or with private and voluntary organizations. People have to learn how to write contracts and specifications for services and how to make sure that services are delivered according to those contracts.

We will look in the municipality of Elbasan, Albania how the contracts have developed and how they affect the delivery of services. First we find that there are different sort of contracts in the different parts of the public sector, including the contract period, whether they are left after a competitive bidding process, how detailed the specifications are and how punitive are the default clauses.

We then try to explain why these differences occur. Explanations include the structure of the market in which contracts are made, managers' ideas about what sort of contract is like to produce efficiency and quality, and the political attitudes of those making the contracting policy. The fact that there are wide variations implies that managers have some discretion. We then look at how that discretion is being exercised. For these we use a framework developed by Mari Sako,¹ who looked at business-to-business contracting in the United Kingdom and Japan. She analyses contractual relationships according to a series of dimensions and proposes two archetypes, an Obligational Contractual Relationship and an Adversarial Contractual Relationship. Her dimensions are used to compare public sector contracts. As well as the nature of the contract, we then consider the nature of the specification, what it contains and who writes it.

DIFFERENT FORMS IN DIFFERENT SECTORS

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Different parts of the public sector have adopted different sorts of contracts. In the case of local authorities which are compelled to use competitive tendering, the contract forms have necessarily reflected the competition process : sealed bids are invited; there can be little chance to establish a relationship with the supplier before the bidding process; apart from checking credentials and references, everything required must be specified at contract stage; the authority must protect its interests with strong penalty clauses and default procedures. At the same time, contracts are for relatively long periods (one to five year for most services) and therefore a relationship with the suppliers has to be developed the contract period.

In the Municipality of Elbasan, contract were initially for one year between the purchasers and providers, but there were long-relationships for both sides. Despite the short-term nature of the contracts, there was not a great use of penalty clauses and destructive default procedures in the early days of contracting. There was, however, great recourse to details about the processes to be carried out under the contracts as the purchasers side do not trust the providers. There were not normally competitions for large blocks of work. There was tendering for most of services, but generally trusts did not have to bid for the bulk of their work against other trust. This lack of bidding would imply the need to establish trust, although the details in the contracts and specifications suggest that this has not necessarily been the case. It is not clear why this was so, but it may simply have been the result of people being put into adverse positions.

There are some doubts about whether what were called contracts in the public authorities, were really a contractual relationship at all in a commercial sense. It has long been known that internal contracts are not legally enforceable, because there is only one legal entity.² Pauline Allen³ pointed out that there were several fundamental differences between a contract and the contractual arrangements

within the public sector, where there was no freedom not to enter to contract (purchasers and providers were compelled to trade with which other), terms were imposed by a higher authority in the event of a failure to agree, and disputes were resolved by internal administrative procedures rather than recourse to the law or the terms of arrangements. She argued that the public sector contractual arrangements were in practice a series of administrative procedures, rather than a set of contracts; because of the control exercised.

She also argued that there was a potential value in using internal contracts to improve performance, but that improvements would have to be made to the process. These improvements included that the administrative resolution of disputes should be clarified, that the consequences of Trust 'failing' needed to be spelled out so that they would know how their actions could influence in the best way.

In the local authorities, different procedures were adopted in different sectors of the Municipalities. Negotiations, rather than a strict sealed bid approach, preceded the outsourcing of the computer contracts, implying the development of a close relationship between the departments and the computer suppliers. The major agreements between the social assistance department, tax departments and the TEC (IT services Firm) in Elbasan Municipality started as a very detailed and punitive contract but grew into more trusting arrangements as the year progressed.

INFLUENCES ON THE TYPE OF CONTRACT

There is a variety of influences on the type of contractual relationship which people adopt within the public sector and between it and the private and voluntary sectors, including legal requirements, the structure of the market, managers' approach to quality and efficiency, and politics and the administrative rules under which contracting is done.

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Law and regulations

A major determinant of the natures of transactions and contracts is of course the rules established by the government. According to the legal Albania framework, there are laws, such as 'Tendering law'⁴, which apply the public authorities to promote competition and therefore mitigate against the development of long term and less competitive relationships.

In the public services, there are those who believe that contracting is a matter for the law and lawyers. This view is especially held by lawyers, who get involved in writing the contracts and therefore think that they should also be involved in determining the relationships between parties. They apply the same principles to contracting with civil engineering companies, cleaning companies and local branch of a charity. While the purchasing side of local authorities need to be protected, the laws is not the only answer. As a standard textbook on the law of contracts says :

Writers of the contract textbook tend to talk as if in real life agreements are effectively controlled by the law as stated in their books. A moment's reflections will show that this is not so. There is a wide range of transactions where the sums at stake are so small that litigation between the contracted parties is exceptionally unlikely..... in substantial areas of business, contractual disputes were resolved by references to norms which were significantly different from the theoretical legal position. The most important single reason for this seems to be that, in many business situations, the contract is not a discrete transactions but part of of a continuing relationship between the parties and that insistence on certain legal rights would be disruptive of that relationship..... In other areas of business, strict insistence on legal rights is common⁵.

It would seem, then, that the law and legal obligations are not the whole explanation for contract forms or sufficient guide to how to contract, except in cases where there are specific legal requirements which they cannot avoid.

Quality and efficiency

More recent work on contracting has suggested that there are other factors beside these structural market determinants which can influence the way in which organizations make transactions with each other. For example, Sako found that even where there is a large number of potential suppliers, purchasers may wish to develop a longer-term relationship with a small number of them. They do this because of the potential for improved quality and a more economical long-run series of transactions.

Politics

The third influence is politics. There is a reasonably close relationship between companies supplying public services and local authorities. For example, the process of developing competitive tendering in local government was informed by advisers drawn from the companies which wished to compete for the local authority work. As well as advisers, working parties were established to allow companies to say how they would like the process to be organized. On the other hand, there were local authority members, especially representatives from the left political parties, who did not want to contract with private sector to carry out functions previously done by directly employed labour. These included left parties-controlled authorities, but there were also right parties authorities whose members resented being told how to run their affairs by the Department of the Environment. In a survey in the Elbasan Municipality, April 2009, contractors complained that some councils deliberately organized the contracting process in such a way as to frustrate competition. Even among those who had won Elbasan local authority contracts, 25% were fairly and 11% very dissatisfied with the process (Elbasani Information Newspaper p. 4). The reasons for dissatisfaction were that councils did not want private contractors, the documents were too complicated and the procedures too difficult. On the other hand, in central government, frequently work has been awarded to private contractors without a bid from the current employees.

'“New” Institutional Economics ‘

Once economists started to realize that the real world exhibited few of the features of the theoretical world of perfect knowledge and perfectly rational choices in a perfectly competitive market, the problem arose : how to explain market behaviour when these conditions do not apply. The problem is important in the context of government contracting, since only rarely do conditions of perfect competition arise in the field of the government procurement: in relatively trivial purchases, such as stationary or vehicles, there may be a highly competitive market with many alternative suppliers competing, in which it is possible for governments to gather sufficient information and have the capacity to make well-informed, optimal decisions.

In procurements that typically absorb large amounts of public funds, such conditions do not apply. Markets for the supply of such things as big computer systems are characterized by a small number of suppliers and complicated products and services, about which the buyer will have less knowledge than the supplier. Local government are often faced with small number of supplier of services, especially in expensive services such as secure accommodation for orphan children. It is likely that governments will not find it possible to collect, absorb and analyse sufficient information to make an optimal choice, even when there is a compulsory tendering system in operation.

The arrangement between a local authority and a contractor is subject to the same pressures as any other contractual arrangement: each side wants the best outcome for themselves and will use whatever advantages they can to achieve them. Both sides will try to minimize the risk attaching to themselves from entering the contract. The contract will reflect the balance of knowledge and power between the parties and the nature of the relationship between the two.

There has been a body of economics concerned with the contractual relationship between parties in the real world (as opposed to the theoretical world of perfect information and large numbers of willing buyers and sellers beloved of economic theory).

This branch of economics is sometimes called 'The new Institutional Economics', although by now it is no longer new. The underlying questions of this branch of economics are:

- Why do firms sometimes choose to buy their inputs in the market place and at other times decide to make the inputs themselves?
- When is it best to organize production through the market and when is it best to organize it through a hierarchy of employees?

More broadly,

- Why do organizations exist, and what determines the boundary between one organization and the next one.

These questions were first asked by Ronald Coase in 1937⁶. Oliver Williamson⁷ developed Coase's work further to look systematically at the problems posed by the fact that markets are not perfect. In a book published in 1975 he looked at the question: when it is better to purchase goods and services in the market and when is it better to produce them yourself, using your own employees?

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This is essentially the question for government: when should they write a contract with an independent body for the supply of services and when should they provide them using their employees? Under conditions of 'bounded rationality' not all information is known, or it is impossible to take account of all information in the decision process. The conditions in the market that Williamson considered were:

- **Complexity** : the transaction is so complex that it is not possible to consider all the options.
- **Uncertainty**: not all possible futures can be predicted, so it is not possible to write a contract that takes them all into account.
- **Language**: It is not possible to specify everything in language that both parties to contract can agree on.
- **Small numbers**: where there are very few suppliers, those in the market can engage in opportunistic behaviours to the disadvantage of the purchasers.
- **Information 'impairedness'**: where one side to the transaction has more information, especially about costs, than the other.
- **First-mover advantages**: by which winners of a contract gain information that puts future competitors at a disadvantage and reduces the impact of competition in all future transactions.
- **Atmosphere**: the moral stance that parties to the transaction take, which may not be perfectly economically self-seeking.

Williamson usefully draws these elements into a framework, which he calls the 'Organizational Failures Framework', which is illustrated in the Figure 1⁸.

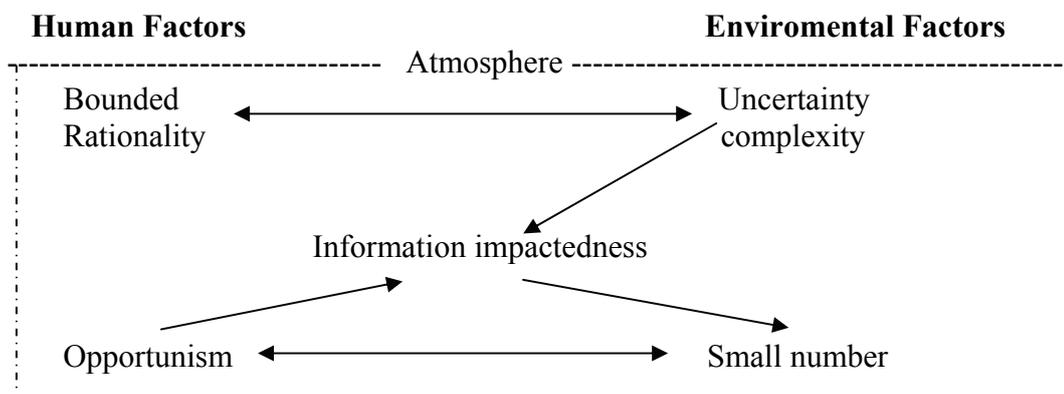


Figure 1 The organizational failures framework

We can use this frame work to interrogate the way contracting has developed between local authorities and companies.

In most markets, people involved in transactions are not normally able to make completely optimal decisions : they do not have perfect knowledge; they do not have the capacity to process all the available information for every transaction.

Even if they had the information and capacity, there remains the problem in any transaction of trying to ensure that the person from whom one party is purchasing delivers what is expected, and is motivated and enabled to do so in all the possible circumstances that might arise.

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Solutions to 'bounded rationality'

A contract that covers all possible events or contingences is called a 'complete contract', which would be written in such a way that both parties know exactly what would be the consequences of every possible event. In practice, such contracts are very rare and can be written only for very simple transaction. Complicated transactions make the cost of writing complete contracts too high under conditions of bounded rationality.

The existence of bounded rationality results in the possibility of 'opportunistic behaviour' through which one party to the transaction tries to take advantage of the other. One way that one side can get an advantage is to know more than the other side, or to keep secret 'private information'. The fact that information is not perfectly shared (known as 'information asymmetry') leads to 'adverse selection' and 'moral hazard', both forms of self-interested misbehaviour made possible by imperfect knowledge.

The problem for local authorities is : how should we organize the procurement process when complete contracts are not feasible?

It is especially difficult in the case of services, as opposed to products, in that the characteristics of the service are technically difficult to design. It is also the case that, in many public services, the specification of the full range of possible contingencies is possible to write in advance.

Paul Milgrom and Jon Roberts describe one set solutions to the problem of bounded rationality in the world of real contracts that can never be complete⁹. These solutions are:

1. relational contracts, through which long-term relationships are developed
2. implicit contracts, where shared objectives make explicit contracts unnecessary
3. developing commitment
4. ex-post renegotiation
5. dealing with specific assets, which the contractor has bought solely for the purpose of fulfilling the contract.
6. the 'hold-up' problem, whereby the buyer is completed dependent on a single contractor.
7. private information and pre-contractual opportunism, whereby the contractor cheats the purchaser.
8. measurement costs
9. adverse selection, where contractors only choose contracts, or part of contracts, that can make big profits, leaving aside the rest.
10. signalling, screening and self-selection.

The question for local authorities can now be reformulated : 'How can local authorities ensure that contracting with private sector avoids the dangers identified in the New Institutional Economics literature'?

The first way suggested by Milgrom and Roberts was the establishment of 'relational contracts', by which they mean a relationship between the buyer and the seller that does not rely entirely on the contract for the supply of a particular good or service at a particular time but involves the establishment of expectations on both sides that a longer-term relationship will develop in which the two sides behave in mutually beneficial ways. Later in this paper we look in more detail at how such relationships require contracts that differ from those appropriate to 'adversarial' relationship, in which there is very low trust and heavy reliance on the contract itself to manage the delivery of the good or service.

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For managers, therefore, there are no simple answers to the questions of how to establish and manage contractual relationships. On the one hand, there are market structure considerations and efficiency and effectiveness considerations which would provide some guidance as to the most effective way to do things. In some cases, these might lead to a preference for long-term contracting, in others for short-term. The nature of the market may lead to a desire to establish long-term close relationships with suppliers, or may lead to frequent competitions to keep prices down. Overlaid on these influences on practice are the legal considerations. The law itself and the regulations may force people to behave in a particular way, even though they know that the results will be less good than if they behaved in other ways. There are some more local legal influences. Legal advice may itself lead people to behave in ways which they do not think make managerial or contractual sense. Lawyers accustomed to caution may be more interested in generating apparently detailed and enforceable contracts which professionals know cannot be enforced in practice. Politics can also determine managerial decisions. While managers may know that it would make more sense to keep a service in-house, they are not able to exercise that choice. The opposite can also be true : managers may wish to contract out but are instructed to retain directly managed provision.

However, there is still some discretion. In the rest of this paper we look at the elements of the contracting process and ask what would be the best approach to each of these elements in different circumstances.

OBLIGATIONAL AND ADVERSARIAL CONTRACTING

‘Relational’ contracts are sometimes referred to as ‘Obligational’ contracts, in which the two parties have obligations to each other to make success of their joint efforts beyond the terms of their immediate contractual relationship. ‘Obligational’ contracts are contrasted with ‘adversarial’ ones in which each side is out for their own advantage from the immediate contract and is unconcerned about the success of the joint enterprise.

Sako¹⁰ has developed a framework for understanding contracting behaviour, using these two archetypal relationships. At one extreme is the Obligational Contractual Relationship (OCR), where the two parties trust each other, work together for mutual benefit, share risk and things for each other which go beyond the details in the contract. Adversarial Contractual Relationship (ACR) is at the other extreme, where there is low trust, the expectation that each side wishes to gain at the expense of the other and contracts are used to protect each side from the other. Sako breaks down the contracting process into eleven elements : transactional dependence; ordering procedure; length of trading; documentation; the approach to ‘contractualism’ or contingencies; contractual trust; competence trust; goodwill trust; technology transfer and training; communication channels and intensity; and risk-sharing.

Transactional dependence

If a purchase wants to be able to switch from one supplier to another, they will have contracts with a large number of people. They can then use the threat of switching to make suppliers do what they want. On the other side, suppliers may wish to maintain contracts with a large number of purchasers to minimize their dependence. In these circumstances, the relationships are likely to be distant. Under OCR, the purchaser may wish to develop closer relationships with a smaller number of suppliers and offset the dependence created by fewer closer relationships.

There is variety of experience with regard to dependency. Local authorities which have established contracts for items such as refuse collection (case of the Municipality of Elbasan and the Commune of Bradashesh) have sometimes become completely dependent on a single firm, which has won the contract for the whole of that local authority area.

We would expect high dependency to result in a close relationship between the two parties. In practice, the legal constraints and the lack of experience on the part of purchasers led to the development of details contracts and specifications with complicated procedures for coping with default. As time went on, however, both sides realized that the interdependency which come from having a single supplier and a single purchaser allows a relationship which is closer than those implied by spot contracts or frequent switching of supplier.

Ordering procedure

The stereotype of the adversarial approach to ordering was encapsulated in the compulsory competitive tendering legislation for local authorities : competitors have to bid for the work, the purchaser chose the supplier as a result of the bid, rather than any other aspect of the bidder’s work or reputation, and the price was fixed before the contract was let. The opposite, OCR, way of ordering may not involved bidding and if it does, the bid price is not the only criterion for placing an order and prices are finally settled after the decision about who will be awarded the contract. The way orders are placed has an effect on the relationship between the parties. If a long-term relationship is expected, both sides need to decide whether such an arrangement would be beneficial. This requires more than doing some pre-tender checks and then opening the sealed bids.

Bidding is almost universal in the public sector, for reasons of propriety. Public accountability requires that contracts are awarded fairly, without corrupt favouritism. This is interpreted to mean that the only way to accept bids is through a procedure which keeps the two sides at arm's lengths. Albanian and EU states regulations require that large public sector contracts are advertised in the Gazette and bids invited from companies from all states. These regulations imply an adversarial style of contract award, rather than the development of a close relationship.

The ordering procedure sets the tone for the nature of the relationship between the two parties. If contracts are based on a quotation against a specification which is the same for all bidders, the responsibility for developing the contract and specification rests with the purchasers, rather than being a joint effort between buyers and suppliers. After the contract is let, the process of contract management is therefore concerned with ensuring conformance to the specification.

Once a contract is let, purchasers may try to develop a closer relationship than that which existed prior to the award. However, contracts are normally for a fixed term, at the end of which a new bidding process is started. The close relationships are stopped and the distancing implied by far treatment begins again.

Length of trading

In a ACR contractual relationship, the parties expect to trade with each other only for the length of contract. In OCR, there is an expectation that, if the things go well, there will be further contracts and there will be a mutual long-commitment between the parties. There is the possibility of 'roll-over' contracts in the local authorities where contractors are allowed to continue for a further period. However, lawyers say that it is unwise to include clauses in initial contracts which imply that successful completion of a given contract would most likely result in another.

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The length of trading can determine the type of company or charity with which the local authorities trades. Large suppliers with a variety of contracts in the public and private sectors are more likely than the small local suppliers to be able to cope with a series of time-limited contracts with any purchaser. This applies especially in community care, where small local voluntary organizations become completely dependent on their local authority for their funds. They are, in other words, dependent on the one transaction, the failure of which would result in the end of the organization. In practice, they often lurch from one short term contract to the next.

Document for exchange

In ACR, there is an attempt to write all the terms and conditions, including substantive conditions. Every possible item is written down. In OCR, the contracts concentrate on procedural rules which set out how problems would be resolved if they arise, and individual issues are dealt with when they occur. Contracts may even be oral rather than written.

In the Elbasan Municipality, contracts and their associated specifications have generally been long and detailed. In some cases, manuals of procedure which were in place when the service is directly managed were used as the basis for the contract and specification. For example, the original contracts between the social assistant department and tax department with TEC (IT service firm) were the old department area office programme manuals. However, people have realized that not everything can be written down and that in any case, the fact that the contract contains a long and detailed specification is no guarantee of service delivery. Contracts have become less detailed as people have learned that are other ways of ensuring quality, such as involvement in the suppliers' quality assurance procedures or talking to the users of the services.

'Contractualism'

Sako refers the treatment of contingencies as 'contractualism'. A contingent claims contract is one in which contingencies have to be defined, a procedure has to be established to agree whether a contingency has occurred, and the consequences of the occurrence are specified.

Most contracts have contingent elements : exceptional weather can affect highway maintenance contracts, etc. The question is whether each possible contingency can be sufficiently defined in advance and whether the recognition of its occurrence can be spelled out in advance. The OCR option is to agree procedures by which both sides can agree on contingencies and what should be done as a result, relying on trust and an expectation that an agreement can be reached. The ACR option assumes that an agreement will not be reached or will be difficult, and that every contingency must be defined in advance.

There is a mixture of approaches to this question in the public sector. Attempts to specify contingencies, have not always worked. Local authorities usually have a 'banding' system in which progressive disabilities trigger progressively intensive service, but there have to be procedures by which the purchasers of service and the provider agree the extent of an individual's difficulties.

Trust : contractual, competence and goodwill

Sako distinguishes three areas of trust : contractual, competence and goodwill. An ACR approach to contractual trust means that supplier do not do anything without a prior, written order. In an OCR relationship, supply or changes to specifications can be started as a result of an oral communication. Competence trust is concerned with the degree to which the purchaser trusts the supplier to deliver the quality of product. If there is low trust, the purchaser will inspect heavily and presume that the supplier will try to skimp. In a high trust relationship, the purchaser may be involved in the supplier's quality assurance procedures, but will not carry out much, if any, inspection. Goodwill trust refers to the degree to which each side is willing to become dependent on the other.

Trust is very important element in public sector contractual relationships. The degree of trust depends partly on the sort of relationship established during the ordering procedure. If the order is placed on the basis of the bid price only, it is likely that the chosen suppliers will be operating on low, or even negative, profit margins. In order to make a profit, supplier have to shave the quality as close to the specification as possible, if not below it. The purchaser's main function then becomes one of trying to make sure that the specifications are met, requiring inspection and checking. If the winning contractors believe in any case that the purchaser did not wish to contract with them but was forced into it by the legislation, there is no initial basis for establishing trust, and adversarial relationships are probably inevitable.

Trust can develop during the contract period or as a succession of contracts is completed. It is natural for buyers to be wary of new suppliers until they have evidence that they can be trusted. Sometimes the voluntary sector may be trusted more than the private sector, whose profit motive causes immediate suspicion by some sectors managers of the local authorities.

Technology transfer and training

In OCR relationship, the purchaser is willing to help the supplier develop the best technology and skills. This may involve helping the supplier to organize training or allowing them to join in joint training, which may not be fully costed. In an ACR relationship, help is given only when it is fully costed and paid for. One area in which this is important is in the cleaning service of Elbasan. If

purchasers do not fund the development of new technologies, research and development has to be funded in other ways. In practice, since prices are supposed to be a little bit higher than the cost in cleaning service contract, there is no surplus available for research, which is funded through a separate mechanism.

It is unlikely that there would be much transfer of technology and training in the mainly adversarial relationships which have developed : public accountability for funds, which pushes the relationship in an adversarial direction, makes it unlikely that free funding of development would occur, as a routine part of long-term contractual relationship.

Communication channels and intensity

In ACR, the communication channels between the two contracting parties are specified in the contract. Nominated officers on each side are allowed to speak about technical and financial matters, according to their individual competence. In an OCR relationship there are multiple channels of communication as each side tries to understand the other. As with other aspects of the relationship between public organization and contractors, frequent contact is treated with suspicion, especially informal contact. Lunches are frowned as corruption. While there may be some basis for suspicion, it is unfortunate that the need for proprietary stops beneficial exchanges between the two sides.

The national audit office surveyed the concessionaire contract¹¹ for the water supply of the Elbasan with the Berliner Wasser Betriebe and showed that both parties, Albanian and German were still mainly concerned with achieving their own distinct objectives rather than coming to a jointly beneficial agreement. Both parties surveyed considered that forming a joint long-term strategies and providing comprehensive and timely information as well as maintaining regular communication between chief executives and different public authorities, were most important in achieving good relationship¹².

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Risk-sharing

In OCR relationship risk is shared, based on principles of fairness. In ACR, risk may not be shared but the acceptance of risk is defined in advance. There are three aspects of risk in public service contracts : risk of prices changes, risk of changes in the volume of demand, and the risk that arises from suppliers making innovations.

With relatively low inflation, the risk of price changes turning out to be much different from that predicted at the time of signing the contract is small. However, there are prices which may fall suddenly, because of the technical changes. For example, a much cheaper computer processing, may produce a 'windfall' increase in profits for a supplier. A risk-sharing approach would lead to such windfalls being shared between the supplier and the purchaser.

The second type of risk refers to the possibility that the volume of work predicted will be not forthcoming. The suppliers sets up an operation to provide the predicted volume and incurs costs which are not recouped. Again, a risk-sharing approach would involve sharing a proportion of these costs. One way of doing that is for the purchaser to guarantee a certain volume of service will be purchased, even though it may not be required.

The third element comes from innovation; a supplier may invent and offer a new way of providing a service, which turns out to be unsuccessful. Without such innovation, the contracting process will stop the development of new services, as all specifications are based on already accepted practice.

Public-Private Partnership are based on the premise that the contract can allocate the risk between the private and public sector and the contract can be formulated to reward risk taking. In the case of unpredictable volumes, such as Water Supply of the Elbasan where the revenue to the contractor depends on number of customer and volume of water that each of them consume, the risk avoidance cannot be achieved by changing contractor behaviour.

THE SPECIFICATION

Inputs, process and outcomes

Sako's work dealt mainly with the supply of components, which could be specified in physical terms. The purchaser of service can be more complicated. First, it may be difficult to specify the result required from the service in an unambiguous way. Even in relatively simple, physical service such as green-grounds maintenance, the result of the work will be hard to describe : what is a well-maintained flower bed, when the answer to the question determines whether a contractor gets paid or not? Attempts to answer such questions have resulted in elaborate schemes of measuring the length of grass and counting the number of flowers.

In other services, the problem can be more acute. What is the satisfactory outcome from the water supply if the water is clean and drinkable? There are ways of defining these things, but if specifications are to be used as the basis for a legal contractual obligation, they are more difficult to define and measure than material things, which can have measurable characteristics and tolerable deviations from them.

Because of this, many specifications rely on describing the processes by which services are provided. If the removing of the garbage and cleaning of the roads is specified in quantity, that is enough to ensure that the bill will be paid. If the processes cannot be described in detail, then the specification may rely on the inputs used : the number of hour of a landscape-gardener's attention for the maintain of the green. These descriptions of the input may include the qualifications and skills of the staff.

What is quoted in the specification has a big impact on the relationship between a purchaser and a provider of services. In general the provider has a professionals or technical expertise which they are offering as a part of the contract. If that expertise is usurped by the specification, the purchaser has to have all the skills required to write the specification and monitor performance against it to ensure that a good job is done.

The use of outcomes as the basis for a contractual agreement has two implications for the relationship. It assumes that the providers have the expertise to decide on the appropriate inputs and process required to produce the outcome. It also implies that the purchaser trusts the provider to make those decisions in the interests of arriving at the outcome, rather than in the interests of the provider or their profits. The higher the degree of trust, the more possible it is to use outcome specifications.

However, in low-trust environments, the use of inputs and processes as the basis for the contract produces problems of its own. How will the purchaser stay up to date with the best procedures? In services such as cleaning, for example, technology changes. New chemicals and machines increase efficiency and change working practices. If the type of such service specify exactly the routines and never change them, best practice cannot be adopted.

As time goes on the purchasers have less direct experience of services. While they may be appointed to a post of purchasing manager with the recent relevant direct experience, inevitable they become detached from it over time. As their expertise deteriorates relative to that of the providers it becomes less easy for them confidently to specify inputs and processes.

Who should write the specification?

Therefore, the question ‘what is in the specification?’ implies another question : ‘what should write the specification?’ If technical and professional expertise is heavily weighted towards the provider side, then it is sensible that they should at least be involved in writing the input and process part of the specification, the purchasers becoming increasingly involved in specifying the required outcomes.

This brings us back to the beginning of the argument. If the purchasers are to allow the providers to specify the inputs and process, with the intention of providing the best possible outcomes for the money available, this implies a high degree of trust. If the providers are only to be trusted as far as to carry out the letter of the contract, then that letter must contain enough details to reassure the purchaser that they are getting a good deal. If they are to be trusted to make an impact on the service user and the left to decide how to achieve that, then there has to be a high degree of goodwill between the two parties.

There are two separate issues here, which are frequently confused. The first is whether the purchasers have the technical competence to write and monitor an input-and/or process-based specification. The second is whether the purchaser has sufficient trust in the provider to do their best to produce the desired outcomes and therefore has the confidence to write an outcome-based contract. Lack of trust was a product of uneven knowledge and profit-maximizing behaviour on the part of the contractors.

LEARNING TO MANAGE THROUGH CONTRACTS

People have now learned that adversarial contracting is unproductive and expensive to maintain. Contractors for the Municipalities in Elbasan have complained about over-complicated paper-work and procedures. Elbasan Municipality’s social service departments are trying to establish more collaborative relationships with the voluntary sector for the provisions of community care services.

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However, people have also realized that there are constraints on the development of obligational relationships. Legal requirements to follow procedures put purchasers and providers at a distance from each other and emphasize the elements where interests are opposed.

While the number of actual and potential suppliers varies among the sectors, there seems to be a relationship between market structure and contracting style : monopolies or near monopolies in the cleaning and maintaining of the green of the Elbasan have led to the development of longer-term relationships, less reliance on detailed inspections and other aspects of ACR relationships. In the relationship between Elbasan Municipality and their contractors there are still signs of adversarial relationships.

If there is an underlying suspicion of the private sector, it is likely that contracts will remain adversarial. The implication is that there will be a continuation of detailed contracts, harsh penalty clauses, heavy inspection and generally poor relationship.

EXPENSIVE FAILURES

The contracting system that was imposed through the imposition of internal markets and enforced outsourcing improved as people, especially in local government, learned how to manage through contracts. Buildings streets procurement in Elbasan was one case in got out of hand and delays were sometimes measured in years rather than in months. The public controlling Committee¹³ investigated in 2008 in Elbasan Municipality 32 building street contracts that produced 1.1 million Euro of overspending. The average slippage was 8 months, or 11% of the projects' lifecycles.

In the year 2000, the Berliner Wasser Betriebe (German Firm) through a Public-Private Partnership-concession contract, entered to provide the water supply and removing the waste water for the Elbasan Municipality. This contract was foreseen to take long 25 years, but resulted as not successfully, and the German side did not go ahead with the work. As the conclusions of the failing of this contract was :

- The project did not find the support of the other public institutions in Elbasan.
- There was no clearance on the specifications of the rights of public institutions.
- There was not a shared approach to risk management.
- It was the fist contract of this type in the local authorities and there is no experience.

BENEFITS OF THE LONG-TERM RELATIONSHIP

The contractor relationship of the Elbasan Municipality and voluntary organization 'Happy ours' in the resettling of the orphan children has had a long time. It led in establishing the collaborative relationship of the social service department of the Municipality and this voluntary Organization.

The contractor relationship of the Elbasan Municipality and the cleaning Firm-Victoria Invest is established from 12 years long. This has brought for the Municipality less reliance on the detailed inspections and less cost.

CONCLUSION

The eagerness of the Elbasan Municipality to contract out large parts of the work required to deliver public services has sometimes run ahead of the capacity to make contracting succeed. There are some structural reasons for this. First, a contract between a local authority and a contractor is not equivalent to a joint venture between two or more companies collaborating to make a project or business venture successful : in most cases the revenues to the company come from public funds, not from customers who are attracted to the product of the joint venture. The cash available is finite, subject to renegotiation as costs rise, rather than subject to success in the market. Companies' profit will come only from getting more money from the local authorities buying their service than the service cost to produce, rather than from jointly making the service profitable.

Second, there is an almost inevitable information impactedness. Whatever the sector, the expertise is likely to be with the contractor rather than the purchaser : that is where the best returns to individuals are and where the greatest professionals satisfaction is. Given the first condition, that there is a finite amount of money and therefore a zero-sum game, the fact that the expertise is likely to be concentrated in the provider side of the transaction is very likely to lead to opportunism.

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GLOBAL ECONOMIC CRISIS AND ITS IMPACT ON THE ECONOMIC GROWTH OF THE ALBANIAN ECONOMY

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ABSTRACT

The aim of this article is a tentative for a dynamic analysis on the impact of global crisis in Albania. It purports to provide some alternatives on how to minimize the negative effects of this crisis.

Is Albanian Economy being affected by global crisis or is it suffering its consequences?

This is the main focus of this study, which starts up from macroeconomic indicators, governmental reforms assessments from IMF, WB, BoA and other interested party's opinion.

Taking into consideration the careful investigation of the progress of macroeconomic indicators, we see that it is necessary to be more careful in some aspects;

First, the good management of the entry and efferent fluxes of currencies in Albanian economy, as a precondition of a sustainable currency exchange, in order to prevent one of the most serious threats of global crisis out of Euro zone, which is the risk of exchange rate.

Second, the composing of efficient policies to keep the budget deficit in accepted levels, which keeps under control the interest rates and gives the possibility of a new respiration of the economy through the process of private sector credit.

Third, trade deficit remains very important, because it has to do directly with exchange rates.

Fourth, a new challenge for the future will be the finding of sustainable resources to finance the economy.

Key words:

Global financial crisis, Economical growth Foreign trade, Financial sector, Remittances, Business, Integration.

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A GENERAL OVERVIEW OF THE BEGINNING OF THE CRISIS

The term financial crisis can be used to describe a “*series of situations in which some institutions or financial assets lose immediately a large part of their value*”⁴. Many economists have been offering their theories on how a crisis starts and develops, what are its causes and effects and how can it be prevented. But, unfortunately they have not yet come to a consensus as far as these issues are concerned and as a consequence the measures to prevent such situations are still lacking nowadays.

World History proves that the economical collapses with the global impact are very hard to predict and even more difficult to be prevented. In Eurasia and America the economical “downturns-et” have appeared approximately 20 times during the last two centuries.

The last crisis is considered as a crisis without a precedent. Almost one year ago the panic that came after the collapse of Lehman Brothers made that the earthquake of the market of mortgage credit in USA to be transformed in an authentic financial crisis with global dimensions.

The integration of financial markets made that the crisis to be spread very quickly, while the vital role of the credit system in the economy of free market transformed it in a recession of the world economy, that affected also the countries of Southeastern Europe.

Today, almost three years after the first signs of the crisis, the economy and the world financial market are in a more optimistic situation. The revitalization of the economy is reflected in the improvement of the indicators of the trust of the businesses and the consumers in smoothing the deflationist pressures, in the normalization of the functioning of the bank and financial systems and also in improving the norms of the economical activity growth in almost all productive sectors.

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However it is true that after every crises, the macroeconomics as a science in general has made steps forward. Every crises is in itself an event with special characteristics, different comparing to those that has happened before. Every crises brings to us a new information, despite the intensity, the geographical expanding or the time it lasts.

After two years, still the US economy remains at the center of the storm. Activity is expected to contract sharply in 2009 and a gradual recovery is not expected before 2010. Rising unemployment, tight credit conditions and a sharp decline in asset prices have negatively impacted consumption in the final months of last year. However, there are signs of an improvement in household sentiment and a modest revival in consumer spending. The American Recovery and Reinvestment Act includes massive spending programs as well as tax credits for the vast majority of households. In addition to the fiscal stimulus package, the Administration has proposed a joint private-public sector effort to remove toxic assets from banks balance sheets with the aim of reestablishing the normal functioning of the financial markets.

Eastern European Countries are facing the most severe challenges since they embraced a market based economy, on account of their heavy reliance on capital inflows and because of vulnerabilities built up during the boom years. In these countries, the risks associated with the retrenchment of foreign investment have led to a substantial widening of sovereign spreads and gaps in budgetary financing. In order to preserve the remarkable

European Union, has a key role to play in this region as trusted advisor and provider of financial support.

4 A.Boriçi, Diploma Thesis” The global financial crisis and its effects in the world and the Albanian economy” (September, 2009), pp 6

RECENT DEVELOPMENT AND CRISIS IMPACT

Financial crisis in a handful of industrialized economies continues to spill over into the real economy, engendering massive contractions in consumer demand, rising unemployment, and mounting protectionist pressures worldwide. Developing countries, including those of SEE have not been spared from its fallout. They are now facing slumping demand for their export products along with falling commodity prices, significant reductions in foreign investment and remittances, and a more general liquidity shortage. In addition, there is the strong interdependence among the EU's economies makes this a truly global economic crisis. Yet, most of SEE countries are the most affected by this world economic crisis.⁵

Table 1. The Global Competitiveness Index 2009-2010 rankings⁶ and Doing Business, 2009 rankings⁷

	Rank Competitiveness	Rank Doing Business
A. Western Balkan Countries	96	89
Albania	109	119
Bosnia and Herzegovina	72	110
Croatia	84	69
Macedonia	62	77
Montenegro	93	90
Serbia	62-109	69-119
Subtotal		
B. Countries Already EU Member		
Bulgaria	76	42
Greece	71	100
Hungary	64	41
Romania	58	45
Slovenia	37	58
Subtotal	37-76	41-100
SEE-total	37-109	

Doing Business recorded 287 reforms in 131 economies between June 2008 and May 2009, 20 per cent more than in the year before. Reforms focused on making it easier to start and operate a business, strengthening property rights and improving the efficiency of commercial dispute resolution and bankruptcy procedures.

Effects of the crisis in the albanian economy

As to the financial sector, the SEE economies have been affected by the financial contagion from the financial crisis because their banking activities were based on traditional models, with no exposure to toxic assets.⁸

The profound crisis of the world's economy has been felt quickly in Albania by testing the bases of the economy; the financial stability and the macroeconomic balance. However, the initial good situation of our economy and the reaction of the macroeconomic politics helped in the successful affrontation of this test. The Albanian economy has provided a positive economic growth during the first 3 months of the year, by conserving the financial stability and the main signs of the

⁵ Domazet & al., 2009.

⁶ World Economic Forum, Global Competitiveness Report, The Global Competitiveness Report Index 2009-2010 rankings of 133 countries.

⁷ World Bank Doing Business Report, 2009

⁸ Fetaj, 2009

macroeconomic stability, the prices` stability, the public debt level and the stability of the payments` assessment. The Albanian economy has had a positive economic growth during the first nine months of the year. However the growth rhythm has been characterized by a progressive slow down during the year 2009. This continuity has been conditioned by the reduction of the external debt and the slow down of the internal demand, in the presence of a stifled situation of liquidity, of the limitation of the financing and the growth of the uncertainty. According to the prerequisite data of INSTAT, the economic growth for the first 9 months of the year resulted in 4,9% against 7,8% of the value scored at the same period last year. In sectorial terms, the sectors that have benefited more from the economic growth are the sectors of services and construction, while the sector of industry has had a more problematic continuity.

WESTERN BALKANS A REGION WITH A HIGH POTENTIAL FOR ATTRACTING FDI's

With the EU expansion toward the east and the south of the continent, the Western Balkans⁹ is continuously considered from actual and potential investors as the next Europe high value location¹⁰. A series of factors make this region very attractive for foreign investments. According to Redžepagić & Richet (2008), when transferring capital in this region foreign companies can access to a market of about 150 million consumers. Also, the labour, land and the public services cost in these countries is still low, even lower than the respective costs in the new members of EU¹¹. The region is also distinguished for a skilled and educated labour force, as well as for a favourable political and legal climate for FDI's¹². Moreover Ranieri (2007) emphasizes the strategic location and raw materials resources (such as wood, metal and agricultural products resources) as two other advantages of the region.

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But, besides these stimulating factors Western Balkans countries have attracted much less FDI's than other countries in the Central and Eastern Europe¹³ and they have been concentrated mainly in Croatia. This has been a consequence of the political and economic instability in the region associated to a slow implementation of structural reforms, a slow progress toward EU membership and a non very much favourable business climate characterized by the corruption phenomenon¹⁴. FDI's in the Western Balkans have been drawn mostly through the privatization process, while the level of greenfield investments has been generally low¹⁵. The services sector has attracted more FDI's, while the home countries of most of the investing companies are Italy, Greece, Austria, Germany, Hungary and Slovenia. The following chart shows the level of FDI's per capita in each of the Western Balkans countries for the period 1989-2008.

9 The Western Balkans is composed of Albania, Bosnia & Herzegovina, Croatia, Macedonia, Montenegro and Serbia (Redžepagić & Richet, 2008) as well as the Kosovo

10 Ranieri (2007), Redžepagić & Richet (2008)

11 Ranieri (2007)

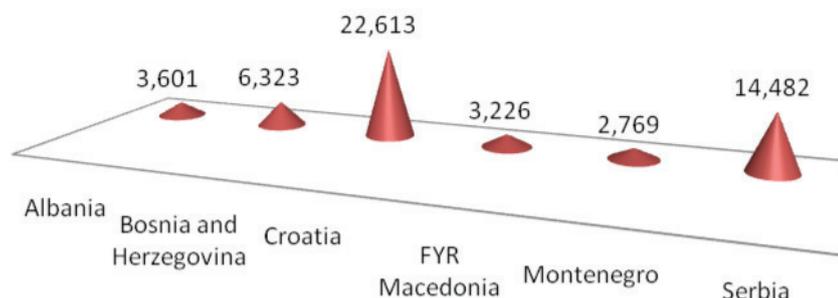
12 Redžepagić & Richet (2008)

13 Dragusha et al. (2008)

14 Redžepagić & Richet (2008).

15 Dragusha et al. (2008)

Chart 1. Cumulative flows of FDIs per capita 1989-2009 (in USD)



Source: Data processed by the authors based on EBRD (2008)¹⁶

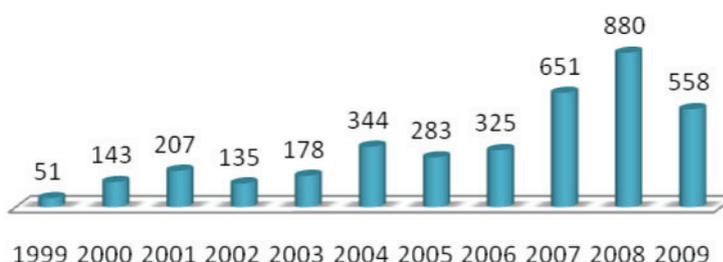
The 29 per cent decline in FDI inflows to developed countries in 2008 was mostly due to cross-border M&A sales that fell by 39 per cent in value after a five-year boom ended in 2007.

Albania

FDIs continue to be an important factor for the economic development of the country. They have determined the progress of the balance of payments capital and financial accounts and have contributed considerably to the financing of the current account deficit. Besides the fluctuations in the level of FDI inflows during the last 10 years the tendency in general has been a continuous increase¹⁷, except for the year 2009, when a decline is expected as a consequence of the actual global recession effects transferred to the Albanian economy.

In the year 2004 FDIs reached the first record value of about 275 million USD which is attributed mostly to the privatization of the former Albanian Savings Banks, which was sold to the Austrian bank Raiffeisen Bank for a value of 126 million USD¹⁸. The second record value was registered in 2007 (651 million USD) an increase by 75% compared to the previous year. Albtelcom privatization and increase of foreign capital participation in the Albanian financial sector have played the major role in this increase. However, FDI inflows peaked in the year 2008 reaching the value of 880 million USD or 7.2% of GDP¹⁹. But, even with this increasing tendency, the level of FDIs in Albania continues to be low, especially when compared to other countries of Western Balkans²⁰.

Chart 2. FDI progress in Albania during the period 1999-2009²¹ (in million USD)



Source: Data processed by the authors based on EBRD (2008)²²

¹⁶ <http://www.ebrd.com/country/sector/econo/stats/index.htm>

¹⁷ Boriçi (Begani) (2009) fq. 58.

¹⁸ Redžepagić & Richet (2008a)

¹⁹ Banka e Shqipërisë, Raporti Vjetor 2008, fq. 55.

²⁰ Boriçi (Begani) (2009) fq. 59.

²¹ The value of FDI inflows for the year 2009 is a projection

²² <http://www.ebrd.com/country/sector/econo/stats/index.htm>

In fact, the Government policy adopted by the country is mainly aimed at reaching two important goals. The first one is that of harmonizing the legal, administrative and institutional systems to the European development standards, in view of a forthcoming entry into the European Union. The second one is that of creating a business climate boosting the development of local enterprises, especially of foreign ones, able to promote, with their technology and know-how, the economic development of the country (ICE 2009).

The results of this policy were greatly appreciated, not only by the European Union, but also by several international bodies such as the World Bank and the International Monetary Fund (IMF). The reason for their appreciation is that, despite the current international financial crisis, the country can boast a GDP which is still positive (4.1% in the last three months of 2009),²³ as well as a consolidation of the market economy and an increased flow of foreign investment into the country itself.²⁴

FOREIGN TRADE

Exports from SEE have been growing, especially in services, in which the trade balance is positive. However, low merchandise exports have been a major problem, and could be an important factor in the unemployment problem of many countries.²⁵

The decrease in the volume of foreign by the end of 2008 and the beginning of 2009 represents the first signal of an economy in deceleration. Besides the fact that during 2008 the growth rate of foreign trade was high (15.3% for imports and 16.5% for exports), it was still lower compared to the year 2007. In addition, during the year 2008 the trade deficit increased again reaching the value of 2.4 billion €, an increase by around 14.8% from the level of the previous year (Bank of Albania)²⁶.

The decline in the foreign trade volume continued too during the year 2009, reaching the level of 593.7 million €, which is equivalent to a 9% reduction compared to the same period of 2008. During these two months imports and exports experienced respectively a 7.3% and 16.1% decline, in annual terms, compared to the first two months of 2008 (Bank of Albania, 2009)²⁷. The decreases in the level of import products prices as well as the developments in the world economy are thought to be the main causes of this reduction.

Following is presented a table that summarizes the trade balance indices for the two first months of 2009 compared to the same period of 2008.

Tabela 2. Trade balance indices

Foreign trade Volume in million €	January 2009	February 2009	Jan.-Feb. 2008	Jan.-Feb. 2009
<i>Exports</i>	53.1	58.3	132.8	111.5
<i>Imports</i>	-223.0	-259.2	-520.2	-482.2
Trade balance	-169.9	-200.9	-387.4	-370.7
Change in %				
<i>Exports</i>		9.9		-16.1
<i>Imports</i>		16.3		-7.3
Trade balance (deficit)		18.3		-4.3

Source: Bank of Albania (2009)²⁸

23 The more developed sectors are: post and telecommunications, transport and trade. For further details on the subject see: ICE, (2010). 3rd quarter 2009: Albania Economic Growth Accounting for 4.1%. <http://mefite.ice.it/CENWeb/ICE/News/ICENews.aspx?cod=15342&Paese=70&idPaese=70>

24 Scalera & Uruci, 2010

25 Domazet & al., 2009.

26 Annual Report, 2008

27 Economic Bulletin, March 2009

28 Economic Bulletin, March 2009

Also, according to the Economic Bulletin (March 2009), and the Annual Report (2008) of the Bank of Albania, the decline in the level of imports, caused by both, the impact of the global crisis and the application of the Foreign Trade Agreements between Albania and the EU or Albania and the South East European countries, has caused the reduction of budget incomes coming from customs duties, both during the 2008 and during the first months of 2009.

The merchandise and services' export provided around 17 and 57 % of the current incomes. Meanwhile, the deficit of the Trade balance has diminished to 591 millions of euros or around 2% in annual terms and its report over GDP is estimated to 28.4%.²⁹

CURRENT ACCOUNT DEFICIT

Current account deficit, mainly very large, of all countries as well as SEE region as a whole is main features for observed period. In parallel it brings great concern in macroeconomic and monetary policy as a consequence of international trade and saving and investment.

Whereas in recent years fiscal deficits shrank relative to the GDP, countries had ample manoeuvring space in which to run up substantial or even massive trade and current account deficits.

High current account deficits have become a source of major concern and it is expected a substantial slowdown in net private capital flows to those countries, with foreign banks more likely to recall more than they land.³⁰

Due to high deficit all SEE countries have take a number of measures and activities, tackling impediments to public and private saving, boosting potential output through labour and product market reforms, and improving corporate governance.

The deficit on the current account of SEE countries is growing steadily, as it is show in the table 3. It shows proportion a current account balance in comparison with obtained GDP in each country.

Table 3. Current account balance 1998-2009 as percentage of GDP

	1998-2000	2001-2003	2004-2006	2007	2008	2009
A. Western Balkan Countries						
Albania	-4.1	-5.1	-5.3	-9.1	-13.5	-11.3
Bosnia&H	-10.2	-16.6	-14.2	-12.7	-15	-9.3
Croatia	-5.4	-5.3	-5.7	-7.6	-9.4	-6.5
Macedonia	-3.4	-6.9	-4	-7.2	-13.1	-14.1
Montenegro		-6.8	-13.3	-29.3	-31.3	-23.2
Serbia	-5.3	-6	-10.3	-15.3	-17.3	-12.2
Subtotal	-5.2	-5.5	-5.9	-9.5	-14.8	-10.4
B. Countries Already EU Member						
Bulgaria	-3.7	-4.5	-12.5	-25.1	-24.2	-12.3
Greece	-4.7	-6.8	-8.1	-14.1	-14.4	-13.5
Hungary	-8	-7	-7.8	-6.4	-7.8	-3.9
Romania	-5.3	-4.9	-9.2	-13.9	-12.6	-7.5
Slovenia	-2.3	-0.2	-2.3	-4.2	-5.9	-4
Subtotal	-5	-5.5	-9.1	-14.3	-14.5	-9.2
SEE - total	-6	-5.5	-7.7	-12.2	-14.6	-9.5

²⁹ BoA, 2010.

³⁰ Domazet&al., 2009

The implications of his constant and rising deficit in the balance of payments of all countries in SEE countries are manifold. It should mention only few of them.

- Domestic consumption during the observed 11 years was always above its domestic possibilities. That was the case especially for the countries were this deficit used to be constantly very high-above the Region average (B&H and Romania);
- The persistence of the current account deficit was possible by two measures, widely used during the past nineteen years.

For Albania, the deficit of the current account's balance during the first 9 months of the year 2009 arrived at 330.6 millions of euro, by registering in this way an annual increase of about 43%.³¹

REMITTANCES AS SIGNIFICANT FINANCIAL SUPPORT

A very important source for all SEE countries in financing of foreign trade deficit is the inflow of remittances.³² Despite of some methodical problems in earlier years (some countries didn't report data on remittances in the IMF balance of payment statistics),³³ the recent reports are giving more precise figures concerned with these inflows, slowing enormous amount of the money entering SEE countries. The whole set of data is presented in the table below.

Table 4. Remittances-Migrant remittance inflows, 2000-2008 e (US\$ million)³⁴

	2000	2004	2008	Index (2000=100)	As % of GDP 2007
A. Western Balkan Countries					
Albania	598	1160	1495	250	13.6
Bosnia&H	1595	1941	2735	171	17.8
Croatia	641	1221	1602	250	2.7
Macedonia	81	213	408	504	4.5
Serbia and Montenegro	1132	4129	5538	489	13.9
Subtotal	4047	8664	11778	291	
B. Countries Already EU Member					
Bulgaria	58	1722	2634	4541	5.4
Greece	2194	1242	2687	122	0.8
Hungary	281	307	2946	1048	1.8
Romania	96	132	9395	9786	5.1
Slovenia	205	266	331	161	0.6
Subtotal	2834	3669	17993	635	
SEE - total	6881	12333	29771	433	

During the transition period emigrants remittances have represented a decisive factor for the alleviation of the high deficit in the Albanian current account. However their contribute during the last year and the first months of 2009 has been decreasing because of the actual global crisis. The majority of the Albanian emigrants live and work in the Euro Zone countries, which have been affected the most by the negative impacts of this crisis.

31 BoA, 2010.

32 World Bank; Migration and Remittances, Factbook 2008, Washington, D.C., 2009

33 Domazet & al., 2009

34 World Bank; Migration and Remittances, Factbook 2008, Washington, D.C., 2009

The level of remittances in 2008 was calculated to be around 800 million € equal to 9.2% of the GDP, which represents also a 16% reduction in comparison to the previous year. Their contribution in the trade deficit alleviation was only 33%, a 12 points reduction compared to 2007 (Bank of Albania, 2008)³⁵. The tendency of remittances to decline in value was stronger during the last three months of 2008. According to the Bank of Albania (2008)³⁶ during this period they decreased by 28.2%.

During the first nine months of the year 2009, the remittances were reduced by 6 per cent compared to the same period of the previous year, and by 19 per cent at the same period of the year 2007, by destabilizing the report of the demand and supply for value by influencing in this way the exchange rate.³⁷

INFLATION TENDENCY AND THE VALUE OF THE ALL

Headline CPI inflation has soared in a number of countries on the back of increases in food prices and administered fuel prices in the past. Indicators of underlying inflation pressure have risen to a lesser extent, but some countries still face risks of further second round effects.³⁸

Table 5. Inflation in period 1991-2009⁴

	1991-2000	2001-2002	2004-2006	2007	2008	2009
A. Western Balkan Countries						
Albania	34.7	3.5	2.6	2.9	3.4	1.7
Bosnia&H		1.8	3.3	1.5	7.4	0.9
Croatia		2.4	2.8	2.9	6.1	2.8
Macedonia		3	1.1	2.3	8.3	-0.5
Montenegro		17	2.9	3.5	9	3.4
Serbia		41	13.4	6.5	11.7	3.9
B. Countries Already EU Member						
Bulgaria	107.9	5.2	6.5	7.6	12	2.7
Greece	9.1	3.7	3.3	3	4.2	3.1
Hungary	20	6.4	4.8	7.9	6.1	4.7
Romania	101.1	24.1	9.2	4.8	7.6	3.4
Slovenia		7.2	2.9	3.6	5.7	3.3

During the year 2008 inflation in Albania has been characterized by a satisfactory stability for the most part of the year, besides some variations (within the interval 2.2-4.6%), but which still remain within the limits predetermined by the Bank of Albania. The average inflation rate during 2007 resulted to be around 2.9 %, whilst during the year 2008 it has been 3.4%. The increase in the level of inflation during this period is a direct consequence of the changes in the prices of the basic products, such as oil and food, in the international markets and of the increase of the energy prices in Albania. Meanwhile, during the second half of 2008 inflation showed a decreasing tendency reflecting therefore the decrease in the basic products prices in the international markets (Bank of Albania, 2009)⁴⁰.

The tendency of inflation to decline has continued too during the first months of 2009. In fact the rate of inflation during the year 2009 was 3.5 per cent. This happened because of the decline in the

35 BoA, Annual Report, 2008

36 Declaration of the Monetary Policy for the second half of 2008

37 BoA, 2010

38 Domazet&al., 2009

39 Domazet&al., 2009

40 BoA, Annual Report, 2008

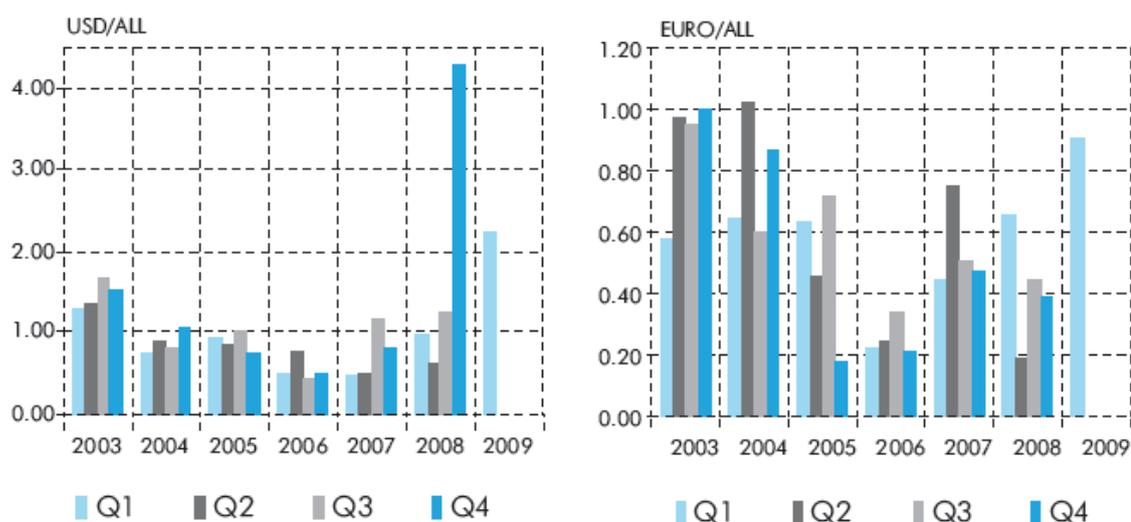
prices of basic products in the international markets, because of the decrease in the internal demand and more strict financial conditions as well as because of future expectations about inflation rates in the domestic market (Bank of Albania, 2009)⁴¹.

As far as foreign exchange rate fluctuations is concerned, there is a tendency that the value of the LEK falls versus both the euro and the dollar, which started in the third quarter of 2008 and has been continuing during the first quarter of 2009. During the second half of 2009 the ALL depreciated versus the American dollar and the euro respectively by 2.36 % and 9.57%, reaching by the end of the year the respective values of 102L/\$ and 139.80L/€.⁴²

The depreciation of the LEK versus the two main currencies above mentioned has continued as well during the first quarter of 2009. As the main factor that is thought to have caused this tendency is the decrease in the level of supply of foreign currencies in the Albanian market, which itself was the result of the reduction in emigrants remittances, in exports and in the volume of LEK purchases by the foreign companies operating in Albania (Shehu, 2009). This is also confirmed by the general manager of Alpha Bank in Albania, Andrea Galatoulas, wh says that the appreciation of the euro might have been the result of a limited supply of it in the Albanian market.

Following is presented a figure that describes the foreign exchange rate between the Albanian LEK and the American dollar, as well as between the Albanian LEK and the euro, from the year 2003 until the first quarter of 2009.

Figure 2.



Source: Bank of Albania (2009)⁴³

RESULTS OF INTERVIEWS WITH BUSINESSES

In order to discover what have been the effects of the actual global crisis on the business activity in Albania a series of semi-structured interviews have been conducted with various companies operating in Albania, which represent various industries and are financed by both the Albanian and the foreign capital. Interviews were directed to the general managers and the financial managers of these companies. For the purpose of this paper, the results of five of these interviews will be presented together with some opinions of the Chief of the Tirana Chamber of Commerce on the reaction of Albanian businesses to the global crisis impacts.

41 BoA, Economic Bulletin, March 2009

42 Declaration of the Monetary Policy for the second half of 2009

43 Economic Bulletin, March 2009

The companies chosen to be presented in this paper are: Albtelecom. Sh.A, Shqipëria Tricot, Jon, Eurograma, Mondial Sh.P.K. and Xherdo. Following is given some basic information about each of these companies.

- *Xherdo* is engaged in the elaboration and export of the medicinal plants. Its activity started in the year 1992 in Maminas (Durrës) and now it is expanded through the whole territory of Albania. It is financed only with the Albanian capital.
- *Eurograma* is a company that produces and sells biscuits and crackers. It started its activity in the year 1992 and is 100% financed by the Albanian capital.
- *Jon Company* operates in the construction sector offering both the construction service as well as selling of construction materials. Its activity started in the year 1994 and now it is expanded through the whole territory of Albania. It is financed only with the Albanian capital.
- *Albtelecom Sh.A.* is engaged in selling telecommunications services and operates in the whole Albanian territory. 76% of its capital is financed by the CETEL Company a.s Ankara, member of Çalik Holding headquartered in Istanbul, Turkey. The government of Albania finances the other 24%. It represents the old General Directory of Post-Telecommunication founded in Albania in 1945, which was owned and managed by the state until the 1 October of 2007, moment at which it was partially privatized.
- *Shqipëria Tricot*, produces lining, with materials provided by the ordering company. It is 100% owned by Cotonella SPA, Italy and operates in the city of Shkodra from the year 1995
- *Mondial Sh.P.K.* operates in the hospitality and tourism industry as well as in the construction sector, and is placed in Tirana and Pogradec. The company is 100% financed by the Albanian capital and has started its activity by the year 1991.

All the interviewed companies seem to be informed about the actual global crisis, its origin and its causes. They also believe that Albania is suffering its effects in many ways. Each of the interviewed companies declares that the volume of the Albanian foreign trade, especially the volume of exports, has been falling because of the crisis. The financial sector, the emigrants remittances, the construction industry as well as the value of the Albanian currency, are through the sectors and economic indices most mentioned by the interviewed companies to be feeling the effects of the crisis. The Chief of the Tirana Chamber of Commerce, who speaks on behalf of the members of the Chamber, also confirms this.

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The financial manager of Albtelecom Sh.A. affirms that the company has not yet been affected by the crisis, but she is skeptic about the future, believing that if the crisis in the international arena will continue to prevail, the negative effects of it are inevitable. On the other hand, the administrator of Shqipëria Tricot says that because of the crisis the company has difficulties to provide credit denominated in euros. With the depreciation of the Albanian LEK versus the European currency, a euro denominated credit has become very much costly. Meanwhile, the general manager of Jon Company affirms that crisis has affected the demand for the company products, which has then caused a reduction in the company's incomes. Consequently, the company has had difficulties to get a return from its previous investments. Eurograma Company confirms the same. Because of the crisis, the company has been facing reduction of the demand, increase of the production costs, difficulties to find credit or cost-effective credit, which have all been translated then into lower incomes and a pessimistic future prosperity for the company. Mondial Sh.P.K. manager affirms too that the crisis has affected negatively its company, particularly by increasing the service delivery costs and reducing the business incomes.

Also, Xherdo manager affirms that the crisis has affected negatively for over one year its company, and this is due to the fact that they work for the export. They have felt the crisis in the fall of the demand for medicinal plants and globally in the fall of the demand for export, accompanied by the fall of the income from business.

The Chief of the Tirana Chamber of Commerce states that the crisis has affected negatively in the number of members of this Chamber, by reducing it. This can be explained by the pessimistic view of various businesses about their future, who may believe that even benefiting from the services offered by a Chamber of Commerce wouldn't be enough for them to overcome the negative effects of the crisis.

All the interviewed companies believe that the crisis and its effects will continue to be present at least in the following 2 years. Each of them seems to have taken some measures to alleviate the negative impacts of the crisis. In the case of Albtelecom, making some infrastructural investments, reducing service tariffs to consumers and improvement of service quality, are believed to provide the company a better position in the market and therefore a stronger defense shelter to the crisis. Increase of control over the expenses and improvement of product quality are the measures taken by Shqipëria Tricot and Jon Company to face the crisis in the next years. The last one is also trying to attract a foreign partner from a developed country in order to strengthen its financial position. Cutting some costs and laying off some workers have been the major measures taken by the Eurogama company to deal with the crisis. On the other hand, Mondial Sh.P.K. measures include: reorganization of the staff, reduction of investments for maintenance and reconstruction, as well as increase of marketing efforts for the low cost products, while in a more far future it plans to enlarge the variety of its products and services. According to the manager of this company, this will help the company be differentiated in the market and therefore increase its ability to be protected by unexpected changes in the environment, such as the actual crisis.

Xherdo measures include We are working to increase the buyers and the products' quality. We are working to decrease the costs and be competitive.

CONCLUSIONS

The global financial clearly tell us that the global economic model has not been sustainable in the last period of time. The world economy should have been more macro economically balanced and the financial markets must be more regulated and more stable, since the main source of the financial and then into economic crisis has been combination of the macroeconomic imbalances and financial market failure.

The SEE economies have been affected by the global financial crisis, but it is not a type of the financial contagion. The financial markets in these countries have indirect negative impact through the decline of FDI, current transfers from remittances, and restricted bank's lending to the private economic sector.

The financial crisis, which originated in the USA, has now been transformed into a real economy crisis and has affected the whole globe.

Albania is not experiencing an economic recession, but it has been suffering from some consequences of the global crisis since the last quarter of 2008, which have been associated with the deceleration of the economic activity. The effects of the global crisis in the Albanian economy have been taken the form of:

- a) the withdrawal of deposits from the banking system and the contraction of the credit to individuals and businesses,
- b) the decline of the volume of foreign trade, especially the decline in the level of exports,
- c) the reduction in the amount of emigrants remittances,
- d) the changing inflation rates and the depreciation of the ALL versus the dollar and the euro,

As far as Albanian businesses is concerned, based on interviews conducted with some of them, is concluded that they all have been affected by the crisis in various ways. The actual global crisis has increased their production and services costs, has reduced the demand for their products and created difficulties for them to get credit, or more precisely, cost-effective credit. In many cases these effects have then been followed by a reduction in their business incomes.

All businesses interviewed believe that the crisis will continue to affect their activity in the next 2 years too and they all have taken some measures to cope with it. Improvement of products and services quality, increase of the marketing efforts, together with the cutting of some expenses, represent the most prevailing measures through the interviewed companies.

RECOMANDATIONS

Based on the above-mentioned conclusions, some modest recommendations directed to both the Albanian government and the Albanian businesses can be offered. First, the government role in stimulating economic development should increase, both as a regulator and as a support factor to the business. In today's crisis situation the government can support the business by offering it favorable conditions credit or by reducing the tax burden to it. Special support must be provided to export businesses or those sectors where Albania has comparative advantages such as tourism.

Second, it is important now to try to keep and attract capital to Albania, since as have been mentioned previously in the paper capital outflows from Albania are higher than capital inflows. It is governments duty to prepare adequate programs for attracting foreign direct investments and orient them to those sectors that contribute the most to the economic development of the country.

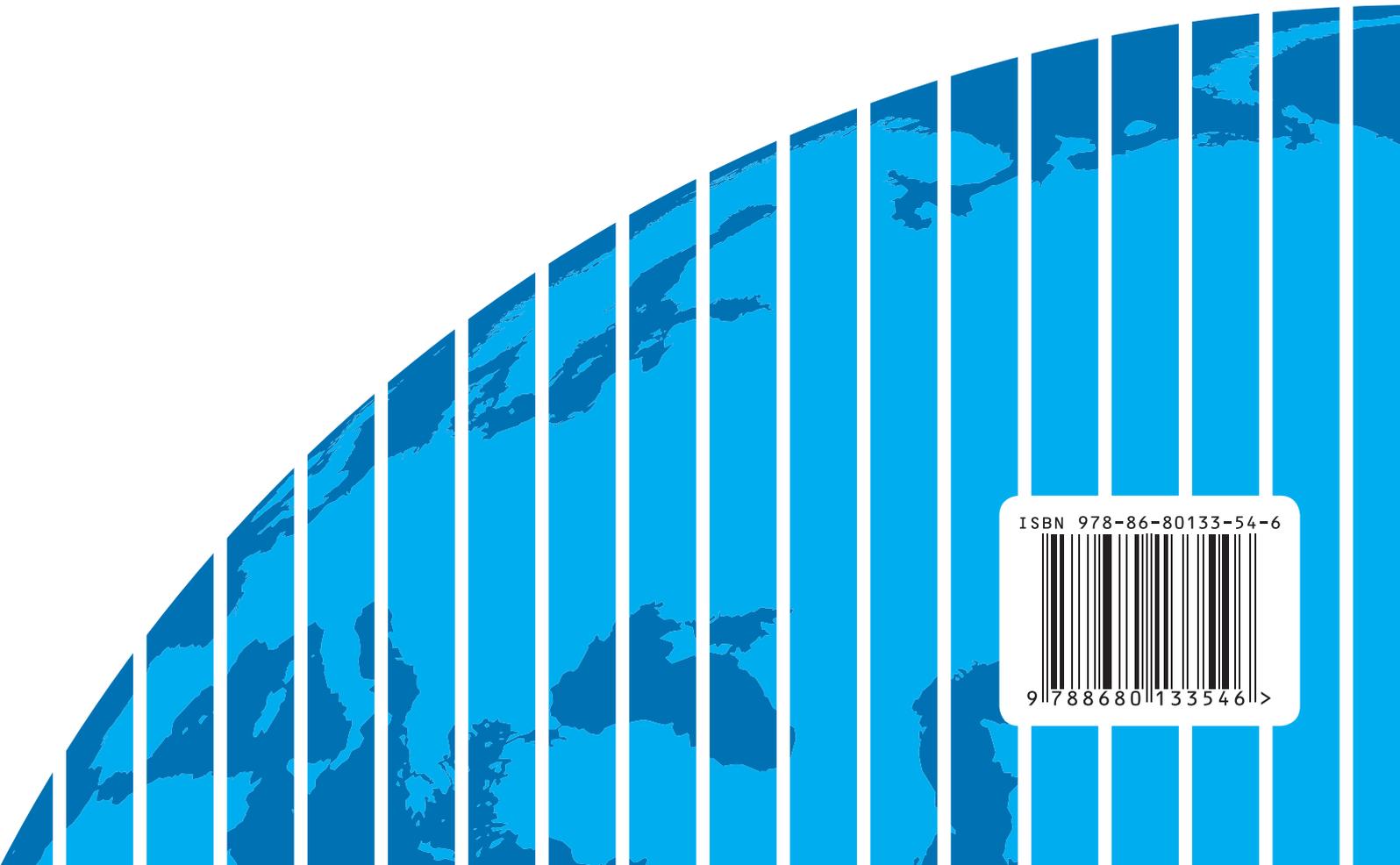
Third, businesses are recommended to be more careful in preparing their plans, focusing more on long-term profits and growth than on short-term profits. Specific plans may be drawn to be prepared for facing unexpected situations such as the actual crisis, which are normal to be expected in open market economy.

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