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**ASSESSING SCIENCE PARKS' PERFORMANCE: SELECTED EUROPEAN  
AND CROATIAN CASE STUDIES**

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**Abstract**

*This paper aims to provide a better understanding of science and technology parks and role they play in increasing the innovation and competitiveness of the economy. Paper presents a theoretical framework of science and technology parks and empirical evidence regarding the effectiveness of some selected European and Croatian science and technology parks. Analysed European examples suggest that the establishment of such organisational forms is a very powerful impetus to development of knowledge-based economy. Research results in science parks in Croatia, indicates that such organisational form is only in its infancy and has not been sufficiently exploited in contributing to the development of knowledge-based economy. These results indicate that necessary changes and systematic approach to the development of science and technology parks in Croatia is needed.*

**Key words:** *science park, assessment, effectiveness, economic growth, Croatia, Europe*

**1. INTRODUCTION**

The **assumption** is, in theory, that firms located in parks are more productive and more innovative than firms that are not located in the park. For the same reason there has been a recent trend among policymakers to consider the science parks as a knowledge-based economic development generator. The above mentioned assumption is tested in this paper. That is by assessing the effectiveness of some selected science and technology parks and by conducting an empirical research. While in developed countries there is a practice of dynamic creation of science parks back in the 1970s and 1980s, Croatia is only at the beginning of development of such parks, which have not yet achieved their intended role. The main **hypothesis** of the paper suggests that parks can be one of the main generators of economic growth, particularly in the region in which they are established. The **purpose** and **main goal** of this study is to examine the role of technology parks in developing of European and Croatian economy. To prove this hypothesis theoretical and practical examples of good practices in selected countries are given.

The paper discusses historical and theoretical overview and critical analysis of existing scientific literature regarding the science parks. It continues with an explanation of paper methodology and appropriate research methods used in paper. The third chapter analyzes the access to scientific and technological parks in selected European countries and then analyze the situation in the Republic of Croatia. The paper concludes that science parks, both in theory and practice, can be very important generators of economic growth. Unfortunately, in Croatia, which has recently shown the initiative, they are not sufficiently exploited.

## 2. RESEARCH, SCIENCE, AND TECHNOLOGY PARKS: DEFINITION, HISTORY OF DEVELOPMENT AND LITERATURE REVIEW

### 2.1 *Definitions of science parks*

At the present time in many scientific and professional papers, as well as in political discussions, concepts such as science parks, technology parks, research parks, innovation and incubator centres, and the like, are used. Due to the confusion that the mentioned concepts may cause, and with a goal of their better understanding, the paper attempts to further define their content. Although the alternative use of different forms, the commonly to all of them is an effort to encourage the application of science in business with goal to maximize its innovativeness. Innovation is, in fact, now considered as a major source of economic growth. In practice, the concepts of science, research, and technology parks are synonymous, although there may be minor differences between them. The use of a term depends primarily on a geographic area in which they are located. The terms „science park“ and „technopole“ are used most commonly in Europe, the term „technology park“ is more prevalent in Asia, while the term „research park“ is preferred in the United States and Canada (further in paper terms science park or just park are used).

To define science park is not easy, given that there is no single, universally accepted **definition**. The literature often cites the definition according to the International Association of Science Parks (IASP). According to the IASP official definition, “a science park is an organisation managed by specialised professionals, whose main aim is to increase the wealth of its community by promoting the culture of innovation and the competitiveness of its associated businesses and knowledge-based institutions (IASP, Accessed 28 November 2011)“. Parks stimulate and manage the flow of knowledge and technology between park firms (tenants) and science institutions, especially universities. These partnerships enhance, both formally and informally, the efficiency of innovation within park firms, but also within universities. Science park facilitates the creation and growth of innovation-based companies through incubation and spin-off processes and provides other value added services together with high quality space and facilities (IASP, Accessed 28 November 2011). For that reason, they are today considered as a powerful tool in promoting national and regional economic growth and competitiveness.

Regarding the existing definitions, the authors of this paper define science park as a science and technology complex (space, building, necessary infrastructure) that is either located at or near universities or other scientific research organizations. Science park either sells or rents the premises (buildings, offices) to business or other organizations to establish cooperation with the scientific sector with the aim of conducting basic or applied research and development of new products, technologies or processes. Actually, that is a place that helps to transform ideas into products for the market. The benefit for firms is a more favourable lease and potential collaboration with the scientific sector, which encourages their innovativeness. The benefit for scientists is in guiding their applied research towards the actual needs of the economy.

From these definitions the basic **characteristics** of the science parks can be derived. The **first** characteristic is established space, modern equipped, and with all necessary infrastructure, which meets the needs of business tenants. That space and equipment is offered to tenants at more favourable prices than the market ones are. Tenants can be both, emerging firms or existing firms that are willing to further develop within the park. The **second** important characteristic refers to the highly specialised management team whose main task is to create and manage the ambient and services which stimulate the knowledge transfer between the various actors involved. The **next** feature of science parks refers to the established efficient links to one or more universities. No one organization could call itself as a

science park, if there is not established a key relationship with science. It means that within the park exist two sides, supply side (knowledge producers) and demand side (knowledge users). Behind the office space the essential **feature** of park is an offer of value-added services, such as intellectual property services in the stage of pre-incubation and incubation. The **fifth** characteristic relates to networking to each other, and in terms of external (nationally and even internationally). The **last** important feature consists in the positive effects beyond their physical boundaries, which means the impact on the regional development. Science parks promote the economic development and competitiveness of regions and cities by:

- Creating new business opportunities and adding value to mature companies
- Fostering entrepreneurship and incubating new innovative companies
- Generating knowledge-based jobs
- Building attractive spaces for the emerging knowledge workers
- Enhancing the synergy between universities and companies (IASP, Accessed 8 February 2011).

## *2.2 History of science parks development*

The first science parks have evolved from industrial parks created in Great Britain during the Industrial Revolution. The concept of such industrial concentrations are very quickly taken over by the Americans. Shortly after the end of World War II, American companies have become aware that science has an important role in their growth and development and have made the first step towards exploiting the benefits offered by collaboration with science. From such initiatives science parks have arisen.

The first such science parks have been established around Stanford University in California, such as; Menlo Park, Stanford Science Park (which subsequently led to the development of Silicon Valley), both created towards 1950s. The concept of science parks in Europe appeared much later than in America. The first science parks in Europe originated in the United Kingdom such as Cranfield in the late 1960s and Cambridge in the 1970s. However, the massive development of science parks in Europe occurred during the 1980s and 1990s. More specific, the majority of the world's science parks were created during the 1990s. The main reasons for that are probably positive effects of parks established during 1950s and later.

Today, there are over 400 science parks worldwide and their number is still growing (UNESCO, Accessed 20 January 2012). At the top of the list comes the USA, which is reported to have more than 150 science parks; Japan comes next with 111 science parks; China began developing science parks in the mid-1980s and now has around 100, 52 of which were approved by the national government and the remainder by local governments (UNESCO, Accessed 20 January 2012). In the Europe there are 108 science parks, which are members of the International Science Park Association (IASP, Accessed 20 January 2012). The large number of science parks are linked through national and international associations where common experience are shared. The best-known international association of science parks is the International Science Park Association (IASP). Also, we can mention the international Association of University Research Parks (AURP) and European Network of Living Labs (EnoLL).

In Croatia there is a considerable delay regarding the establishment of science parks. The first technology park of high technologies in Croatia was established in 1994 within the group Koncar -

Technology Park Ltd. This technology park was established with an aim to promote entrepreneurship and private initiative. However, although the Park is a good example of encouraging small and medium enterprises (SMEs), it should be noted that it has not been established with an aim of co-operation with science sector. The co-operation with science should in fact be the basic purpose and mission of each science park. The first such institutional form of science park, oriented to co-operation between science and economy is Technology-innovation Centre of Rijeka, Ltd., created in 1998 by the University of Rijeka, Primorsko-goranska county, City of Rijeka, and Privredna bank Zagreb. However, more serious approach to science park establishment in Croatia occurred in 2000s.

USA	[Redacted]			
Europe/Canada/Japan	[Redacted]			
Asia-Pacific	[Redacted]			
Rest of the World	[Redacted]			
	1950	1980	1990	2000

Figure 1: Arrival of Science and Technology Parks (Bellavista and Sanz, 2009, pp. 502)

### 2.3 Literature Review

Science and technology parks are seen increasingly around the world as a mean that foster innovation, economic growth and competitiveness. Therefore, it is really important to understand the academic literature related to science and technology parks. That literature has an influence on juridical and institutional frame of public policies related to park creation and its financing.

Although first science parks appeared in 1950s, the first relevant scientific literature on science parks occurs in 1990s. That **literature** refers to the disclosure of essential facts and experiences **related to first scientific parks**. Among the first such papers should be mentioned Castells and Hall (1994) describing the Silicon Valley (California) and Route 128 (around Boston, Massachusetts), which are considered as precursor of today's science parks. Additionally, the authors who summarized scientific aspects of the parks in the 1990s are: Gibb, M.J. (1985), Goldstein, H.A. and Luger, M.I. (1990), Grayson, L. (1993), Guy, I. (1996), Hilpert, U. and Ruffieux, B. (1991), and Vedovello (1997). Another aspect of that **literature** is **dealing with the assessing of science parks' performance**. So, Bigliardi, Dormio, Nosella and Petroni (2006) provided a sound and theory-grounded methodological framework to science parks performance measurement and some practical suggestions useful for the design and the implementation of a science park's performance evaluation in Italy (Bigliardi et al. 2006). However, there are many authors who have before them in their studies dealt with the subject of assessing science park performance (Chordà, I.M. (1996), H.Y, Jung, M.J., Mian, S.A. (1997), Sherman, H. and Chappell, D.S. (1998), and Westhead, P. and Storey, D. (1994) and others. Yang, C.H., Motohashi, K. i Chen, J.R. (2009), in their empirical findings show that the innovativeness of new technology-based firms located within science parks is significantly higher than that of other firms. However, there are studies that have found that innovation activities did not depend on the presence of research institutions and universities, for example Kleinknecht and Poot's (1992), Massey et al. (1992).



In domain of Croatian science there are very few authors who devoted their scientific research to the issues of science and research parks. Among the first authors should be mentioned Zuvela, I. (1993); Malekovic, S. (1995); Brunsko, Z. (1995). They are from a theoretical and historical aspects analysed the importance of parks for economic development. Zuvela, I., went a step further than other listed authors, and in addition to the theoretical overview, he presented the main criteria for judging the success of parks as well as the necessary initial conditions which established science park must meet (more on this see in Zuvela, 1993., pp. 111 and 116). The authors of a recent date in Croatia, who have explored issues of science parks are Zekić, Z. and Bukovac, B. (2008). They in their paper, on a theoretical level, sought to prove that the establishment and development of technology and science parks in Croatia is one of the basic prerequisites for economic and technological development as well as for development of SMEs. The main critique to that paper refers to the theoretical approach and conclusions without apparent empirical analysis.

The academic literature of science parks can be divided into two opposing opinions about benefits for companies that are tenants of parks. Some authors are supporters of positive aspects, while some advocate neutral and even negative aspects of cooperation and knowledge transfer in parks. The authors of this paper advocate that established science parks can be a very important impulse for fostering cooperation between science and economy, which according to the results of series empirical studies certainly contribute to the development of innovation. This assumption the authors tested by research of European experiences and by empirical research conducted on Croatian companies in and outside the park.

### 3. METHODOLOGY

This paper is structured in three main parts. The first part refers to the theoretical framework of science parks in which the existing literature on that subject is researched. The used methods are compilation method and method of analysis and synthesis. For study of European experiences is used case study method. For the analysis of effectiveness of European science parks are used information and data that are collected by screening formal documents such as the statute, business report, financial reports and data available on their web-pages and web-pages of the European Commission (project examples of successful regional policy).

The study of the situation in Croatia was made by analyzing the all existing Croatian science parks and by empirical research on companies that are tenants of science parks and those that are not tenants of such parks. The empirical research was conducted in autumn 2010. Research instrument was a highly structured questionnaire. What the authors of this paper wanted to determine by that empirical research is whether the tenants of the parks are more innovative than firms outside such organizations. The authors also wanted to define whether the intensity and quality of cooperation with science sector depends on fact that firm is tenant of park or not. For the analysis of the results of the empirical research descriptive statistics and Pearson's chi-square test are used.

### 4. EUROPEAN SCIENCE PARKS PERFORMANCE OUTCOMES

The empirical literature related to science parks performance outcomes is not yet sufficiently developed. Generally, when evaluating (measuring) the success of such parks there are some difficulties. There is no consensus on what that success would consist of. The authors of this paper as indicators of success have taken the indicators related to **innovation** patterns (number of start-ups,

patents, headcounts, new products launched by incubated companies) and some **financial** criteria. Although their primary objective is to influence on regional development, their contribution is in some cases unclear. Nevertheless, each park has a different impact. Here, we show some success stories. In paper, “Does a Technology Incubator Work in the Regional Economy? Evidence from South Korea”, the authors (Kim and Jung) use 5 indicators that Mian (1997) has suggested: (1) number of current clients; (2) total number of graduates since program inception; (3) number of graduate firms still in business and the survival rate; (4) sales and exports by tenants; and (5) employment by tenants (Kim, H.Y. and Jung, C.M., 2010, pp. 276). Regardless of clarity of these indicators, they cannot in every case be considered as indicators of success. According to them, large parks would be more successful than the small ones, because the large ones have more tenants, projects, etc. The authors disagree with such universal indicators, given that even very small parks can be of great importance for the initiation of business activity, particularly in small remote areas. Therefore, this paper presents some of the available indicators for chosen successful parks. The aim is, in fact, to present some examples of good practice and to confirm the hypothesis of this paper which quote that established parks can be a very successful generator of economic development in region in which they are established.

#### 4.1. *Profile and results of the Finnish Turku science park*

An example of successful cooperation between science and economy exist in Turku Science Park in Finland. The park was established in 1982, in the similar city that is located in the south-western part of Finland. For the whole development of science park is responsible the Turku Science Park Ltd. Park has a role in connecting business with research and public sector with the aim of converting business opportunities into commercial activities. For their customers it offers affordable business premises, a wide range of value-added services and two technology incubators. In the near of Turku Science Park, there are three universities (the University of Turku, Åbo Academy University, Turku School of Economics), Turku University of Applied Sciences, Turku University Hospital and many research organizations that represent their partners (Tekel, Accessed 5 February 2011).

The fundamental task of the Park is to encourage development of business activities based on expertise within the higher education institutions and local companies, whether it is about creating new business activities or improving existing ones. Realization of these tasks is possible by linking with various participants including scientists, entrepreneurs and public sector. The professional services offered in the Park are:

- business development,
- consultation,
- development projects
- locating services (Turku Science Park, Accessed 5 February 2011).

**Business development** services are provided within two business incubators: the Bio Incubator with lab facilities and DIO Business Centre. Incubators are mostly specialized in field of ICT and biotechnology, but also in shipbuilding, wood processing and for providing other services. Research services are provided for projects that have commercial potential. In addition to research services, the Park provide services for evaluation of new business ideas, making the final business plan, finding partners and additional sources of funding. Companies can also use the office space and consulting services in areas of incubator’s specialization (Turku Science Park, accessed 5 February 2011). Those planning to start entrepreneurial activity can contact the incubator already when working up their business idea. A so-called pre-incubator service can be applied to examine whether the business idea is

feasible and suited to the incubator. Business incubator can take in start-up firms with an acceptable business plan. The incubator team advises and guides in drawing up the business plan. In the pre-incubator service it is possible to get funding for the project from Tekes (The National Technology Agency of Finland), intended for financing research and development in Finland. Services of the Business Incubator include:

- Expert services for developing a company strategy, marketing and financing, training
- Premises: office and laboratory facilities, negotiation rooms
- Office services: e.g. telephone exchange, and photocopying and secretary services
- In Bio Incubator also servicing of equipment
- Application creating for TULI programme (Tekes)
- Co-operation and networking with other companies, financiers and the public sector (Turku Science Park, Accessed 5 February 2011).

**Consulting services** related to the development of innovation system are new, but growing part of their service supply. Park has gathered long experience in creating and developing science parks activities. For more than two decades, they have contributed to the growth of the expertise-based business of universities and companies.

Turku science park prepares and coordinates user-oriented education, research and **development projects** designed to improve the application of technology in various fields and especially to increase the activities of their leading sectors at regional, national and international level. They offer a preparation and implementation of research and product development projects that can be financed from EU funds and national Tekes fund.

Among the other **results**, the business incubators of Turku Science Park have given a start to over 160 technology companies which have generated around 850 new jobs. The survival rate of companies that have started in the mentioned incubators is about 90% (Turku Science Park, accessed 5 February 2011). Only in 2008, 44 business ideas as potential new incubator companies were assessed. The number of new pre-incubator projects launched was 14, of which 7 were in the ICT, 4 in life sciences and 3 in other sectors. A total of 8 new incubator companies were started, of which 3 in the ICT, 3 in life sciences and 2 in other fields, while 4 businesses grew out from the incubator stage. During the year, the incubator fostered a total of 26 start-ups. The incubator stage companies produced a turnover of nearly EUR 5 million and created 80 new jobs (Turku Science Park Ltd, 2008, pp. 22). The results achieved in the region would not be like that if there was not cooperation with the local universities.

#### *4.2. Profile and results of the German Science Park Potsdam – Golm*

A good example of cooperation between science and business in Germany is the Science Park Potsdam-Golm. From its inception until today, the Park is transformed into one of the most innovative and most prosperous location for scientific research in Germany. It covers an area of approximately 50 hectares, attracting brilliant minds who conduct research in the broader thematic area from biotechnology to gravitational physics. The park offers excellent infrastructure and ideal conditions for renowned scientific research institutes, technology-oriented companies, scientists and innovative entrepreneurs.

Restoring the former building of the University of Potsdam, where today Park is, began in 1993. In its initial construction phase the site attracted much investment from national sources. In the second and

third phase, the project was funded in part from the European Regional Development Fund (ERDF). The main goal of the project were to create a park which would integrate both science and business, combine research through greater inter-institutional co-operation, initiate spin-offs, support know-how and technology transfer to local and regional businesses. The extensive research potential offers optimal conditions for new product development and services and new enterprises.

The University of Potsdam was founded in 1991 and within it today is studying 18,000 students. It consists of five faculties: The Philosophical Faculty, the Faculty of Life Sciences, the Faculty of Mathematics and Natural Sciences, the Faculty of Economics and Social Sciences and the Law Faculty. The major goal of the University, declared in the development strategy, is to become the leading medium-sized university in academic excellence. This ambitious goal will be achieved by promoting international research cooperation, technology transfer to business sector, and by close cooperation with renowned research institutes and companies. The main focus of research activities refers to commercialization of scientific research, such as patenting, licensing, establishment of spin-off companies and other innovative activities.

A total of five research institutes were established in the Park. Their research activities outmatch regional character. These are three Max Planck Institutes and two Fraunhofer Gesellschaft Institutes (Wissenschaftspark Potsdam, Accessed 20 February 2011).

In order to support technology transfer and to foster networking between science and business, the City of Potsdam created GO:IN, the Golm Innovation Centre (GO:IN), co-financed by the European Regional Development Fund (ERDF). Innovation Centre was open 2007, and is offering 4,000 square meters of office space, laboratories and storage. It represents a place where for the first time new entrepreneurs and scientists can meet. The park is an ideal place for new entrepreneurs that need special business services and developed infrastructure. Those services are also offered to students, graduates and scientists who wish to start their own businesses and commercialize their business ideas. Before founding a company, GO:IN provides services regarding a business plan by brainstorming, looks for the appropriate consultants and funding sources. Once established company can get assistance in the realisation of business objectives. By the summer of 2008, 80% of available space was booked and 28 enterprises were housed within GO:IN (European Commission, 2010, pp. 58-59).

GO:IN incubator offers the following services:

- Business planning and business model development
- Advice about grants
- Corporate finance advisory (e.g. venture capital, loans)
- Networking events and opportunities for further qualifications
- Infrastructure (offices, laboratories, co-working) (Wissenschaftspark Potsdam, Accessed 20 February 2011).

In recent years Potsdam has undergone significant economic growth with the number of new business registrations per year more than doubling between 2001 and 2007, from 720 companies to 1,847 while there has been only a slight increase in business de-registrations per year from 823 in 2001 up to 1,247 in 2007. As a result of this business growth Potsdam has created a profile for itself as a modern business centre with a rich tradition (Urbact, Accessed 25 February 2011).

Potsdam is one of the most important centres for biotechnology in the region Berlin-Brandenburg, thanks to Science Park Potsdam-Golm. Biotech companies that are located in the region, especially

esteem the near of prestigious universities and research institutes located in the park. Thanks to the concentration of research facilities and specialized workers Potsdam is ranked among the leading cities in Germany, with a total of 160 companies from biotechnological activity that directly employ 3,200 people, alongside 5,000 people working in science-related jobs, and 4,000 people employed in the pharmaceuticals and services field. Overall, biotechnology is responsible for employing around 12,000 people in the region. More than half of the companies are direct spin-offs from the research institutes of Potsdam. The formation rate of spin-offs among academic staff is 3-4 companies per year, and among students 30 to 40 companies (URBACT, Accessed 25 February 2011). University of Potsdam, together with its partners, Chamber of Commerce, Industrial Associations and both national and international companies, was established in 1998 the UP Transfer LLC (limited liability company) as a company for the commercialization of scientific results. In delivering knowledge and technology transfer UP Transfer delivers a highly professional service working on approximately 40 to 50 projects per year of which 10 to 15 would be related to organisations in Potsdam (URBACT, Accessed 25 February 2011).

#### *4.3. Profile and results of the Italian Bioindustry Park Canavese*

Bioindustry Park Canavese is a science and technology park located in the Canavese area of the northern Italian region of Piemonte. The park was established as a limited liability company (LLC), and the origins of the park date back to 1994. Construction works started in 1995 and the park became operational in 1998, after some years of “greenfield” investments dedicated to building facilities. Today, the park covers some 16,000 square meters, providing facilities devoted to research laboratories and advanced services in the biotech sector. The Park comprises 28 companies, four foundations and associations, research teams from three universities and the National Research Council (CNR) which altogether provide work for over 300 employees. Research activity is carried out by a group of an average of 40 scientists / year from universities and the CNR. The aim of the park is to promote and develop research in biotechnologies and life sciences, hosting enterprises carrying out research and pilot production activities in the chemical, pharmaceutical, diagnostic, bioengineering and information science fields. As part of its core activity, the Bioindustry Park offers research facilities, scientific services and a complete set of support services, such as technology transfer, patent support, tutoring/mentoring of start-ups and spin-offs, project management and financial support.

The park creates a link between the university sector and private research. The main beneficiaries are biotech spin-offs, small and medium sized enterprises (SMEs) and large companies wishing to carry out research activities in an environment specifically created for the biotech industry. The staff of the park assists the start-ups, spin-offs and growth of innovative companies providing equipped premises and offering scientific services and know-how.

The reason for this approach to economic development of the region was a difficult economic crisis that Canavese region went through in the early 1990s. The Italian information technology company Olivetti went bankrupt leaving 10,000 people unemployed (in the region with only 250,000 inhabitants). This led to severe economic and social consequences for the region as a whole. In response to the economic crisis, local stakeholders joined forces with local entrepreneurs and business associations in revitalising economic activities in the area. Local stakeholders focused on providing support to local industry and in implementing of new economic sectors based on innovative technologies. This joint initiative led to the proposal of creating a science and technology park specialized in the biotech sector. Selection of biotechnology sector rested on the existence in the region of a dynamic business base and on the availability of advanced knowledge in this field at local universities. The purpose of the park was to develop a regional innovation system based on a network

of life-science companies and research institutions. The idea of the Bioindustry Park came from the managing director of a pharmaceutical company located in Canavese. He proposed the idea to the regional authorities. Both the public and private stakeholders were aware that the project was highly risky because of the presence of just one small pharmaceutical company in the area and because of the typically long-term highly expensive investments required by biotech projects. However, the proximity of research institutions provided the incentive to build on the local innovation system and the opportunity to kick start an industry that was completely new for the area of Canavese and attract external investments in the area. The decision to settle in the park only those laboratories that are not available at local universities contributed to creating a critical mass of research facilities and researches that was attractive for companies. The above mentioned was a key step that led to maximisation of interaction between research institutions and the Park.

At present, to locate in the Park, a company must:

- be active in fields of high level of knowledge or technological content in the life science area (or related fields such as information and communication technologies, new materials or nanotechnology);
- conduct activities of basic or applied research, in strategic branches of science and have a strong technological platform or know-how;
- have innovative R&D projects and programmes, with strong market orientation;
- be backed by adequate financial support and with a clear marketing and business plan;
- contribute to growth in economy and level of employment, both locally and regionally;
- make a substantial contribution to the scientific and technological knowledge;
- have a committed management team (European Commission, Accessed 28 February 2011).

Monitoring of the activities of the Park is not a highly formalised process. Given that the biotech industry itself is extremely expensive and highly risky, evaluation of projects to be funded from Eporgen companies (companies for seed capital in the Park, founded by private investors), public funds and EU funds, requires special attention to reduce the risks of wrong investments. External referees from local universities occasionally evaluate research activities carried out at the park. However, this process is changed since 2008 with the creation of a scientific board for research commercialisation. Furthermore, each project suitable for incubation in Discovery, before being incubated must pass stringent internal criteria and external evaluation. The external evaluation involves the assessment of projects from peer reviewers (industry experts).

The Bioindustry Park represents a successful example of partnership between public and private stakeholders that is generating a fast growing process of innovation and contributing to regional economic development. By mid-2007, the Park hosted 28 companies (mostly small and medium sized enterprises), of which 10 companies were attracted to locate some of their facilities in the Park and the remaining 18 companies are start-ups born inside the Park. A key indicator of success is the continued growth of companies located in the park. Moreover, private investment is eventually exceeded the level of investment from the ERDF. In terms of innovation outputs researchers working in the Park published more than 100 scientific articles in last 5 years, while companies in the park filed more than 25 patents. Furthermore, in order to obtain technology transfer services, over 180 small and medium-sized enterprises are contacted the Park. Over 150 different events and workshops were held at the

Park, with more than 3,500 attendees (European Commission, accessed 28 February 2011). In 2006 the Park was ranked among the top ten on a global scale.

## 5. CROATIAN EXPERIENCES IN COOPERATION OF SCIENTIFIC AND ECONOMIC SECTORS THROUGH ESTABLISHED SCIENCE PARKS

### 5.1 *Examples and analysis of Croatian science parks*

Science parks in Croatia are new players in Croatian innovation system. The first such park in Croatia is Technology-Innovation Centre of Rijeka, Ltd., created in 1998 by the University of Rijeka, Primorsko-goranska county, City of Rijeka, and Privredna bank Zagreb, Ltd. However, serious approach to science parks creation in Croatia occurred in 2000s. It is important to emphasize that real effects of parks can be achieved only 10-15 years after their establishment.

Examples of successful Croatian model of science-industry partnerships are Science and Technology Park of University of Rijeka Ltd. (STePRi), Technology Park Varazdin, Ltd., Regional Development Agency Medjmurje - REDEA Ltd. and TERA Technopolis Ltd. in Osijek (BICRO, Accessed 01 February 2011). However, it should be noted that in Croatia till now there has not been conducted serious studies dealing with evaluation of science parks' performance. There are studies that evaluate conditions in which business incubators operate. The problem is that not all of those business incubators have features of science park. Furthermore, those studies involve attitudes of incubator managers, rather than results achieved in the same. The authors in this paper continue to cite main characteristics of each existing park in Croatia.

University of Rijeka is one of the more prominent examples of good practice in Croatia. The OECD document *Thematic Review of Tertiary Education: Country Background Report for Croatia* (Ministry of Science, Education and Sports of the Republic of Croatia, 2007, pp. 52) as an example of best practice of higher education institution's regional impact which formalized relations with regional structures cites only the University of Rijeka. **The Science and Technology Park of the University of Rijeka Ltd. (STePRi)** was established in August 2008. The aim was to encourage development of science and entrepreneurship through synergy of scientific, technological and entrepreneurial resources at regional, national and international level. The Park was created on the initiative of the University. Its partners are Primorsko-goranska county and City of Rijeka with crucial support of Business Innovation Centre of Croatia (BICRO Ltd.). The objectives of the STePRi are incubation of emerging knowledge-based companies and emerging intellectual property protection (StepRi, Accessed 01 February 2011). This process describes the short term technology transfer. Basic steps in technology transfer are formation and incubation of spin-offs, development of new products, models, prototypes and new technologies in general, licensing of new technologies into existing regional, national and international companies, and connecting members of the University community, entrepreneurs and partners at both national and international level (StepRi, Accessed 01 February 2011). The mission of StepRi is to create a scientific-technological and business environment that inspires and encourages the development of science, innovation, creativity and entrepreneurial spirit by providing adequate infrastructure, professional services and strategic networks (StepRi, Accessed 01 February 2011). Today the Park is laid in building area of 1,300 m<sup>2</sup>. The space is divided by purpose to the incubator, office space and space for special purposes. Although the Park presents praiseworthy business venture of the University of Rijeka it is necessary to mention that they have not yet made visible analysis of their business activities results. Park currently has 10 tenants (StepRi,

Accessed 15 March 2012). The reason for the lack of serious analysis of their business activities results probably is only four years of existence.

**The Technological Innovation Centre of Rijeka Ltd. (TIC)** is a science and technology incubator. It assists entrepreneurs in establishing businesses and developing products and services based on high technology. Centre was founded in 1998 although the idea of establishing a centre at the University of Rijeka emerged 1994. Partners of TIC are the University of Rijeka, Primorsko-Goranska County, the City of Rijeka and Privredna bank Zagreb Ltd. (TICRI, Accessed 01 February 2011). Entrepreneurs that have a registered company or those without a company, but who have products or services based on innovation and high technology can become members of the Centre. On that way they can shorten a way from ideas, innovation, knowledge, products and / or services to market commercialisation. The aim of the Centre is transfer of science from the University to small and medium entrepreneurs. From its creation 35 businesses with more than 400 highly skilled professionals have been a part of the Centre, 15 prototypes were made, 20 seminars were held, the Centre has participated in two EU projects and has realised a number of innovative projects (Mandic, V., ed. , 2010, pp. 49). Currently, the Centre houses 14 tenants (TICRI, Accessed 01 February 2012).

**The Technology Park Zagreb** is the first technology park in Croatia, founded in 1994, under the Koncar concern. In 1998<sup>th</sup> became the property of the City of Zagreb with the aim of encouraging entrepreneurship and private initiative in the scope of development and high technology. In 2007<sup>th</sup> the Park has become a part of the Zagreb Holding company, and in 2008<sup>th</sup> it became part of the Development Agency Zagreb (TPZ Ltd.) (RAZA, Accessed 03 February 2011). Components of the Agency are Technology Park, Business Centre, Guarantee agencies and Centre for development projects. Park operates as a business incubator with 1,300 m<sup>2</sup> of office space and is intended for development of SMEs, particularly in initial stage of growth and development. In addition to the available facilities the Centre provides necessary professional help. Although the Park is a good example of encouraging development of SMEs it should be noted that it is not a classic example of encouraging cooperation between science and economy. In encouraging the development of SMEs the Park has achieved remarkable results. Some of the Park's results are large concentration of entrepreneurs in the field of high technology. Currently, the Park includes 17 tenants, and 35 ex tenants completed the incubation stage and left the Park. Since its arrival in the Park companies achieved significant growth and increase of number of employees with an average entry rate with one employee, and they left the Park with, on average, 15 employees. In the period since 2001 till 2004 it is produced 150 new products as a result of its own development, and in 2005 it was developed 39 new products (RAZA, Accessed 03 February 2011). On average companies in the Park develop about 25-30 new products annually. Those companies export products even in 44 countries of the world. Within the Park companies registered 10 patents and 1 industrial design, they won 110 awards for innovation and successful business activities, and 25 governmental, economical and professional recognition (RAZA, Accessed 03 February 2011).

**The Technology Development Centre Osijek Ltd. (TERA)** was established in 2002 as a result of an initiative of the Josip Juraj Strossmayer University of Osijek, the City of Osijek and Osijek-Baranja County. The mission of the Center is development of knowledge-based economy implementing significantly improved technologies (products, services and processing); commercialization of public funded research by the University; support of regional development and prevention of brain drain of competent experts of the region; and promotion of enterprises in the business incubator of the TERA Ltd. and outside companies (TERA, Accessed 02 February 2011). The Centre is consisted from Business incubator TERA which represents an office space intended for small and medium-sized entrepreneurs who both start business or expand an existing one. Entrepreneurs can use offices,



workstations (larger space that is shared by more tenants - the concept of incubation for companies with one employee), computer classroom, seminar rooms, meeting rooms and toilets. In addition to the Park facilities residents are offered with consulting services in implementation of entrepreneurial ideas. Tenants and clients are provided with business advisory services in all areas and with services of intellectual property protection. Areas of interest include biotechnology, environmental protection, ICT, and projects that provide for entrepreneurs an opportunity for development. Currently the Centre has 24 tenants (TERA, Accessed 02 February 2012). Here is also necessary to mention that they have not yet made a visible analysis of their business activities results which worsen the possibility to assess the Park's performance.

**The Technology park Varazdin Ltd.** is a project that was started in 2003. Initiators of the project were County of Varazdin, City of Varazdin, Croatian chamber of economy, University of Applied Sciences and Secondary school of electrotechnics and mechanics in Varazdin. In the year 2007 the City of Varazdin decided to transform the project into a Ltd. The owners of the newly established company are The City of Varazdin, Faculty of organization and informatics and University of Applied Sciences in Varazdin. The Technology Park provides the business infrastructure (office, Internet connection, meeting rooms, equipment, labs and everything necessary for commercialization) and the package of consulting services necessary for development. All the services are available at benefited prices in accordance with the period of incubation process. Emphasis is placed on innovative emerging technology companies or those that already exist but are in that group. By 2009, more than 35 companies had gone through the incubation process. Several companies that have successfully completed the incubation process employ over 100 development engineers. Most of the companies in the Varazdin Technology Park are export oriented and have very competitive products in the world market, most of them being from the ICT sector. Several foreign companies had also completed the incubation process and transferred their development activities to Croatia. Two companies that entered the Varazdin Technology park as start-ups, purchased land in the entrepreneurship zone of the City of Varazdin in 2008, for the purpose of building their own business premises. Today there are 22 technologically innovative companies in the Technology Park which employ over 250 employees, and 3 supporting institutions (the Microsoft innovation centre, a marketing agency and an employment agency) (Tech Park Varazdin, Accessed 03 February 2012).

**The Rudjer Innovations Ltd.** began its work in the first half of 2007 as a subsidiary of the Rudjer Boskovic Institute with a goal of encouraging the cooperation and partnership of research institutes, universities and innovative community with companies from industry. The mission is to contribute to the development of Croatia as a knowledge society and to strengthen the competitiveness of the Croatian economy in the world market. Rudjer Innovations represent and protect intellectual property of innovators and play an important role in technology transfer and application of innovative technologies. The company combines science with business and industry, and through partnerships with science, innovative community and economy is open to the entire Croatian community, providing support for commercialization of ideas, innovation and scientific research (Rudjer Innovations, Accessed 03 February 2012). It helps in converting innovative ideas into market product. At the company's website it is not visible realized projects and other forms of commercialization of scientific knowledge. On that way it is not possible to assess the company's performance.

The analysed parks are the only examples of established science parks in Croatia. Apart from them, 2 science parks are only in their project phase. Since the analysed parks are relatively new and that there are no studies about the parks' performances, the authors of this paper conducted an empirical research about the innovation activities of business tenants, regarding the fact that primary goal of encouraging cooperation with science through science parks is to increase the innovativeness of those tenants.

5.2. *The results of the empirical research in Croatia*

Regarding the fact that in Croatia there are no serious studies that deal with assessing the results achieved in the existing science parks, the authors of this paper conducted an empirical research. The aim of that research was to assess if these parks contribute to increasing the innovativeness of tenants and if they contribute to increasing the cooperation of tenants with scientists. The study was conducted in October 2010. The survey instrument was a questionnaire. The sample (N1) was composed of all tenants of the analysed science parks (a total of 136). From the whole sample the questionnaire fully fulfilled 24 companies (N1), which makes the response rate of 17.6%, which is considered acceptable for this type of research. In addition to the tenant companies another sample was composed of companies that are not tenants (N2) of the mentioned parks. That is because the authors wanted to test the differences in the innovativeness of these two samples. Another sample is much bigger, regarding that there is much more companies that are not tenants of science parks. Of the total sample, the survey questionnaire fully fulfilled 94 companies (N2). The authors tested the differences in their innovativeness by innovative indicators which are new products, new services, new production processes and new registered patents in the last three years (2008-2010). Finally, the authors tested the differences between the two samples regarding their realised formal cooperation with scientists, considering the fact that purpose of science parks should be cooperation with scientific sector.

The first question that firms (tenants) in the first sample (N1) needed to answer was (Q1): "Have your firm in last three years (2008-2010) developed any form of business cooperation with public research institutes in Croatia with a goal of improving business activities and innovativeness of company?" Offered answers were Yes, No and I do not know. Most park tenants (N1) responded negatively to this question, 79%, while only 12.5% of respondents responded positively. The second question was (Q2): "Have your firm in the last three years developed any form of business cooperation with institutions of higher education in Croatia with a goal of improving business activities and innovativeness of your company?" Again, the majority of respondents responded negatively (71%), while only 25% of them responded positively.

The same questions were answered by respondents from sample 2 - firms that are not tenants of science parks and incubators (N2). The obtained answers are somewhat different from the responses of tenant firms. To the first question (Q1), which refers to the existence of co-operation with public research institutes, 33% of respondents responded positively, while even 64% of respondents answered negatively. On the second question (Q2), which refers to the collaboration with higher education institutions, even 41% of respondents responded positively, while 51% of respondents answered negatively.

Table 1: The results of the empirical research (collaboration with scientific institutions)

Q1 (Collaboration with public research institutes)	Yes	No	Do not know	TOTAL
Sample N1 (tenants firms)	3	19	2	24
Sample N2 (firms beyond parks)	31	60	3	94
Q2 (Collaboration with public tertiary institutions)	Yes	No	Do not know	TOTAL
Sample N1 (tenants firms)	6	17	1	24
Sample N2 (firms beyond parks)	39	48	7	94

The responses listed in Table 1 indicate that firms which are tenants of Croatian science parks have not the higher intensity of cooperation with scientific institutions than the firms which are not tenants, although it should be the purpose of science parks. The results of empirical research suggest that development of cooperation with scientific institutions is even higher in companies that are not tenants of parks. It follows that the Croatian science parks do not yet realize its mission, which is transfer of knowledge and technology between science and industry with a goal of increasing the innovativeness of all entities in the system.

Questions aimed to get insight into the innovativeness of companies in the sample N1 and N2 refer to (Q3) the total number of innovations in the company (number of new products, new services and new production processes) and (Q4) the total number of registered patents in the company. The aim was to research differences in innovativeness (measured by these indicators) among the firms from N1 and N2 samples. As a method of analysis is used Pearson chi-square test. Results of the chi-square test indicate that there is no statistically significant difference between N1 and N2 samples according to the both number of innovations (Prob = 0.5438) and number of registered patents (Prob = 0.5769).

Table 2: The results of the empirical research (innovativeness)

Q3 (Total number of innovation)	Innovations	M <sub>o</sub>	M <sub>e</sub>	$\bar{X}$	Standard deviation ( $\sigma$ )	Number of examinees
Sample N1 (tenants firms)	56	2	2	2,4	2,3	24
Sample N2 (firms beyond parks)	413	0	3	4,5	7,0	94
Q4 (Total number of patents)	Registered patents	M <sub>o</sub>	M <sub>e</sub>	$\bar{X}$	Standard deviation ( $\sigma$ )	Number of examinees
Sample N1 (tenants firms)	2	0	0	0,1	0,3	24
Sample N2 (firms beyond parks)	35	0	0	0,4	3,5	94

Regarding the results listed in table 2 it can be concluded that there is no statistically significant difference in innovativeness of the companies in two researched samples. From that point it can be further concluded that science parks in Croatia are still not achieved its primary task, which is transfer of knowledge and technology between science and industry with a goal of increasing the innovativeness of Croatian economy.

## 6. CONCLUSIONS

The main objective of this paper was to bring science and technology parks closer to the public and the role that parks play in increasing innovativeness and competitiveness of economy. By describing the content and role that science parks have, and by given historical overview and review of scientific literature, the paper is fulfilled the first part of its task. Demonstration of the role that parks play in increasing the innovativeness and competitiveness of economy was given by overview of European good practice examples. For each selected park in the paper the achieved results are presented. In that way, the selected case-studies illustrate that the approach to regional development through cooperation

between science and economy in science parks is much more than simple metaphors. Considering the achieved results, analyzed examples of European science parks prove the hypothesis which states that parks can be one of the main generators of economic growth, particularly in the region in which they are established. Unfortunately, the analysis of Croatian experiences and results of the empirical research in Croatia, do not support the mentioned hypothesis, considering that the results achieved in the Croatian parks are much more modest and in many cases there are no visible analysis of the results of functioning. Furthermore, the results of empirical research conducted on park tenants indicate that most of tenants actually in the last three years had not even realized the cooperation with science institutions. So, it can be concluded that science parks in Croatia have not yet been sufficiently exploited in stimulating the innovativeness and competitiveness of tenants and economy in general. The reason for that can be a shorter span of their existence, which indicates the possible future potential. Therefore, the aim of our further empirical research will be the analysis of specific results of the Croatian science parks, and defining the performance criteria that would be applicable at the Croatian level. Also as a recommendation to managers of Croatian science parks the authors emphasize the obligation of regular assessing the science park's performance, and of making an annual report that should be published and available on the website of park.

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**THE IMPACT OF APPLIANCE OF CONTEMPORARY ACCOUNTING COST  
MODEL TO OPERATING RESULT**

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**Abstract**

*This paper presents the research results on appliance of Activity-Based Costing method. A mathematical model of the ABC method is presented in the paper, which outlines the necessary procedures for its application. When carrying out entrepreneurial activity, and because of the need for a clearer insight into the utilization of resources, data on the cost per product, process and all processes together will provide an advantage over competitors.*

*In order to realistically as possible estimate the general cost of individual products, it is necessary to identify the activity that caused the costs and determine the basis for allocation of production overheads to Activity Cost Drivers and then from activities to products or cost holders. The assumption of the ABC model is that the costs holders are using activities that are using the resources, and that spending of specific resources is causing creation of costs.*

**Key words:** *Costs, ABC method, Activity Cost Drivers*

**1. INTRODUCTION**

To avoid the constant starvation of the costs, in terms of cost overestimating or underestimating, management can be entrusted with applying the ABC method which is based on process orientation, which provides a more accurate allocation and better management of overall costs. This approach allows accurate calculation of cost price in order to improve business performance because it allows transparency of costs, indicating the areas where it can increase efficiency, increase the strategic options of business and continuous improvement of the processes to create competitive advantages.

Application of the ABC method, which requires high cost of reorganization and restructuring of large companies, discourages small businesses in its application. But just a small business, because of its flexibility, can introduce ABC method at very low cost in cost management. Recognizing the important indicators of the necessity of applying the ABC method like manufacture of a wide range of products, high production overheads that are not proportional to the quantity of certain products, present automation of business and insignificant amount of direct labour and difficulty to determine the gross margin, requires the application of the ABC model. Its application in small businesses can create a rapidly growing company despite the existence of great competition.

In this paper, the offered mathematical model of the ABC method provides a picture of the business results achieved per particular product that allows the reaction to the causers, level and correction of costs, or even termination of product production.

## 2. DEVELOPMENT, DEFINITION AND PRINCIPLES OF ABC METHOD

The idea that the activities are observed as causes of costs can be found in the literature that is several decades old (Solomons, 1968, pp. 426-443) which is stating the basic terms underlying the ABC method. Application of a conceptual framework for the calculation of costs, in which firms determine the activity as a cause of expenses, are applicable in the United States since seventies. Application of simple forms of cost accounting processes have been reported yet in the forties (Peršić and Janković, 2006, p. 400).

Costs management based on activities has started with intense application in the beginning of eighties of last century, as a result of the efforts of many companies to improve the quality of information necessary for a more realistic estimate of the costs of products. The method itself was the result of research in the late eighties of last century with the aim to provide realistic data to calculate the cost of products and strategic management decisions-making, and it is defined as an accounting system that collects financial and operational data on business activities (Cooper and Kaplan, 1998). General Electric Company has defined the concept of activity as the cause of cost, early 1960's, when within the mentioned company, model based on the analysis of the costs of activities, has been developed in order to enhance the quality of information in assessing the indirect costs (Johnson, 1992, p.32). Surveys carried out in enterprises in the U.S. and Europe in the 1980s and 1990s became the subject of a large number of practical studies at Harvard Business School. The results of these studies have led to the construction of the so-called "Harvard network" (Jones and Dugdale, 2002, pp. 121-163) in which framework mentioned approach of cost calculation was named as – Activity-Based Costing (ABC) or calculation of costs based on activity. Instead costs accompany the particular product this method follows the trend of costs for each activity or part of the business process. This allows easier control of costs in certain organizational areas plus the managers can easier focus on eliminating unnecessary costs and effects (Cingula, 2001, p. 115).

ABC method provides an integrated view of all functions within the company, its activities and business processes, and includes the methodology for calculating costs in a manner that assigns the cost of products and services based on the number of events or transactions involved in the process of manufacture. Determining the costs based on the activities is not only giving better control of costs, but also allows you to control the results. (Škrtić, 2005, p. 110) The main assumption of applying the ABC method is based on the principle that the company does not control its costs. It directs what causes these costs, which are activities that take place in the company. Cost holders respectively products and services are using activities, activities are using resources, and consumption of resources conditions development of costs.

In terms of business, where a large amount of work is used that is not directly linked to specific product or service, the ABC method provides much better information to management about incurred costs and achieved business results. Beside that, since the time when costs of not making are several times more than the cost of making, usage of the ABC method has significant place in management costs.

When using the ABC method it defines two types of allocation bases: 1) the basis for allocation of production overheads to individual activities and 2) the basis for allocation of production overheads from the activities to the products. The bases for the allocation of production overheads to the activities is determined for the reason that a cost can be challenged with more activities while on base for the allocation of production overheads from the activities to the products are determined by factors of expenditure. The causes of costs, in this case,

the activities, are criteria which identify the link between activities and object of cost, such as products, services or consumers. ABC model "converts" direct costs in general.

Every product awarded the costs that he actually caused. Monitoring of costs for the identified activities is shown in Figure 1. (Chadwick, 2000, p. 73).

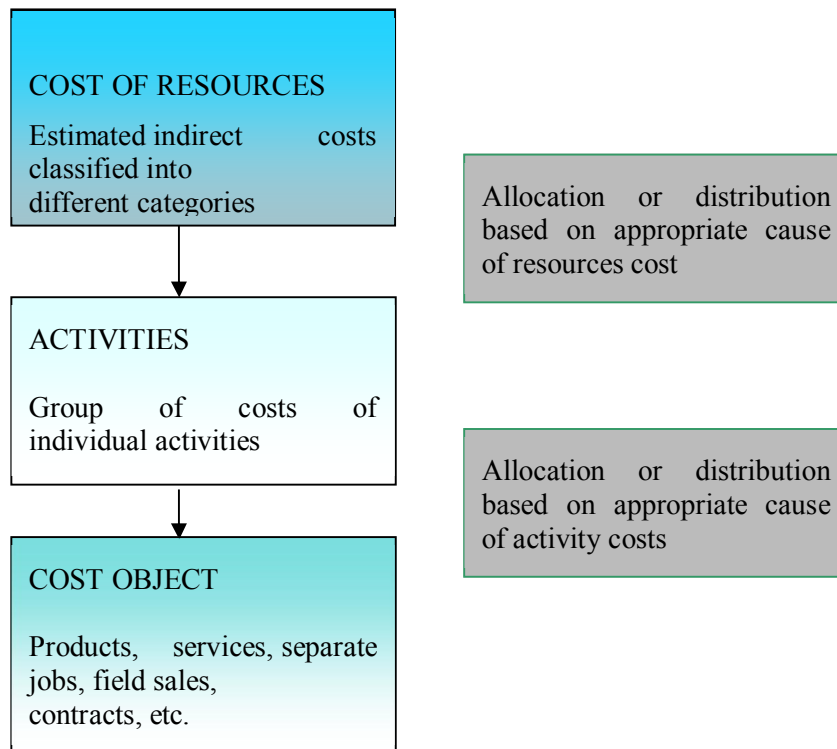


Figure 1: Activity-Based Costing

### 3. STAGES IN THE APPLICATION OF ABC METHOD

The theoretical development of the ABC methodology is accompanied by its practical application and introduction to business undertakings. The necessary steps to implement the ABC method are: 1) determining which products are the holders of costs, 2) determine the direct costs of materials and labour that are directly distributed to the holders, 3) determining the activity and the factors of costs, 4) determine the general cost of each activity in the accounting records, 5) the allocation of overhead costs to individual products using selected bases - the factors of costs and 6) determining the total cost per product unit. (Drury, 2000, pp. 387-390) Application of the ABC method begins with the identification of products that are cost holders. Determine the direct costs of materials and direct labour costs, which are directly allocated to cost holders, identify the activities and places of indirect costs and the wear factor for these activities. Factors of costs can be number of product deliveries, production operations, etc. Following step is to determine the indirect costs of production per individual activities by using accounting records. Allocation of



indirect costs to individual products using selected bases is next step in determining the cost of the ABC method, which results in a determination of indirect costs per unit of product or service. The last step in the ABC method is to determine the total costs of production and cost per unit of product or service. (Hornngren et al, 2003. pp. 144-148)

Due to the high costs of introducing the ABC method into the business, it is usually introduced into the operations of large enterprises. Lack of sufficient management quality in managing the costs of small enterprises among other factors makes small enterprises even more inefficient and their products more expensive. This paper presents a mathematical model that presents that the application of contemporary models costing in small companies can be simple and do not always need high costs.

ABC is characterized by horizontal and vertical dimensions. The vertical dimension is a cost assignment to activity cost objects and cost holders (products, services, customers, market segments ...). The horizontal dimension refers to a process orientation, process monitoring of production or service provision. It provides information on various activities within the company, as well as the quality of their performance and identifies the causes of activities. (Peršić and Janković, 2006, p 406)

The vertical dimension, as shown in Table 1, calculates the costs in two phases. The definition includes the allocation of costs to those activities which have caused costs. The calculation presents cost accounting of activities to be allocated to cost objects. The calculations in Table 1 are part of the ABC method except determination of activity costs (column 8) that are obtained from the accounting records of the company. All calculations in Table 1 are part of the ABC method except of determining the costs of (column 8) which are obtained from the accounting records of the company. The amount of factor of cost is calculated by the mathematical formula (1), and the cost of each activity by each product is calculated by mathematical formula 2. Total cost of activity in a particular product is divided by the amount of product  $m$ , or  $\sum TA_m/Q_m$ , an indirect cost per unit of product  $m$ .

Indirect costs per unit of product  $m$ , together with the direct costs of materials and direct labour costs represent represents the undistorted cost of each product. ABC method is thus conceived as a method for total costs.

$$IFT_1 = \frac{ITA_1}{\sum_{i=1}^m a_{1i}} EUR / unit$$

$$IFT_1 = \frac{ITA_2}{\sum_{i=1}^m a_{2i}} EUR / unit \quad (1)$$

$$IFT_n = \frac{ITA_n}{\sum_{i=1}^m a_{ni}} EUR / unit$$

$ITA_n$  – amount of the cost of certain activity

$IFT_n$  – amount of factor of costs for certain activities

$\sum_1^m a_{ni}$  – the sum of activities of the products from  $l$  to  $m$

$$TA_1 = a_{1m} IFT_1$$

$$TA_2 = a_{2m} IFT_2$$

$$TA_{nm} = a_{nm} IFT_n \quad (2)$$

$TA_{nm}$  – cost of activities per product

$a_{nm}$  – the quantity of activity  $n$  by the product  $m$

Table 2 shows the application of the ABC method for calculating the cost price of product  $m$ , which includes a schedule of direct material costs by product and distribution overheads based on activities. The cost per product activity was calculated by multiplying the quantity of each activity by a factor of costs of each activity and divided by the quantity of production of product  $m$ . Since the manufacture of product  $m$  consists of two processes, or two groups of activities, the cost was calculated for each activity by the group per product  $m$ , which gives a clear insight into the utilization of resources needed to manufacture the product  $m$ .

DEFINING							CALCULATION							
Type of activities	The quantity of activity					Resource cost drivers	Amount activity cos	Activity cost drivers	The cost of activities per product					
	Product								ITA	IFT	TA1	TA2	...	TAm
	1	2	..	m	$\Sigma$				€	€/unit	1	2	...	m
1	2	3	4	5	6	7	8	9	10	11	12	13		
								8/6	9×2	9×3	...	9×5		
Act 1	a11	a12	..	a1m	$\sum_{i=1}^m a1i$	FT 1	ITA 1	$\frac{ITA1}{\sum_{i=1}^m a1i}$	a11 × IFT1	a12 × IFT1	...	a1m × IFT1		
Act 2	a21	a22	..	a2m	$\sum_{i=1}^m a2i$	FT 2	ITA 2	$\frac{ITA2}{\sum_{i=1}^m a2i}$	a21 × IFT2	a22 × IFT2	...	a2m × IFT2		
Act 3	a31	a32	..	a3m	$\sum_{i=1}^m a3i$	FT 3	ITA 3	$\frac{ITA3}{\sum_{i=1}^m a3i}$	a31 × IFT3	a32 × IFT3	...	a3m × IFT3		
.	.	.	.	.	.	.	.	.	.	.	.	.		
.	.	.	.	.	.	.	.	.	.	.	.	.		
.	.	.	.	.	.	.	.	.	.	.	.	.		
Act n	an1	an2	..	anm	$\sum_{i=1}^m ani$	FT n	ITA n	$\frac{ITAn}{\sum_{i=1}^m ani}$	an1 × IFTn	an2 × IFTn	...	anm × IFTn		
$\Sigma$									$\Sigma TA1$	$\Sigma TA2$	...	$\Sigma TAm$		
Q									Q1	Q2	...	Qm		
$\Sigma/Q$									$\Sigma TA1/Q1$	$\Sigma TA2/Q2$	...	$\Sigma TAm/Qm$		
									↑	↑	↑	↑		
									1	2	...	m		
									Direct cost of material					
									Direct cost of production					
									DIRECT COST					

Table 1. Mathematical model of the ABC method (Authors creation)

<b>PRODUCT <math>m</math></b>				
	<b>Price</b>	<b>Cost of materials</b>	<b>Direct cost of material product <math>m</math></b>	<b>Total</b>
<b>MATERIAL</b>	€/1m	unit/1m	€/unit	€/unit
material <sub>1</sub>	X <sub>1</sub>	Y <sub>1</sub>	X <sub>1</sub> Y <sub>1</sub>	
material <sub>2</sub>	X <sub>2</sub>	Y <sub>2</sub>	X <sub>2</sub> Y <sub>2</sub>	
material <sub>3</sub>	X <sub>3</sub>	Y <sub>3</sub>	X <sub>3</sub> Y <sub>3</sub>	
material <sub>4</sub>	X <sub>4</sub>	Y <sub>4</sub>	X <sub>4</sub> Y <sub>4</sub>	
material <sub>5</sub>	X <sub>5</sub>	Y <sub>5</sub>	X <sub>5</sub> Y <sub>5</sub>	
				$\sum_{i=1}^5 X_i Y_i$
<b>ACTIVITY group 1.</b>			<b>Cost of activity per product <math>m</math></b>	
activity 1			$a_{1m} \times IFT_1 / Q_m$	
activity 2			$a_{2m} \times IFT_2 / Q_m$	
activity 3			$a_{3m} \times IFT_3 / Q_m$	
activity 4			$a_{4m} \times IFT_4 / Q_m$	
activity 5			$a_{5m} \times IFT_5 / Q_m$	
			$\sum_{i=1}^5 a_{im} \times IFT_i / Q_m$	
<b>ACTIVITY group 2.</b>				
activity 6			$a_{6m} \times IFT_6 / Q_m$	
activity 7			$a_{7m} \times IFT_7 / Q_m$	
			$\sum_{i=6}^7 a_{im} \times IFT_i / Q_m$	
<b>TOTAL COST per unit of product <math>m</math></b>			$\sum_{i=1}^5 X_i Y_i + \sum_{i=1}^7 a_{im} \times IFT_i / Q_m$	
Selling price per unit of product $m$				
Gross profit per unit $m =$ total sales price $m -$ total cost $m$				

Table 2 The application of mathematical models of the ABC method of calculating the cost of products  $m$  (Authors creation)

The total cost per product unit presents the sum of cost of material for product  $m$  and cost of activity product  $m$  which after deduction of the selling price gives the category of gross profit per unit of product. The procedure of calculating the gross profit per unit of product by using the ABC method provides information to management on the profitability of product  $m$ .

#### 4. CONCLUSIONS

From this model it is evident that the ABC method "eliminates" the concept of overhead expenses, and converts the overhead costs to direct ones so that all costs can be relatively easily assigned to the products and services. Offered mathematical model of the ABC method outlines the procedures necessary for its application. After identification of factors of costs and their amount, it is necessary to determine cost of each activity by each product and to allocate the expenses to each product that he actually caused. With the correct data on the amount of cost per product, process and all processes together, the company acquired a useful tool for decision making and an advantage over competitors who do not possess it. In this way, monitoring of costs per activities we have a clearer insight into resource utilization and response to the question of why the cost incurred.

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## THE INTELLECTUAL CAPITAL AND THE LEARNING ORGANIZATION

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### Abstract

*Following the transformation of the contemporary globalization, of the the competition, of the the need to integrate the cultural differences, adaptive organizations seek new ways, new forms and organizational configurations, new relationships and partnership networks.*

*In the organizational theory and practice, there is an increasing emphasis on the relationship between learning and adaptation processes, change, development and innovation that use the intellectual capital available inside an organization.*

*The present study aims to highlight the link between the organizational culture and the implementation of a strategy for learning and continuous adaptation of the organization to the current environmental challenges. Also, we wanted to emphasize the importance the intellectual capital holds in the development status of an organization intending to progress through continuous learning.*

**Key words:** *learning organization, organizational culture, intellectual capital, external challenges.*

### 1. INTRODUCTION

The organization is a social invention designed to achieve common goals through the group efforts. Today, the customers, the competition and the changes have created a new world in business and is becoming increasingly clear that the organizations which are designed to operate in a specific environment can not only be adjusted to fit and successfully operate in a totally different environment. The managers face many problems in order to adapte their organizations, to ensure a certain level of competitiveness and to restore them in a gradually evolving process of an international class.

Gathering knowledge, skills, abilities of the individuals working in a company, their creative potential and the innovative human capital of the knowledge-based organization, that is the key to its competitiveness, to the market positioning, of its market value and of its survival. To perform on the markets, the organizations rely on their human capital, rather than on their physical or financial capital. In the knowledge economy the attention is focussed on knowledge assimilated in the individual. He is the bearer of the tacit knowledge. Therefore, it is considered that the main involved factor in the process of creating value is the tacit knowledge that resides in people-(Swart & Kinnie 2003).

Human capital is the source of innovation and for the strategic renewal of the organizations. According to Edvinsson and Malone (1997), the market value of a firm is given by the finance capital and by its intellectual capital. The intellectual capital of an organization is divided into the following parts: *the human capital*, represented by the skills, the abilities, the creativity and the employee's values, *the philosophy and the culture* of the organization and the *structural capital*. The XXI-th century organization is creating and integrating knowledge. At a fundamental level, knowledge is

created by the individuals (Nonaka 1994). A single organization can not create knowledge without individuals, it supports the creativity, it develops its human capital, providing the necessary background as its people generate knowledge. The organizational knowledge creation is a process where knowledge held by the individuals is amplified and crystallized (Nonaka 1994). The human capital of the company is involved in this process, he the initiator and its champion. Those who keep working the process of the organizational knowledge creation are the people. They are continuously engaged in re-creating the world, according to their own perspectives and perceptions, to their professional and social skills. The human capital, reflected in the level of the education and the ability to adapt and to relate to individuals is crucial in the re-configuration of the world. The individuals' implication in the organizational processes of creation and re-creation of knowledge emphasizes the valence of human knowledge as to be important creative activities.

## 2. THE LEARNING ORGANIZATIONS- THEORETICAL APPROACHES.

The literature on the "organizational learning" has focused on the collection of the gathered information and on analysis of the processes involved in the individual and collective learning inside organizations, while the literature on the "learning organizations" is action oriented and it is geared toward the use of the specific diagnostic tools and of the evaluation methodology that can help to identify, to promote and to evaluate the quality of learning inside the organizations. Peter Senge's vision of an organization that is learning, organization seen as a group of individuals who continuously capitalize their intelligence and creative skills, had a considerable impact. The researches has shown that although all the people have, theoretically, the ability to learn, the organizational structures do not always allow them to create and integrate their new knowledge. Moreover, all the individuals lack, usually, the proper tools to extract a general sense from their particular experience. The organizations that want to plan their future, must change the employees' mentality as well the individual learning may induce the organizational learning through the expansion of the mental models, as shown in the Bratianu's and Murakawa's (2004) paperworks. In the Peter Senge's view, the learning organizations have other five advantages:

- systemic thinking;
- individual professionalism;
- mental models;
- consensual views;
- team learning.

People can influence the structures and the systems where they belong to, in order to gain these advantages on their side, moving the focus from "everybody makes his job" towards "to do a good work together", passing through from the body of employees as a collective passive receiver to a team as an active participant, prepared for the future.

A *learning organization* and, therefore an *intelligent organization*, uses knowledge management as a tool to adapt to the changing environment, for the early identification of the opportunities and to avoid risk behaviors overlapping the strategic orientation of the company, understood as the capacity to long term position, in order to generate and maintain the competitive advantages.

Inside the organizations, the capacity to learn through self learning it is essential, this is achieved by processing the organizational experience, the tacit knowledge, "learned" through direct experience.

However, as the organizational experience relates to what happened in the past, to the history of the company, such processing organizational experience (the tacit knowledge) may be insufficient to ensure the survival of the modern organizations. So, even if this knowledge is still appreciated, the organizations can not progress without calling also the explicit knowledge, based on formal training. "Therefore, the knowledge management must be aware of the tacit dimension of knowledge and of the organizational capacity to properly exploit them, by stimulating the process of converting the individual's tacit knowledge to the organizational tacit or explicit knowledge." (Bratianu, 2006).

The knowledge management must find new ways to structure and use these processes, in order to increase the competitiveness of the organization and developing the organizational intelligence. A new paradigm must be created, to measure the levels of knowledge and to express quantitatively the dynamics of knowledge inside a *learning organization*. The *learning organization* focus on the employees' lifelong and collective learning, accomplished through knowledge. The administration and the processing of knowledge, as to be suitable for use in the employees' activities, is achieved through a series of thoughtful and directed processes. The true learning is made by direct action, through experimentation, thus transforming information into explicit knowledge, which is able to store it and then truly become a part of us. Only the individual-as a receiver, has the power to transform the messages that reach him from outside, in knowledge, through relevance to the degree of his involvement and association with the context. Among other things, the knowledge management is to influence the reactions of the individual and others in order to target knowledge processes. Thus, the knowledge management is not an end in itself. "

The significance of the concept of "learning organization" has grown in the field of business, expanding, then, at all the economic and social levels, denoting an ideology (specific values), a structure and a range of coherent strategies. In such an organization, every employee share knowledge and learn from others. Peter Senge defines learning organizations (Learning Organization) as "those organizations that consistently enhance their ability to create their own future" [Senge, P. (1990), *The Fifth Discipline: The Art and Practice of the Learning Organization*, Doubleday, New York, p 14]. The organizations that continually learn can be defined through the following features:

- They constantly create learning opportunities;
- They promote investigation and dialogue;
- They encourage collaboration and learning inside the teams;
- They build and strengthen a distribution systems of knowledge;
- They support the development vision between the groups;
- They values the relationship between the organization and the environment.

Even Paul Senge mentions two fundamental defining elements for the Learning Organizations: 1) an organizational configuration that supports learning and 2) the employee skills. Although there are essential, the two features does not guarantee, however, the occurrence of an organization that learns, but they create the internal availability for the development of such forms of strategic orientation. The same author has formulated five basic subjects that are both subjects of learning, and useful for the leaders, some of these five disciplines have individual character, others relate to a particular group, and the last of them integrates all the four previous, reporting the level of an specific organization. They are: *the excellence*, allowing to clarify and to deepen the personal vision, to focus on the main internal subjects and allowing the quality of the objective observation the reality, in order to achieve personal goals ; *the mental models*, that it means the integration of the individual images that one



created upon the world and which allows his more effective adaptation; *the common vision*, which can boost the group by the shared values, by the pool of practices and principles, with an increased responsibility for the joint projects; *the team learning*, with dialogue and active listening that involves no templates and stereotypes, that supposes free presentation of the ideas, without constraints in a multidimensional –type communication; *the systemic thinking* that supposes to take into account the interrelations, the functionality and the evolution of the organizational systems.

The learning processes, whether individual or inside the groups, is even more necessary as the assimilation of the five subjects or stages are subject in training and for the personal and group development. These aspects are

favoured and explained through the theories of the social interaction (see F. Dansereau, G. Graen, WJ Haga, where the leader identify the capable and motivated employees, the *in-group*, and give them some autonomy, as they form the first class of collaborators, while the other employees form the *out-group*. After some time, the *in-group's* members may become, in turn, new leaders, while the *out-group's* members remain confident workers, aspiring to fame and recognition within the organization, but they prove a lack of enthusiasm and real development opportunities) or through the transactional leadership theory, where the leader gives something, the employee receives something in return, based on an informal psychological contract and the essential feature of leadership is the idea of a reward for the employees' s efforts, with beneficial individually and collectively results.

Despite the opportunity of this subject, there are some fundamental questions that concern the specialists in management, their substance can not being exhausted without: *who is the subject of the individual or organizational learning? what is the relationship between the individual and organizational learning? what is it and how long it could take for a learning process? what are the most effective methods of learning and how this process can be covered inside a strategic and logistic perspective?*

One of the critical oppinions about the learning organizations refers to the failure in changing a bureaucratic organization, mainly through the accumulation of knowledge and skills. It is also a custom to regard *learning organizations* as an ideal, to which other organizations tend, in an attempt to cope with minimum damage, to the permanently changing environmental challenges .

There are a number of principles and theoretical approaches, which reflect questions like the following:

- An employee, integrated in two different organizational environments or with two different professions, will have a unique motivation for learning in both professional issues?
- An individual may exhibit two types of learning motivations and beliefs in a simultaneously or differently way?
- What is the role of the organizational culture in determining individual or collective beliefs for learning?
- Individuals who feel strongly organizational membership are determined and how much they are influenced by the leaders / managers' beliefs and motivations for learning?
- Organizational change can influence employees' desire to continuously learn?
- There is a causal link between the motivations of learning at the individual, group and organizational level? What does this causal link consists in?

The representatives of the modern organizations have realized that their core values are knowledge and the intellectual capital available to each of them. In order to obtain competitive advantage it must be taken into account the ability to use this knowledge out on technologies and organizational processes.

### 3. THE APPLICATION

Our investigations were carried in the small and medium type of economic agents in North-East region of Romania and aim as the general objective, the analysis of the human capital of these forms of economic organization; our researches revealed the phenomena of interdependence between overall and individual satisfaction and the training programs related to other motivating factors; training generate emotional balance within the organization, a correct perception of the future, in a present organizational environment or in one of the perspective; training sustain adherence to environmental values and culture. Learning and the human capital development of these organizations not just reside in a quantitative accumulation, but also make a strong interdependence between the cognitive, emotional, motivational factors and the social behavior.

In order to evaluate the brainpower of SMEs in the North East of the country we used a questionnaire which seeked to determine the existing level of intellectual capital in the analyzed at a time organizations, focusing on assessing the intensity of each component.

The research objectives were:

- An analysis and understanding of the degree of the intellectual capital in SMEs in the North East region of the country;
- The implementation of an evaluation research on the intellectual capital through its components: human capital, structural capital, relational capital;
- The stage or the existence of the learning organizations in the North East region of the country.

The objectives of the applied questionnaire were:

- The assessment in terms of human, structural and relational intellectual capital available to SMEs in the North East region of the country;
- establish a correlation between the quality and the quantitative aspects of the intellectual capital and the size of the surveyed SMEs;
- the assessment of intensity of each component of intellectual capital that help in determining the stage of development in the learning processes inside the analyzed SMEs;

The survey results shows that, in 2010, SMEs in Romania are not longer making a significant contribution to create new jobs in the economy, as they do in other years, due to major problems they have facing the economic crisis, which it means that most part of the SMEs have employed less than 5 people and a very small number of them have employed more than 11 people. This is shown in chart no.1

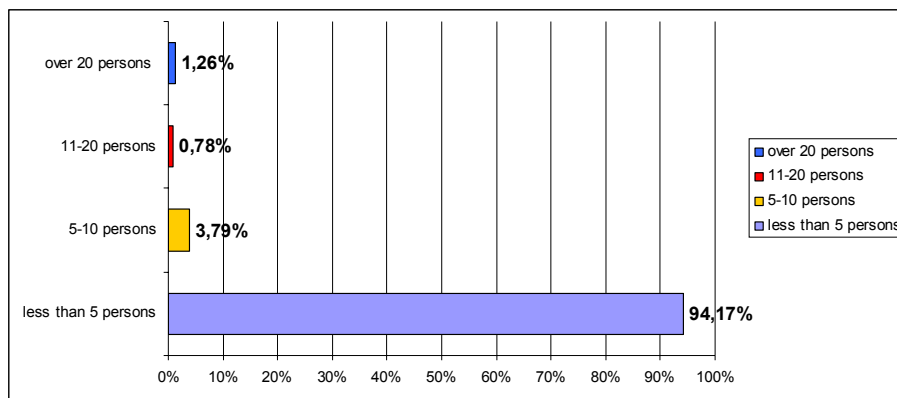


Chart no.1 The picture of the new employed individuals in the Romanian SMEs.

The analysis of SMEs in the average number of working days per employee consumed for training, in the past year, is presented as follows in chart no.2

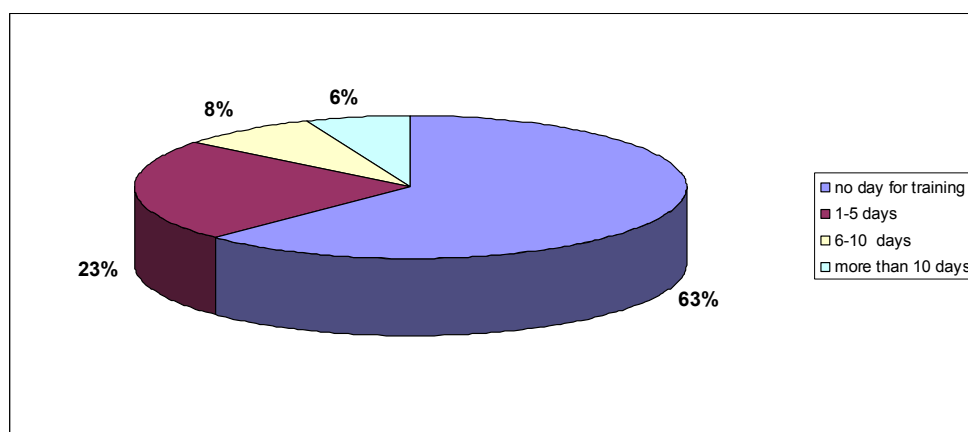


Chart no.2 .The structure of the SMEs, related to the average number of training days/employee.

From the chart no. 2 it can be seen that more than half, namely 62.52% of SMEs had not mentioned in their budget any sums for the human resources training activities, and 6.16% have not spent more than 10 days of training per employee .

The inquiry made at the regional level revealed that the innovative efforts of the SMEs from the North-East region of the country were mainly concentrated towards (see chart 3)

- The new products and services- 30,37%;
- The new technologies- 20,79%;
- The new managerial and market approaches - 19%;
- The modernization of the informatic systems- 15,70%;

- The proper and modern training of the human resources- 13,95%.

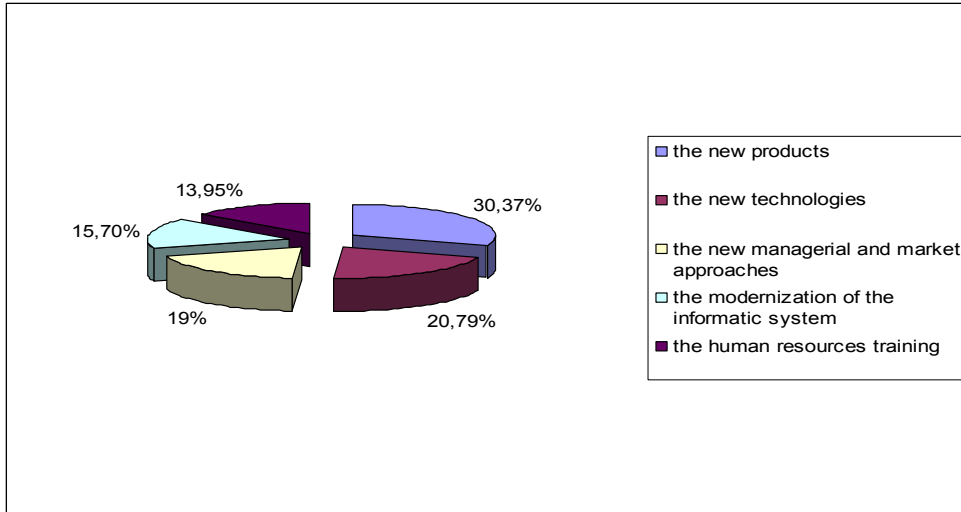


Chart no.3. The nature of the innovative activities of the SMEs from the North-East region of Romania

	The development stage from the point of view of the generation and the human capital's development
<i>The professional knowledge (A)</i>	2,98
<i>The employees' behavior(B)</i>	3,11
<i>The intellectual skills(C)</i>	3,96
THE HUMAN CAPITAL	3,35

Table no.1. The human capital's evaluation in the SMEs from the North- East region of the country

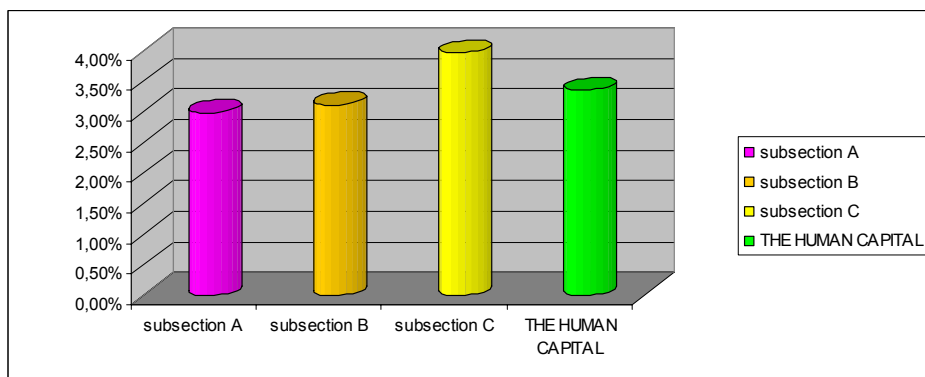


Chart no. 4. The picture of the opinions referring to the human capital's evaluation in the SME's from the North-East region.

The human capital's evaluation in the SMEs in the North East region of the country recorded a score of 3.35 and corresponds to a mature level of development.

The professional knowledge, the employees' behavior and the intellectual skills are considered as personal characteristics that employees need to perform at work related to their positions. Here, it may be included some issues such as education, technical and professional knowledge, academic qualifications, the employees' needed training and experience, the manual and intellectual skills, the interpersonal skills and leadership useful in managing teams. A vital element of the intellectual capital assessment is the need to harmonize employees' skills and attributes, except the changing demands of the position held, and by consequence, to influence their behavior. It should be noted that the employees, not the companies are the ones who own the human capital, therefore it must be beared in mind that it could be a risk that the employees leave the organization and the company have an imbalance of the intellectual capital. So, knowledge and understanding of primary factors (the professional knowledge, the employees' behavior and the intellectual skills), are the major and profound premises, underlying the human capital's evaluation

#### 4. CONCLUSIONS

According to the 361/2003/CE Recommendation, "the category of micro, small and medium enterprises (SMEs) is made up of enterprises which employ fewer than 250 people and have an annual net turnover of 50 million and / or have the total assets of up to 43 million ". (see Table 1.)

Category of enterprise	Average number of employees	Net turnover	Total assets
medium	< 250	< 50 million euro	< 43 million euro
small	< 50	< 10 million euro	< 10 million euro
micro	< 10	< 2 million euro	< 2 million euro

Table no. 1. EU recommendations on employment in the SMEs.

In Romania, in accordance with the Ordinance no.27 of 26/01/2006 to amend the Law 133/1999 on the establishment and fostering the SMEs' development, the employment is under the Recommendation 361/2003/CE.

Comparing the definition of SMEs in Romania with the EU recommendations, we noted that the harmonization of classification was made for the micro-enterprises and the SMEs. Thus, a microenterprise means a company that has a maximum of 9 employees and a turnover of more than 2 million, a small enterprise can be up to 49 employees, turnover was up 10 million euros and medium-sized enterprise is considered a company that has a maximum of 249 employees and a turnover exceeding 250 million Euro.

*The training directly refers to the learning processes, while the education also implies the skills and abilities development.* The organizations may be efficiently built or conceived as learning entitites and the learning processes, both inside the organizations and at the individual level, become able to influence the forward direction, by the means of planned interventions

For the capitalization of the opportunities and facing the challenges, the SMEs from the North-East region must have some scale actions, on multiple sides, which claim joint efforts coming from the entrepreneurs, the SMEs associations or from the part of the different international bodies or organizations.

The SMEs' and their managers made large capital investments for the future development of the employees' knowledge, using the training programmes and the continuous education programmes.

Meantime, the knowledge based developing economy encourage the employees inside the SMEs from the North-East region to emphasize on themselves, concerning the tracking of their career objectives and their professional ideals. In this environment, the vision upon the knowledge tend to be increasing egocentric. The employees inside the SMEs from the North-East region, owners of the knowledge, protect the sources of information, dedicate themselves to the continuous learning, not only for the benefit of their company, but for their personal development, for increasing their market value and, perhaps, for becoming essential for the employers. Consequently, the employee and the employer may have different perspectives upon the management and possession of knowledge and their value on the market.

Taking into account that inside the SMEs from the North-East region of the country the employees are individuals with various educational level, the knowledge management system offers a proper facilitating communication method, useful for establish a collaboration between employees, able to offer to each other the necessary information, otherwise having huge difficulties in interpersonal relationship. All these issues determine the knowledge management help to the internal harmonization and good practices. McCampbell (1999) observes that, in order to actually transfer knowledge, it becomes essential the existence of the teams, of the interpersonal and work relationships and of the networks.

The SME sector is an area of strategic interest to modern economies, being the most active sector of the economy and also a highly innovative one. Called as "the main catalyst of growth" (Drucker, 1999), this sector provides new ideas and processes, reviving the markets. The SMEs mainly target the markets niches and locations avoid by the large companies, effectively and intense exploiting them as real opportunities.

About the ways to learn, both the individual and the organizational methods, we can find some final conclusions, such as:

- The efficient individual learning is a mixed formula between the formal training and the increasing information, resulting from the daily solutions in the usual work;
- The most important capacity of the human capital inside an organization is "to know how to learn"; who is able to efficiently learn and practice this know-how, both at the group level and at the individual level, may become a good specialist, having an important status and high benefits and rewards ;
- The organizational learning processes, at the whole enterprise level, or at the sections level, maximizes by the managers' contribution and monitoring and so, they learn, on their behalf, developing themselves.

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**COMMUNICATION PROBLEMS AMONG TOURISTS AND COMMUNITY FORM  
THE TOURIST PERSPECTIVE "A CASE STUDY FORM KARAK GOVERNORATE"**

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**Abstract**

*This study aimed at recognizing the problems of communication among the tourists and the local community in Karak Governorate forms the perspective of tourists. It determined the problems that might lead to a fault in the communicative process.*

*This study is an explorative-analytical one, where it adopted the methodology of data collection and analysis to conclude findings. The researcher distributed 250 questionnaire forms, where he retrieved 220 and excluded 20 forms. This figure represented the population and sample of the study either.*

*From the perspective of tourists to the southern region there were communicative problems among the tourists and community in terms of organizational party, except the existence of tourist police at the tourism sites continuously to protect the tourist from the abuse by community individuals.*

*There were lingual problems among tourists and community besides psychological and social matters. But there were no problem for excuse in case of any mistake by the tourist.*

*The study recommended that such organizational problems should be solved, where the state should increase the figures of tourist to the southern region. The psycho-social problems should find a solution in terms of sensitive and religious aspects which might lead to misunderstanding by community and harsh the feelings of tourists besides the difficulty of building friendship relations with tourists and treat them with respect.*

**Key words:** *Communication Problems, Tourists, tourism, Community, local community, religious, organizational.*

**1. INTRODUCTION**

The communication represents an essential social need for any body that leads to interaction among individuals, groups, and countries around the world. The communication process by itself is a human activity that plays an important role in any setting either individual, group, organization or else. The human activity needs communication to integrate people with each others so as to exchange information necessary to achieve their daily goals and tasks. Therefore the communication is a vital aspect of society, community, organization and individual setting so as to run the life smoothly. (Stephne, H.1996)

The study handled this subject which is considered a critical element in the settings of life aspects. The problems among tourists and community in terms of communication may affect various aspects of life. Therefore recognition of communication problems may determine the methods and procedures of communication required to reach an appropriate state to both parties. The proper use of body language may affect positively the communication process through gestures and signs that should be understood by both parties in a proper way. (Tawfiq, A.1998)

## 2. LITERATURE REVIEW

Gunilla Berglund & Per-Olow Sjöden (1987), Communication Problems with Medical Staff: A Correlate of Distress in Cancer Patients.

Forty cancer patients, mainly with small cell lung carcinoma or carcinoid tumors were interviewed with a Swedish version of the Cancer Inventory of Problem Situations (CIPS 1). Data from the following variables will be presented: Anxiety and control in medical situations, communication problems with medical staff, emotions, worry, pain, anticipatory and post-chemotherapy nausea and vomiting and other side effects of chemotherapy. The main finding was that communication problems with medical staff correlated positively with anxiety in medical situations and with anticipatory nausea and vomiting

David H. Moreby (1990), Communication problems inherent in a cross-cultural working environment.

The globalization of shipping means that the industry needs cosmopolitan managers who can negotiate with and manage people of different cultures. The causes and consequences of cultural differences are explained in the paper with particular reference to power differentials and rule orientation. The dangers of stereotypes are highlighted. Communication problems are discussed in the context of transmitting values.

Stephne Herselman (1996), Some Problems in Health Communication in a Multicultural Clinical Setting: A South African Experience.

Because of their different perceptions and frames of reference regarding health care, it is unlikely that doctor and patient communicate with total accuracy. This situation is exacerbated if they do not share a sociocultural orientation, even though both doctor and patient apply specific strategies in attempts to overcome the barriers that prevent effective communication. This article deals with some problems that arise in a multicultural clinical setting involving a group of Xhosa-speaking patients and Western medical practitioners in South Africa, the source of the problems, and their implications for the communication process.

Jennifer L. Boothe & Joaquin Borrego Jr. (2004), Parents' Acceptance of Behavioral Interventions for Children with Behavior and Communication Problems.

The purpose of the study was to examine what parents find as acceptable treatment options for children with behavior problems in a communication disorders population. Parents' acceptability of seven treatment options, including positive reinforcement, time-out, and response cost, spanking, overcorrection, differential attention, and medication were assessed using hypothetical vignettes. Contrary to previous research which has consistently found positive reinforcement to be the most accepted treatment overall, the results indicate that response cost was the most accepted treatment for this parent population. Additionally, the results indicate that the co-existence of other clinical

problems might influence the acceptability ratings of different treatment options. The implications of these findings are discussed and direction for future research is offered.

Khawaldih (2000) study aimed at revealing the obstacles against the communicative process among public schools master, teachers, students and parents at Jerash governorate from the perspective of the schools master. The study also aimed at determining the impact of each variable of gender, education level, and experience of schools masters. The study concluded that the most harsh obstacles were related to the receiving parties (teachers, students and parents) such as the lack of parents' participation in the school activities, low motivate of parents to participate and weak communicative skills of teacher. The obstacles of communicative methods obtained the second rank due to the clack of material sources, unavailability of meeting auditorium besides the low activation of opinion and complaints process. The study also revealed the obstacles related to the sender (school master) with teachers, students and parents, and motivating them to participate which in turn affected negatively their participation in the process of decision taking. The study found no statistically significant differences ( $P < 0.05$ ) among the responses of school master about the obstacles of communication attributed to gender, qualification and experiences.

A'ayid (2004) study aimed at recognizing the administrative communication among the section chiefs at the applied education sector, and the methods to overcome them. The study sample consisted of 60 individuals of chiefs, where the questionnaire included four parts (administrative and organizational obstacles, communication channels obstacles, personal and perceptive obstacles and socio-environmental and material obstacles). The study concluded that the most severe obstacles which precluded the efficiency of administrative communication were the weak communication channels among the colleges and external parties; adoption of vertical communicative process rather than the horizontal one. The study recommended the conduction of development courses for the chiefs.

### **3. PROBLEM OF THE STUDY**

Due to the vital importance of communication problems, this study tried to investigate the problems of communication between tourists and local community at Karak governorate and determine the best methods to solve such problems. In this sense, the problems of the study were determining these problems within four aspects, the organizational, technical, socio-psychological, and material aspects.

### **4. QUESTIONS OF THE STUDY**

1. What is the degree of communication problems between tourists and Karak community from the perspective of tourists?
2. Are there essential differences in communication problems attributed to gender, age, and the origin country of tourist?

### **5. OBJECTIVES OF THE STUDY**

1. Recognize the communication problems among tourists and Karak local community by defining the problems which might distort the communication process from the perspective of the tourist in the following dimensions :
  - o organizational dimension

- customs and traditions dimension
- socio-psychological dimension
- lingual dimension

## 6. IMPORTANCE OF THE STUDY

Communication is important since it is the most effective method for interaction among individuals and group. Due to the increase rate of tourism and number of tourists to Jordan, the need arose to open channels of communication to strengthen the relations between tourists and community to the benefit of tourism and development. The importance of the study is based on:

1. It is the first study of its type-upon the knowledge of the researcher- where it recognized the problems on the communication process, therefore it presented some solutions that could reduce these problems which in turn would improve the personal, psychological and human relationship between both parties.
2. It investigated the impact of gender, age of the tourist and the period of time spent in Jordan on the problem of communication between both parties from the perspective of tourists
3. Other researchers would benefit the results to conduct more research's through recognizing the conduct conclusions and recommendation of the study

## 7. OBSTACLES OF THE STUDY

Lack of similar studies

## 8. TYPE AND METHODOLOGY OF THE STUDY

This study was an explorative-analytical one and adopted the methodology of data collection and analysis. The researcher distributed 250 forms of the questionnaire over tourists where he retrieved 220 forms and excluded 20 ones. This figure represented the population and the sample of the study alike.

## 9. STUDY HYPOTHESES:

- H1: There are no statistically significant differences among the communication problems among the tourists and community attributed to the gender variable of tourist.
- H2: There are no statistically significant differences among the communication problems among the tourists and community attributed to the gender variable of tourist.
- H3: There are no statistically significant differences among the communication problems among the tourists and community in terms of social and psychological aspect.
- H4: There are no statistically significant differences among the communication problems among the tourists and community in terms of custom and traditions aspect.

H5: There are no statistically significant differences among the communication problems among the tourists and community in terms of lingual aspect.

H6: There are no statistically significant differences among the communication problems among the tourists and community organizational aspect.

## 10. STABILITY OF INSTRUMENT

The stability of the instrument was tested by Chronbach-Alpha Coefficient where:

1. Alpha value for social and psychological aspect was 0.85
2. Alpha value for traditions and customs was 0.86
3. Alpha value for lingual aspect was 0.87
4. Alpha value for organizational aspect was 0.90
5. Alpha value for all items was 0.94

All these values were  $> 0.6$  which means that the instrument was stable as shown in table 1

Table 1: Results of Chronbach-Alpha Test for all dimensions of the study:

Dimension	Alpha value
The social and psychological dimension	0.85
The traditions and customs dimension	0.86
The lingual dimension	0.87
The organizational dimension	0.90
All items combined	0.94

## 11. DESCRIPTION OF PERSONAL AND JOB CHARACTERISTICS OF RESPONDENTS.

Table 2 describes the characteristics of tourist as follow:

- Gender  
The table shows that 58% of respondents were female tourists
- Age  
The table shows that 42% of respondents were between 36-42 years, 34% were between 18-25 while 18.5% were between 26-35 years and 5.5% of respondents were 46 years or more of age
- Monthly income  
47% of respondents obtained income between \$501-1000, while 35.5% obtained \$1001 or more and 17.5% obtained income between \$ 200-500

- Education level:

The table shows that 35% of respondents earned Bachelor, 20% earned diploma, while 19.5% earned masters and 17.5% held secondary certificate.

Table 2: Frequency, % for personal variables

Factor	Element	Freq	%
Gender	Male	84	42%
	Female	116	58%
Age segments	18-25	68	34%
	26-35	37	18.5%
	36-45	84	42%
	46+	11	5.5%
Monthly income	200-500	35	17.5%
	501-1000	94	47%
	1000+	71	35.5%
Educational level	<secondary	16	8%
	Secondary	35	17.5%
	Diploma	40	20%
	Bachelors	70	35%
	Graduate	39	19.5%

## 12. TEST AND ANALYSIS OF HYPOTHESES

H1: There are no statistically significant differences among the communication problems among the tourists and community attributed to the gender

Table 3 shows that, except for the traditions dimension, the significance levels of differences were  $> 0.05$ , which means insignificance of these dimensions; therefore no differences among such dimensions were attributed to gender. This means that both female and male respondents felt the same towards the psychological, social, lingual and organizational dimensions. The dimension of traditions and customs earned difference significance level of  $0.03 < 0.05$  which means that there were differences among female and male respondents to the favor of male respondents. Therefore, the male respondents felt the problems related to the customs and traditions more than female respondents with significance level of zero.

Table 3: Results of one sample test related to gender

Dimension	Arith mean		Sig level of		T value for diff	Sig level for t value
	M	F	M	F		
Social-psychological	3.53	3.48	0.00	0.00	0.54	0.58
Traditions	3.71	3.51	0.00	0.00	2.20	0.03
Lingual	3.64	3.62	0.00	0.00	0.14	0.88
organizational	6.52	3.62	0.00	0.00	0.97	0.33

H2: There are no statistically significant differences among the communication problems among the tourists and community attributed to the gender variable

Table 4 shows that, except the dimension of organizational problems, all significance levels were > 0.05. therefore there were no significant difference among these problems

Table 4: ANOVA test result in terms of age

Dimension	F test	Sig, level for F test of diff
The social and psychological dimension	0.46	0.75
The traditions and customs dimension	2.63	0.06
The lingual dimension	0.29	0.83
The organizational dimension	5.54	0.001

For the organizational dimension the observed significance level was 0.001 which means that there were differences among the feelings of age segments towards these problems. To detect the sources of differences table 5 shows that there were two statistical difference, the first was between the segment of (46+) and the segment of (18-25) to the favor of the first segment. The second difference was between (46+) segment and (26-35) segment to the favor of the first segment.

Table 5: Results of Tukey Test in terms of the organizational dimension.

Age segment	18-25	26-35	36-45	46+
18-25	X	X	X	X
26-35	-0.09	X	X	X
36-45	-0.30	-0.22	X	X
46+	-0.87*	0.78*	-0.57	X

H3: There are no statistically significant differences among the communication problems among tourists and community

Table 6 shows that, except items 6 and 7, all items obtained means  $> 3.00$  and significance levels  $< 0.05$ . Therefore such items were significant. Item 1, which measured the misunderstanding between tourists and community due to the difference in traditions obtained the first rank with a mean of 4.47 while item 2, which measured the inappropriateness of tourists dress to the community renditions, obtained the second rank with a mean of 3.85 and item 4, which measured the unacceptance of community to the viewpoint of tourists towards the traditions in a flexible way, obtained the last rank with a mean of 3.26 among the statistically acceptable items. Item 6, which measured community unrespect of religious beliefs of tourists, obtained a mean of 3.03 but its significance was  $> 0.05$  so it was not statically significant. Item 7, which measured the unrespect by tourists of the religious beliefs of community, obtained a mean  $> 3.00$  but it significance was  $> 0.05$  so that problem was not statistically significant. All items combined obtained an aggregated mean of 3.5 and significance level of zero. Therefore the second hypothesis was rejected which means that there were differences among the communication problems among tourists and community

Table 6: Arithmetic mean, std. dev., t value, and significance level of t value related to the traditions dimensions.

Item No	Item details	Arith mean	Std. dev	T value	Sig lev
1.	There is a misunderstanding between tourist and community as a result of difference in traditions	4.47	0.93	22.17	0.00
2.	My dress doesn't fit local traditions	3.85	1.30	9.22	0.00
3.	I feel the lack of respect to local traditions by tourists	3.27	1.64	2.28	0.02
4.	I see that community doesn't accept my viewpoint towards the traditions flexibly	3.26	1.74	2.11	0.04
5.	I feel the community doesn't respect the conditions and feelings of tourists	3.30	1.74	2.44	0.03
6.	I feel community doesn't respect the religious rituals of tourists	3.03	1.75	0.03	0.78
7.	The tourist doesn't respect the religious rituals of the community	3.16	1.73	1.30	0.19
8.	I feel the community ignores our viewpoints as tourists	3.73	1.66	6.21	0.00
All items		3.50	0.59	12.16	0.00

H4: There are no statistically significant differences among the communication problems in term of the organizational dimension.



Table 7 shows that, except item 13, all items obtained means > 3.00 and significance levels < 0.05, thus such items were statistically significant. Item 9, which measured whether the numbers of tourists outweighed the capacity of the city, obtained the first rank with a mean of 4.22. Item 11, which measured the misunderstanding between the community and tourist due to the bad behaviors of tourists such as love making and drugs, obtained the second rank with a mean of 3.72. Item 12, which measured the lack of sufficient control by authorities on the organizational procedures related to the tourism companies, obtained the last rank with a mean of 3.34. Item 13, which measured the unexistence of tourist police at the site to protect the tourists, obtained a mean of > 3.00 but the significance level was > 0.05 which means that such problem was not existed

All items combined obtained a mean of 3.60 and significance level of 0.00, therefore the fourth hypothesis was rejected, which means that there was actually significance differences related to the organizational dimension.

Table 7: Mean, std. dev., t value, and significance level related to organizational dimension.

Item No	Item details	Arith mean	Std. dev	T value	Sig lev
9.	I feel that the number of tourist to the city outweighs its capacity	4.22	1.36	12.67	0.00
10.	Tourists don't comply with the terms of travel companies to reserve the region	3.50	1.59	4.46	0.00
11.	I feel that there is a misunderstanding between tourists and community due to the bad behavior of tourists like drugs or sex	3.72	1.47	6.86	0.00
12.	There is no sufficient control by public authorities to follow up the organizational procedures that tourism companies should adopt	3.34	1.72	2.76	0.00
13.	No continuous existence of tourism police to protect tourists form abuse	3.23	1.72	1.85	0.07
14.	I feel that there is an abuse of tourist by guides	3.59	1.71	4.85	0.00
All items		3.60	0.65	12.91	0.00

H5: There are no statistically significant differences among the communication problems attributed to the lingual dimension.

Table 8 shows that all items of this dimension obtained means > 3.00 and significance levels < 0.05. Therefore these items were statistically significant. Items 18, which measured whether the language was an obstacle against the communication among tourists and local community, obtained the first rank with a mean of 3.83. Item 15, which measured the efforts made to understand conversation, obtained the second rank with a mean of 3.43. All items combined obtained a mean of 3.63 and significance level of zero. Therefore the fifth hypothesis was rejected.

Table 8: Mean, std. dev., t value, and significance level of lingual problems

Item No	Item details	Arith mean	Std. dev	T value	Sig lev
15.	I make my ultimate efforts to understand the other party	3.81	1.55	7.35	0.00
16.	When I speak I try to make my vocabularies and sentences clear and short	3.56	1.65	4.76	0.00
17	I can't estimate and understand the signs of body language and face expressions by looking at the other party	3.65	1.64	5.60	0.00
18.	The language is an obstacle against my communication with community	3.83	1.73	6.79	0.00
19.	I try to know the simplest terminologies in Arabic through books and net to deal with local community	3.50	1.58	4.43	0.00
20.	I find difficulty in conversation and communication with elders than young people	3.43	1.70	0.00	
All items		3.63	0.80	11.09	0.00

H6: There are no statistically significant differences among the communication problems attributed to the psychological and social dimension.

Table 9 shows that, except item 24, all items of the dimension obtained means  $> 3.00$  and significance levels  $< 0.05$ , thus such items were statistically significant. Item 21, which measured whether the tourists suffered from tabooed and religious subject that might lead to psychological negative influence, obtained the first rank with a mean of 4.07. Item 25, which measured the uncared by tourists to their words impact on the other party, obtained the second rank with a mean of 3.65. Item 22, which measured the difficulty of expressing the inner feeling of tourists when they were obsessed by the other party, obtained the last rank with a mean of 3.50. Item 24, which measured the excuse in case of a mistake by a person, obtained a mean of 3.20 but the level of significance was  $> 0.05$  thus this item was not statistically significant. All items combined obtained a mean of 3.58 and significance level of zero. Therefore the sixth hypothesis was rejected

Table 9: Mean, std. dev., t value, and significance level of psychological and social problems

Item No	Item details	Arith mean	Std. dev	T value	Sig lev
21.	I suffer from the sensitive and religious issues which obsess me	4.07	1.53	9.84	0.00
22.	It is difficult to express my inner feeling when I was harmed psychologically	3.50	1.56	4.50	0.00
23	I can't solve my problems with the harming person without losing my temper	3.54	1.65	4.59	0.00

24	If I committed a mistake I find it difficult to excuse	3.20	1.68	1.64	0.00
25	I don't care the impact of my words and actions on the other party	3.65	1.66	5.54	0.00
26	It is difficult for me to establish an amicable social relation with local community	3.60	1.67	5.08	0.00
27	I feel sometime that the community treat me with respect.	3.51	1.76	4.11	
All items		3.58	0.76	10.73	0.00

### 13. RESULTS AND RECOMMENDATIONS

#### 13.1. Results

1.1 There were no statistically significant differences among the lingual, psychological and organizational communication problems attributed to gender variable, but male tourist felt greater than female with the problems related to traditions.

1.2 There were no statistically significant differences among the psychological, lingual and traditions problems attributed to the age variable. There were two differences related to the organizational dimension between the segment of (46+) and both 18-25) and (26-35) segments, to the favor of the longer one.

1.3 In general there were problems related to the traditions at the south region, but there were neither problems related to the respect of tourist religious beliefs by the community nor respect of religious beliefs of the community by the tourist.

1.4 From the viewpoint of the tourists there were communication problems related to organizational dimension except for continuous existence of tourist police at the sites to protect tourists from greed.

1.5 There were lingual communication problems between tourists and community

1.6 There were social and psychological communication problems between both parties but there was no difficulty in excusing by the tourist in case of a mistake.

#### 13.2. Recommendations

2.1 Authorities should eliminate or reduce the impact of traditions problems between the community and tourists, such as the misunderstanding between both parties, inappropriateness of tourist dress to the traditions; the lack of tourist care to the local traditions, unacceptance of community to the viewpoint of tourist towards the local traditions, beside the uncare of community to the conditions and feelings of tourists, the uncare of tourist of the local beliefs of community and ignore of community to the viewpoints of tourists.

2.2 Encounter the organizational communication problems through increasing the capacity of the city to meet the increasing numbers of tourists besides imposing the terms set by travel companies to reserve the sites, and make efforts to eliminate the misunderstanding reasons represented by some bad behavior by tourists (sex and drug) in addition to establish sufficient control by authorities to follow up the organizational procedures that companies should adopt and protect the tourist from greed.

2.3 Eliminate or reduce the lingual problems through increasing the mutual understanding, conduct training programs for the community in terms of language and focus on elders to encourage them deal with tourists.

2.4 Defend the social and psychological problems especially the sensitive and religious issues which may affect negatively the tourists, and encourage establishing amicable social relations and respect with tourists.

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**INFORMATION SUPPORT OF INNOVATION DEVELOPMENT OF THE REGION  
(SIBERIAN FEDERAL OKRUG AS AN EXAMPLE)**

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**Abstract**

*Technology and Innovation Support Center (TISC) was founded on the base of the major library of Siberian region - State Public Scientific and Technical Library of the Siberian Branch of the Russian Academy of Sciences (SPSTL SB RAS) on the initiative of the World Intellectual Property Organization (WIPO). The Center's main guidelines of activity concerning activation of Russian developers including but not limited to formation of specialized funds of business, patent, scientific and technical information; specialized domestic and world resources provision, methodological and consulting assistance on the matters concerning commercialization, organization and conduction of information and educational events are set forth in the report.*

**Key words:** *innovation system of the region, information support, patent information, Technology and Innovation Support Centers.*

Considerable number of published works in media, science journals and Internet information resources are devoted to problems of innovation infrastructures development. Most authors agree that economics of developed countries of the world becomes more and more innovative. In these countries scientific and technical sphere is already practically rebuilt. Now it is aimed at demands of economic growth and economic growth depends more and more on application of scientific and technical achievements. The process of formation of national innovation system and regional innovation systems development in Russia is at the initial stage.

Traditionally innovation system means the group of organizations participating in innovation activity, efficiently cooperating with each other in the process of innovations (new knowledge) creation, distribution and use.

In the general layout of innovation system infrastructure there are several elements:

- production and technological;
- financial;
- human resources;
- marketing;
- consulting;
- information.

Speaking about information element it should be noted that in this sphere exists rather branched network of organizations including regional system of state scientific and technical information centers, structures supporting small business, regional information networks.

Increase of innovativeness and competitive recovery of home economics at national level are declared as a strategic trend of Russia development. Attempts to create integral mechanism associating science, industry and education as the base elements of innovation system are made in the last ten years. At present more than 80 science parks, still more technology and innovation support centers, more than 100 technique transfer centers, 10 national innovation analytical centers, 86 scientific and technical information centers, more than 120 business incubators, 15 innovation consulting centers and other innovation infrastructures organizations are registered in Russia. National Information and Analytical Center for Monitoring of Innovation Infrastructure of Scientific and Technical Activity and Regional Innovation Systems (NIAC for MIIRIS <http://www.miiris.ru/>) supports the information on 688 organizations of innovation infrastructure.

The most part of innovation activity takes place on the level of regions, territorial clusters and cities so institutional environment, sociocultural peculiarities, scientific, technical and industrial development level the state of educational environment affect its development to a great extent.

Two main segments are marked out in the structure of regional innovation system (RIS): knowledge creation and distribution, knowledge introduction and application.

The segment of knowledge creation is represented mainly by non-profit organizations, universities, state research institutes and research laboratories, knowledge and technique distribution establishments and agencies as well.

The segment of introduction to a great extent consists of private and commercial organizations for which competitive capacity raising and additional profit making are the main motives of innovation activity. Firms cooperate with other agencies by means of vertical and horizontal relations. Vertical relations include cooperation between a firm, counteragents and customers. Horizontal relations include cooperation of a firm with competitors and business partners.

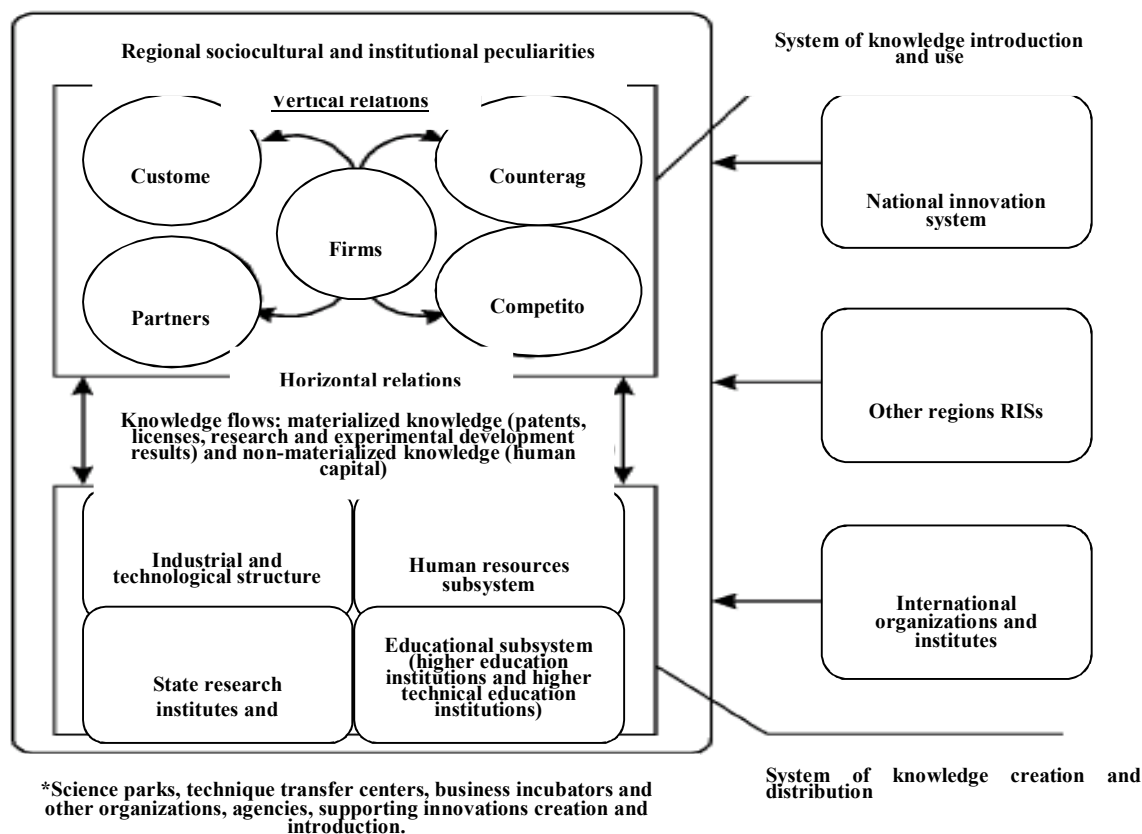
Both segments of RIS are structural elements of the national innovation system and communicate with other RISs. RIS's development level is determined by the efficiency of functioning of both segments, the grade of their integration into the national and international innovation systems (see Fig. below).

The above layout of RIS shows only the main elements. It is necessary to know the peculiarity of development of both segments of the region, working channels of knowledge transfer, regional administration possibilities and competence concerning innovation policy etc. to work out concrete measures for acting RIS formation.

In the report it is considered only one segment of RIS – knowledge creation in which the significant place take processes of information support of innovation development of a region, Novosibirsk region in particular.

Novosibirsk region is known in the country and in the world for its unique scientific and technical achievements. Higher intellectual and technological potential of the region is its main strategic resource. The base of integral innovation system is formed in the region. At present here work branches of the Russian Academy of Sciences, Academy of Medical Sciences, Academy of Agricultural Sciences, Naukograd Koltsovo (science city), branch research institutes and higher education institutions.

Figure 1. Regional innovation system structure



The industry of the region mainly consists of high-tech industry, the number of small innovation enterprises and organizations of innovation infrastructure grow year by year. The system of higher and secondary professional education, training and retraining of specialists for all spheres of activity develops at full speed. Private capital of more than 40 countries of the world is invested into the economics of the region. Consulates, scientific and technical, economic and cultural centers of different countries of the world as well as representative offices of transnational companies are opened in Novosibirsk.

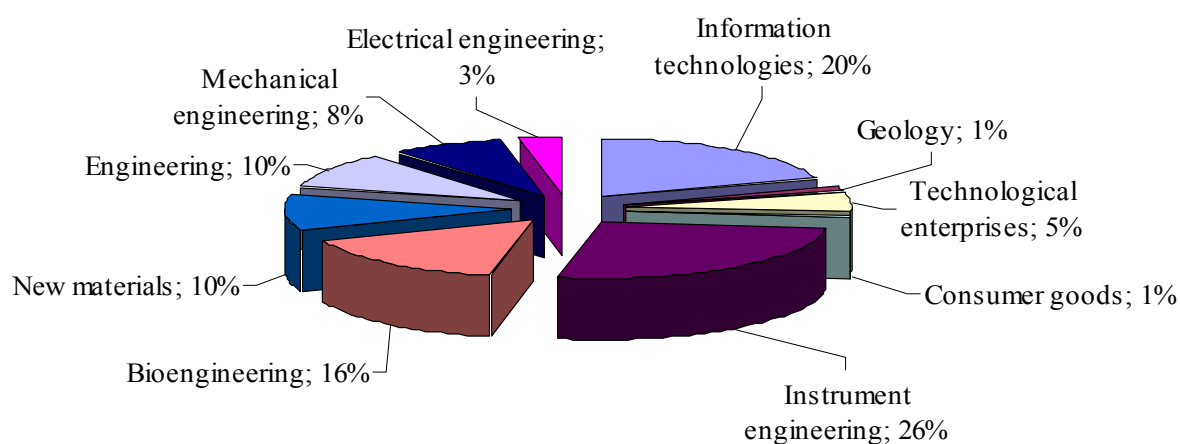
Novosibirsk Scientific Center (NSC) of the Siberian Branch of the Russian Academy of Sciences (NSC SB RAS) is represented by 39 research institutes. There are 10 research institutes of Novosibirsk Scientific Center of the Siberian Branch of the Russian Academy of Agricultural Sciences and 7 research institutes of the Siberian Branch of the Russian Academy of Medical Sciences. Higher education institutions are represented by 11 state and 15 commercial higher education institutions.

In addition to research institutions innovation industrial enterprises: small-scale, middle-scale and large-scale, which can be called the industrial sector of NSC of Novosibirsk region (NR), are engaged in research and experimental development as well as in production.

In addition to scientific-educational and production organizations there are about 300 innovation companies in Novosibirsk region such as Innovation Power Center, Ltd. (ООО «ИННОВАЦИОННЫЙ

энергетический центр»), Innovation Technological Center of Technopark «Novosibirsk» (ИТЦ Технопарка «Новосибирск»), Koltsovo Innovation Center, Technique Transfer Center of the SB RAS (ЦТТ СО РАН), Sibacademinnovatsiya Small Business Association (Ассоциация малых предприятий «Сибкадеминновация»). It should be noted that the staff of the above organizations numbers about 7 thousand persons, total annual income of these companies amounts more than RUB 11 billion, export volume – more than RUB 1,8 billion. The branch distribution of innovation companies - see diagram below.

Figure 2. Companies branch distribution



Legislative and legal base is improved, new strategic approaches in social and economic policy of the region are developed and much attention is paid to information support in order to provide more effective development of regional innovation system.

The information system based on up-to-date technology facilitating more active use of intellectual property and growth of domestic products competitiveness is created to solve actual problems of innovation activity in the region.

Speaking about intellectual activity the particular attention should be paid to patent documentation which is notable for other sources of scientific and technical information. It includes practically all fields of technique, contains up-to-date and the most prospective innovations and leaves behind all the other published works. Such features make patent information extremely valuable material for appraisal of technologies availability at the very early stage of their origination. However, great intellectual potential concentrated in the intellectual property does not find an application at first because of lack of information about it among potential users. As well as because authors themselves cannot determine correctly the form of created innovation use, choose the field of its application, circle of potential customers as a result of total unreadiness of Russian specialists for commercialization of their ideas, inability to find channels of their developments positioning.

So, one of the trends of information support improvement is the creation of complex information system integrating data bases of scientific and technical information, patent information in particular and specialized data bases containing the wide range of technical, economical and market information necessary for successful innovation activity and conduction of information and educational events of different levels.



In such conditions we are talking about active participation of libraries in implementation of government policy in the field of intellectual property (IP) closely related to the priorities of scientific and technical, innovation and industrial policy of the state, about patent information support of innovation processes at domestic enterprises and organizations, in the field of legal safety and IP commercial application as well, about formation of man's informational and patent culture which means ability to work competently and purposively with information including patent information, applying new information technologies, up-to-date technical facilities and technique in course of its creation, processing, transfer and application.

State Public Scientific and Technical Library of the Siberian Branch of the Russian Academy of Sciences (SPSTL SB RAS) being the first-rate information institution in Siberian region solves in its activity a number of major tasks which include:

- formation of patent, scientific and technical information fund;
- service organization and provision of access to information resources;
- carrying out patent research;
- training to work with patent, scientific and technical information;
- consulting and methodological assistance concerning the matters of intellectual property protection.

In addition the library organizes and conducts a great number of information and educational events providing continuous process of getting and developing different skills and knowledge.

It should be noted the great attention paid by the World Intellectual Property Organization (WIPO) to educational processes in the sphere of intellectual property which take place in different countries. Thus, in the Russian Federation by the Framework Cooperation Agreement of 10.12, 2001 concluded between Rospatent and WIPO it is provided the organization of free remote learning in Russia and also for Russian-speaking specialists in CIS countries and far abroad according to the program developed by the World Academy of WIPO "Basics of Intellectual Property". Rospatent acts as a partner and provides organization of remote learning process.

The Memorandum of mutual understanding on the matter of foundation of Technology and Innovation Support Centers (TISC) in the Russian Federation signed on September 28, 2011 became the logical continuation of the attempts of WIPO and Rospatent in the field of education and popularization of intellectual property.

The main office of TISC is situated on Rospatent premises and works as the office of TISC network in the Russian Federation. SPSTL SB RAS was chosen as the regional TISC in Siberia. The main purpose of TISC is activation of Russian developers in order to create and make the best use of the results of intellectual property. For this purpose it is assumed the solution of the following problems:

- increase of effectiveness of distribution of knowledge on the matters concerning legal protection of intellectual property results and carrying out patent research by means of remote learning and learning programs in this sphere;
- propaganda and popularization of innovation activity in society by conduction of conferences and seminars in regions.

On the base of regional TISC being created Russian developers will be provided free access to patent and nonpatent recourses of Rospatent, will be organized consulting as for the main Internetwork

accessible services concerning patent and nonpatent search that will promote successful solution of the above problems. Additional services which renders TISC will include organization and conduction of educational events on the base of modules of remote learning and learning programs.

I should like to emphasize that it is no accident that TISC is being founded exactly on the base of SPSTL SB RAS as far as over the whole period of its work the library functions as the public information and education center in the region and particularly in the sphere of intellectual property.

Information and educational events conduction experience aimed at advanced training of patent engineers and formation of information and patent culture of the region population total more than 30 years. The seminar “Basics of Intellectual Property. Patent and Information Resources” is conducted in the library since 2010. The audience may listen to lectures on intellectual property, Russian and foreign law, principles of patent and license work and patenting procedures. Special course is devoted to the role of patent information in scientific research and detailed characteristic of the world and domestic patent information flow. Master class “Patent Search” using patent resources of SPSTL SB RAS and Internet public data bases is proposed at the audience will.

Speaking about advanced training it is necessary to touch the problem connected with users’ skills and ability of electronic scientific and technical resources operation. At present the main task of the librarians is the gradual transition to service by means of electronic facilities, comfortable work sites arrangement, support and consulting of users if they work independently.

In 2010 the Young Scientists Information School was opened where in conditions of benevolent and partner atmosphere the audience is given the main user’s skills and methods of work with any one soft copy of information publication or Internet accessible resource.

In general, speaking about the above mentioned initiatives of SPSTL SB RAS it may be stated that information and educational events are aimed at formation of information knowledge system and practical mastering modern information resources and services by the audience. The lectures are free of charge. The lecturers are the leading specialists of the library.

In order to provide consulting services Virtual Inquiry Service (<http://www.spsl.nsc/win/ssl.htm>) and daily working Intellectual Property Consulting Point were set up in the library.

At present we may confidently say that the program of foundation of the network of TISCs in the Russian Federation began to become a reality. So, the first training seminar for Russian Federation regions was conducted on May 24-25, 2012 in St. Petersburg on the base of the Institute of International Business and Law (<http://www.imbip.com/>). The organizers of the seminar were World Intellectual Property Organization (WIPO), Federal Intellectual Property Service (Rospatent), Federal Industrial Property Institute (FIPI), Institute of International Business and Law of the Federal State Government Financed Education Institution of Higher Professional Education “St. Petersburg National Research University of Information Technologies, Mechanics and Optics”. The participants of the seminar have listened to the reports on the main trends of TISCs’ activity and strategy of further development of such centers in Russia. The seminar program included regional TISCs representatives training to operate information search systems. The training included practice and lectures given by the officers of WIPO and Rospatent.

Mr. Andrew Chaykovsky, the Head of Technology and Innovation Support Department of WIPO has greeted the seminar participants on behalf of WIPO. He acquainted the audience with the project, the learning program and the TISC resources. The leading specialists of the Federal Industrial Property

Institute (FIPI) acquainted the audience with the active innovation network in the Russian Federation, TISC's project implementation plans, told about remote learning courses of WIPO Academy, observed patent landscapes etc. The seminar program also included specialized representations on the following matters: patent system, the role of patent information in innovations support, main principals and types of patent search, effective strategies and instruments of patent search, international patent classification, patent and nonpatent data bases. Practical training was conducted on several search systems operation. As a result of training 32 representatives from different cities of Russia got the complex of knowledge and specialized data bases operation necessary skills. According to the main tasks of TISC these knowledge will be transferred to the population of remote regions of the Russian Federation.

In conclusion I should like to emphasize that TISC network foundation in the Russian Federation will allow its users to implement effectively the advantages of free access to patent and nonpatent information resources of FIPI as well as the other international free information resources concerning intellectual property, to get possibility of free remote learning using education modules of WIPO Academy. TISC foundation and development will also allow to strengthen domestic technological base in the whole country, activate technique interchange, activate propaganda and popularization of innovation activity in the society and exactly libraries which have rich experience of work and dispose of professional stuff are able to provide the solution of these problems.

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WIPO information on Technology and Innovation Support Centers

[http://www.wipo.int/freepublications/en/patents/434/wipo\\_pub\\_1434\\_10.pdf](http://www.wipo.int/freepublications/en/patents/434/wipo_pub_1434_10.pdf)

**A COMPARATIVE ANALYSIS OF THE APPLIED STRATEGIES FOR FISCAL POLICY  
(ADJUSTMENT AND EXPANSION EPISODES) IN EUROPEAN UNION COUNTRIES**

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**Abstract:**

*Current financial and economical context brings new challenges for most of the countries - the decrease of public revenues and the incapacity to adjust the public expenditures, caused by the economic recession and by the fiscal system structure. This article aims to identify the applied strategies for large discretionary fiscal changes - fiscal adjustments and fiscal expansions – for the period 1996-2011 in European Union countries (through changes in public revenues or public expenditures, and the effects on the economic growth process).*

*Using data for fiscal adjustments (improve of more than 1.5 percentage points of the budget balance) and for fiscal expansions (deterioration of more than 1.5 percentage points of the budget balance), there are analysed the strategies that led to this change in fiscal position and the consequences for the economic growth process of reducing/increasing the deficit.*

**Key words:** *fiscal policy, fiscal adjustment, fiscal expansions, public revenues, public expenditures*

**1. INTRODUCTION**

Current fiscal context sustain the need for fiscal adjustment, which may be obtained by increasing the public revenues or by decreasing the public expenditures (as a share in GDP). The member states of EU have serious fiscal and indebtness problems that have to be resolved through fiscal adjustments.

Stoian (2011) investigate government's reaction to increasing public debt for European Union countries, using a fiscal reaction function on annual data spanned mostly on 1980.2012.

The current economic situation at national and international level highlight the need to identify the adequate economic measures, capable to bring savings on an increasing trend and restore public balance, creating thus the prerequisites for a sustainable economic development in the medium-term (Câmpeanu, 2011).

The scope of this paper is to identify the applied strategies for obtaining fiscal adjustment (a reduction of the public deficit more than 1,5 pp) in European Union countries for the period 1996-2011, and determine if there is an "optimal" fiscal adjustment, depending on the reaction of economic growth.

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The rest of the paper is structured as follows - section 2 aims to identify the key definitions for fiscal adjustment and for adjustment's success. In Section 3 I present the empirical study on episodes of fiscal adjustment in the context of the EU27 during 1996-2011, I identify the applied strategies for adjustment and their consequences on the economic growth. Section 4 concludes and section 5 contains the bibliography.

## 2. LITERATURE REVIEW

Fiscal adjustment is described as a significant decrease of budget deficit.

In order to understand the process of fiscal adjustment, this section contains the definition of fiscal adjustment in the context of the classification of fiscal policy, the definition of the fiscal adjustment's success depending on the sustainability of deficit reduction.

### Definitions for fiscal adjustment

- Alesina, Perotti (1995) define the stance for fiscal policy depending on the changes of the budget deficit (called fiscal impulse, denoted by FI): (a) neutral if the FI is in the range (-0.5pp; +0.5pp); (b) relaxed, if FI is in the range (+0.5pp; +1.5pp); (c) very relaxed, if FI is greater than 1.5pp, (d) restrictive or moderate adjustments, if FI is in the range (-1.5pp; -0.5pp); (e) very restrictive or strong adjustments, if FI is less than -1.5pp.
- Purfield (2003) defines the very restrictive fiscal policy episode as an episode of fiscal adjustment characterized by an improvement of budget primary balance by at least 1.5 percentage points of GDP in a year or at least 1.25 percentage points of GDP in at least two consecutive years.
- Alesina, Perotti (1995) – fiscal policy is considered to be: (a) neutral if the FI is in the range ( $-\mu_i - 0.5\sigma_i$ ;  $-\mu_i + 0.5\sigma_i$ ); (b) relaxed, if FI is in the range ( $\mu_i + 0.5\sigma_i$ ;  $\mu_i + \sigma_i$ ); (c) very relaxed, if FI is greater than  $\mu_i + \sigma_i$ , (d) restrictive or moderate adjustments, if FI is in the range ( $\mu_i - \sigma_i$ ;  $\mu_i - 0.5\sigma_i$ ); (e) very restrictive or strong adjustments, if FI is less than  $\mu_i - \sigma_i$ .

### Definitions for a successful fiscal adjustment

- Alesina, Perotti (1995) define the successful fiscal adjustment as the situation in which a very restrictive fiscal policy generates gross debt ratio to GDP after 3 years lower than in the year of fiscal adjustment with at least 5 percentage points of GDP.
- Alesina, Perotti (1996) define the successful fiscal adjustment as the situation in which an episode of very restrictive fiscal policy meets the following conditions: (i) within three years after the restrictive episodes, the cyclically adjusted primary deficit is on average 2% lower compared to last year of the restrictive fiscal policy, (ii) three years after the last year of the restrictive fiscal policy, the debt to GDP is 5% below the level registered last year of the restrictive fiscal policy.
- Purfield (2003) defines a successful episode of fiscal adjustment as the situation in which the average of the general government balance after two years is at least 2 percentage points lower than in the two years preceding the adjustment.

### Definitions for expansionary fiscal adjustment

- Purfield (2003) defines an episode of fiscal adjustment as being expansionary if the average growth rate of real GDP during the adjustment period and over the next two years is at least one standard deviation above the average growth rate recorded for the country throughout the period.

In order to analyze the consequences of the fiscal adjustment process, there must be taken into consideration the following: the size of the adjustment, the applied strategy - reduced public expenditures or increased public revenues, and changed structure of public revenues and expenditures, the sustainability of fiscal adjustment, macroeconomic consequences of fiscal adjustment.

### 3. EMPIRICAL RESEARCH

In this section we analyze the periods of fiscal adjustment and identify the determinants of the likelihood of successful adjustment.

Notation for variables used is presented below:

#### *Variables for fiscal indicators:*

*balance* = public budget balance in GDP (data source: AMECO)

*exp* = public expenditures share in GDP (data source: AMECO)

*rev* = public revenues in GDP (data source: AMECO)

*debt* = general government consolidated gross debt (data source: AMECO)

#### *Fiscal adjustment indicators:*

*size* = size of fiscal adjustment, measured as the change in budget balance (delta balance)

*exp\_contrib* = proportion of fiscal adjustment achieved by diminishing expenditure to GDP  
= (- delta exp)/delta balance

*rev\_contrib* = proportion of fiscal adjustment achieved by diminishing expenditure to GDP  
= delta rev/delta balance

#### *Economic growth indicators*

*growth* = real GDP growth rate (data source: AMECO)

*gdppccp* = GDP per capita in constant price (data source: AMECO)

#### *Dummy variables*

*success* = dummy variable for success if fiscal adjustment is successful, this success is defined by the condition that a year after the adjustment the deficit remains below 3% of GDP

*dbalance\_dexp* = dummy variable for the case that the increase of the deficit (in the case of fiscal expansions) and the decrease of the deficit (in the case of fiscal adjustments) is obtained by a more increase of the public expenditures / a more decrease of the public expenditures

In this context,

$dbalance\_dexp = 1$  if  $exp\_contrib > rev\_contrib$

*expansionary* = dummy variable for expansionary aspect of a fiscal adjustment, this expansionary adjustment is defined by the condition that a year after the adjustment the growth rate is greater than in the previous year of adjustment

The database consists on countries from European Union - EU27: AT, BE, BG, CY, CZ, DK, EE, FI, FR, DE, EL, HU, IE, IT, LV, LT, LU, MT, NL, PL, PT, RO, SK, SI, ES, SE, UK. The data base contains annual data for the period 1996-2011 for EU27 countries.

For European Union countries, in the period 1996-2011, there are identified the fiscal adjustment and relaxed episodes. The methodology consists in determining the stance of fiscal policy depending on the values of fiscal impulse (changes of public deficit):

**a** - very relaxed or very expansionary, if FI is greater than 1.5pp,

**b** - relaxed, if FI is in the range (+0.5pp;+1.5pp);

**c** - neutral if the FI is in the range (-0.5pp; +0.5pp);

**d** - restrictive or moderate adjustments, if FI is in the range (-1.5pp; -0.5pp);

**e** - very restrictive or strong adjustments, if FI is less than -1.5pp.

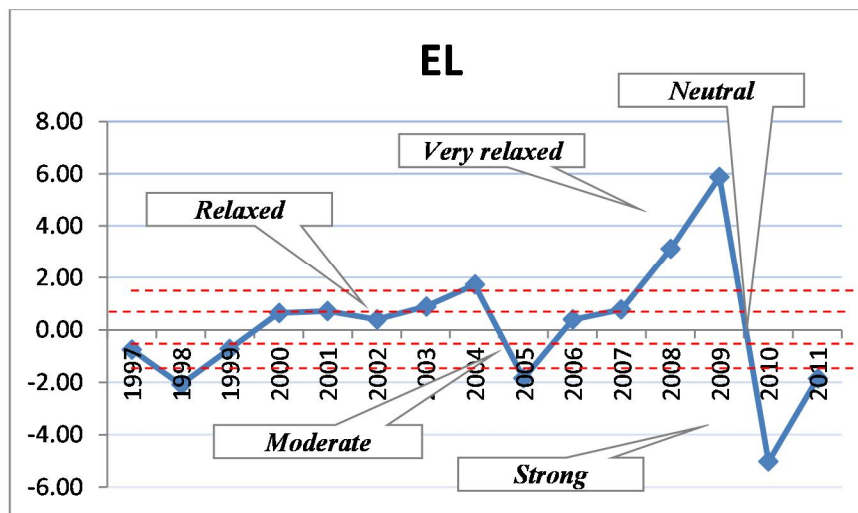
Table 1: Stance of fiscal policy in European Union countries – 1996-2011

	No.e	No.a	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<i>AT</i>	3	2	e	b	c	d	e	b	b	a	e	c	d	c	a	c	d
<i>BE</i>	3	2	e	d	c	d	c	b	c	c	a	e	c	b	a	e	d
<i>BG</i>	3	2	e	c	b	b	e	a	d	e	b	d	b	d	a	d	d
<i>CY</i>	4	5	a	d	c	e	c	a	a	e	e	d	e	a	a	d	b
<i>CZ</i>	2	2	c	b	d	c	a	b	c	e	c	d	e	b	a	d	d
<i>DK</i>	2	2	d	d	d	d	b	b	c	e	e	c	c	a	a	c	b
<i>EE</i>	3	3	e	a	a	e	c	c	d	c	c	d	c	a	d	e	d
<i>FI</i>	4	3	e	e	c	e	a	b	a	c	c	d	d	b	a	c	e
<i>FR</i>	0	2	d	d	d	c	c	a	b	c	d	d	c	b	a	c	d
<i>DE</i>	4	2	d	c	d	e	a	b	c	c	c	e	e	c	a	b	e
<i>EL</i>	4	3	d	e	d	b	b	c	b	a	e	c	b	a	a	e	e
<i>HU</i>	5	3	b	a	e	e	b	a	e	d	a	b	e	d	b	c	e
<i>IE</i>	3	5	e	d	c	e	a	b	d	d	c	d	a	a	a	a	e
<i>IT</i>	2	2	e	c	d	d	a	c	c	c	b	d	e	b	a	d	d
<i>LV</i>	2	3	e	b	a	d	d	c	d	d	d	c	c	a	a	d	e
<i>LT</i>	4	3	a	e	c	c	c	e	d	c	d	c	b	a	a	e	e
<i>LU</i>	3	4	e	c	c	e	c	a	a	a	d	d	e	b	a	c	c
<i>MT</i>	4	3	c	a	e	e	b	d	a	e	e	c	c	a	d	c	d
<i>NL</i>	1	3	d	c	d	e	a	a	b	d	d	d	c	c	a	d	d

<i>PL</i>	3	3	c	c	e	b	a	c	b	d	d	c	e	a	a	c	e
<i>PT</i>	2	2	d	c	d	c	b	d	c	c	a	e	d	c	a	c	e
<i>RO</i>	2	2	b	d	b	c	d	d	d	c	c	b	b	a	a	e	e
<i>SK</i>	4	4	e	d	a	a	e	a	e	c	c	c	d	c	a	c	e
<i>SI</i>	1	2	b	c	b	b	c	e	c	c	d	c	d	a	a	c	c
<i>ES</i>	3	2	d	d	e	c	c	c	c	c	d	d	c	a	a	e	e
<i>SE</i>	5	3	e	e	c	e	a	a	c	e	e	c	d	b	a	d	d
<i>UK</i>	3	4	e	e	d	e	a	a	b	c	c	d	c	a	a	d	d

Greece is characterized by the maximum level of public deficit for the period 1996-2011 (8,91% of GDP) and it had only 4 episodes of fiscal adjustment – in 1998, 2005, 2010, 2011.

Figure no.1: Fiscal policy in Greece



Romania had only 2 fiscal adjustments:

Figure no.2: Fiscal policy in Romania



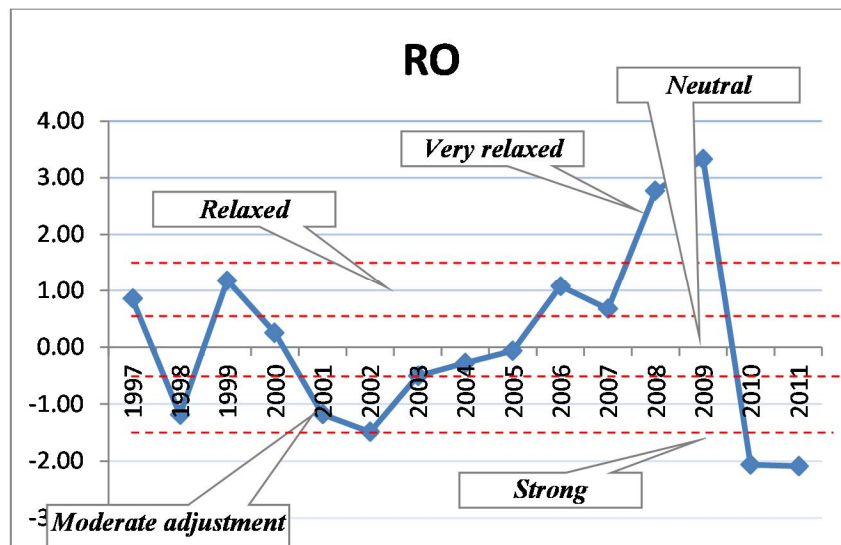
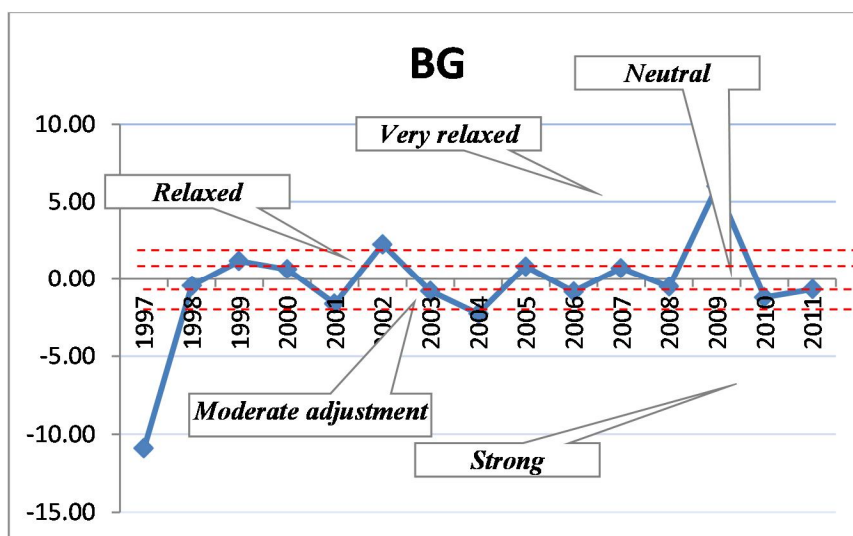


Figure no.3: Fiscal policy in Bulgaria



For these countries, in the following table there are determined the average level of total expenditures and revenues, growth rate in each of the stances of fiscal policy.

Table 2: Average levels for public revenues, expenditures and economic growth in each of the stances of fiscal policy in the selected countries – 1996-2011

<i>fiscal policy</i>	<i>balance</i>	<i>debt</i>	<i>TOTAL EXPENDITURES</i>		<i>TOTAL REVENUES</i>		<i>GROWTH RATE</i>		<i>GDP per capita PPS in CP 2000</i>			
			<i>uug</i>	<i>d_uug</i>	<i>urug</i>	<i>d_urug</i>	<i>growth</i>	<i>d_growth</i>	<i>Gdppepps</i>	<i>d_gdppepps</i>	<i>dr_gdppepps</i>	
<b><u>BG</u></b>												
a	-2.76	33.50	40.12	0.68	37.36	-3.45	-0.40	-5.60	6.00	-0.15	-1.7%	
(2)	2.22	26.67	0.79	2.41	1.43	0.24	7.21	8.63	0.26	0.62	9.8%	
b	0.44	48.71	39.57	1.49	40.01	0.66	5.73	0.33	5.97	0.15	2.6%	
(4)	0.81	30.80	1.67	2.82	1.19	2.91	0.94	0.71	0.77	0.03	0.7%	
c	1.27	79.61	39.38	6.49	40.65	6.94	4.00	9.60	5.10	-0.61	-10.7%	
(1)												
d	-0.49	22.68	37.37	-1.69	36.88	-0.89	4.20	1.76	6.36	0.07	1.2%	
(5)	2.30	12.46	1.84	1.05	2.38	0.94	2.72	2.42	0.33	0.15	2.6%	
e	1.25	69.33	37.35	-4.12	38.60	0.80	1.77	1.17	5.86	-0.40	-5.2%	
(3)	0.54	34.17	3.99	6.05	4.27	0.96	6.50	2.65	0.42	0.99	13.9%	
<b><u>EL</u></b>												
a	-11.06	114.02	50.11	2.33	39.05	-1.24	1.13	-2.60	17.38	-0.46	-2.5%	
(3)	4.27	14.80	3.96	1.34	1.43	1.30	3.20	0.96	0.83	0.97	5.5%	
b	-5.20	103.70	46.40	0.74	41.19	-0.01	4.73	0.60	17.04	0.49	3.3%	
(4)	1.35	3.83	1.16	1.92	1.64	1.96	0.79	1.52	1.03	0.64	4.3%	
c	-5.45	104.96	45.35	0.20	39.90	-0.19	4.30	1.05	17.86	0.75	4.4%	
(2)	0.81	3.35	0.21	0.58	1.02	0.58	1.27	2.62	0.71	0.04	0.1%	
d	-4.54	96.17	45.04	0.43	40.50	1.17	3.50	0.60	14.30	0.05	0.3%	
(2)	2.00	1.86	0.34	0.51	1.66	0.53	0.14	0.85	0.43	0.14	1.0%	
e	-7.29	126.09	47.46	-1.35	40.17	1.35	-0.45	-0.83	15.81	-0.24	-1.3%	
(4)	3.12	32.98	3.23	1.57	1.13	0.59	3.89	1.85	1.30	0.66	4.4%	
<b><u>RO</u></b>												
a	-7.34	18.52	40.20	1.44	32.85	-1.61	0.10	-6.70	5.62	0.30	5.6%	
(2)	2.35	7.23	1.29	0.55	1.06	0.15	10.18	10.89	0.13	0.16	3.2%	
b	-3.50	15.47	36.90	2.37	33.40	1.43	2.23	-1.08	5.53	-0.22	-2.0%	
(4)	1.10	4.31	2.18	0.87	2.31	0.83	5.96	5.17	0.44	0.83	12.8%	
c	-2.35	19.00	35.24	-0.17	32.89	-0.14	5.03	0.60	5.49	-0.37	-6.2%	
(3)	2.01	3.34	2.88	0.41	0.87	0.67	3.13	4.25	0.66	0.68	11.2%	

d	-2.55	22.22	35.11	-0.98	32.56	0.11	3.48	1.40	5.38	-0.09	-0.9%
(4)	0.96	4.06	1.21	1.52	0.44	1.64	3.73	1.94	0.43	0.79	13.3%
e	-5.90	32.50	39.86	-1.14	33.96	0.93	0.10	4.30	5.45	-0.14	-2.5%
(2)	1.48	2.06	1.47	1.33	0.00	1.31	1.98	2.12	0.04	0.13	2.2%
<b><u>UE27</u></b>											
a	-5.15	49.41	46.48	3.06	41.32	-0.69	-0.19	-3.43	19.16	-0.31	-1.7%
76 (19%)	5.12	27.72	6.00	2.81	6.20	1.39	4.74	4.41	9.88	1.23	6.0%
b	-2.65	52.65	45.65	0.90	43.00	-0.05	2.54	-0.45	17.22	0.06	0.6%
50 (13%)	2.91	29.62	5.91	1.31	6.28	1.34	3.05	2.74	8.98	0.81	5.8%
c	-1.89	48.10	44.25	-0.07	42.35	-0.06	3.76	0.68	18.95	0.34	1.6%
106 (26%)	2.82	27.66	6.39	1.27	6.50	1.27	2.58	3.16	8.74	0.64	4.0%
d	-1.88	49.92	43.98	-0.81	42.11	0.13	3.64	0.93	18.35	0.42	2.3%
94 (23%)	2.79	28.87	6.66	1.22	6.59	1.22	3.13	3.04	8.72	0.65	4.6%
e	-1.88	57.51	44.82	-2.40	42.94	0.59	3.63	1.35	17.82	0.44	2.2%
79 (19%)	3.87	30.65	6.28	2.91	7.07	1.39	2.98	3.32	8.79	0.81	4.5%

Each row contains two values: average and standard deviation for the indicator.

In the next table there are statistics descriptives for each type of fiscal policy, in the context of UE countries for the period 1997-2011:

Table 3: Statistics descriptives for each type of fiscal policy

<i>fiscal policy</i>	<i>balance</i>		<i>debt</i>		<i>TOTAL EXPENDITURES</i>		<i>TOTAL REVENUES</i>		<i>GROWTH RATE</i>		<i>GDP per capita PPS in CP 2000</i>		
	<i>balance</i>	<i>d_balance</i>	<i>debt</i>	<i>d_debt</i>	<i>uutg</i>	<i>d_uutg</i>	<i>urrg</i>	<i>d_urrg</i>	<i>growth</i>	<i>d_growth</i>	<i>gdppc pps</i>	<i>d_gdppc pps</i>	
<b><u>a (76)</u></b>													
minim	-31.31	-17.13	4.52	-13.61	33.02	-1.02	31.39	-4.17	-18.0	-17.6	5.524	-5.207	-12.79%
maxim	4.96	-1.52	129.31	29.66	66.82	17.92	56.11	4.71	7.5	6.6	49.637	2.992	20.25%
average	-5.15	-3.75	49.41	4.41	46.48	3.06	41.32	-0.69	-0.19	-3.43	19.159	-0.315	-1.71%
stdev	5.12	2.37	27.72	6.94	6.00	2.81	6.20	1.39	4.74	4.41	9.878	1.227	6.00%
<b><u>b (50)</u></b>													
minim	-9.40	-1.48	9.60	-9.51	33.35	-1.64	30.18	-2.59	-6.7	-8.1	5.118	-1.510	-17.88%
maxim	4.14	-0.51	107.42	9.53	58.16	5.39	55.37	4.67	9.8	8.3	52.266	2.420	16.49%

average	-2.65	-0.96	52.65	0.71	45.65	0.90	43.00	-0.05	2.54	-0.45	17.218	0.056	0.62%
stdev	2.91	0.28	29.62	4.03	5.91	1.31	6.28	1.34	3.05	2.74	8.983	0.810	5.84%
<b><i>c (106)</i></b>													
minim	-9.79	-0.50	3.69	-25.45	33.22	-4.57	31.69	-4.33	-1.1	-8.7	4.961	-1.089	-15.20%
maxim	6.11	0.50	114.94	13.16	58.47	6.49	58.90	6.94	12.2	11.3	47.850	3.211	11.05%
average	-1.89	0.02	48.10	-0.36	44.25	-0.07	42.35	-0.06	3.76	0.68	18.947	0.342	1.65%
stdev	2.82	0.29	27.66	4.19	6.39	1.27	6.50	1.27	2.58	3.16	8.744	0.639	3.96%
<b><i>d (94)</i></b>													
minim	-10.28	0.51	4.41	-11.22	33.04	-4.28	31.77	-3.21	-13.9	-8.8	4.867	-1.410	-20.78%
maxim	5.18	1.50	120.47	10.22	56.68	5.75	56.78	6.68	10.6	17.7	51.947	2.345	13.76%
average	-1.88	0.94	49.92	-0.66	43.98	-0.81	42.11	0.13	3.64	0.93	18.353	0.417	2.30%
stdev	2.79	0.30	28.87	3.32	6.66	1.22	6.59	1.22	3.13	3.04	8.718	0.646	4.56%
<b><i>e (79)</i></b>													
minim	-10.76	1.51	5.12	-10.52	31.18	-21.13	32.71	-2.86	-5.6	-3.2	5.424	-2.717	-21.26%
maxim	6.83	21.02	162.83	17.95	60.66	0.71	59.66	6.98	11.7	17	53.775	3.345	8.64%
average	-1.88	2.99	57.51	-0.36	44.82	-2.40	42.94	0.59	3.63	1.35	17.820	0.440	2.24%
stdev	3.87	2.63	30.65	5.00	6.28	2.91	7.07	1.39	2.98	3.32	8.793	0.806	4.51%

In this paper we intend to analyze the difference of the applied strategies regarding fiscal policy, so there is important to observe the adjustment and expansion episodes. The next table contains the periods for each type of fiscal policy – fiscal adjustment and fiscal expansions.

Table 4: Episodes of fiscal adjustment and expansions for UE27 countries – 1996-2011

	<i>Fiscal adjustments</i>	<i>Fiscal expansions</i>
	<i>d_balance &gt; 1,5pp</i>	<i>d_balance &lt; -1,5pp</i>
AT	1997, 2001, 2005	2004, 2009
BE	1997, 2006, 2010	2005, 2009
BG	1997, 2001, 2004	2002, 2009
CY	2000, 2004, 2005, 2007	1997, 2002, 2003, 2008, 2009
CZ	2004, 2007	2001, 2009
DK	2004, 2005	2008, 2009
EE	1997, 2000, 2010	1998, 1999, 2008
EL	1997, 1998, 2000, 2011	2001, 2003, 2009
ER	-	2002, 2009
DE	2000, 2006, 2007, 2011	2001, 2009
EL	1998, 2005, 2010, 2011	2004, 2008, 2009
HU	1999, 2000, 2003, 2007, 2011	1998, 2002, 2005

IE	1997 2000 2011	2001 2007 2008 2009 2010
IT	1997 2007	2001 2009
LV	1997 2011	1999 2008 2009
LT	1998 2002 2010	1997 2008 2009
LI	1997 2000 2007	2002 2003 2004 2009
MT	1999 2000 2004 2005	1998 2003 2008
NI	2000	2001 2002 2009
PI	1999 2007 2011	2001 2008 2009
PT	2006 2011	2005 2009
RO	2010 2011	2008 2009
SK	1997 2001 2003 2011	1999 2000 2002 2009
SI	2002	2008 2009
ES	1999 2010 2011	2008 2009
SE	1997 1998 2000 2004 2005	2001 2002 2009
UK	1997 1998 2000	2001 2002 2008 2009

In the next table there are registered the number of episodes for each type of fiscal policy and the structure depending on their success, expansionary characteristics and the expenditure contribution for fiscal position.

Table no. 5: Episodes for each type of fiscal policy

success	expansio	nary	dbalance_	dexp	Fiscal expansions (very relaxed)		relaxed		neutral		moderate adjustments		strong adjustments	
					no.	%								
					76	100%	50		106		94		79	
1					22	28,95%	19	38%	64	84.21%	63	67.02%	51	67.11%
0					54	71,05%	31	62%	42	39.62%	31	32.98%	28	35.44%
1	1				12	15.79%	11	22%	30	39.47%	44	46.81%	36	47.37%
1	0				10	13.16%	8	16%	34	44.74%	19	20.21%	15	19.74%
0	1				44	57.89%	19	38%	25	32.89%	20	21.28%	21	27.63%
0	0				10	13.16%	12	24%	17	22.37%	11	11.70%	7	9.21%
1	1	1			3	3.95%	4	8%	17	22.37%	33	35.11%	26	34.21%
1	1	0			9	11.84%	7	14%	13	17.11%	11	11.70%	10	13.16%
1	0	1			4	5.26%	6	12%	19	25.00%	12	12.77%	9	11.84%
1	0	0			6	7.89%	2	4%	15	19.74%	7	7.45%	6	7.89%
0	1	1			8	10.53%	7	14%	11	14.47%	11	11.70%	12	15.79%
0	1	0			36	47.37%	12	24%	14	18.42%	9	9.57%	9	11.84%
0	0	1			1	1.32%	4	8%	11	14.47%	7	7.45%	4	5.26%
0	0	0			9	11.84%	8	16%	6	7.89%	4	4.26%	3	3.95%

1		56.00	73.68%	30	60%	55	72.37%	64	68.09%	57	75.00%
0		20.00	26.32%	20	40%	51	67.11%	30	31.91%	22	28.95%
1	1	11	14.47%	11	22%	28	36.84%	44	46.81%	38	50.00%
1	0	45	59.21%	19	38%	27	35.53%	20	21.28%	19	25.00%
0	1	5	6.58%	10	20%	30	39.47%	19	20.21%	13	17.11%
0	0	15	19.74%	10	20%	21	27.63%	11	11.70%	9	11.84%
	1	16	21.05%	21	42%	58	76.32%	63	67.02%	51	67.11%
	0	60	78.95%	29	58%	48	63.16%	31	32.98%	28	36.84%

Analyzing the situations of fiscal expansions in European Union 27 countries, there can be observed the overall situation, regarding the success (success = dummy variable for success, depending on the condition that for the next year the deficit remains below 3% of GDP), the effect on economic growth (expansionary = dummy variable for expansionary aspect, defined by the condition that for the next year the growth rate is greater than in the previous year of adjustment) and the applied strategy for fiscal policy (exp\_contrib = proportion of balance change achieved by expenditure to GDP =  $(-d\_exp)/d\_balance$ ).

From the total fiscal expansion episodes, 28,95% had success, respectively one year after the adjustment the deficit remains below 3% of GDP, 73,68% were expansionary (a year after the adjustment the growth rate is greater than in the previous year of adjustment) and 78,95% had been realized through greater public revenue than the public expenditure adjustment (the total fiscal impulse is influenced more of public revenue decrease than public expenditure increase).

From the total fiscal adjustment episodes, 64,56% had success, respectively one year after the adjustment the deficit remains below 3% of GDP, 60,76% were expansionary (a year after the adjustment the growth rate is greater than in the previous year of adjustment) and 64,56% had been realized through greater public spending than the public revenue adjustment (the total fiscal impulse is influenced more of public expenditure decrease than public revenue increase).

In the next table there are registered the episodes of fiscal expansions and their characteristics: success vs. no succes, depending on the condition that a year after the adjustment the deficit remains below 3% of GDP, expansionary vs. contractionary, depending on the condition that a year after the adjustment the growth rate is greater than in the previous year of adjustment and adjustment realized through expenditures vs. revenues.

Table 6: Fiscal expansions

- successful and unsuccessful, expansionary and contractionary characteristics

<i>Success</i>	<i>1</i>	<i>0</i>		
<i>expansionary</i>			<i>1</i>	<i>0</i>
<i>no</i>	<i>22</i>	<i>54</i>	<i>16</i>	<i>60</i>
size	-3.09	-4.02	-4.01	-3.68
exp_contrib	0.60	0.83	0.65	0.80
growth (t+1)-(t-1)	-2.48	-3.82	1.46	-4.76

growth (t+1)	0.74	-0.58	3.88	-1.3
d_gdppcps (t+1)-(t-1)	-0.274	-0.331	0.456	-0.520
dr_gdppcps ((t+1)-(t-1))/(t-1)	-0,91%	-2.04%	1.41%	-2.55%
exp	46.75	46.37	47.22	46.28
d_exp	2.21	3.41	3.40	2.97
rev	45.78	39.51	41.02	41.41
d_rev	-0.88	-0.62	-0.61	-0.71

Comparing the successful with the unsuccessful episodes of fiscal adjustment, there can be noticed that in the case of the first one (a year after adjusting the deficit remains below 3% of GDP): the size of the fiscal expansion is smaller, and the contribution to the public deficit increase of public expenditures is smaller, economic growth (measured by the growth rate and of the value and the change of GDP per capita in constant price in PPS) is greater, public expenditures are similar but the expenditure expansion is smaller, public revenues are greater and the revenue adjustment is greater.

Comparing the expansionary with the contractionary episodes of fiscal adjustment, there can be noticed that in the case of the first one (a year after the adjustment the growth rate is greater than in the previous year of adjustment): the size of the fiscal expansion is greater, and the contribution to the public deficit change comes more from decrease of public expenditures in the case of non-expansionary episodes, economic growth (measured by growth rate and GDP per capita in constant price in PPS) is greater, public expenditures are greater and the expenditure expansion is greater, public revenues are smaller and the revenue adjustment is smaller.

In the next table there are registered the episodes of fiscal adjustments and their characteristics: success vs. no success, depending on the condition that a year after the adjustment the deficit remains below 3% of GDP, expansionary vs. contractionary, depending on the condition that a year after the adjustment the growth rate is greater than in the previous year of adjustment and adjustment realized through expenditures vs. revenues.

Table 8: Fiscal adjustments

- successful and unsuccessful, expansionary and contractionary characteristics

<i>Success</i>	<i>1</i>	<i>0</i>		
<i>expansionary</i>			<i>1</i>	<i>0</i>
<i>no</i>	<i>51</i>	<i>28</i>	<i>51</i>	<i>28</i>
size	2.8	3.32	3.33	2.36
exp_contrib	0.77	0.76	0.79	0.73
growth (t+1)-(t-1)	1.40	1.25	2.58	-1.07
growth (t+1)	4.41	2.1	3.83	3.24
d_gdppcps (t+1)-(t-1)	0.569	0.206	0.425	0.468

dr_gdppcpps (((t+1)-(t-1))/(t-1))	2.64%	1.51%	2.28%	2.16%
exp	44.65	45.14	43.99	46.34
d_exp	-2.16	-2.82	-2.73	-1.78
rev	44.81	39.54	42.29	44.13
d_rev	0.64	0.50	0.59	0.59

Comparing the successful with the unsuccessful episodes of fiscal adjustment, there can be noticed that in the case of the first one (a year after adjusting the deficit remains below 3% of GDP): the size of the fiscal adjustment is smaller, but the contribution to the public deficit reduction from decrease of public expenditures is similar, economic growth (measured by the growth rate and of the value and the change of GDP per capita in constant price in PPS) is greater, public expenditures are smaller and the expenditure adjustment is smaller, public revenues are greater and the revenue adjustment is greater.

Comparing the expansionary with the contractionary episodes of fiscal adjustment, there can be noticed that in the case of the first one (a year after the adjustment the growth rate is greater than in the previous year of adjustment): the size of the fiscal adjustment is smaller, but the contribution to the public deficit reduction is more from decrease of public expenditures, economic growth (measured by growth rate and GDP per capita in constant price in PPS) is greater, public expenditures are greater and the expenditure adjustment is greater, public revenues are smaller and the revenue adjustment is smaller.

Obreja Braşoveanu, L. (2011) obtains empirical results that sustain that the probability of success is determined by a complex set of factors: the size of the consolidation effort (significant adjustments should be more successful in supporting deficit reduction, while representing a signal change in regime, maintaining policy credibility and irreversibility) and the need of fiscal adjustment (the necessity of applying an adjustment should significantly influence the credibility of the changes).

#### 4. CONCLUSIONS

Analyzing the situations of fiscal expansions in European Union 27 countries, 28,95% from the total expansion episodes had success, respectively one year after the adjustment the deficit remains below 3% of GDP, 73,68% were expansionary and 78,95% had been realized through greater public revenue than the public expenditure adjustment.

From the total fiscal adjustment episodes, 64,56% had success, 60,76% were expansionary and 64,56% had been realized through greater public spending than the public revenue adjustment.

Comparing the successful with the unsuccessful episodes of fiscal adjustment, there can be noticed that in the case of the first one the size of the fiscal expansion is smaller, and the contribution to the public deficit increase of public expenditures is smaller, economic growth is greater, public expenditures are similar but the expenditure expansion is smaller, public revenues are greater and the revenue adjustment is greater.

Comparing the expansionary with the contractionary episodes of fiscal adjustment, there can be noticed that in the case of the first one the size of the fiscal expansion is greater, and the contribution



to the public deficit change comes more from decrease of public expenditures in the case of non-expansionary episodes, economic growth is greater, public expenditures are greater and the expenditure expansion is greater, public revenues are smaller and the revenue adjustment is smaller.

Comparing the successful with the unsuccessful episodes of fiscal adjustment, there can be noticed that in the case of the first one: the size of the fiscal adjustment is smaller, but the contribution to the public deficit reduction from decrease of public expenditures is similar, economic growth is greater, public expenditures are smaller and the expenditure adjustment is smaller, public revenues are greater and the revenue adjustment is greater.

Comparing the expansionary with the contractionary episodes of fiscal adjustment, there can be noticed that in the case of the first one: the size of the fiscal adjustment is smaller, but the contribution to the public deficit reduction is more from decrease of public expenditures, economic growth is greater, public expenditures are greater and the expenditure adjustment is greater, public revenues are smaller and the revenue adjustment is smaller.

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**THE AGRO-TOURISM INFLUENCE ON PROCESSES OF FORMATION, DEVELOPMENT  
AND RESTORATION OF THE HUMAN CAPITAL OF REGIONAL ECONOMY**

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**Abstract**

*In the article the positive effects development of agro-tourism in the field of formation, development and restoration of human potential and the human capital of the region, especially at rural territories are considered. Definitions of terms «formation, development and restoration of human potential and the human capital of the region» are given. Specific problems of the human capital of Russian rural regions are represented. There is the analysis of positive experience of state support of rural tourism in some other countries. The perspective directions of state support of agro- tourism development in the Russian regions are marked. The article pay attention to the agro- tourism influence on the social support of unprotected people.*

**Key words:** *rural tourism, human capital of the region, human potential of the region, formation, development and restoration of human potential and the human capital state support of rural tourism.*

**1. INTRODUCTION**

A key factor of a sustainable development of modern social and economic systems is the human capital of high quality, which is created under the influence of certain conditions of formation, development and restoration, taking into account specific features of regional economy. Thus the human capital is based on human potential of the region. Therefore the most important problem of regional and municipal government is to search the mechanisms of effective solution, which can help to improve the quality of human potential and human capital. Development of rural tourism could become one of such effective mechanisms, in our opinion.

**2. DEFINITIONS**

In this article we consider *human potential* as the set of attributive signs and qualities of the person which, under certain conditions, become tools of purposeful activity on creation of the benefits and services. The *potential labor* is the human potential offered on a labor market. The *functional labor* is the part of the potential labor which is recognized by employer. Then the *human capital* can be considered as the set of potential and functional labor of the person, which is being shown through interaction with the employer.

*Formation of the human capital* in the region is a purposeful process of influence of local authorities and other organizations of the region on the personality during which it acquires knowledge, skills and the abilities. This influence allows the person to offer potential labor on a labor market.

*Development of the human capital* in the region is a process of influence of local authorities and other organizations of the region on the personality included into the economic relations during which cost of its functional labor increases.

*Quality of human potential* is the level of professional and personal qualities (including both physical, and spiritual components) of the person; this level characterizes the possibility of participation in processes of a social production, and also in cultural and public life.

Quality of the human capital is level of professional and personal qualities of the person defining productivity of his work and possibility to form the added cost in economic system.

The special place in regional social and economic system is occupied by questions of *restoration of the human capital*.

It is necessary to agree with the approach given in work of Kotov T.M. and Sharafanova E.E. According to these authors, the qualification and abilities of economically active population are the specific form of the human capital, which (similarly for material factors of production) are formed as a result of certain investments. I.e. the human capital are subject to wear and need a restoration (renovation), which can be carried out only under condition of interaction of regional and local authorities, enterprises and public organizations [1].

The regional conditions (which impact on quality of human potential and capital), are highly differentiated in regions of Russia. It is connected with objective factors (different natural resources, structure of production and structure of a manpower, national and cultural traditions, mentality, ecological conditions, etc.), and with subjective factors (low efficiency of both regional policy of the federal center, and regional social and economic policy of local authorities).

But non-uniformity of territorial development also exists at intra regional level. First of all, here it should be noted problems of the rural territories (particularly remote from the regional centers and the cities) where it develops stably low level and quality of life, i.e. negative conditions of formation, development and a renovation of the regional human capital.

The integrated, general characteristic of conditions of formation and development of the human capital is *quality of life* of the population of the region, this category includes parameters of activity of local authorities, and also other regional organizations which defines: quality of the biological environment of formation of the personality; level of protection of motherhood and childhood; education system condition; degree of a criminality of society; ethical and esthetic standards of society; a production and consumption level in the region.

### **3. AGRO-(RURAL) TOURISM AND HUMAN CAPITAL: DIRECTIONS OF IMPACT**

The sharp problem of Russian regions is how to overcome poverty which for the majority of rural territories has almost comprehensive character, and the poverty is constantly reproduced. Researchers note that in regions it is necessary to organize system work of social and economic institutes in the field of overcoming of economic poverty (caused by unemployment and low level of a salary) and social poverty (poverty of socially vulnerable groups of the population) [2].

For rural territories in the conditions of decline of activity of traditional forms of agricultural production the problem of employment and providing the minimum income practically is solved at the expense of a personal part-time farm. It leads to devaluation of value of honest work, education at younger generation, distorts their system of vital reference points. The human potential of this

generation considerably degrades. The human capital (formed on the basis of the human potential of low quality) isn't capable to participate in the solution of problems of innovative development of economy. Moreover, this part of the population frequent becomes incapable to use «social lifts» (for passing from one social group to another), and poverty is restoring itself, becomes chronic. Therefore it is possible to tell, in great extent, that for rural territories actual task is not improvement of quality of the human capital, but prevention of its further degradation.

According to the necessity of complex solution of these problems, there are good perspectives of development of rural tourism. As it is noted in M.A.Belova and O. S. Komova's work, objects of rural tourism can be: the rural real estate (the house in rural areas with the isolated rooming house and kitchen); country farm; the tourist centers which are focused on use of tourist's resources of rural areas; agricultural parks (agro-parks); agricultural objects (farms, apiaries, fishing farms, etc.); historical objects (noble and merchant real estates, monasteries etc.); the stylized means of placement (the agro-tourist village, a hunting lodge etc.); the restored historical houses (the historical village, the national village, settlements, etc.) [3].

From the point of view of influence on human potential and the human capital, rural tourism:

- 1) Promotes creation of new workplaces, employment of the indigenous rural people in service of tourists. Possibilities of employment of women, including women with small children, and people of advanced age thus increase.
- 2) Creates obstacles for youth outflow from rural areas, forming social prospects.
- 3) Raises revenues of local budgets, and also the population income.
- 4) Promotes transition from in fact natural economy (when the population lives at the expense of a personal part-time farm) to obtaining the income in a monetary form, therefore, increases access of rural dwellers to social and cultural values, to health care services.
- 5) Forms a mini-cluster around objects of agro-tourism (excursion, national crafts, non-polluting agricultural production, transport service, bathing complexes, dining rooms, etc.), that is creates intra regional points of growth. Combined types of tourism (for example, together with sports, extreme, informative, etc. can develop.
- 6) Forms healthy forms of leisure for indigenous people.
- 7) Gives social prospects to children, promotes increase of a demand of education.
- 8) Promotes a sustainable development of the territory (balanced development of the social, economic and ecological sphere) at preservation of a habitual way of life.

I.e. the human potential not only remains, but also gets a growth vector, forming the high quality of human capital.

#### **4. DIRECTIONS OF THE STATE SUPPORT OF AGRO (RURAL) TOURISM**

It is necessary to note the main problems for development of agro-tourism in the Russia:

1. Absence of the national conceptual document which defines the directions of development of rural tourism.
2. Non-system state federal and regional policy in the sphere of agro-tourism and, respectively, systems of law for regulating this kind of activity.

3. Absence of the special federal legislation regulating activity in the field of rural tourism in the Russian Federation.

4. Lack of standards of a regulating sphere of rural tourism as special sector of the tourist's industry. It is necessary to emphasize that state demands for hotel business and recreational business are not suitable for the sector of small family hotel business owing to specifics of the last.

5. Lack of qualified personnel

6. Absence of knowledge and experience in the field of service of foreign and domestic tourists.

7. Lack of knowledge and information about own recreational resources.

8. Weak information and marketing support of enterprises of rural tourism.

9. Lack of knowledge and information about positive foreign experience.

10. Underestimation of possibilities of rural tourism in ensuring social protection of socially unprotected segments of the population

Thus, realization of potential of rural tourism is possible only with active support of the state, first of all, in the following directions.

First, infrastructure objects (roads, etc.) can't be constructed by strengths of locals, and also at the expense of local budgets owing to their low fullness. Support from the regional authorities is possible only in rich regions. That is why the federal program of support of rural tourism (or, other program and target forms of support, for example, the subprogramme of the national project on development of rural areas) is necessary.

Secondly, it is necessary to give support in area of creation of the special legislation and the regulations for effective organization of rural tourism (and, probably to use certain privileges).

Thirdly, support in the field of professional development and training of the personnel occupied in the sphere of rural tourism is expedient.

Fourthly, it is necessary to form system of grants and credit support of rural dwellers, farms, the travel agencies which are developing the directions of rural tourism, including microcrediting and subsidizing of interest rates.

At last, information support of advance of products of rural tourism at interregional and intercountry level, promoting of objects of rural tourism is necessary.

These measures can be effectively realized under conditions of:

- active interaction of authorities of federal, regional and municipal levels, associations of rural tourism, the Russian union of the tourist's industry and other non-profit organizations,
- the developed interregional and international cooperation.

## 5. THE POSITIVE FOREIGN EXPERIENCE

Let's note that rural tourism in the countries of Europe has the development from 70th years of the last century, and quite extensive experience of activity in this sphere now is accumulated, volumes of providing such tourist's services make today 10-20 % in total amount of services of the tourist's industry. Businessmen in the sphere of rural tourism, as a rule, can use tax privileges (for example,

business can be released from taxes at whole if the quantity of rooms for leasing doesn't exceed five, also the long-term practises –tax exemption till forty years), a number of programs of microcrediting is focused on them.

The rural tourism is recognized at the former Soviet Union as the perspective direction. For example, there is high rate of growth of rural tourism in Belarus where in 2006 the special Decree of the President «About measures for agro-eco-tourism development in Republic of Belarus» (the term agro-eco-tourism corresponds to concept of rural tourism) was adopted. Now there are over 700 houses in Belarus which are accepting agro-tourists. Such activity is connected with the opinion of the World tourism organization. This organization recognized that rural tourism can become a niche in the tourist market for Republic of Belarus which can bring success and social results.

In Belarus the procedure of rendering of services in the sphere of agro-tourism has the simplified character. So, the individuals who are constantly living in rural areas or small city settlements and are having a personal part-time farm, and also farmer farms have the right to carry out activities for producing services in the agro-eco-tourism sphere. Requirements are following:

- to pay collecting for activity in the fields of rendering services in the agro-eco-tourism sphere;
- to submit the written application in any form to local authorities about intention to carry out activities for producing services in the agro-eco-tourism sphere, with the information: A full name of the applicant, the name and the house address, quantity of the rooms which are planned for leasing, existence of conveniences;
- individuals in addition submit to tax authority in a residence the application for account.

Collecting has symbolical character. For activity implementation in the sphere of agro-tourism it is not required special permission (license). Besides, there are special credit programs of support of agro-eco-tourism [4].

The Belarusian researchers note that the majority of owners of houses lack knowledge of a new kind of activity therefore it is necessary to develop the system of training seminars, including connected with foreign experience of rural tourism [5].

## 6. TENDENCIES AND PERSPECTIVES

It should be noted that in the Russian conditions rural tourism actively develops. Among regions of the Russian Federation in this regard it is possible to call the Kaliningrad, Pskov, Leningrad areas, the Republic of Karelia, the Republic of Bashkortostan and some other. According to Association of assistance to agrotourism development "Agroturizm Assotsiatsiya", now there are such data on quantity of guest houses on federal districts: Far East-70, Volga – 135, Northwest - 81, North Caucasian – 12, Siberian-344, Ural – 48, Central – 151, Youzhny – 222 houses [6].

It is useful to mark some positive tendencies.

.....1.Now the federal target program «Development of internal and entrance tourism in the Russian Federation (2011-2016)» on the basis of the offers presented by regions of the Russian Federation is developed.

.....2. In Russia there were appeared the associations which activity is directed on advance of rural tourism: Association of development of agrotourism (АгроТуризмАссоциация); Association of owners of rural real estates (Republic of Karelia).

Aims of Association of development of agrotourism are the expansion of cooperation with the organizations interested in development of rural, agrarian tourism in regions, also identification and establishment of business contacts to agrotourist country farms, informational support of agro-tourism activity.

....3. Tens projects of agro-tourism are already realized In Russia . For example, «The road to the house» (Leningrad region) «The green house» (Mountain Altai), the so-called B&B network (Pribaikalye). There is an experience in the fields of the organization of the agrotourist enterprises on such models, as "board", «around the nomadic traditional dwelling», «the national village», «rural hotel», «the guest house» and others.

....4. The numerous of international conferences, seminars, master-classes concerning agro-tourism are organizing in the Russian regions.

In the Leningrad region the development of rural tourism is considered as one of the priority directions of tourist activity. According to an official site «Tourism in the Leningrad region», rural tourism develops most actively in Luga, Tikhvin, Priozersk areas [7]. The question of development of special system of privileges for businessmen in the field of rural tourism is considered. So, the regional authorities of the Leningrad region proposed release from a tax on the income of individuals and the earth of owners of guest lodges (term of granting a privilege – five years) that, respectively, demands legislative definition of concept «the rural house for guests» [8].

However still offers are mainly focused on the provided, middle class which wants to receive certain non-standard services with national color. If the cheap, budgetary options of accommodation is offered, there is no additional services (animation, feeding of animals, excursions and т.п). It promotes development of human capital of rural territories only in a small extent.

We think, that formation of zones of economic rest for families with children will allow to solve a problem of improvement of quality of human potential and restoration of the human capital of citizens with limited means. It is possible under condition of the state support. It became especially actual in connection with reducing of demand of the population during the post-crisis period, which caused reorientation of a choice of vacation spots to territories within the country. As a whole the combined forms of rural and social tourism could become the priority direction of support from the state.

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**CHANGES IN INSTITUTIONAL SUPPORT EMPLOYMENT  
IN THE CZECH REPUBLIC IN RECENT YEARS**

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**Abstract**

*The text aims to identify changes that occur in the last few years (since 2006) in labor, personnel management and labor market in the Czech Republic. Based on the statistics state that economic development since 2006 was not accompanied by any significant changes in employment, which could be characterized as qualitative breakthroughs. Trends in the labor market, employment and human resources there are have a relatively long history and are not caused by the unfavorable economic situation in the Czech Republic and other countries.*

**Key words:** *employee, labor market, personnel management, economic crisis.*

**1. INTRODUCTION**

How has changed the human resource management in recent years? How has reflected it in the time of economic stagnation of recent years? Crisis occurs due to significant qualitative changes in the staffing business operation? These are issues that are current and we would like to contribute to the answers. This article is the part of result presentation of the project The crucial aspects of the development of business competitiveness of national economies in the global economic systém IGA 02 VSE TD010093.

**2. CHARACTERISTIC OF ECONOMIC DEVELOPMENT IN THE CZECH REPUBLIC AND LABOR MARKET DEVELOPMENTS SINCE 2008**

In the 2009 year the Czech economy to a decline in economic results and since then the situation has not significantly improved. In any case it is not possible to say that would be a significant economic boom started, the first about 2011, speaks of a lower value than in 2010 and first quarter of 2012, a decrease -1 percentage point.

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
3,1	2,1	3,8	4,7	6,8	7,0	5,7	3,1	-4,7	2,7

Table 1 Growth of the Czech Republic GDP in constant prices (source: czso.cz)

For this reason, many economists talk about a tipping point, a milestone in the development of the economy or the need for a new perspective on the economy. This is obviously a question. If we consider the conditions of specific organizations in the field of personnel management, it is a rapid and large changes in order to talk about the qualitative turnover?

When comparing data on economic growth and CR data on unemployment shows that the lower economic performance brings higher unemployment and vice versa growth performance is associated with a decline in unemployment, even though logically easily justifiable certain time lag.

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
8,13	7,28	7,78	8,30	7,93	7,14	5,32	4,39	6,66	7,3

Table 2 Unemployment in the Czech Republic from 2001 to 2010 (source: czso.cz)

The lowest unemployment in that period was in 2008, it is two years after the highest GDP growth in 2006. Also, other statistics reveal the extraordinary recent developments (talking about the current crisis) or a dramatic drop in employment and occupation.

The dramatic change in status of employees can testify inflation rate. High level of moth bring real decline in revenue and depreciation savings. As is evident from the values in the table below does not show the evolution of inflation and the state of the radical deterioration of 2008, excluding them from the more favorable terms than in the pre-crisis period.

2006	2007	2008	2009	2010
2,5	2,8	6,3	1,0	1,5

Table 3 Inflation in the Czech Republic from 2006 to 2010 (source: czso.cz)

Even in household income can not identify signs of dramatic change. It is listed in the table structure of employees by salary. A very important consequence of the crisis and possible measures to eliminate the difference can be considered an increase in income and especially massive increase in the proportion of people with low incomes and reducing the number of people with higher and higher incomes. If apart from the overall level of income and what you can get for these revenues, data show overall favorable trend.

The values in the table clearly shows that reducing the proportion of people with incomes up to 20 thousand Czech crowns and increase the groups with higher proportions (20 to 30 000 and 30 to 40 thousand CZK) and highest (over 40 000 CZK) income. If we have characterized the situation only through the prism of a shift in income groups, despite the crisis can be recorded favorable development direction changes.

To assess the impact of the economic downturn on the status of employees and their standard of living is of course essential that the fact that we had previously excluded from consideration. This is what living man and his family provided his income. But this is a psychological problem (what I want, what I need) and the problem of social and cultural (what is considered normal like and what needs are

produced in a given society). Unfortunately, the facts about these statistics do not tell, or only a very limited extent. You can find some information that can characterize the status of employees?

	2006	2007	2008	2009	2010
Do 10 000	5,62	3,87	3,20	3,02	3,03
10 001 – 12 000	7,02	5,66	4,71	4,69	4,49
12 001 – 14 000	8,81	7,49	6,17	6,30	5,84
14 001 – 16 000	10,12	9,03	7,60	7,61	7,25
16 001 – 18 000	10,49	9,73	8,87	8,80	8,28
18 001 – 20 000	10,47	9,82	9,50	9,26	9,14
20 001 – 30 000	31,71	35,14	36,91	36,40	36,97
30 001 – 40 000	8,87	10,81	13,16	13,32	13,94
40 001 a více	6,90	8,46	9,89	10,63	11,06

Table 4 Structure of employees by the gross monthly wage in the Czech Republic. (source: czso.cz)

The status and situation of employees in enterprises also reflects information about the amount of overtime hours. According to the findings of the Ministry of Labour and Social Affairs, the number of overtime hours. In 2 quarter of 2010 hours it was about 1/3. The amount of overtime hours are limited by law (up to 8 hours per week and 150 hours per year, some groups can not be mandated overtime). According to expert estimates, the number of overtime hours actually worked much better, but these hours are not all registered employers.

Consequences of the economic crisis of 2008 - 2009 and subsequent years in the personnel area can be seen that both the development of unemployment and other specified characteristics and also on measures that could be adopted in enterprises.

### 3. THE RESULTS OF EMPIRICAL RESEARCH ON THE IMPACT OF ECONOMIC CRISIS ON THE PERSONAL AREA OF THEIR BUSINESS

In 2009, the research team implemented the project "A new theory of economics and management organizations and their adjustment processes" (MSM 6138439905) empirical investigation. The aim was to find out what the consequences of the crisis of 2008 - 2009 for companies including the effects of CR in the personnel area. Were questioned around 144 representatives of companies from Czech Republic, operating in the field of manufacturing, construction and transport, ie in key areas of the economy. Although unable to obtain data from a representative sample and the results are only roughly indicative, have on the situation in the Czech Republic interpretive value. It was found about this (see Table). Estimated number of workers greater part reperezentantů businesses at the same level, another large portion of their estimated decline. In the case of total personnel costs was expected to decline, and expected only a minor part of the same level. As a result, this means reducing personnel costs per employee.

	Increase of 10% or more	increase to 10%	same level	Decrease to 10%	Decrease by 10% or more
Total staff cost in the enterprise	4	10	36	33	36
Total number of employees in the company	1	12	59	23	5

Table 5 Expected development in these areas for 2010 (source: own calculation)

According to financial newspaper “*Hospodářské noviny*” of 19.2.2009, where they were presented the results of interviews with HR recruitment agencies are soon punished dismissal agency workers, but then the tribal workers. The crisis is to reduce the number of working days, and salary is reduced. Expenses are eliminated, which are judged to be superfluous, they are spending for education staff and their development as well as expenses related to staff motivation in a positive direction and stabilization. Is it possible to record a higher uncertainty of employees, increased fear and lack of motivation, including key employees. Recruitment is limited and is only interested in certain specialists who are absolutely necessary. Recruitment is primarily addresses while inside the organization.

The overall trend can be characterized as a reduction in staff costs and work intensification. Given the need to remain competitive compared to companies in the world and the need to cope with the consequences of this crisis is a major reason to support this trend.

#### 4. INSTITUTIONAL SUPPORT FOR ECONOMIC OPERATORS IN THE CZECH REPUBLIC

##### National System of a profession (NSP)

Competitive Companies, technological progress, competition for workers in the labor market and other cause need for rapid variations in the direction of higher education in the effectiveness of training and exchanges of people in jobs and people need to adapt to new work and lifelong learning in response to the raising of new knowledge. These processes are also the cause of disparities in the labor market. One of the important tools that are formed to address the structural disproportions in the labor market in the Czech Republic, the National System of occupation and the National Qualifications Framework. Further quoting from the text, which presents that institution on the official website.<sup>3</sup>

The national system is developed as a profession systematically developed catalog of professions and their performance requirements. This catalog will be publicly available on the Internet. The result should be a qualified general description of the situation on the Czech labor market in terms of supply and demand for workers. (There is an overview of vacancies and job seekers, not this particular effect. Contains regularly updated descriptions of occupation and type of positions, including a description of the detailed requirements for the executor of labor - workers in the form of general and professional competencies. Primary source of information on these competencies are employers professional organizations, unions, guilds, etc.

<sup>3</sup> <http://info.nsp.cz/default.aspx> (cit. 22. 6. 2012)

The main objectives of the National System of professions:

- Strengthening the role of employers in the development of human resources.
- Ensuring awareness of educators about the needs of the labor market on human resources.
- Promoting labor market needs in the education system
- Massive involvement of experts from the social and other partners in the process of collecting and processing information on the qualification needs of the labor market through sector councils.
- Increased mobility and flexibility in the labor market in the CR and the EU.

Labor market requirements identified the need for the National Professional services are obtained through so-called sector councils, employer organizations are involved in the project. Additionally, the program will participate in regional council for the development of human resources, administrative units (regions), Office of the Republic work, individual departments and educators.

Based on this information from the National System of professions is built by the National Qualifications Framework, which provides educational institutions with the following requirements. This Qualification will allow educators to communicate accurate and comprehensive information necessary for the formation of truly employable skills. It also simplifies the proof of the skills needed to perform a specific job or profession in the EU because it will be in accordance with the methodology of the European Qualifications Framework. So they can be prepared for future graduates so that their acquired knowledge and skills to strengthen the employability of graduates in the labor market in the Czech Republic and other European Union countries without the need to incorporate long.

A very rational idea of finding information space needs for mutual confrontation business entities, interests and efforts of state bodies of educational establishments is not controlled by some really complicated processes.

In particular, this system is dependent on a constant flow of relevant information. The system can be compromised as a lack of information, and their abundance. In the absence of relevant information may also positive efforts to strengthen stakeholder disproportion to be removed by the system and the higher the efforts of stakeholders, the greater the discrepancy might be raised. In the case of an excess of information that can be understood primarily as a large amount of detailed information and unrelated, there is paralysis of both flooding potential stakeholders and also controlling the mind of those entities that everything relates to everything, and that it is futile to try to control things.

The system must overcome the inertia of the functioning of educational establishments. First of all develop new educational programs to bring the intended effects, not a matter of weeks, months, and it takes more years. It is the identification of training needs, which will be based on practical business needs and their satisfaction meaningful content, the search for effective forms of teaching and evaluating results. About finding a suitable motivation of pupils, apprentices and students to acquire good knowledge and skills. Added to this is the problem of the overall evaluation of the success of graduates and share lessons on this success and the evaluation of the effectiveness of the educational establishment. This means that failure is the cause of poor education graduates work or enter the wrong, what has to be able to graduate?

Until that system is not involved in office of the Ministry of Education, Youth and Sports. Development strategy for all levels of education (excluding apprenticeships) but this is the ministry responsible. Transfer of employers' demands for workers in the curricula of schools of the state graduation and accreditation to colleges and universities is not clear.

It is also the question of how to be formulated requirements of employers to workers. No educational system is not able to produce exactly that knowledge and skills of workers for specific practical purposes. Since the formulation of a particular educational system to the application of the first graduates always pass some time (for different levels of education, this time is different, but you can count on a minimum period of 5 years). During this time due to technical progress, many things will change. When formulating the needs is therefore not necessary to define the current needs, but the estimated needs for five years or more. Are employers and other stakeholders capable of this estimate? Another thing is that generally increase the effort to produce graduates of educational institutions flexible, adaptable and able to cope with real problems (that are not always successful, is another matter). How, therefore, formulate the requirements for qualification in this particular position. In addition, we believe the flexibility and adaptability, attitudes, and more things will employee and not knowledge.

The problem in formulating requirements may be different interests of individual employers and their bargaining power. It is expected that large employers interested in using the example of flow production are consistent with employers in small businesses at times giving greater scope for independent work of employees. Not respecting the requirements of both side on the contrary strengthen the qualification structure and flexibility of a small staff?

The problem may also be to what extent should processes of balancing the requirements of employers for skilled workers and the functioning of educational institutions are managed and to what extent they should be left only to the decisions of stakeholders. Management processes can cause resistance ratio, the natural history usually delivers identifiable effects for some time and this time, the system may seem inefficient, and the parties it can go.

For these reasons, this system is therefore particularly suitable for the expansion of skills, retraining and business training courses.

### **Changes in the forms of mediation work - new ways of obtaining and employing workers**

The fundamental and crucial thing for the organization's success in the current economic environment is the ability of orientation in the environment. Change in the outdoor environment usually induces a change in the internal environment. The external environment largely determines what will take place within the company. A firm that ignores changes in the outside world and responding to them, is sentenced to problems. Under the changes, in the context of this article, means a particular change in the use of modern technology (computers, Internet) on the acquisition and employment of workers. These methods deepen labor market flexibility, help to reduce unemployment, the organization allow you to select the right employees with the best conditions for job performance. Of these methods, the article provides basic forms of e-recruitment, as a method of recruitment and employment agency as a modern form of employment for workers.

#### **E – recruitment**

The term e-recruitment (or recruitment line) understand the use of modern technology and web tools to address, information, identification and acquisition of job seekers. It is a system of recruitment, which in recent years has experienced a huge boom. Prefix E identifies that this is a recruitment

process implemented using electronic resources, especially the Internet, as many acquisition processes were moved to the Internet (online - recruitment). Because these activities elektronizovaly, it is possible to use modern technology (such as data-mining) and draw on information stored in databases. Vacancies are beginning to offer online (eg, Job Advertising Boards). Communication is possible through the web sites of the organizations, specialized software for acquisition and selection of employees, job portals (job-portals), blogs, e-mails, but also through SMS, MMS, social networks like Facebook, LinkedIn, Twitter, but Google Youtube, Myspace. E-recruitment has become a phenomenon as well as modern management and communication in the labor market and is gaining popularity.

The advantages of e-recruitment is speed - job seekers will pair very quickly with offers of vacancies. Cost savings - time, finances, etc., for both employees and employers. With this form of recruitment associated costs much less than for example an ad in newspapers or other media. The opportunity to work with the applicant independently. Independent information about the applicant works as well as HR and line manager. Another benefit is the feedback, the vacancies are reported more applicants, greater geographic reach. With e-form is a simple integration of the Internet to other human resource processes. Job offers can be more descriptive - ie longer. These offers can be written at any time - essentially 24 hours a day. Of course there is the advantage of hypertext, everything is online, everything is connected to everything disadvantages of e-recruitment is usually stated that the vacancies reported more applicants, but many of them may be unskilled. This makes the work of personnel or other persons responsible for recruitment. This problem is solvable in a certain way through the selection of sophisticated software solutions, which are part of the system called Resume scanners - filters that at the outset to identify, unsuitable candidates, according to a specific, predetermined criteria. Of course these filters have updated to the requirements of jobs. As one of the other arguments against e-recruitment echoes that not everyone is online, has access to the Internet, moving on the network, etc.

To sum up, then you can e-recruitment tool by which employers use to recruit employees, divided into the following areas - online recruitment websites with employers using online recruitment portals labor supply, online recruitment through social networks. The latest trends in e-recruitment is the use of social networks. The most popular professional social network is LinkedIn, which was put into operation in 2003.

### **Agency employment**

Temporary employment is a dynamic form of the so-called flexible employment. Worldwide, there is not a novelty - the company for many years, this service widely used, but in the Czech Republic's official history agency work is relatively short. Institute of agency employment in the Czech legislation was introduced in late 2004 and in connection with the need to respond to changing labor market requirements. Temporary employment offers many advantages for companies that use it, as well as agency employees themselves. On the other hand, are associated with it of course also some disadvantages.

Temporary employment is one of the ways to access the collection and selection of employees (Lorencova, 2008). The nature of agency employment lies in the fact that the company you work for the agency ordered a certain number of workers with the profile to fill well-defined job, employment agency then looks for these workers, employing them as their employees and the company is hiring for an agreed period. In the Czech Republic, agency staff used by large foreign companies, but also Czech firms in the service slowly getting used to and become increasingly its users. (Semoradova, 2006).

Businesses use agency employment, in particular due to its flexibility. It enables them to respond flexibly to sudden changes in demand for manpower. The Agency is able to work almost immediately to provide enough qualified workers (Konstandinovova, 2011). Temporary agency work helps to increase the competitiveness of firms in the market - the company must be able to respond quickly to new market demands and just use of agency workers is one of the means which allows her this<sup>4</sup>. The use of agency staff gives companies the opportunity to optimize the number of internal employees and thus leads to efficient use of human resources, which in turn contributes to the growth of labor productivity (Semoradova, 2006). The disadvantage is that the service agency work is not exactly the cheapest proper governance, compliance with laws, when agency employees with comparable wages and working conditions as comparable employees of users are spending on agency workers more than their own employees. A key advantage of the employment agency is that it enables employees to gain valuable experience and thus increase their competitive advantage in the labor market. Some people prefer agency work because of its flexibility. As the main advantage of seeing most of that agency work provides some flexibility in career direction and variability of work. It enables them to become familiar with different people and learn about various companies. Others on the contrary sees the opportunity to gain employment agency permanent employment. The benefits that brings further employment agency, are relatively wide range of jobs and the possibility of getting a job fast.

However, agency workers are also exposed to a number of adverse factors. The biggest disadvantage of agency employment is certainly uncertainty concerning the duration of employment - that is can be quickly completed. Agency staff can certainly nekontinuita mind and career. The problem is the fact that agency workers are often exposed to the worst wages and working conditions than comparable employees of the user though the law prohibits such practices.

In the Czech Republic, the agency employing the public law is governed by Act No. 435/2004 Coll. On employment in the private law Act No. 262/2006 Coll. Labour Code. According to the Employment Act, the agencies will work alongside the work of the Office of the Republic for finding employment. This is where agencies understand the job of a natural person to work for the user. Temporary employment is a business - mediate employment agencies for consideration and may show a profit. Agency work may only require the payment from their clients - companies, allowing them to agency employees. On the contrary may not require payment from individuals to whom the employment agency work provides. For a typical employment agency considerable flexibility but also significantly weakened the legal security of agency employees (Subrt, 2008). Will solve the problem of limited legal certainty, which is the flexible forms of employment often associated, is evident from the efforts to modernize labor law in many countries. For example, in the European Union seeks to ensure that member states into their systems incorporate a labor law, the principle of flexicurity. He also has to ensure the required degree of flexibility, and achieving a measure of legal certainty of employees (Konstandinovova, 2011).

#### 4. CONCLUSIONS

It is very difficult to deal with changes to the current time bringing in personnel management. Difficulties are approximately twofold. In particular, authors and lacking any person who will deal with those things, the time interval. Over time, many great things seem to appear as an insignificant little things, and vice versa as significant. Furthermore, the economy as a space for activities is that

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<sup>4</sup> The agency work industry around the world 2011 (CIETT).



people very difficult without a direct insight into the mechanisms and patterns. Found clear indications fail, even if a relative simple fact - the status of employees.

Nevertheless, we would like to conclude that economic development does not last in personnel radical qualitative changes. That does not mean that no changes occurred. They are not the result of the recent years, but changes gradually to promote the field of personnel management. The economic crisis could accelerate the process or slightly deviate from the current trajectory of development, but we believe that no change images.

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## Legislation

Act No. 262/2006 Coll. Labour Code.

Act No. 435/2004 Coll. On employment

**ORGANIZING AND TRAINING PERSONNEL  
IN THE CROATIAN HOTEL INDUSTRY**

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**Abstract**

*This paper aims to underline the importance of organizing personnel within the hotel industry when designing an offering for the tourism market. A well-designed and appealing hotel offering is becoming a decisive factor in the competition that takes place on the tourism market. Tourist behaviour is influenced by an ever faster changing and developing system of values, views, opinions and ways of life. More and more people are leaning towards tourism and participating in tourism activities. Tourists are becoming increasingly discerning when it comes to selecting tourism offerings and, in turn, hotel offerings. The success of the hotel offering on the tourism market depends upon how the providers of the hotel offering are organized, as well as upon the personnel who influence how the offering is designed.*

**Key words:** *organizing, hotel offering, hotel staff*

**1. INTRODUCTION**

The dynamic development of tourism, together with the hotel industry that is striving to present a high quality and competitive tourism offering on the tourism market, calls for highly skilled and creative workers in all fields of tourism, as well as in the hotel industry. Educated and professional personnel are the basis for creating a well-designed and competitive offering on the global tourism market. Special emphasis is placed on educating managerial staff that will, through good organizing, direct the work process towards designing an offering for the tourism market

**2. ORGANIZING THE CROATIAN HOTEL OFFERING**

Croatia is one of the leading tourist destinations on the Mediterranean, with an excellent competitive position on the international tourism market. Its competitiveness can be seen, among other things, in the ecological awareness of its tourism policy, the authenticity of its land and people, in efforts made by the providers of the tourism offerings, and so on.

Tourism trends and demands are changing. When analysing travel motivations, it is important to point out that the participation of a temporary visitor in tourism activities is not tied to only one motivation or one wish, but to many, that intertwine, complement and replace one other. The primary motivation is also the prevailing factor for tourists in deciding where to travel, which destination to visit and in which accommodation facility to stay.

While numerous motivations exist, the basic group of travel motivations consists of the following (Landry & Fesmire 1994):

- Self-searching - Tourists learn about themselves by learning to understand the world around them. Instead of having “the world brought to them” through television and books, they take the opportunity of searching and experiencing for themselves, rather than absorb experiences that others have processed.
- Social interaction - People want to be with other people. This makes social interaction the most important matter in everything that people do and experience. According to this argument, sports and sport activities were primarily defined as social, rather than athletic, activities. The more technology is integrated into society, the more people want to be with other people.
- Excitement - For many tourists, “prestige” is the prevailing factor when choosing a destination. Going to visit a known and valued destination is important for being accepted by certain groups of people. The tastes and interests of one group will set the standards that other groups will try to uphold and follow. Change in taste and fashion may destroy a tourist destination, or more often, may attract tourists of lower purchasing power.
- The experience as perceived by tourists - The degree to which expectations are fulfilled may also depend upon the depth of emotion that tourists have put into a certain experience or event.

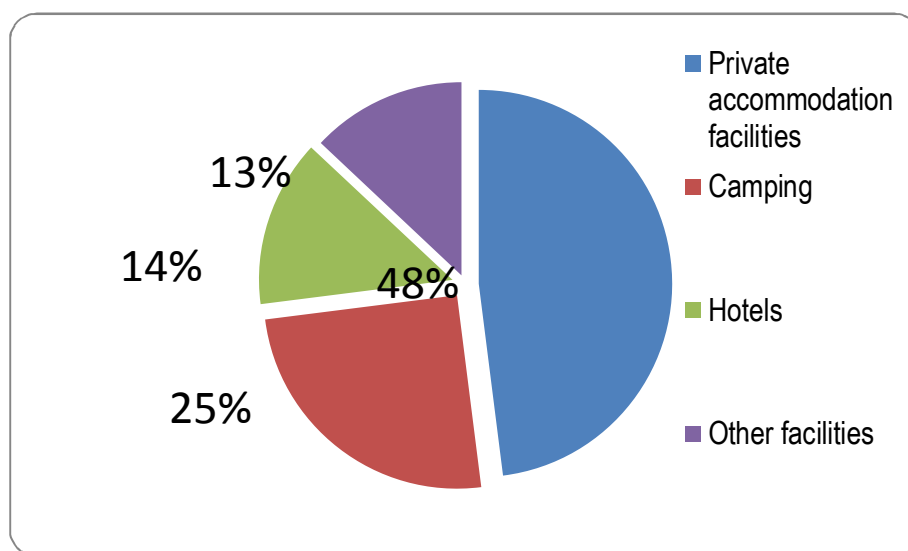
Today's tourists, the end consumers of the hotel offering, are more culturally-minded, possess broader educations and have a vast amount of information at their disposal. They are familiar with all tourism trends and set a high standard for their trip and stay in a hotel facility. The modern tourist has developed a new system of tourism values that is based on ecological orientation, an experience of the ambience, the identity of the destination, the hotel facility, prices and quality, and activity holidays.

Hotel management is faced with the question of whether the hotel product is sufficiently multi-faceted, appealing and competitive for potential tourists. They are also faced with the question of whether the hotel product can keep up with the requirements of an ever more dynamic demand. Tourism trends and demands are changing, and travel motivations are no longer limited only to the “sun and sea“. Instead, the need for special interest tourism is emerging. The hotel product needs to adapt to demand that is forming on the tourism market. But, is Croatia, and the providers of its hotel offering, ready to make such a shift?

The development of the Croatian hotel industry largely depends upon its ability to adapt to a new system of values. Hotel management must adapt to the demands on the tourism market and, accordingly, bring about changes in its business operations, such as changes in hotel management based on innovation, new ideas, and an appealing and well-designed offering. Preconditions for success are the attributes of the behaviour and activities of modern hotels:

- An orientation focusing on the consumers of a hotel offering
- Rapid innovations to the hotel offering
- Developing the flexibility of business operations by encouraging and training hotel staff
- Developing an inclination towards change within management, organization and staff
- Developing information systems and control mechanisms.

The Croatian hotel offering is striving to achieve year-round operations. However, it is hindered by a relatively unfavourable accommodation structure. Namely, hotel accommodations account for only 14%, while comparative accommodation facilities prevail (with motor camps and private accommodation accounting for 25% and 48%, respectively).



**Fig. 1.** Accommodation capacities in Croatia by type of accommodation facility

In adjusting the hotel offering to tourism demand, the providers of hotel offerings see it as their priority to renovate facilities by upgrading the quality of amenities and providing new services. The goal is to change the qualitative structure of hotel accommodation facilities. The providers of the hotel offering place special emphasis on employing qualified and trained staff in designing the hotel offering.

### 3. STAFF PROFILES IN HOTEL FACILITIES

Hotel staffs play an exceptionally vital role in the hotel industry. They are the primary driving force behind the work process. No other industrial activity is so directly attached to the guest as is the hotel industry. The quality of the hotel product and hotel services depends to a huge extent upon the efforts made by hotel employees. To be able to meet the needs and specific wishes of guests, not only do employees need to be professionally trained, they must also be motivated on a daily basis.

The quality of a hotel product is linked to the quality of work, which is in turn related to special knowledge and skills in the field of hospitality and the hotel industry, general culture, etiquette, as well as to technological knowledge and processes.

Hotel staff comprises all employees involved in the work process, including the manager who is the head of operations. The staffs are responsible for accomplishing the specific goals and tasks of a hotel facility, and at work they are connected by a common interest to succeed. In doing their jobs, hotel

staffs are required to act professionally, have a pleasant appearance, display flexibility, possess a willingness to help guests and co-workers, and have special skills and knowledge.

In addition to the specific traits that characterize the hotel industry as a service industry with a sophisticated attitude towards hotel guests, the characteristics of hotel staff are also vital for the quality of work. The features of hotel staff that affect how a job is done are (Cerović, Pavia & Galičić 2005):

- Ability – What is a person able to do?
- Habits, skills and knowledge – What does a person know how to do?
- Interests, preferences, opinions, motivation – What does a person want to do?

It is the task of hotel managers to compile a list of the personality traits hotel staff should possess which could help them in doing their jobs. This list of personality traits should include (Cerović, Pavia & Galičić 2005):

- Professional conduct
- Pleasant appearance
- Willingness to help
- Flexibility
- Attractive appearance
- Special skills

When selecting hotel staff, hotel managers should keep the above traits in mind. Efficient and trained hotel staffs are a vital factor of a hotel's offering

#### **4. PERSONNEL TRAINING**

Similar to any other enterprise, a hotel aims at accomplishing its planned goals and objectives, which practically speaking means greater profits, higher wages and a stronger personnel base that can guarantee the overall satisfaction of hotel guests and employees alike. By using their knowledge, skills, abilities and creativity, employees contribute the most towards successfully accomplishing these goals.

A successful manager is one who has completed the appropriate course at an institution of higher education and has followed this up with professional training. In Croatia, managers are schooled at faculties and schools of higher education, in accordance with the study system of the Bologna Declaration. Higher education in tourism in Croatia has a tradition spanning more than 50 years (Vujić & Črnjar 2010).

In Croatia, higher education courses in tourism are linked to an economics-based group of institutions (with the exception of one course at the University of Zadar). The titles of courses – Tourism, Hospitality, Tourism Management and Hospitality Management – reflect their primary objective: to educate managers in tourism and hospitality. The titles of other courses, such as International Tourism and Hotel Management, Event and Leisure Management, Managing Sustainable Tourism Development, and Culture and Tourism, point to further specialisation in which managers are schooled in specific forms of the tourism and hotel offerings. It should be noted that all courses are

consistent with contemporary European and world trends, as well as with the quality and creativeness of the tourism and hospitality offering.

A hotel is a work-intensive environment. To ensure guest satisfaction and repeat visits to a hotel facility, employees across all organizational levels need to be encouraged and trained to do their jobs properly.

The need for permanent training of hotel staff has emerged as a result of a number of changes that occur daily within a hotel, as well as changes taking place in a hotel's environment. A hotel must provide and organize coaching for its staff in carrying out their duties. For coaching to be successful, the following procedure should be followed (Cerović, Pavia & Galičić 2005)

- Prepare well for coaching
- Know how to demonstrate the exercise
- Have staff execute the exercise
- Monitor the exercise

Although hotel staff coaching is an important standard, Croatian hotels in which it is established and followed are rare. It must be remembered that without this standard hotel staff tend to become critical of, as well as passive and indifferent towards, hotel objectives. It is known that survival at the top is possible only through daily and continuous training. For the training process to be carried out, it must be organized properly.

A vital element in training hotel staff is the training method used, of which there is a variety. The type of method applied depends upon what the training programme is about, that is, the type of job it targets. From this perspective, all hotel jobs fall into two basic groups (Buble 2006):

- Non-managerial jobs
- Managerial jobs

*Methods for training non-managerial employees* (employees who work directly on a job or task) are basically divided into on-the-job training and off-the-job training methods. On-the-job training is the most common method in which the immediate manager or a knowledgeable co-worker assumes the role of instructor. Off-the-job training involves the application of numerous training methods, the most important being (Buble 2006): the debate method, lectures in classes, programmed instruction, the computer-aided method and simulation.

*Methods for training managers* differ from those used in training non-managerial employees in the hotel industry, although certain methods may be applied in both cases (debates, lectures in classes, etc.). Methods for training managers fall into two categories:

- Acquiring experience on the job – managers learn from mistakes
- Acquiring experience off the job through instruction – may be carried out individually or in groups, and in special programmes or seminars.

The process of training employees will help to enhance their efficiency by giving them a higher level of knowledge and skills. By improving the level of education of its employees, a hotel will increase its competitive ability.

## 5. CONCLUSION

As a Mediterranean country, Croatia possesses all the essential preconditions needed to develop into a tourism country that would be an integrated and functional part of Europe's tourism economy. When designing a hotel product, in addition to selecting the target market for the product and the way to market it, it is necessary to recruit skilled and capable hotel staff. Special attention should be focused on providing continuous staff training, for both managers and other employees in the hotel industry. Without efficient human-resource development policies, the hotel industry cannot expect to develop properly. New knowledge and professional development should be made possible to all who see their professional future in the hotel industry. Special emphasis should be placed on training hotel managers who are responsible for increasing the quality of the hotel offering.

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**SOME ELUCIDATIONS IN THE AUSTRIAN BUSINESS CYCLE THEORY**

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**Abstract**

*This study investigates the behaviour of the interest rate over the business cycle that is predicted by the Austrian theory of economic fluctuations. The first part briefly introduces the Austrian model and develops some of its basic tools. The second part focuses on the gap between the market rate of interest and the natural rate and identifies the monetary policy as its main source. The core of this paper is then focused on the most important inconsistencies in the Austrian theory. In particular, it mainly clarifies how the interest rate gap is eventually closed and what are the major repercussions in the real economy over the process of its closure. The last part extends the model by considering the endogenous nature of money in the modern banking system and investigates further movements of the interest rate in this particular environment.*

**Key words:** *business cycle, natural rate of interest, capital, Austrian school*

**1. INTRODUCTION**

The recent financial crisis has brought about unprecedentedly low nominal interest rates for an unprecedentedly long period of time. However, before the year 2008 the usual U-shaped behaviour of the interest rate was observed in the majority of the most developed countries. The recovery after 2001, characterised by very low interest rates, was then followed by a significant boom with higher interest rates ending up with a new and more painful recession at the end of the decade that brought about (again) a fall in the interest rates.

This paper is focused on this interest rate dynamics over the business cycle and tries to clarify this movement with the help of the Austrian theory developed by Mises (1912) and Hayek (1929, 1931a) nearly one century ago. Based on Wicksell (1898, 1901, 1906) theory of the natural rate of interest and Böhm-Bawerk (1884, 1888) theory of capital the Austrian theory states that the business cycle is caused by the gap between the actual and the natural rate of interest. Furthermore, if this interest rate imbalance is sustained sufficiently long, the economy should suffer from continuously rising inflation leading to a bitter hyperinflationary collapse, once the spiral gets out of control.

The paper proceeds as follows. The first two parts elucidate the dynamics of the interest rate over the business cycle predicted by the Austrian theory. The main focus is on the transmission mechanism leading to the deviation of the market and natural interest rate and the consequent reverse, U-shaped behaviour of the market interest rate. The third part tries to clear up some of the misunderstandings and seeming inconsistencies that were pointed out by the critics of this theory. The last part investigates the endogenous nature of the money supply in the modern banking system and its relationship to the business cycle. The paper concludes with recommendations of a great caution the central bank has to keep in mind mainly at the beginning of the boom, if forces of the business cycle are not to be emerged, forces that finally make the behaviour of the natural interest rate impossible to follow.



One important note deserves brief attention. Since the Austrian theory has never been developed into a rigorous and condensed mathematical model, the exposition in this paper will mainly follow verbal and occasional graphical reasoning. Simple graphs and numerical examples are given especially to discipline one's mind, as it can be easily trapped in vicious circles when analysing such a complicated phenomenon as the business cycle.

## 2. THE AUSTRIAN MODEL

The Austrian business cycle theory stands and falls with the Austrian theory of capital, outlined by Menger (1871), thoroughly developed by Böhm-Bawerk (1884,1888) and refined by Hayek (1941) and Lachmann (1956). As it is not the main objective of this paper to go into deep intricacies of the capital theory, this part just briefly introduces simple tools usually used by the Austrian theorists.

The Austrian capital theory assumes that production of any economic good proceeds in time. No consumption good is created directly by labour, it usually takes some time to manufacture even the simplest one. Using a simile from biology consumption goods gradually mature out of the unfinished goods called capital goods. A useful tool widely employed to describe this process was developed by Hayek (1931a), and further refined by Rothbard (1962), Garrison (2001) or de Soto (1998), hence the name - Hayek triangle.<sup>5</sup>

On Figure no. 1, the horizontal line represents the period of time that has to elapse for the least matured and unfinished goods (e.g. raw materials) to become fully matured consumption goods prepared for direct consumption. The length of the vertical leg measures the nominal value of consumption goods. By cutting the triangle at any point of time and erecting a vertical line, one can get the value of the unfinished goods. It is obvious that the further the point from the eventual vertical leg, the lower the value of the unfinished goods. This simple approach resonates with the Austrian view that the value of goods in process (or capital goods) is directly derived from the value of consumption goods (Menger 1871), while keeping in mind that the value of capital goods is always lower due to the personal discount of future (Böhm-Bawerk 1888).

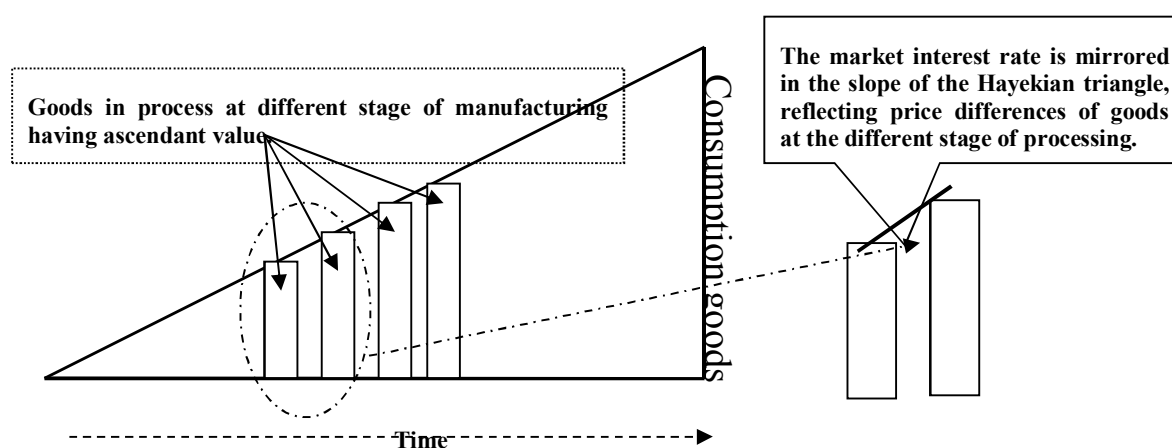
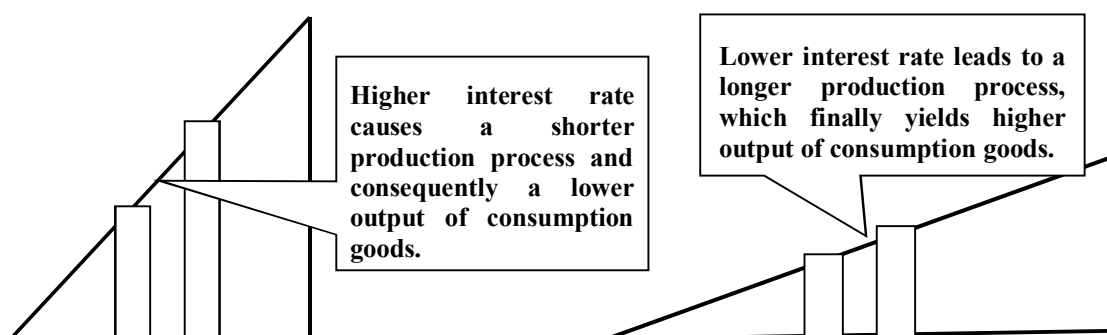


Figure no. 1, The Hayekian triangle

<sup>5</sup> Hayek (1931:38) himself accepted Marschak's suggestion to designate this figure as Jevonian investment figure.

The third most important property of the triangle is its slope, reflecting the size of the personal discount of future; the higher the discount, the bigger the slope. According to the Austrian theorists, the personal discount of future should be also reflected in the market interest rate, so the slope of the Hayekian triangle is (among other things) determined by the market interest rate. The reason is obvious. If the slope of the triangle exceeded the interest rate, or in other words if the value of a good in one stage of the production process significantly dwarfed the value of the same good in the preceding stage, the resulting above-average profit would motivate entrepreneurs to buy goods in one stage and sell them in the other till the profit rate would level with the ongoing market rate of interest.<sup>6</sup> The direct effect would be an increase in price of the good in the more remote stage and decrease in price in the closer stage making the difference in values and consequently the slope of the triangle consistent with the market interest rate.

Figure no. 2 shows that the lower the interest rate, the longer the production process. This property comes from the theory of Böhm-Bawerk (1888), who demonstrated that the lower personal discount of future and consequent lower interest rate allow the factors of production to be locked and used in longer production processes. In Fisher (1930) terms, the lower the time preference (or impatience), the longer is the particular consumer prepared to wait till the production process provides consumption goods.



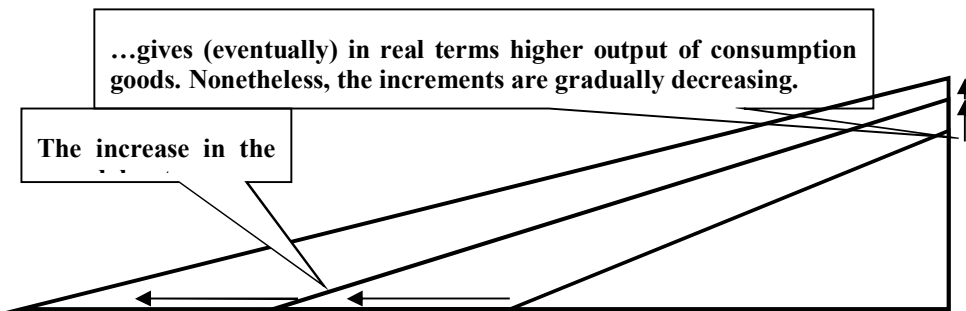
**Figure no. 2,** Production process for a high and a low interest rate

Figure no. 2 is rather inaccurate in the fact that it suggests that shorter processes provide more consumption goods. However, it is generally believed (Böhm-Bawerk 1888, Hayek 1941) that exactly the opposite is true. For the given level of technology and quantity of labour, higher output of consumption goods is possible, only if the factors of production are employed for a longer period of time. The fundamental reason is the requirement of efficiency; the given output of consumption goods is produced by the shortest possible method of production. The higher output necessarily requires longer production process, in Böhm-Bawerk (1888) terms - more roundabout process.

The picture would be more consistent with the Böhm-Bawerkian theory, if the Hayekian triangle was plotted in real terms. Figure no. 3 demonstrates that in real terms longer processes after completion produce bigger output than the shorter ones. As can be easily seen, the picture is also consistent with the assumption, that an increase in the roundaboutness has its limits. Every increase in the time period,

<sup>6</sup> Hayek (1931, 1941) even calls this difference the profit margin, or price margin.

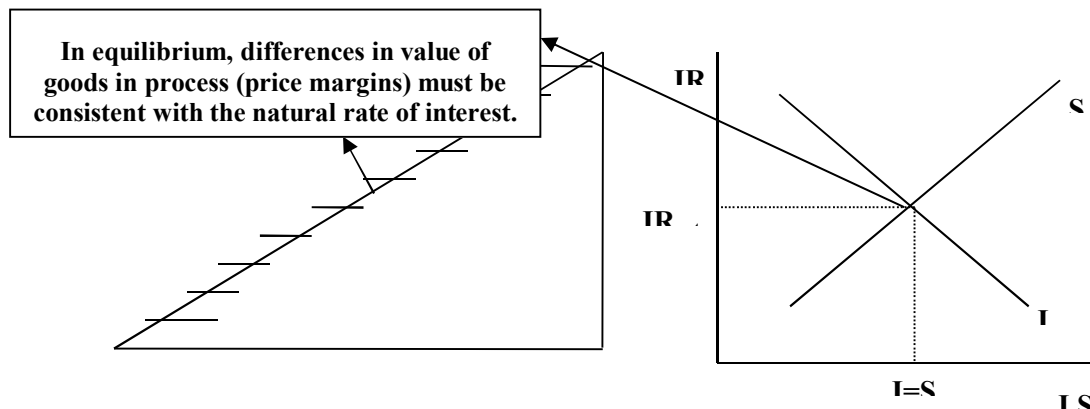
for which the factors of production are tied up in the production process, raises the eventual output of consumption goods, but at a decreasing rate. In other words, the analysis assumes decreasing marginal productivity of the roundabout methods of production (Böhm-Bawerk 1888, Hayek 1941).



**Figure no. 3,** Decreasing marginal productivity of the roundabout process

The transition period between two processes with different roundaboutness will be discussed later on. Nonetheless, it is more convenient to analyse the theory in nominal terms. Hence in this article, the Hayekian triangle depicted on Figure no.1, reflecting the market interest rate, will be utilized.

R. Garrison (2001) enriched the Austrian exposition by the loanable funds market model.<sup>7</sup> The interest rate, which is an integral part of the slope of the Hayek triangle and determines the difference in value of goods at different stages of completion, is to be consistent with the interest rate that equilibrates supply and demand on the loanable funds market.

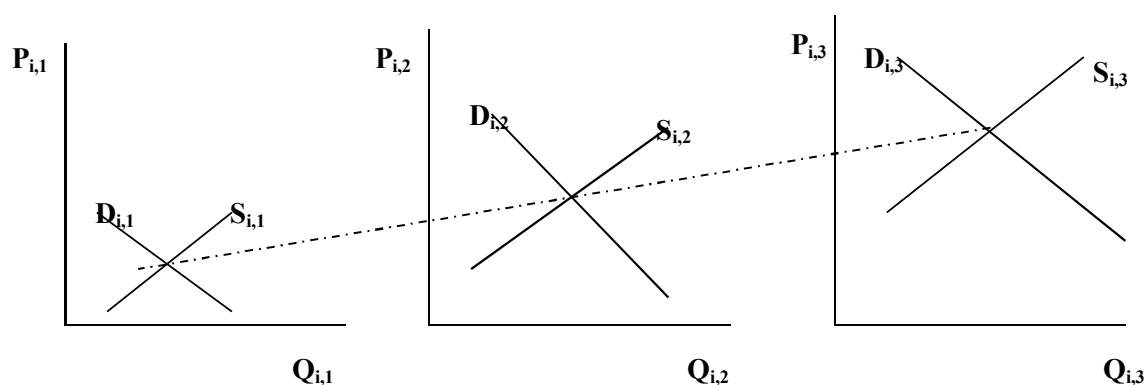


**Figure no. 4,** The loanable funds market and the Hayek triangle

<sup>7</sup>The critique of the Garrison's approach can be found in Hülsmann (2001), Fillieule (2005), the critique of Hayekian triangles in Barnett and Block (2006).

Figure no. 4 depicts one of the most important variables in the Austrian model - the natural rate of interest ( $IR_{nat}$ ). The adjective “natural” comes from the assumption that it is determined purely by real forces. As is suggested on the figure, by the flow of investment (I) and the flow of savings (S).<sup>8</sup> The increasing saving function can be derived from a rising marginal rate of time preference, the decreasing investment function stems from a decreasing marginal productivity. This rather Fisherian (1930) explanation<sup>9</sup> of the natural rate is consistent with Hayek (1941) theory, whereas Mises (1949) and Rothbard (1962) strictly rejected that productivity could be of any importance in the explanation of the interest phenomenon. Although this obvious controversy among Austrian authors would require further investigation, this paper will stick to the Hayekian and Fisherian explanation of the natural rate of interest.

A variable as important as the natural rate can be read on the horizontal axis. For the given natural interest rate, the investment equals saving. At the same time, it is assumed that this amount of saving is exactly the one that is needed to keep the production process intact. In other words, the economy creates precisely such the amount of new capital that is required to maintain continuous and undisturbed process of production, to preserve the given shape and size of the Hayek triangle.



**Figure no. 5,** Markets of production goods at a different stage of completion

The processes inside the Hayekian triangle have not been discussed yet. Figure no. 5 illustrates Hayek’s idea that capital goods are mainly production goods in process ( $Q_i$ ) that finally mature in consumption goods ( $Q_c$ ). Each good in process ( $Q_{i,1}$ ;  $Q_{i,2}$ ,  $Q_{i,3}$  ; ...) has its own market with its own market price. At the same time, the price of the production good that is posited further from the final consumption is lower than the price of the production good that is closer to it. The price margins between goods in the different phase of completion reflect the slope of the Hayekian triangle. They are also consistent with the natural rate of interest.

<sup>8</sup> Modern literature and the New Keynesian model (Woodford, 2003) assume that the natural rate of interest is consistent with the natural level of output, also known as the flexible-price output.

<sup>9</sup> Fisher (1930) himself attributed this explanation to Böhm-Bawerk, although in his point of view Böhm-Bawerk’s inclusion of productivity was rather confused and misguided. On the other hand, Austrian economists that adhere to the pure time preference theory blame Böhm-Bawerk for inconsistencies and criticise the element of productivity in his theory. See e.g. Kirzner (1993).

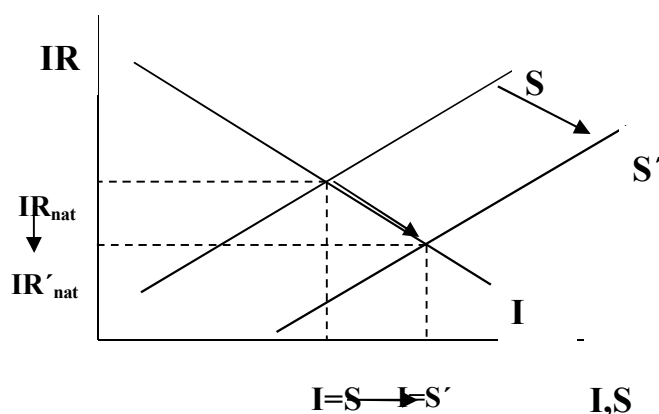
The supply side of each market is represented by companies or entrepreneurs operating in different stages of production. Although the demand on each market is driven by firms producing in the subsequent stage, the key agents of the demand side on each market are to be found somewhere else, namely at the end of the entire production process. In identifying the major drivers of the demand for production goods, one has to realize the economic essence of these goods. Production goods are nothing less and nothing more than future consumption goods. Hence, the demand for them originates on the part of individuals who demand future consumption goods. And the major demanders are people saving part of their income, since saving is just the demand for consumption goods that will mature at some moment in the future.<sup>10</sup>

### 2.1 A decrease in time preferences

The simple tools just developed suffice to describe the nature of the process that transforms the Hayek triangle from one shape to another (Figure no. 2) and shed some light on what is known as the change in the roundabout process of production.

There can be no doubt that every individual tries to adjust her time shape of consumption such as to maximize her utility. As was demonstrated by Fisher (1930), the specific stream of consumption of the individual depends on many factors, such as the time shape of her income, average level of her income, composition of income, degree of risk in different periods and many others. At this stage, we are interested neither in the major determinants affecting the specific stream of consumption of an individual, nor in the response of the individual to these factors. The main objective of this section is to find out, whether the Austrian theory is well designed to analyze mechanisms in the structure of production and the roundabout processes, once a large number of individuals change their optimal allocation of consumption over time.

Consider a change in the optimal path of consumption such that a remarkable part of consumers reshuffle their stream of income to consumption in more remote periods in the future. In other words, suppose that in the economy the relative demand between present consumption goods and future consumption goods is shifted toward the later at the expense of the former. To put it plainly, people start to save more.<sup>11</sup>



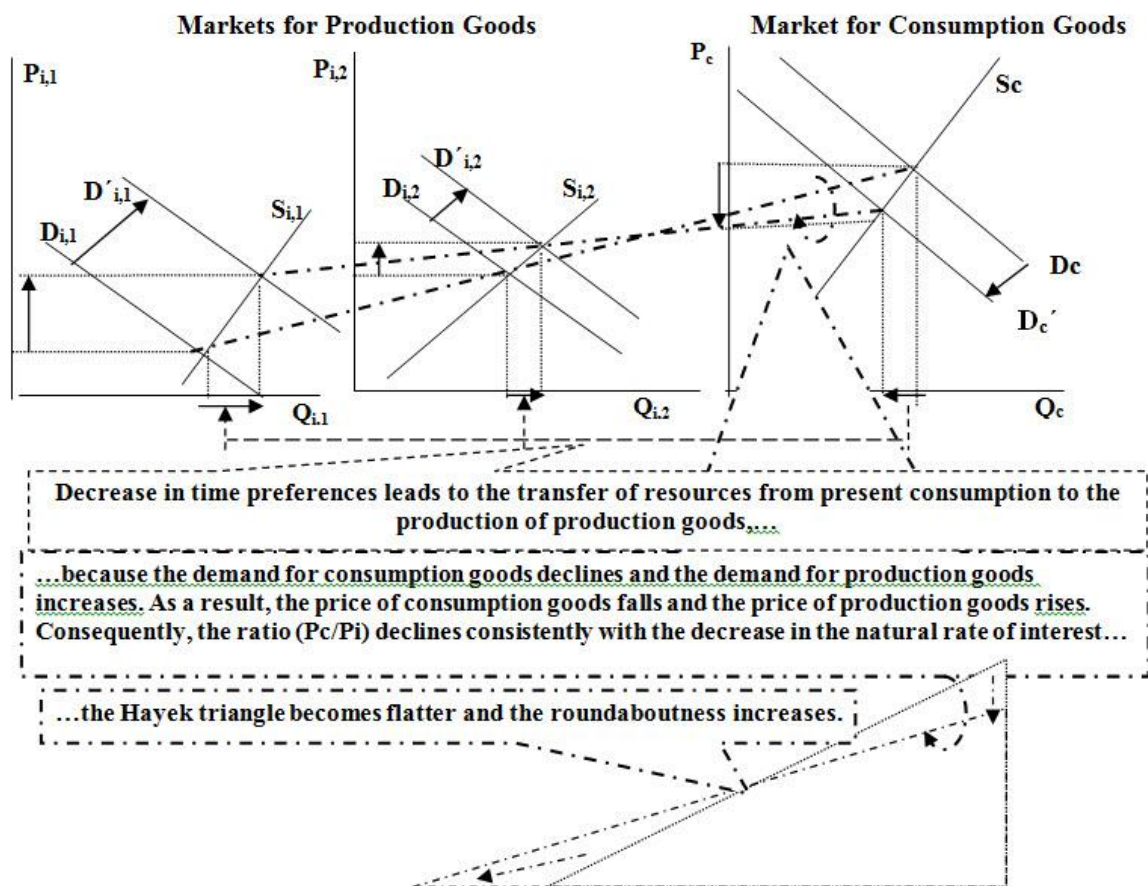
<sup>10</sup> This idea is best developed in Böhm-Bawerk (1888) and Hayek (1941).

<sup>11</sup> More thorough analysis of this process can be found in Böhm-Bawerk (1888), or Hayek (1931a, 1931b)

**Figure no. 6,** Decrease in time preferences on the loanable funds market

The reduced demand for present consumption goods will be felt first in the stages producing goods for immediate usage and in the stages very close to final consumption, whereas earlier stages manufacturing production goods should experience an increase in the demand, as the new savings, representing demand for future goods, are channelled to this part of the production process. However, new savings would never find their way to the earlier stages of production, if the interest rate did not decrease. In other words, the initial phase of this mechanism hinges on the assumption that increased saving will result in a decrease in the interest rate. This decline in the interest rate encourages investment spending, as is depicted on Figure no. 6. If something blocks the smooth transformation of saving into investment, further steps of the mechanism cannot proceed and the structure of production can be never transformed.

Nevertheless, if this process operates without disturbances, the inflow of saving into earlier stages will show up as an increase in the demand for production goods and the resulting higher price encourages supply to meet this expanded demand (Figure no. 7). The crucial question is, however, whether the economy is endowed with enough factors of production such that the supply can at least partly respond to higher demand or whether the supply of production goods is fixed due to the lack of the essential factors of production.



**Figure no. 7,** Decrease in time preferences and the structure of production

The answer is to be found at the end of the production process, in the consumption stage or in the stages very close to final consumption, which suffer from the diminution of the consumers' demand. Sooner or later the lower demand will cut prices of consumption goods ( $P_c$ ). Together with an inevitable reduction in the amount of sales of the consumption goods, their lower prices should depress profits of the firms producing them. As a direct consequence, factors of production in this stage of production, especially labour, experience a fall in the value of their marginal product. This is how the market manifests that the factors of production are not worth as much as before in the consumption stage. The market also demonstrates that consumers value inputs more than the resulting output in some sectors of the consumption stage and lower profits or even losses are a direct proof that some of the factors of production should be released.

Here is to be found the source of factors of production that are eagerly demanded in the earlier stages of production. As is depicted on Figure no. 7, the decrease in the consumption demand should release labour and other resources from this stage of the production process. At the same time, the higher demand for labour in earlier stages of production may absorb it. If this truly happens, then the supply of consumption goods declines and the supply of production goods rises. However, this process is conditioned by a working price system that ought to reflect not only the increase in savings via a lower interest rate, but also a decrease in the consumption demand through a decline in the prices of consumption goods ( $P_c$ ). In addition, the price system must also reflect an increase in the demand for production goods via a rise in the prices of production goods ( $P_i$ ). The structure of wages is affected in such a way that earlier stages of production should experience a rise in wages and stages closer to consumption a decline in wages, which is the straightforward signal for labourers to move from one sector to another.

At this moment, several observations deserve our attention. First, as can be seen on the loanable funds market, the natural rate of interest has declined. Second, the slope of the Hayek triangle is lower, as the demand for consumption goods plummets. Moreover, the triangle is also longer, which stems from the fact that lower interest rate motivates entrepreneurs to increase the roundaboutness of the production process even by opening some very long processes of production, which were impossible to start before. This observation is consistent with the fact that the increase in the demand for production goods is more robust in stages of production furthest from the final consumption.<sup>12</sup> Third, the profit margins, represented by the differences in value between goods at different stages of production, are also lower, since there is a general tendency to equalize profit rate with the interest rate. Fourth, although it is not immediately obvious from this simple picture, the capital in the economy has not only changed its size and shape, but also its structure, because more factors of production are allocated in relatively more remote stages of production. Furthermore, some very remote stages of production have been even newly created.

And finally, unless consumers abruptly change attitudes toward the time shape of their stream of consumption, new structure of production is sustainable. It will provide higher output of consumption goods after completion, as was posited by the Austrian theory of capital mentioned at the beginning.

The foregoing paragraphs suggested that the role of the interest rate should not to be underestimated, since it orchestrates the entire process of capital restructuring. It mirrors the slope of the system of

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<sup>12</sup> As can be seen on Figure no. 7, there is a point in the structure of production, where the demand neither rises nor falls. It is exactly the point, where the so called effect of the derived demand and the discount effect offset each other (Garrison 2001).

demand functions in different stages of production and eventually decides which of these stages will expand, which will shrink, which will be newly created and which of these will disappear at all.<sup>13</sup>

The analysis suggests that it is the interest rate, which transmits the key information about changes on the intertemporal markets. It represents probably the only guideline in the market economy, the only link among many individuals, as to the fact of how the scarce resources should be optimally allocated over time to maximize utility and profit.

If this signal is disturbed or blurred by reasons that do not stem from real economy, it is highly unlikely that the intertemporal allocation of resources will not be affected simultaneously with the real economy itself. The key question is whether the sequence of events thus triggered is sustainable and whether the path of the process originally initiated by non-real (e.g. monetary) factors will not be eventually reversed.

### *2.2 Money and the interest rate*

Although the natural rate of interest has been introduced as a variable equilibrating real phenomena - saving and investment, on the loanable funds market, neither investment nor saving is traded in kind in real world. Flows of saving and investment come on the market in the form of money; hence it is sometimes rather difficult to identify certain exchange as an act of saving or investment. At the same time, it would be quite inconceivable, if a change in the realm of money, namely the supply of money or the demand for money, did not affect the loanable funds market as well. Only in a hypothetical barter economy, where investment is by definition equal to saving, no problems (such as the ones discussed later in the paper) would ever emerge.

One of the most important disturbances, which the loanable funds market could face from the money part of the economy, is a change in the money supply. Let us assume that the central bank injects some amount of generally accepted medium of exchange on the money market. By using any tool at its disposal, sooner or later this injection should end up as new reserves in commercial banks. Although it is sometimes conceivable that the story stops here, in normal times the optimal ratio of reserves to deposits in commercial banks is somewhat disturbed, which motivates them to re-establish a more profitable relation. The most straightforward method on the part of the commercial banks is to offer more loans to their clients, either to the old ones or to the new ones.

This action will undoubtedly increase the supply on the loanable funds market. However, assuming a stable investment demand function, new loans will be accepted only for a lower interest rate. Hence, monetary expansion leads to an overall decrease in the interest rates.<sup>14</sup> At the same time, it has to be stressed that the interest rate on the loanable funds market falls below the level of the natural rate, as the real forces determining its level have not changed (see Figure no. 8). Thus, the monetary expansion should at least for some time produce a negative gap between the actual market interest rate and the natural rate, unless time preferences decrease hand in hand with the money supply expansion.

Although the natural rate of interest is unchanged at this stage of the process, the information about the scarcity of factors of production and about the relative demands for present and future consumption goods is conveyed by the market interest rate, which has been somewhat lowered. Hence, a lower

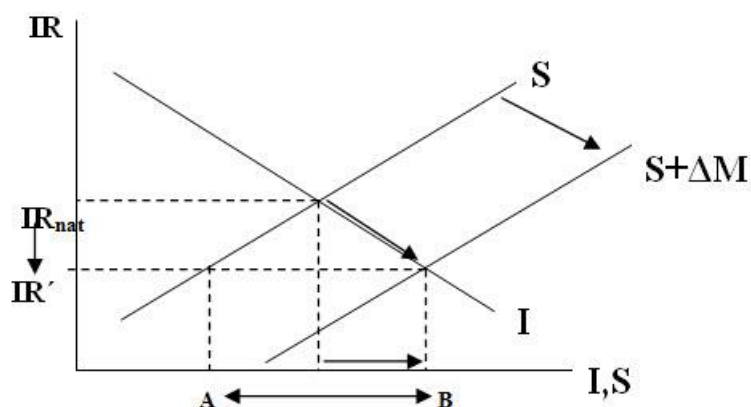
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<sup>13</sup> In this connection Hayek (1931:83) stated: "*But to think of interest only as a direct cost factor is to overlook its main influence on production. What is much more important is its effect on prices through its effect on demand for the intermediate products and for the factors from which they are produced.*"

<sup>14</sup> Almost one century ago Mises (1912) clarified, while criticising theories of the Banking School, that virtually any amount of newly created money can be placed on the market by a sufficient reduction in the interest rate.



interest rate is an explicit signal for the producers of production goods that the demand for production goods has increased at the expense of the demand for consumption goods. The net present value of business projects that are highly sensitive to the interest rate will become positive. The responsiveness is clearly the strongest in case of the projects that ripe in a relatively distant point of time in the future. As a result, a new profitable space to produce more capital goods has emerged, as well as the opportunity to open new stages of production that would be never lucrative, if the interest rate did not decline.

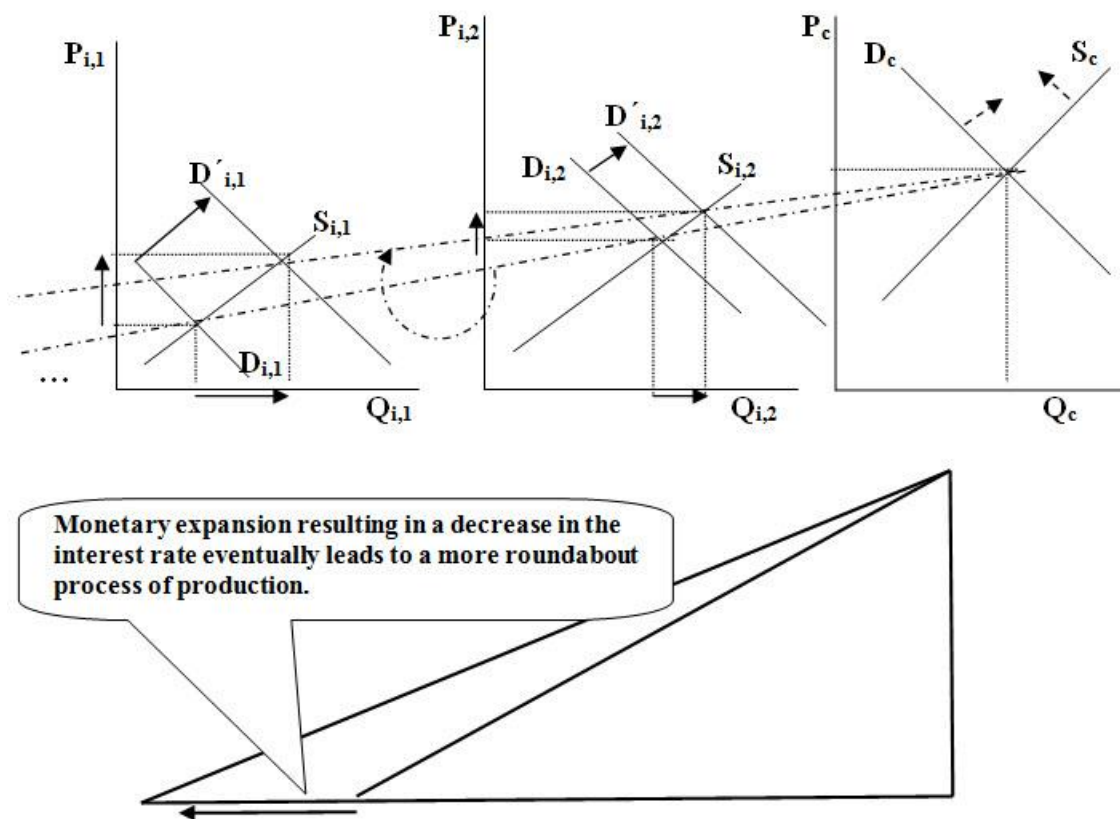


**Figure no. 8.** Monetary expansion on the loanable funds market

In our graphical model, this decrease in the interest rate is depicted similarly as the decline in time preferences (Figure no. 9). An increase in the demand for production goods raises their prices, relatively more in the furthest stages from the final consumption, and the price ratio between consumption goods and production goods ( $P_c/P_i$ ) falls. This fact is translated in a lower slope of the Hayek triangle, where the creation of new stages of the production process very remote from the final consumption can be clearly seen.

One obvious question deserves much attention. Can a higher demand in early stages of production be readily met by a higher supply? As was demonstrated before, this was the case when the time preferences declined. However, after the monetary expansion, the loanable funds market model suggests (Fig. no. 8) that the flow of real saving has been decreased rather than increased (to point A). Moreover, this model depicts an excess of investment over saving (distance AB). Unlike in the case of the decline in time preferences, the consumer demand seems to be intensified; a logical corollary of the credit expansion and the interest rate decrease.

The right upper graph on Fig. no. 9, depicting the consumption goods market, would be more in line with the loanable funds market, if the demand curve was shifted outwards, which would consequently increase the price of consumption goods as well. However, even in that case the slope of the curve connecting all the demand curves in the structure of production (the dash-dot line) should be flatter than before, since it reflects a lower interest rate on the loanable funds market.



**Figure no. 9, Monetary expansion and the structure of production**

What is especially important on Figure no. 9 is the direction of arrows on the quantity axis. As can be perfectly seen, all are inclined to the right, to the expansion of production on every stage of the process, yet the strongest tendency is clearly observed in the earliest stages. Hence, the question, whether the supply can readily meet the demand, once all demands are increasing, does not seem to be answered in the affirmative.

As a first approximation of the whole problem, Hayek (1931) assumes that the economy operates on its potential (full-employment) level. In Hayek's own words, there are no idle resources that can be readily mobilised to satisfy the increased demand.<sup>15</sup> In that case, the supply will be raised only in the stages that have the biggest power to attract necessary factors of production. Figure no. 9 suggests that these are the stages very remote from the final consumption. They enjoy not only a widespread increase in demand, but another strong impulse in this phase of the production process comes in the form of the lowered interest rate. Furthermore, it is very likely that in the real world more than the proportional amount of new loans is channelled to industrial sectors and other capital-intensive branches of the economy. Nevertheless, the key economic reason rests in the fact that these sectors are

<sup>15</sup> A situation of the economy below its potential is discussed in a different paper in progress of the author of this article.

highly sensitive to changes in the interest rate, inasmuch as they are producing capital goods rather than goods very close to final consumption.

The foregoing analysis suggests that the earlier stages of production should attract factors of production (mainly labour and other unfinished and capital goods) at the expense of later stages and stages very close to final consumption. With the newly employed factors of production, new capital formations are initiated and the economy is on the way to more roundabout processes through capital restructuring as if the time preferences had been decreased. Nonetheless, compared to the decrease in time preferences, which resulted in a lower demand for consumption goods and consequently a reduced supply of these goods, in case of monetary expansion, the demand for consumption goods is rather increased. Paradoxically, the supply of consumption goods is reduced as the factors of production have been attracted to earlier stages of production.<sup>16</sup> This relative lack of consumption goods that was brought about by monetary expansion is known as the “forced saving” phenomenon, on Figure no. 8 represented by the distance AB. This type of saving makes the new investment possible to materialize. For some time, it supports the formation of new capital.

The key question, which immediately springs to one’s mind, is whether this triggered process is sustainable, whether the new capital formation can be finished and whether the new more roundabout process of production will finally provide higher output of consumption goods. This does not seem very probable, as the forces of supply and demand in the consumption stage are not consistent with each other; the consumer demand is boosted, yet the supply of consumption goods is partly reduced due to the transfer of resources to earlier stages of production. At the same time, the loanable funds model displays that the interest rate is below its natural level.

The Austrian theory of the business cycle predicts that the interest rate gap is not sustainable and the market interest rate should eventually return to the (initial) natural level. With the increase in the interest rate, the new longer roundabout processes will collapse, as they cannot be completed and the economy will move to a painful recessionary phase (see Figure no. 10). However, the main objective of this paper is not to describe the Austrian business cycle theory in a deep detail and discuss why the new capital formations are abandoned due to lower profitability, but to elucidate the reverse process of the interest rate to its natural level, even though the impact of this interest rate reversion on the real economy will necessarily accompany the analysis too.

The next part of the article compares major contributions of F.A. Hayek, L. Mises and M. Rothbard to the theoretical explanation of this interest rate process and then points out some of the inconsistencies that could emerge while analysing this phenomenon.

Hayek (1931) regards the interest rate mainly as the price margin between two successive stages of production. The lower the price margin, the longer and more roundabout methods of production the economy can afford. The monetary expansion depresses these price margins and enables the lengthening of the structure of production. In other words, it leads to a more capital demanding methods of production. New structure can be achieved only by attracting factors of production previously employed in the late stages of production by offering higher wages and other forms of income. Through this channel, the newly created money is obtained by the owners of various factors of production, mainly by workers. It is highly improbable that workers, now in the role of consumers, would dramatically change the time shape of their consumption in favour of the more remote one, in

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<sup>16</sup> On Fig. no 9 the transfer of factors of production from the market of consumption goods could be manifested as a north-western shift of the supply function.

favour of the future consumption goods, whose production has been just initiated in the form of various production goods.

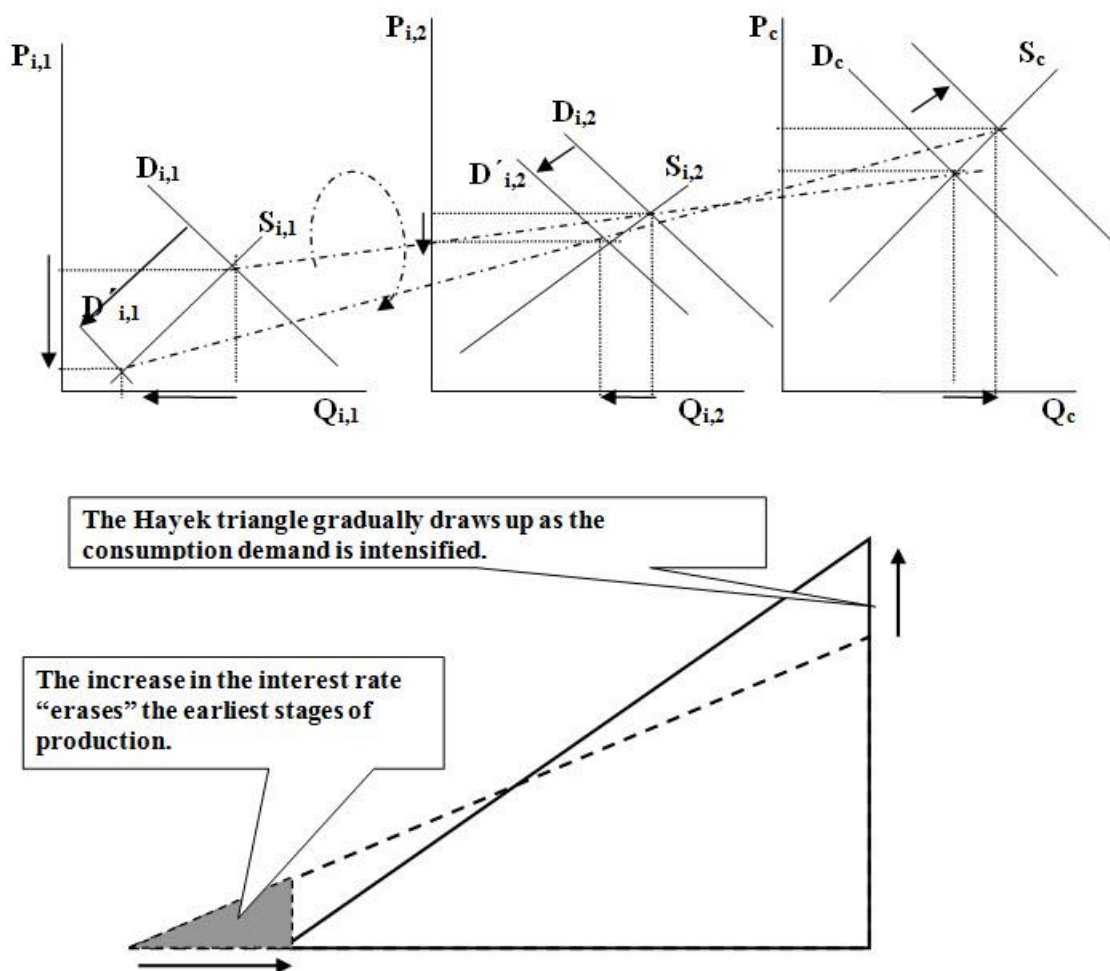


Figure no. 10, The reversion process of the interest rate and the road to recession

It is rather the opposite that can be expected, since the interest rate has been decreased. The enlarged demand for consumer goods on the part of workers produces a substantial upward pressure on prices of consumption goods further supported by the outflow of resources to earlier stages of production. The increase in the price of consumption goods will eventually lead to a rise in the price margins ( $P_c/P_i$ ) back to the pre-monetary expansion level. This explanation is precisely the core of the Hayekian approach to the interest rate reversion. In effect, the Hayek triangle changes its slope and the earlier stages of production are abandoned, since the higher interest rate decreases the demand for their products. As can be seen on Figure no. 10, the slump in prices is especially remarkable in the earliest stages of production, i.e. in the stages that experienced the highest price-increase at the beginning of the monetary expansion.

Hayek (1931:89) stresses that:

*At the same time incomes of wage earners will be rising in consequence of the increased amount of money available for investment by entrepreneurs. There can be little doubt that in the face of rising prices of consumers' goods these increases will be spent on such goods and so contribute to drive up their prices even faster. These decisions will not change the amount of consumers' goods immediately available, though it may change their distribution between individuals. But—and this is the fundamental point—it will mean a new and reversed change of the proportion between the demand for consumers' goods and the demand for producers' goods in favour of the former. The prices of consumers' goods will therefore rise relatively to the prices of producers' goods. And this rise of the prices of consumers' goods will be the more marked because it is the consequence not only of an increased demand for consumers' goods but an increase in the demand as measured in money. All this must mean a return to shorter or less roundabout methods of production if the increase in the demand for consumers' goods is not compensated by a further proportional injection of money by new bank loans granted to producers.*

This point of view is perfectly consistent with his approach in Hayek (1929:217):

*If, however, the fall in the rate of interest is due to an increase in the circulating media, it can never lead to a corresponding diminution in the price margin, or to a readjustment of the two sets of prices to the level of an equilibrium rate of interest which will endure. In this case, moreover, the increased demand for investment goods will bring about a net increase in the demand for consumption goods; and therefore the price margin cannot be narrowed more than is permitted by the time-lag in the rise of consumption goods prices — a lag existing only as long as the process of inflation continues. As soon as the cessation of credit inflation puts a stop to the rise in the prices of investment goods, the difference between these and the prices of consumption goods will increase again, not only to its previous level but beyond, since, in the course of inflation, the structure of production has been so shifted that in comparison with the division of the social income between expenditure and saving the supply of consumption goods will be relatively less, and that of production goods relatively greater, than before the inflation began.*

It is obvious that in Hayek's explanation the key role is played by the ratio of prices of consumption goods to the prices of producers' goods. This ratio will decide about the maximum length of the process of production the economy can eventually afford. For Hayek, the evolution of the general level of prices is by no means as important as the behaviour of the structure of relative prices, which substantially distinguishes his approach from modern business cycle theories. Hayek (1931) himself recognised an important contribution of his predecessor L. Mises. However, his big master was criticised for an excessive reliance on changes in the purchasing power of money in investigating the business cycle phenomenon.

L. Mises is considered as the founder of the Austrian business cycle theory. Hence, his approach resembles the more elaborated Hayek's theory. In his first magnum opus Mises (1912) analysed the effects of changes in the quantity of money on the interest rate. According to Mises, the money expansion firstly decreases the interest rate and triggers more roundabout methods of production. However, sooner or later the so called subsistence fund<sup>17</sup> is exhausted, which is manifested by a lack of consumption goods and an increase in their prices. This again means (almost by definition) a rise in the interest rate, since the price-difference between consumption and production goods spreads out.

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<sup>17</sup> The subsistence fund theory is much criticised in Hayek (1931, 1941).

Mises suggests that the increase in the interest rate is further reinforced by a decline in the objective purchasing power of money.

Let us document his approach in the following passage (Mises 1912:363):

*The increased productive activity that sets in when the banks start the policy of granting loans at less than the natural rate of interest at first causes the prices of production goods to rise while the prices of consumption goods, although they rise also, do so only in a moderate degree, viz., only in so far as they are raised by the rise in wages. Thus the tendency towards a fall in the rate of interest on loans that originates in the policy of the banks is at first strengthened. But soon a counter-movement sets in: the prices of consumption goods rise, those of production goods fall. That is, the rate of interest on loans rises again, it again approaches the natural rate.*

*This counter-movement is now strengthened by the fact that the increase of the stock of money in the broader sense that is involved in the increase in the quantity of fiduciary media reduces the objective exchange-value of money. Now, as has been shown, so long as this depreciation of money is going on, the rate of interest on loans must rise above the level that would be demanded and paid if the objective exchange-value of money remained unaltered.*

In his later work Mises (1949) greatly relies on changes in the purchasing power of money in analysing the dynamics of the interest rate over the business cycle. His reasoning closely resembles that of Fisher (1930) as he assumes that an expected decline in the purchasing power of money results in the increase in the interest rate and vice versa. That component of the interest rate, which responds to the changes in the purchasing power of money, Mises calls a price premium.

Mises claims that the size of the initial cut in the interest rate is closely related to the relative amount of money that is injected on the credit markets compared to the inflow of money on the markets for consumption goods. According to him, it is perfectly conceivable that the interest rates would not decline at all, if the initial injection of money was poured solely on the consumers' markets.<sup>18</sup> Nevertheless, once the interest rate is decreased, the well-known process of the business cycle is triggered. The rise in the quantity of money will sooner or later depress the general purchasing power of money (i.e. increase the price level). Afterwards, this widespread upsurge in prices will be manifested in higher interest rates through the price premium. And finally, higher interest rate should upset the process initiated by the monetary expansion and the phenomenon of the business cycle is on the way.

However, a key problem is whether the price premium does not raise only the nominal interest rate leaving the real interest rate at the artificially depressed lower level. At this moment, the explanation that the interest rate increases due to the fall in the purchasing power of money is not sufficient. If the nominal interest rate does not keep pace with inflation, the real interest rate can decline below its natural level resulting in further artificial lengthening of the structure of production.<sup>19</sup>

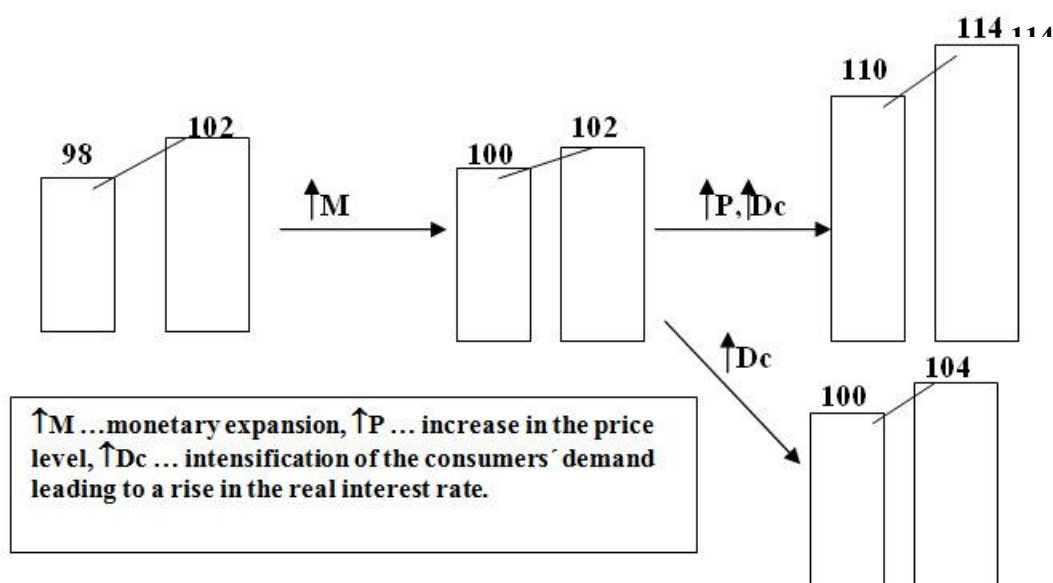
The explanation of the interest rate reversion cannot therefore hinge only on the general increase in prices. The more important ingredient must be found in Hayek's price margins, roughly (in aggregate) expressed as a ratio between prices of consumption and production goods ( $P_c/P_i$ ). The real interest rate, which is nothing more and nothing less than a particular relative price, is mirrored as a price

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<sup>18</sup> Similar statement can be found even in Hayek (1931) and Garrison (2001).

<sup>19</sup> Mises (1949) himself points this out.

difference<sup>20</sup> between goods in various stages of processing; regardless of the movement of the general price level. Even though this ratio falls immediately after the expansion of the money supply, sooner or later it is again raised by a substantial upsurge in the demand for consumption goods, when newly created money is earned by workers in the form of wages. In this phase of the business cycle, prices of consumption goods are rising at a higher rate than prices of capital goods due to the fact, that factors of production were attracted to the production of the later at the expense of the former. It is the relative scarcity of the consumption goods compared to the quantity of production goods (i.e. capital goods, future consumption goods at the different stage of processing) that causes the reversion of the real interest rate – price margin, back to its previous level.



**Figure no. 11, The dynamics of the interest rate in the Misesian system**

The entire process can be illustrated on Figure no. 11. Monetary expansion firstly reduces the real interest rate (ratio  $P_c/P_i$ ) from about 4 % ( $102/98$ ) to 2 % ( $102/100$ ). However, economic forces, which were thoroughly elucidated in the foregoing analysis, start to operate such that it is returned back to 4 % ( $104/100$ ). It is very probable that monetary expansion will also provoke an increase in the general price level (e.g. by 10 %), that will result in an upward shift of the nominal interest rate to 14 %. As the process of production proceeds in time, the nominal interest rate is to be calculated by comparing the initial value of the unfinished goods at time  $t_0$  (i.e. 100) with the value of more processed goods at time  $t_1$  (i.e. 114).<sup>21</sup>

M. Rothbard, another important proponent of the Austrian business cycle theory, sums up the findings of the previous authors, yet not many new ideas can be found in his exposition. His analysis about the dynamics of the interest rate can be documented by the following paragraph (Rothbard 1962:996):

<sup>20</sup> more accurately a logarithmic difference

<sup>21</sup> More on this topic can be found in Rothbard (1962).

*The owners of the original factors, with their increased money income, naturally hasten to spend their new money. They allocate this spending between consumption and investment in accordance with their time preferences. Let us assume that the time-preference schedules of the people remain unchanged. This is a proper assumption, since there is no reason to assume that they have changed because of the inflation. Production now no longer reflects voluntary time preferences. Business has been led by credit expansion to invest in higher stages, as if more savings were available. Since they are not, business has overinvested in the higher stages and underinvested in the lower. Consumers act promptly to re-establish their time preferences—their preferred investment/consumption proportions and price differentials. The differentials will be re-established at the old, higher amount, i.e., the rate of interest will return to its free-market magnitude. As a result, the prices at the higher stages of production will fall drastically, the prices at the lower stages will rise again, and the entire new investment at the higher stages will have to be abandoned or sacrificed.*

Further in his book Rothbard elaborates one important idea. It has been assumed so far that the (real) interest rate finally returns to its (previous) natural level. This assumption de facto embraces the idea that money is neutral in the long run leaving the natural rate of interest unaffected. The Austrian analysis could accept this as a first approximation, yet by investigating this phenomenon in a more detail, the Austrian authors usually extend their analysis by the following findings. The injection of money into the system never enters all markets at the same time and with the same intensity. Hence, prices of various goods produced by various people are affected very unevenly. Even in the long run, the resulting structure of relative prices will be presumably different compared to the pre-expansion period. The pouring of money into the economy changes the relative income and wealth of different people disproportionately, depending on the closeness of the particular individual to the stream of newly injected money. Some people certainly gain, others lose. And since people usually differ in their time preferences, it is highly probable that the aggregate saving function will be at a different position than it was before the money injection.

It would be quite surprising if the second blade of scissors on the loanable funds market - investment did not change its position as well. If the Austrian explanation of the economy-wide fluctuations is at least partly correct, business cycle will undoubtedly bring about losses of capital on a large scale. Hence, final marginal productivity scheme is blurred in obscurity. As the monetary disturbances and the triggered business cycle finally affect both curves on the loanable funds market, the eventual level of the natural rate of interest is impossible to determine. This idea is also present in Mises (1912:364):

*A precise re-establishment of the old price-ratios between production goods and consumption goods is not possible, on the one hand because the intervention of the banks has brought about a re-distribution of property, and on the other hand because the automatic recovery of the loan market involves certain of the phenomena of a crisis, which are signs of the loss of some of the capital invested in the excessively-lengthened roundabout processes of production.*

Hence, it can be concluded that money is not neutral even in the long run. However, this long run non-neutrality of money substantially differs from the well known New Keynesian theory of hysteresis. New Keynesians (Mankiw and Romer, 1991) quite often predict that monetary restriction or expansion can affect the natural rate of unemployment; relaxed monetary policy may decrease it through a reduction of the actual unemployment rate, whereas tighter monetary policy leaves visible scars on the economy in the form of permanently higher unemployment. The Austrian theory by no means implies that the monetary expansion could reduce permanently not only the actual, but also the natural rate of interest and thus inflame faster economic growth with lower unemployment rates, as some of the New Keynesians would suggest. As was demonstrated before, monetary expansion disturbs the equilibrium



of the economy, so the eventual level of the natural rate is undetermined. At the same time, monetary expansion temporarily deflects the interest rate from its natural level and triggers the business cycle process rather than sustainable economic growth. This brings about losses of capital rather than its new creation. It is highly unlikely that such a process would reduce long term unemployment. The opposite evolution of the natural rate of unemployment is quite reasonable to expect.

The evolution of the interest rate in the Austrian story can be depicted on Figure no. 12. These graphs show that at time  $t_0$  monetary expansion decreases both the nominal and the real rate of interest below their natural levels. As was demonstrated before, at one moment the process is reversed, even though it is not known how long it will take before it comes. However, it is quite reasonable to expect that the nominal interest rate starts to grow earlier than the real interest rate ( $t_1 < t_2$ )<sup>22</sup>, as its growth is fuelled by one more source – inflation. Nevertheless, the eventual level of both rates is not determined, yet the nominal interest rate will presumably exceed its initial level as it should include higher inflation rate, if the monetary expansion has produced it as well. The primary reason of final indeterminacy of the market interest rate (full line) is the unknown path of the natural rate of interest (dashed line) after the money supply injection.

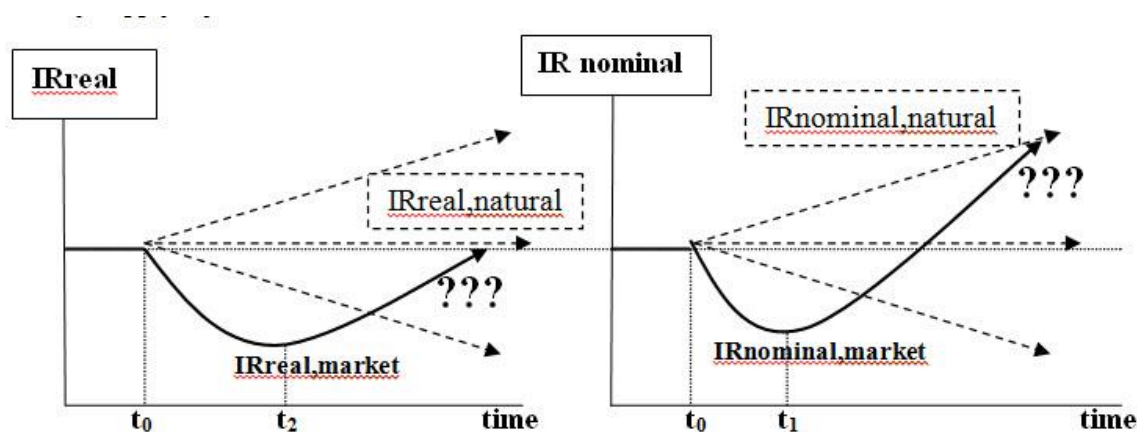


Figure no. 12, The indeterminacy of the eventual level of the interest rates

### 2.3 Hayek strikes back – the Ricardo Effect

In the late thirties and early forties Hayek refined his theory and introduced a new argument that should have supported his previous findings. His new approach soon became a target for a sharp critique of the Austrian theory leading to a definite victory of the Keynesian revolution.<sup>23</sup>

The analysis begins at the top of the boom phase of the business cycle, when the consumer demand is reinforced by higher earnings of the primary factors of production (especially labour). Markets for consumption goods experience a positive demand shock, leading to an increase in consumption goods'

<sup>22</sup> As can be seen on Figure no. 13, there is a time period (from  $t_1$  to  $t_2$ ), when the nominal interest rate is actually rising, however, the real rate is still declining. This lag of the real interest rate behind the nominal rate was mentioned even by Fisher (1930), who stated that nominal interest rate does not respond enough (both in time and height) to inflation, which leads to a decline in the real interest rate.

<sup>23</sup> Hayek's new approach can be found in Hayek (1939,1941,1942a). The critique in Kaldor (1942), and consequent Hayek's response in Hayek (1942b).

prices. At this stage of the process Hayek assumes that the increase in their prices exceeds the rise in wages. Thus the real wages fall, defined by Hayek as a ratio of nominal wages to the price of goods produced by the given labour. At the same time, consistently with the foregoing analysis, Hayek claims that price margins are rising as well, yet in his later works called the profit margins. In this phase of the business cycle, Hayek proves that this particular development of the profit margins necessarily results in the shortening of the methods of production, in the substitution of labour for capital and in the abandoning of the most roundabout methods of production initiated at the beginning of the boom. His novel argument should give additional reasons for the straightening of the Hayekian triangle at the end of the boom and the outset of the recession.

Hayek again claims that the increase in the consumers' demand at the top of the boom leads to a reduction in the investment spending. However, he adds one important assumption, namely that entrepreneurs cannot borrow money on credit markets. Hence, he analyses the behaviour of entrepreneurs in the situation, when profit margins mount, while the access to new loans is limited. By this assumption, Hayek bypasses the influence of the loanable funds market and focuses only on the processes within a single firm.

The key question is which methods of production are to be used by entrepreneurs, once the profit margins go up. Let us go over Hayek's own numerical example, yet extending his approach by additional calculations. Consider a hypothetical firm that has three different methods at its disposal for manufacturing a given output. At the beginning, all three methods earn the same profit rate, hence the firm is indifferent which of these should be used. The first method is characterised by a very low profit margin, say 1 % (e.g. the entrepreneur buys inputs for 100 and sells output for 101), but the rate of turnover of this method is rather high – the firm can repeat this production process 6 times per year, from buying inputs to selling the final output, as the final output matures just in two months. As a result, the profit rate on the year basis is about 6 % (precisely 6.15 %). The second method turns over the firm's capital once a year and it has the profit rate of about 6 % as well (e.g. inputs are bought for 95 at the beginning of the year and output is sold at the end of the year for 101). And finally, the profit margin of the third method is high – 80 %, however, the rate of turnover is very long -10 years (e.g. the firm buys inputs for 56 while selling the output after 10 years for 101). Yet, the profit rate on the annual basis of this really roundabout method of production is also only 6 %.

As was stated above, the cycle is at the top of the boom and the methods of production have been lengthened as a result of an artificial lowering of the interest rate. Now, the newly created money is earned by workers trying to restore their real consumption somewhat decreased by the shift of resources to earlier stages of production.<sup>24</sup> At this stage of the process, the strong consumers' demand flows on the markets for consumption goods, leading to a rise in their prices, say by 5 % (from 101 to 106 in our example). This increase in consumption goods' prices cannot leave the profit margins and profit rates of our hypothetical methods of production unaltered.

The profit margin of the first method rises from 1 % to 6 % (106/100), but the profit rate on the annual basis skyrockets to 42 % (without compounding to 36 % = 6\*6 %). The second method registers an increase to 11 % (106/95) and the third method, the most roundabout method, will be almost unaffected – the profit rate on the year basis will go up just by 0.6 p.p. to 6.6 %.<sup>25</sup>

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<sup>24</sup> We may say that this is exactly the point of time, when the phenomenon of the forced saving is about to end, as the workers have finally the newly created money at their command.

<sup>25</sup>  $(106/56)^{1/10} - 1 = 6.6\%$

Such abrupt changes in the relative profitability of various methods of production should induce the entrepreneurs to use those methods, which reach the final output as fast as possible. It is obvious that firms will be motivated to reduce the roundaboutness of their production process. In particular, Hayek (1942a) offers several ways – to substitute the labour-intensive methods for labour-saving processes, to overuse the capital goods at firms' disposal or not to renew the worn out capital units.

This effect, by Hayek called the Ricardo effect, thus supports the fundamental conclusion of the Austrian theory – an upsurge in the consumers' demand leads to a reduction of the roundaboutness of the production process, to the shortening of the Hayekian triangle. The core reason lies in the fact that an increase in the rates of profit favours those methods of production generating consumption goods in a relatively shorter period of time.

At the end of this chapter let us mention one objection raised by N. Kaldor (1942), which will form the basis of the next part of the article. In his point of view, it seems to be absurd that an increase in the rates of profit should result in the reduction of the capital invested rather than in the capital extension. After all, is not it the rise in profitability (the marginal productivity of capital) that should primarily lead to an increase in investment spending? One possible resolution is suggested in the following chapter.

### 3. CONFUSION IN THE AUSTRIAN BUSINESS CYCLE THEORY

In this chapter, we will try to clarify some confusions, misunderstandings and contradictions that can be detected in the Austrian analysis. Even though these misunderstandings seem to be trivial, as the original authors did not use much graphical or even mathematical apparatus, they provoked much discussion between the adherents and critics of the Austrian theory.

In brief, the Austrian business cycle theory and the resulting dynamics of the interest rate can be portrayed by the following chain of implications:

- 1) Monetary expansion induces a decrease in the interest rate, which motivates entrepreneurs to increase investment spending.
- 2) However, massive investment demand should sooner or later raise the interest rate back.
- 3) And finally, higher interest rate depresses the investment spending and subsequently triggers the recession.

No deep scientific investigation is needed to uncover the fact that the foregoing statement is a clear example of circular reasoning. In particular, the implications do not distinguish between the movement along the (investment) curve and the shift of the entire curve. The first confusion is partly present in the second sentence, yet the biggest problem is to be found in the logical link between the sentences as such. In the following paragraphs, we will try to explain some sources of this confusion.

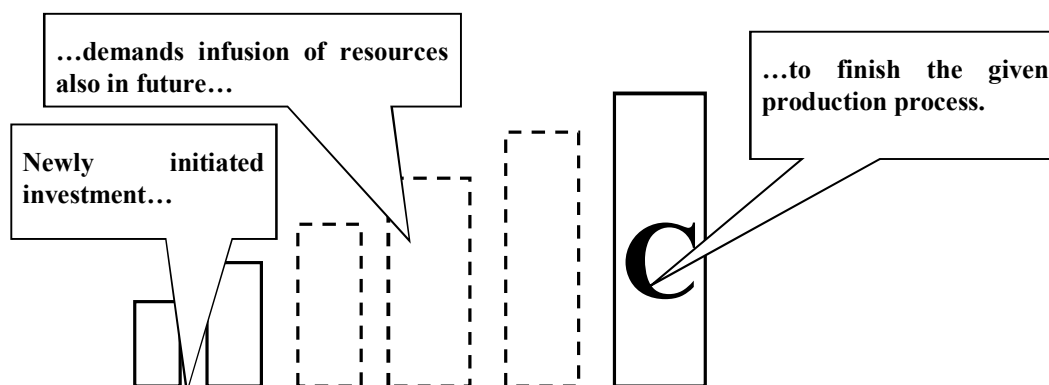
On Figure no. 8 it can be clearly seen that monetary expansion lowers the interest rate. And this interest rate cut results in the growth of investment. However, a more precise conclusion should be that the decline in the interest rate increases the quantity of the investment. No shift of the entire investment curve is initiated. Hence, there can be no subsequent increase in the interest rate, as is suggested in the second statement. In other words, the second statement is by no means implied by statement no. 1.

The fundamental problem rests in the fact that the Austrian theory is a dynamic theory, whereas the neoclassical loanable funds market is a static model. Hayek (1937) quite persuasively identifies one important fact- the investment initiated today requires additional capital investment also in the future, if the entire process of capital formation is to be completed. This simple idea is depicted on Figure no. 13. The additional important view can be found in the following paragraphs:

*“Anything which will lead people to expect a lower rate of interest, or a larger supply of investible funds, than will actually exist when the time comes for their utilization, will in the way we have suggested force interest rates to rise much higher than would have been the case if people had not expected such a low rate.” Hayek (1937:176)*

*“An increase in the rate of investment, or the quantity of capital goods, may have the effect of raising rather than lowering the rate of interest, if this increase has given rise to expectation of greater future supply of investible funds than is actually forthcoming.” Hayek (1937:176)*

Hayek’s words suggest that the interest rate has a tendency to go up, if the expected inflow of saving (or better to say, an expected increase in the supply of loanable funds that can be brought about even by monetary expansion) does not arrive. The unfounded increase in investment, that will eventually lack necessary savings, will initiate an abrupt rise in the interest rate, once this error is realised. We will return to this phenomenon later on.



**Figure no. 13,** Investment that demands further investment

The second and more important problem in the sound reasoning is present in the implication between sentences no. 2 and 3. As was mentioned before, N. Kaldor subjected Hayek’s theory to a rather unpleasant critique. If the profitability of firms grows at the end of the boom, then this fact should undoubtedly result in the outward shift of the investment function. As is obvious from Figure no. 14, it will surely increase the interest rate. Nonetheless, the overall quantity of the capital invested can never

decline (as is suggested by statement no. 3)<sup>26</sup>, unless the saving function has a perverse downward sloping shape. According to Kaldor, higher profitability can never induce the elimination of capital and consequent recession, as was continually asserted by Hayek in his articles. In graphical terms, it is highly improbable that higher profit margins could ever straighten the Hayekian triangle and erase the earliest stages of production (see the grey zone on Figure no. 10).

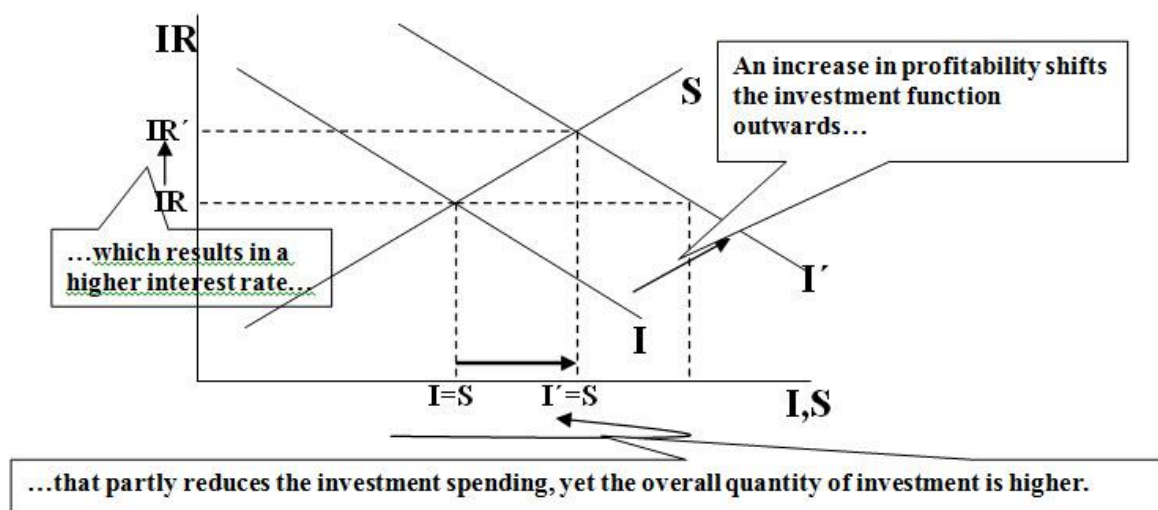


Figure no. 14, Ricardo effect in Kaldor's reasoning

It seems that the Austrian theory can hardly overcome the Kaldor's critique. However, quite fortunately for Hayek's theory, Kaldor omitted one important step in the Austrian reasoning. It is undoubtedly true that a rise in prices of consumption goods leads to a higher profitability. Nevertheless, this upsurge in prices is caused by a reinforced flow of consumers' demand, thoroughly elucidated in the foregoing chapters. This resurrection of consumers' demand represents the end of the forced saving phenomenon. In other words, higher consumption demand reduces saving in the economy. Obviously, it must result in an increase in the interest rate. And consistently with a rise in the interest rate, the profit margins ( $P_c/P_i$ ) go up with higher prices of consumption goods. Figure no. 15 illustrates this rather complicated process.

<sup>26</sup> Some traces of similar confusion can be found in Mises (1949:553):

*Of course, in order to continue production on the enlarged scale brought about by the expansion of credit, all entrepreneurs, those who did expand their activities no less than those who produce only within the limits in which they produced previously, need additional funds as the costs of production are now higher. If the credit expansion consists merely in a single, not repeated injection of a definite amount of fiduciary media into the loan market and then ceases altogether, the boom must very soon stop. The entrepreneurs cannot procure the funds they need for the further conduct of their ventures. **This gross market rate of interest rises because the increased demand for loans is not counterpoised by a corresponding increase in the quantity of money available for lending.** [emphasis added]*

and also in Garisson (2001:72):

*The bidding for increasingly scarce resources and the accompanying increased demands for credit put upward pressure on the interest rate.* [emphasis added]

As can be seen on the picture, the increase in the interest rate reduces rather than raises the amount of investment, as was claimed by Kaldor. And the rise in the interest rate manifests itself in the shortening of the Hayekian triangle and in the reduction of the entire roundabout process of production. This abrupt shortening, accompanied by massive losses of artificially created capital especially in the very early stages of the production process, is identified as a recession (Figure no. 16). Furthermore, by an upward movement along the investment curve, it can be perfectly seen that the marginal product of capital rises. In other words, profit margins grow, which consistently closes the logical chain of the reasoning.

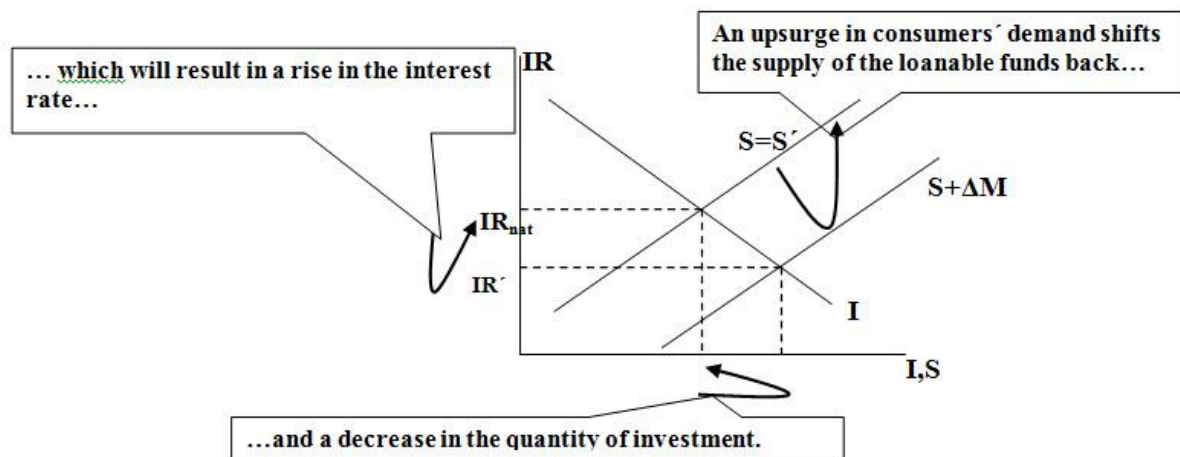


Figure no. 15, The reversion of the interest rate in the Austrian theory

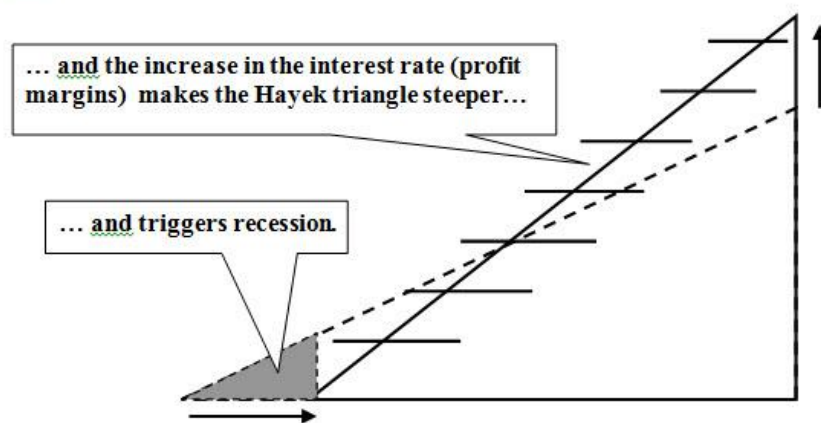


Figure no. 16, Straightening of the Hayekian triangle: A road to recession

The foregoing analysis suggested that high profit margins are consistent with the reduction of the capital stock, once we realise that the Austrian analysis predicts a decrease in saving (i.e. the shift of the saving function to the left) at the top of the boom rather than an outward shift of the investment function. However, the key question is, which phenomenon moves the saving function inwards, as only this movement rescues the Austrian analysis from the Kaldor's critique.

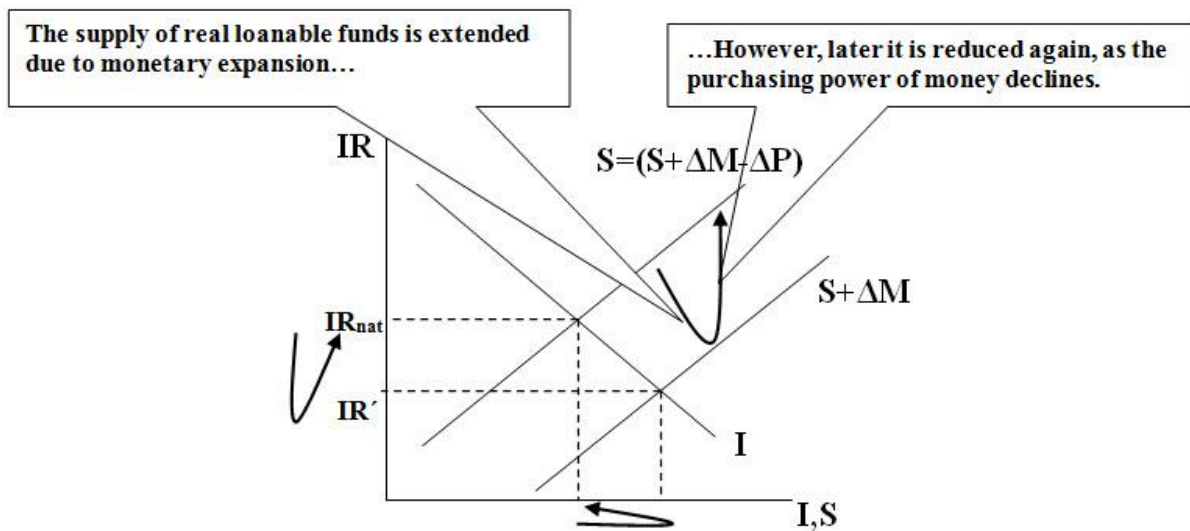


Figure no. 17, Reversion of the interest rate based on the decline in the purchasing power of money

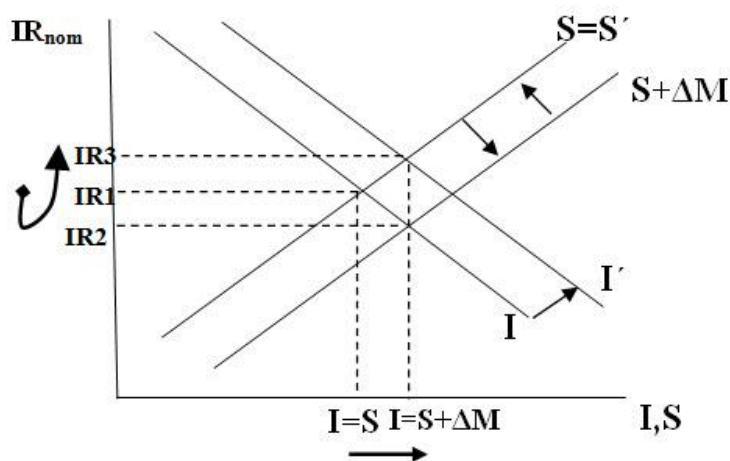


Figure no. 18, Monetary expansion and the Fisher effect

The first solution may be traced in Mises's theory. So far, it has been assumed that the loanable funds market is a model with real savings, real investment and the real interest rate. However, as in reality the intermediation between saving and investment comes in the form of money, the initial increase in the supply of credit, brought about by the pure monetary expansion on the part of the banking sector, undoubtedly leads to an extension of supply of real loanable funds.<sup>27</sup> The presence of higher real supply on the credit market cuts down the real interest rate, which works as a signal to entrepreneurs

<sup>27</sup> At this moment, it would be better to avoid the term – expansion of real savings. The injection of money into the system extends the supply of real funds firms have at their disposal. Using the term “increase in real savings” would suggest that monetary expansion brings about higher saving on the part of people, which is obviously never the case; rather the opposite is true.

that more real resources may be used in the creation of new capital. Sooner or later, as Mises stated, the monetary expansion will be reflected in the lower purchasing power of money, which reduces the supply of real loanable funds to the previous level. The major reason lies in the fact that higher price level reduces the purchasing power of funds obtained by entrepreneurs and diminishes the amount of real resources that can be attracted by them. This type of the reversion process is illustrated on Figure no. 17.

The question is whether this movement of the supply function, representing the supply of real loanable funds on the market, is justifiable. As was analysed earlier, increasing price level may push up only the nominal interest rate, leaving the real rate unchanged. It is therefore conceivable that the monetary expansion would depress the real interest rate permanently. As a result, the crucial reversion dynamics of the interest rate will never occur. Figure no. 18, where the variables are expressed in nominal terms rather than in real terms, represents this process.

As can be seen on Figure no. 18, monetary expansion depresses the nominal interest rate from IR1 to IR2. A gradually increasing price level, which results from the monetary expansion, will provoke expectations on the part of both savers and entrepreneurs. Savers are willing to offer lower saving in expecting lower purchasing power of money in the future (the saving function moves to the left). On the other hand, entrepreneurs are prepared to invest more for the given nominal interest rate foreseeing the fact that in the future the debts can be repaid with depreciated money (the investment function shifts outwards). Both tendencies push the nominal interest rate upwards to IR3. This process, known as the Fisher effect, moves the nominal interest rate one-to-one with inflation, yet the real interest rate can be stuck at an artificially lower level.

The problem is that there does not exist any mechanism that would compensate for the initial increase in the money supply. As a result, the investment can be permanently boosted, since the real interest rate remains at a lower level.

Hence, at least one more element is necessary for the explanation of the rise in the real interest rate and the eventual reversion of the forces initiated by the monetary expansion. And this element is to be found in the mounting of the consumers' demand at the end of the boom. This upsurge of demand leads to the exhaustion of the forced saving phenomenon and to the return of price margins ( $P_c/P_i$ ) back to their initial level. Exactly at this moment, the economy starts to suffer from a lack of saving. The artificially initiated capital structures cannot be completed, because resources are attracted back to the stages closer to consumption.

As was discussed before, the more important in the entire process is the dynamics of the relative prices (in this case  $P_c/P_i$ ) rather than the movement of the general price level. This reversion process of the interest rate may be depicted on Figures no. 19 and 20.

An alternative graphical representation of the interest-rate reversion can be based on Hayek (1937). Entrepreneurs, erroneously led by a decrease in the interest rate, expect a sufficient amount of real saving in the future. Yet, as was demonstrated before, monetary expansion cannot guarantee this permanently. Hence, the relative lack of real saving results in an increase in the interest rate, overshooting the level, which would have been established on the market, if the false signal in the form of an artificially low interest rate had not been introduced. However, it is not obvious, why the expectations about the future amount of real savings are to be wrong. One possible explanation can be found in the monetary part of the economy. Changes in the money supply disturb the only fundamental signal entrepreneurs have, namely the interest rate. As a result, this deformed signal leads to a behaviour on the part of entrepreneurs that has no support in real economy.



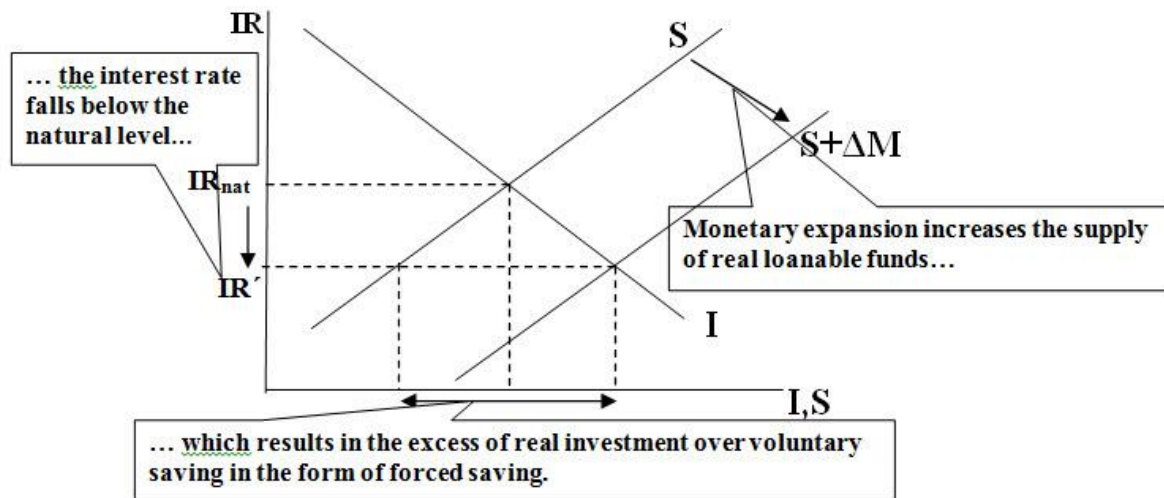


Figure no. 19, Dynamics of the interest rate in the Austrian business cycle theory (I)

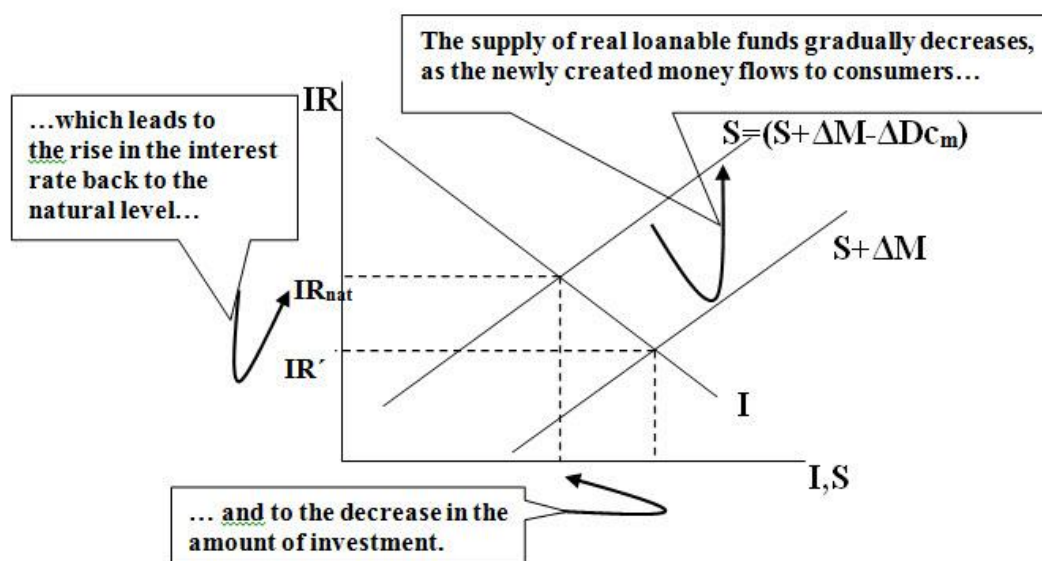


Figure no. 20, Dynamics of the interest rate in the Austrian business cycle theory (II)

In essence, a cut in the interest rate brought about by the monetary expansion can be considered as a regulation of price, leading to an excess of investment over saving. However, sooner or later, robust economic forces are activated in the economy, which eventually make this intervention ineffective. Initial decrease in the real interest rate will bring about a drop in real savings, leading eventually to a steep increase in the interest rate - IR3 on Figure no. 21.

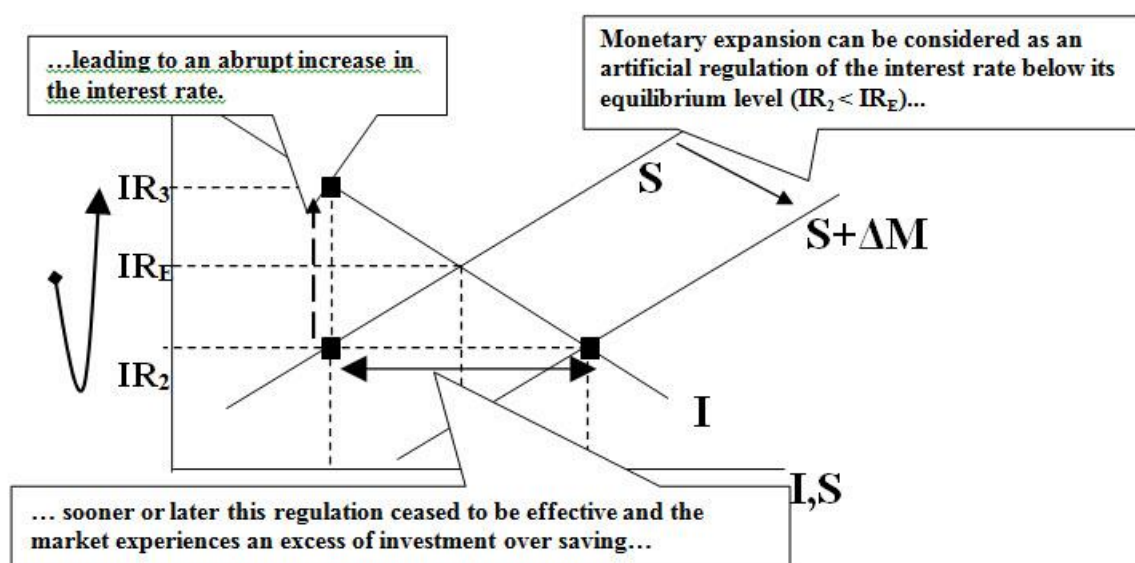


Figure no. 21, Alternative representation of the interest rate reversion

For some economists, even this type of analysis may not be satisfactory. Especially the fact, that a rise in consumption and profitability should reduce investment, must be totally fantastic at least for Keynesians. However, the Austrian capital theory provides us with the necessary insight.

Suppose that we accept the Keynesian argument that the upsurge in consumption demand and overall profitability would lead to a general increase in investment. Let us analyse consequent implications in the Austrian model. In the Austrian theory, a rise in investment will be manifested by an increase in the roundaboutness of the production process. However, newly being built capital requires resources not only in the form of the original means of production (labour, land), but also in the form of complementary variable capital. Assuming that resources are scarce, which is quite reasonable assumption especially at the top of the boom, resources can be obtained only at the expense of other stages of production, namely those operating very close to final consumption. Hence, newly built capital structures start to attract more resources from the very late stages of production. This shift should consequently reduce the supply of present consumption goods, as the initiated capital structures will provide consumption goods in a more remote future. As can be seen, the Keynesian analysis leads to a rather paradoxical conclusion; the upsurge in the consumption demand (i.e. demand for present goods) finally brings about a reduction in the supply of consumption goods (i.e. the supply of present goods), since resources are shifted to the production of future consumption goods.

It would be quite difficult to find a more significant failure of the working of the market system. Moreover, if the increase in the demand for consumption goods results in the reduction of their supply, the entire process cannot be sustainable, as both tendencies push their prices upwards. With higher prices of consumption goods the profit margins skyrocket, because the ratio  $P_c/P_i$  increases without any bounds.<sup>28</sup>

<sup>28</sup> As the resources are moving to early stages of production, finally producing more capital goods, and at the same time, the demand is mainly directed to final consumption goods, the term  $P_i$  (i.e. price of capital goods) falls down, further encouraging growth in the profit margins ( $P_c/P_i$ ).

Sooner or later, the whole process must be upset, since very high profit margins and the deficient supply of present consumption goods motivate entrepreneurs to shift a considerable part of the factors of production back to the production of final consumption goods. Hence, the upsurge in the consumption demand can never lead to the growth of capital in the economy; it can never provoke the lengthening of the Hayekian triangle.<sup>29</sup>

The foregoing paragraphs suggest that the Austrian analysis has sufficient tools to disprove the traditional Keynesian idea. Furthermore, taking the Keynesian argument ad absurdum, its fantastic content will be immediately unmasked. As was shown above, Keynesians assume that the increase in consumption demand should induce higher investment spending. As a result, factors of production are then attracted to early stages of production, where they earn income for their services. It is quite reasonable to expect that new incomes are mainly used for consumption. However, at the same time, only a negligible part of just initiated processes mature in final consumption goods. This must necessarily lead to an imbalance between the supply and demand on the market for consumption goods, to a subsequent increase in their prices and eventually to a higher profitability of stages that are posited very close to final consumption.

By following the Keynesian argument, the increase in profitability leads to the additional rise in investment spending, which in the Austrian model results in further lengthening of the structure of production. As a result, more and more factors of production and other resources are attracted into processes that produce no or just a small amount of final consumption goods in the near future. By using the reductio ad absurdum argument, the Keynesian analysis necessarily implies that the continuing flow of demand for consumption goods leads to a zero supply of these goods, which is really impossible. This analysis could only work, if the entire income earned by various factors of production that have been attracted to early stages was saved. Yet, no reasonable economic argument entitles us to assume that no part of the new income will be used for consumption. It is as inconceivable as the argument that the increase in consumption demand will provoke lengthening of the structure of production.

Finally, we may state one fundamental conclusion: An upsurge in the consumption demand will always bring about a partial destruction of capital in the economy, especially during the business cycle. The entire process is orchestrated by the interest rate, or more precisely - by its reverse (or U-shaped) dynamics.

#### **4. ENDOGENEITY OF THE MONEY SUPPLY**

It has been consistently assumed throughout our analysis that the initial impulse for the business cycle and the consequent dynamics of the interest rate are to be found in the behaviour of the central bank and the monetary policy as such, especially in the interest rate cut below the natural level. This stream of reasoning, which can be found especially in the works of Mises (1949) and Rothbard (1962), will be slightly modified in the following parts. Specifically, we will investigate different evolution of the interest rate that can be also observed over the business cycle.

Hayek (1929) in his works admits that the initial impulse for the business cycle may arise also in the real economy. Following his reasoning, let us assume that the economy is hit by a positive

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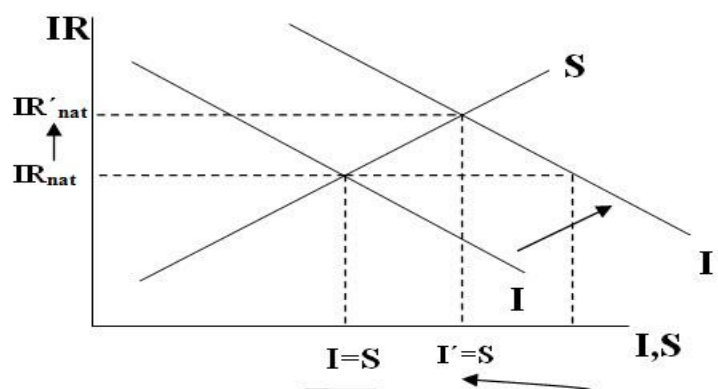
<sup>29</sup> This theory is at odds with the concept of the accelerator, thoroughly investigated in Hayek (1939).

technological shock, which is a modern analytical counterpart of the older assumption of a new invention that suddenly arises in the economy.

In the Böhm-Bawerkian analysis, the new invention can further improve the superiority of present goods over future goods, and at the same time it usually makes the time shape of the income stream steeper (Fisher 1930). Both tendencies will undoubtedly increase the premium of present goods over future goods. In terms of our analysis, it will increase the natural rate of interest.

In a well-known Fisherian analysis, new invention will improve the investment opportunities in the economy, which will lead to an increase in the natural rate of interest at least for the period, till the possibilities of new invention are completely exhausted.<sup>30</sup> Hayek (1941) in his famous work follows the Fisherian or even the Knightian analysis by stressing the importance of the marginal productivity of capital, or better saying, marginal increase in final output that results from a rise in the roundaboutness of the production process. In addition, a positive technological shock, or a new invention, will surely increase the schedule of the marginal productivity of capital.<sup>31</sup>

In the loanable funds market model, this improvement will be manifested as an outward shift of the investment function. For the given shape of the saving function, the natural rate of interest must necessarily increase. However, according to Hayek (1929), if no reaction is activated in the monetary part of the economy, there is no reason to expect, that the phenomenon of the business cycle should ever be triggered, as the voluntary saving is consistent with higher investment.



**Figure no. 22, Positive technological shock on the loanable funds market**

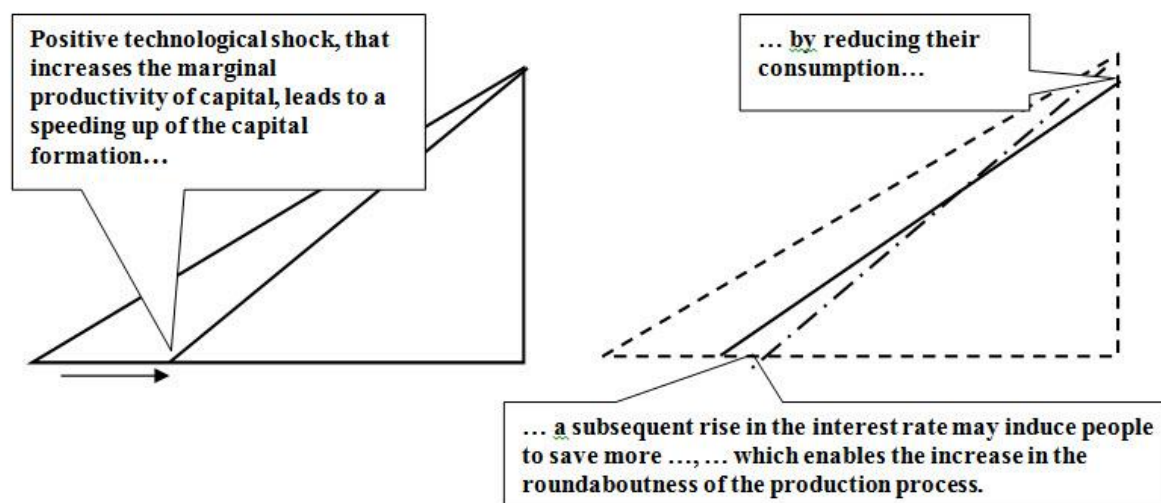
As can be seen on Figure no. 22, the initial natural rate of interest is no longer consistent with equilibrium on the loanable funds market, since at this level investment exceeds voluntary savings. To clear the market, the natural rate of interest must go up. It is obvious that the increase would be more

<sup>30</sup> The subsequent dynamics of the natural rate of interest will be surely much more complicated than the path suggested in this paper. New invention will bring about an increase in income that will push the interest rate downwards. However, the precise description of the path of the natural interest rate would require a more complicated model of the growth theory. Fisher (1930) himself suggested that the eventual level of the interest rate would be somewhat lower. On the other hand, modern growth models as the Solow or the Ramsey-Cass-Koopmans models base their predictions on the distinction, whether the initial shock improves only the level of technologies in the economy, or their growth rate.

<sup>31</sup> Rothbard (1963:32), as the adherent of the pure time preference theory, strictly rejects this type of analysis:

*In defense of the Mises "anti-bank" position, we must first point out that the natural interest rate or "profit rate" does not suddenly increase because of vague improvements in "investment opportunities." The natural rate increases because time preferences increase.*

significant for a steeper saving function. As the interest rate goes up, two phenomena start to operate. First, part of the investment is detracted, since only the most profitable ones can survive with higher interest rate. Second, higher interest rate attracts new voluntary savings. In the end, more investment projects are initiated compared to the situation before the invention. We may also add that the number of the investment projects crucially depends on the willingness of people to forego part of their present consumption.



**Figure no. 23,** Positive technological shock with perfectly inelastic (left part) and elastic (standard) saving function (right part) – Hayek triangle representation

A little bit puzzling could be the attempt to illustrate such a change in the natural rate in the Hayekian triangle model, since this simple model was mainly designed to depict changes in the saving rate. Nonetheless, as the interest rate increases, it is obvious that the triangle becomes steeper. At the same time, it is quite reasonable to assume that new invention allows the given output of consumption goods to be produced (with the given amount of primary factors of production) more quickly than before. Hence, the triangle will become also shorter.<sup>32</sup> If the saving function is perfectly inelastic, in other words, if the increase in the interest rate does not persuade people to postpone their present consumption, the positive technological shock will transform the Hayek triangle in a way that can be seen on the left part of Figure no. 23. On the other hand, if people respond to changes in the interest rate, its rise will somewhat reduce their present consumption, which allows partial increase in the roundaboutness of the production process (right part of Figure no. 23).

The foregoing analysis suggested that the positive technological shock increased the rate of interest. However, the model intentionally disregarded the monetary part of the economy. Since the saving and investment are traded in the form of money, may we assume that money will not play any significant role in this transmission process? In other words, will the response of the banking sector be purely neutral to the increase in the natural rate? Will the banking system follow the evolution of the natural rate of interest by increasing market interest rates in the economy?

<sup>32</sup> This change of shape can be partly deduced from Hayek (1941, 1942a).

A hypothetical scheme on Figure no. 24 offers two possible responses of the banking system to the increase in the natural rate of interest.

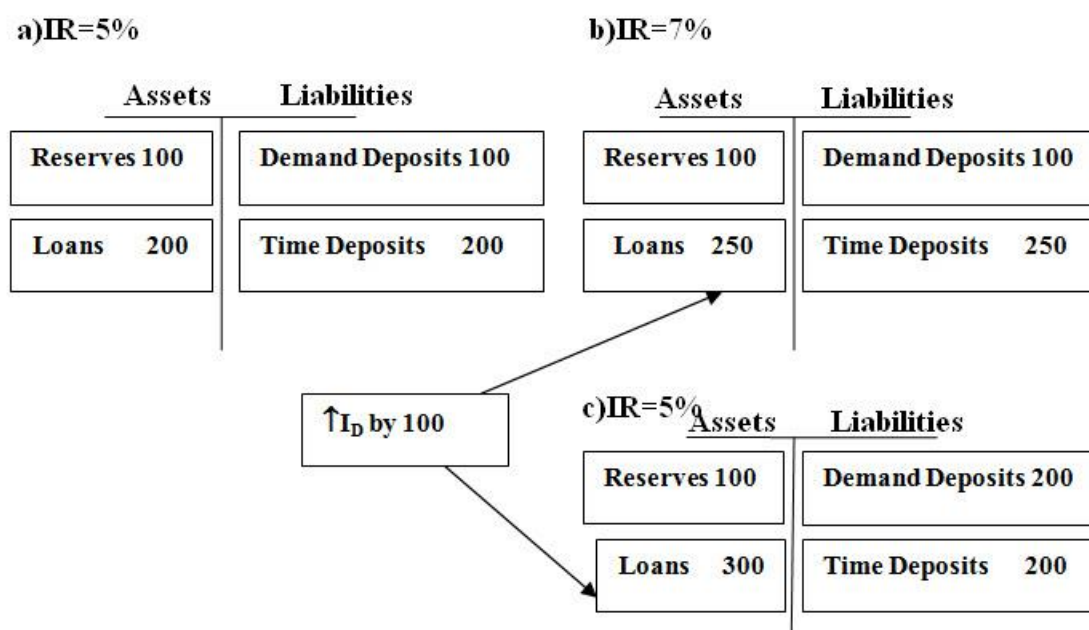


Figure no. 24, Endogeneity of money in the Austrian model

This scheme represents a simplified balance sheet of commercial banks holding initially 100 % reserve ratio. In situation a), banks hold 100 as reserves to fully back demand deposits, whereas loans of the size of 200 are financed by time deposits that may not be immediately withdrawn by clients.<sup>33</sup> This situation can be also interpreted as that the investment is financed by voluntary savings, where the equilibrium natural (and market) interest rate is for instance 5 %.

Consider again a positive technological shock increasing the investment demand, which is manifested as a higher demand for loans in the banking sector (e.g. from 200 to 300). At this stage, the demand of 300 exceeds the supply of 200 and the interest rate in the banking sector should go up. If this truly happens (situation b), part of the investment demand is repelled (e.g. from 300 to 250) and presumably, some savings are attracted (from 200 to 250). As we can see, the voluntary savings are again in balance with investment. This balance has been brought about by an increase in the natural (and market) interest rate from 5 % to (say) 7 %.

However, a slightly different response of the banking sector is also conceivable. Let us assume that the banking sector keeps the market interest rate unaltered and fully accommodates the increased demand for loans by creating new demand deposits (situation c). In this case, the phenomenon of the forced saving emerges, since the investment (300) exceeds voluntary savings (200) and the market interest rate (5 %) does not keep pace with its natural counterpart (7 %).<sup>34</sup> The imbalance between voluntary

<sup>33</sup> For simplicity, we assume that the time structure of loans and time deposits is very similar.

<sup>34</sup> The reader may excuse the example here, even though it is highly stylized. One big inconsistency lies in the fact that investment and saving are flows, whereas monetary and credit aggregates are stocks. It would be more in line with the concept of flow, if we stated that

saving and investment is made possible by the elastic supply of money. Specifically, money supply increases from 100 to 200, as banks do not hold 100 % reserves; the reserve ratio falls from 100 % to 50 % (=100/200).

It can be perfectly seen, that the interest rate fails to transmit the information about the increase in the investment demand. Furthermore, it would be rather surprising if this failure had no repercussions in the real economy.

We have suggested two extreme responses of the banking sector. However, the reaction of the banking sector in reality may be at any point of this hypothetical interval. Hayek (1929) assumes that once the demand for loans increases, commercial banks seldom raise their interest rates sufficiently high and promptly enough. Their typical response is much closer to situation c), as they rather increase their credit capacity instead of the interest rate. As a result, the market interest rate falls below the natural level, meaning that it does not increase sufficiently to keep pace with the natural rate of interest.

So far, we have completely disregarded the response of the central bank. However, it is not very far-fetched to assume that the central bank will reinforce the entire process rather than dampen it. For in the modern world central banks fix their interest rates at some predetermined level, the commercial banks may keep their reserve ratio intact simply by borrowing high-powered money directly from the central bank. As a result, the increased demand for loans is transmitted throughout the banking system directly to the central bank, which eventually feeds up the entire process.

Although the central bank may follow some policy rule in setting the policy rates, the biggest weight is usually put on the output gap and inflation, not on credit or monetary aggregates. Since only these aggregates provide the vital information about the fact that the demand for loans has been somewhat intensified, it would require an enormous precision in the central bank predictions to uncover that the natural rate of interest went up. Moreover, the output gap and higher inflation are rather the outcome of the entire process. They both come into existence especially due to the inability of the central bank to keep track with the natural rate of interest. In other words, by increasing the policy rates after the positive output and inflationary gaps have occurred, it is too late for the central bank to avoid the business cycle.

Hence, it is quite reasonable to assume that under the current banking and monetary system the market interest rate does not respond sufficiently to the increase in the natural rate of interest, either due to the accommodative behaviour of the commercial banks or due to the lag in the monetary policy response.

The consequent dynamics of the interest rate may be described by the following system of graphs. The positive technological shock shifts the investment demand outwards. For simplicity, Figure no. 25 assumes that the saving function is vertical; nonetheless, higher investment demand is fully satisfied by the inflow of money from the banking sector. At this stage, it is not at all essential, whether the primary source of newly injected money is the central bank, or the commercial banks, or both. What is important is the fact, that part of the investment is financed by newly created money rather than by voluntary savings.

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investment demand increased to 100 and part of it (50) was repelled. The similar reasoning would also hold for saving. A more detailed analysis of the money creation process can be found in de Soto (1998).

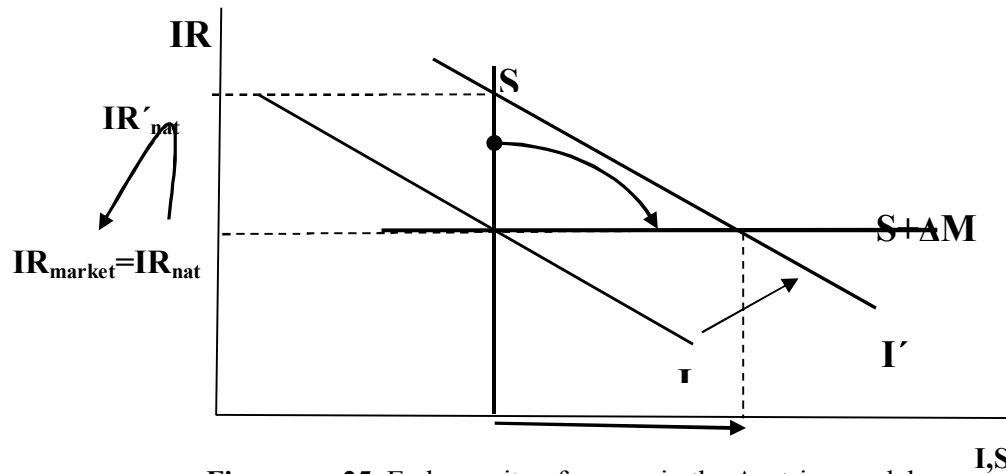


Figure no. 25, Endogeneity of money in the Austrian model

As can be seen on the picture, the natural rate of interest exceeds the market rate, which is equivalent to the statement that the forced saving phenomenon has emerged in the economy. Forced saving allows the capital structure to be artificially lengthened, as is obvious on Figure no. 26.

It should be perfectly clear, that in this case too, the business cycle process has been triggered. The structure of production is artificially lengthened, as more investment has been made than is justified by voluntary savings. The only difference lies in the fact, that the money supply is endogenous rather than exogenous, since the banking system, for one reason or another, fixes the interest rate.

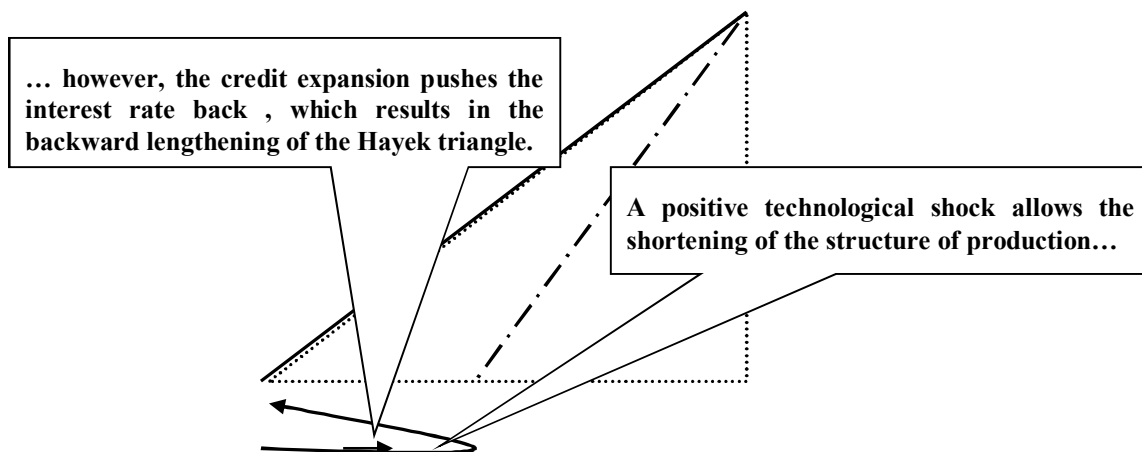


Figure no. 26, Investment demand being accommodated by the injection of money -Hayek triangle representation



One more interesting fact deserves our brief attention. Call and Cochran (2000) identify that the boom in the process just described is rather peculiar.<sup>35</sup> It actually contains two components, indistinguishable in the official statistics, yet the Austrian theory provides us with enough insight to disentangle them. First part of the faster growth of the economy can be attributed to the positive technological shock (new invention) and can be considered as sound and genuine. However, the second part of growth has been provoked by the artificial credit expansion that has accommodated increased demand for loans. Thus, the second part is not supported by voluntary saving. We may also say that the growth of the economy is faster than it would have been, if no inflow of money into the system had ever arisen. It seems that this analysis is quite consistent with official statistics about boom, since they usually suggest that investment is far above the average in this phase of the business cycle. The Austrian analysis would predict similar behaviour, since the credit expansion is mainly channelled to the formation of new capital structures, as the primary demand for credit comes from the sectors that experienced an increase in the marginal productivity of capital.<sup>36</sup>

Nevertheless, as has been thoroughly analysed in previous sections, the artificial boom cannot be maintained forever. Sooner or later, the newly created money will appear in the hands of consumers. This will end up the forced saving source of the lengthening of the capital structure in the economy. Resources will be attracted back to the consumption stages of production and the creation of new capital will never be completed. This phase of the business cycle seems to be also consistent with the data, as they suggest that in the recession the investment spending somewhat collapses. The same prediction is made by the Austrian model.

The crucial reason for capital shortening is to be found in the reverse dynamics of the interest rate that should gradually move to its natural level. Only the additional round of credit expansion can overturn this reverse process. However, it would be rather surprising if the central bank did not play a significant role in this process, too. The increased demand for cash is usually observed in booms, so banks that exposed themselves to lower reserve-deposit ratio by credit expansion can hardly continue with this policy without a backing from the central bank. In other words, a relaxed monetary policy is needed to keep the credit expansion on the path. Otherwise, the commercial banks ought to stop granting new loans, as their exposition would become too fragile. It can be shown that only accelerating credit expansion can keep the market interest rate below the natural level.<sup>37</sup> The eventual consequences of the credit expansion are depicted on Figure no. 27 and 10.

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<sup>35</sup> More on this can be also found in Cochran and Call (1998), Cochran et al. (1999, 2003) and Cochran (2004).

<sup>36</sup> It must be mentioned that the Austrian analysis is at odds with the approach of the real business cycle theory (King and Plosser 1984) that states that the expansion of deposits in boom is just a neutral response of the banking sector to the positive technological shock.

<sup>37</sup> A thorough analysis of the dynamics of the money supply in this process is carried out in the different paper of the author.

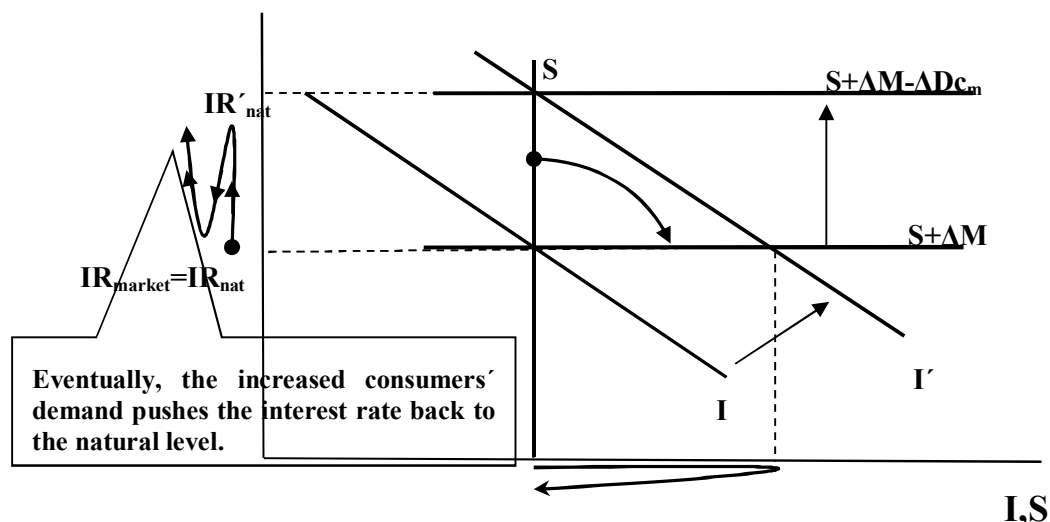


Figure no. 27, The reverse dynamics of the interest rate

We have demonstrated that a genuine growth of the economy may end up in a painful recession, if the initial boom is fed by the inflow of money from the banking system that is sluggish to raise the interest rates. At the same time, it is extremely difficult for the monetary authorities to disentangle this fact from the official statistics that the growth of the economy is not healthy. Their own (in)action may be the source of this unsustainability, even if the interest rate policy is considered and praised as being passive.

## 5. CONCLUSION

This paper outlined the dynamics of the interest rate in the Austrian model of the business cycle. The first part suggested that the effort of the central bank to keep the interest rate below the natural level cannot be successful, as the economic forces will eventually reverse the interest rate back. It was also shown, that the return of the interest rate is always accompanied by the business cycle phenomenon.

The next part thoroughly investigated what is the fundamental nature of the forces that push the interest rate back to the natural level. However, many confusions in the analysis have arisen, so the third part tried to clear them up. The last part relaxed the assumption that the original source of the business cycle was always on the part of the central bank.

The objective of this paper was also to demonstrate that the real and monetary parts of the economy are so interconnected that the response of the central bank to events in the real economy can never leave the real variables, on which the central bank based its action, unaffected. As a result, conducting the monetary policy even in a good will may provoke more damage than anyone could have imagined before the action was taken.

As our understanding of the incredibly complicated processes in the economy is rather limited, the institutional framework, in which the central banks nowadays operate, seems to give them too much power and discretion. It is based on the illusory idea that the knowledge has so advanced over the last thirty years that the economy may be fine tuned without any considerable risk of failure.

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**SOCIO-CULTURAL PROFILE OF OLTENIA REGION: IMPLICATIONS ON THE ETHICS OF DECISION-MAKING IN THE RESIDENT ENTREPRISES**

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**Abstract**

*The cultural elements are an aspect taken into consideration as a leitmotiv by the specialized writing in this field in the recent years, when the organizational decision-making processes are discussed. This aspect is even more prominent when the issue of the ethical dimension of decisions is debated. This paper aims to analyze to what extent the regional culture of Oltenia (a region situated in the south-west of Romania) is sufficiently particular and has a significant impact on the business ethics within the resident organizations in this region (if they are able to slightly differentiate them from those activating in other regions).*

**Key words:** *decision making, business ethics, culture, regional culture, organizational culture, Oltenia*

**1. INTRODUCTION**

Every economic activity (either at macro level or micro level) has a significant socio-cultural determinant, this approach also predominating in the specialized writings in this field in the recent years.

This paper aims to focus on the cultural aspects, namely their influence on the organizational decision-making processes. Culture, at the level of the managerial approaches, supposes a plethora of concepts, with complex significances for the different levels of approach: individual culture, organizational culture, regional culture, national culture etc.

Among these dimensions of culture we will focus on the regional culture and, further on, on the identification and analysis of the regional culture implications on the ethics of decisions taken at the level of an economic organization.

Our analysis is particularized at the level of Oltenia region. We start from the following hypothesis: there are appreciable cultural differences between the different regions of Romania; these differences lead to a differentiation of the ethics of decision-making in the enterprises from those regions.

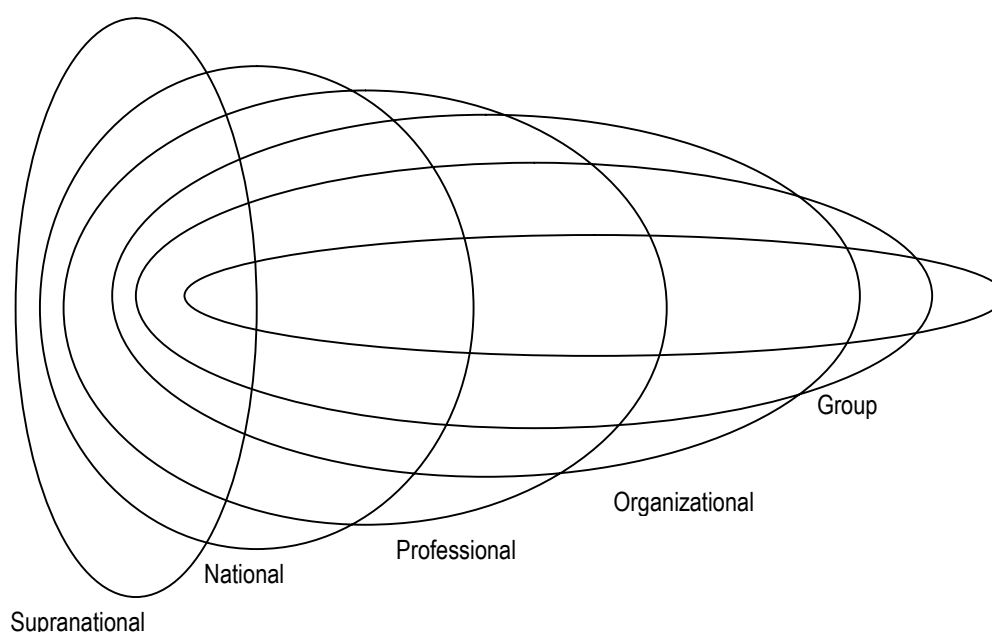
In this context, our approach will try to identify the specific socio-economic elements that have an impact on the culture of Oltenia region, which could justify the possible differentiations of ethics of the businessmen behavior from this region.

We believe that the originality of this paper consists in the connection and interpretation through managerial optics of some studies from different domains such as history, ethnography, sociology, psychology etc.

## 2. REGIONAL CULTURE – THEORETICAL DELIMITATIONS, INFLUENCE ON THE MANAGEMENT OF ORGANIZATIONS

For our approach, we consider useful the following definitions of culture: „culture can be described as the collection of values, beliefs, behaviours, customs, and attitudes that distinguish a society” (Fan, 2000). Boesch (2006) considers, as a completion of the anterior definition, that in the concept of culture there are also included projections in society of the aforementioned elements which are concretized in: cultural objects (artifacts), institutions, economic structures, landscapes, settlements, land use patterns etc.

Culture can be analyzed at several levels. Karahana et al. (2005) speak about culture stratification. The levels, in the approach of the quoted authors, are presented (hierarchically and interconditioned) in figure 1<sup>38</sup>.



Source: Karahana et al. (2005)

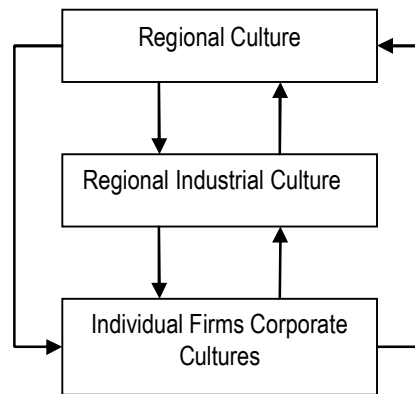
**Fig. 1.** Cultural levels

Weiss (1988), in a somehow pioneer’s work, which lately became a reference for the specialized writings in this field, defines the regional culture as the: „environmental influences that have particular historical, political, economic, and social characteristics and patterns of shared beliefs, observations, expectations, and traditions whose participants have similar ways of viewing space, time, things, and people.”

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<sup>38</sup> Supranational cultures are those that transcend national boundaries (in this category are included regional cultures).

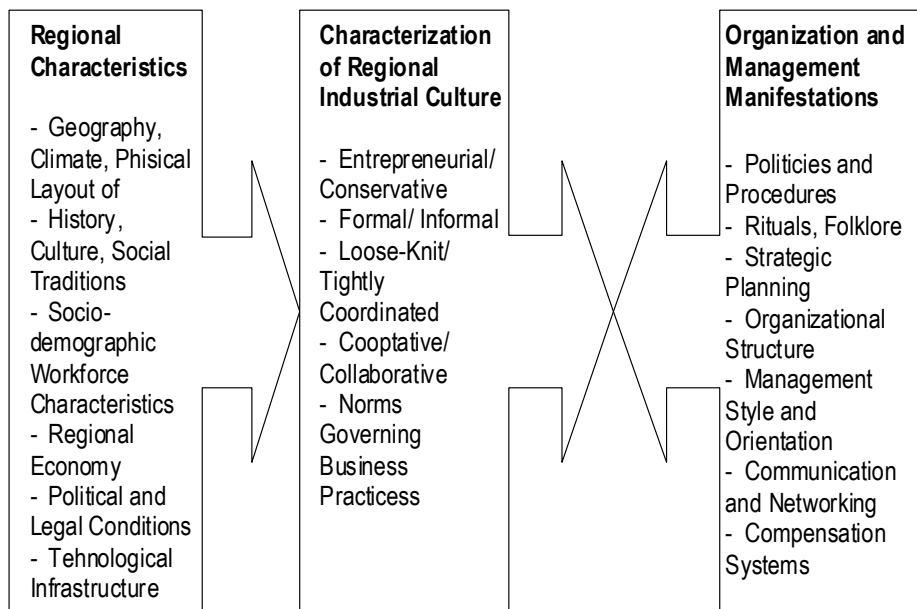
Oinas (1995), quoted by James (2003), identifies the following structuring and interactions at the level of the regional culture:



Source: Oinas (1995)

**Fig. 2.** Levels of the regional culture

The approach is similar to that of Weiss and Delbecq (1988) and aims to schematize the influences of the regional characteristics on culture and business practices:



Source: Weiss (1988)

**Fig. 3.** Influences of Regional Characteristics on Business Cultures and Practices

Authors state that „the arrows placed between Regional Characteristics, Industrial Culture, and Organizational Manifestations should not be interpreted as causal relations, but as associational influences. The relationship between these described categories is dynamic and interactive”.

Our analysis of a historical region of Romania – Oltenia will have as framework these two models.

### 3. GENERAL CHARACTERISTICS OF OLTENIA REGION

Before passing to the identification of some cultural elements specific to Oltenia region and, subsequently, to the establishment of the possible factors which contribute to these differentiations, we try on the basis of some elements from the literature in this field, to argue that the different historical regions of Romania have a distinct cultural specificity.

P. Finch, although is a foreigner, makes some interesting remarks which we completely agree: each region “wants to prove their superiority. In general, they are very proud of their native region and that is why they do their best in order to prove to their peers that their region is the greatest”.

The author mentions some elements of cultural differentiation, at individual level, inside every region, but also some causes of the cultural differences between regions (in the article only Transylvania and Moldavia are mentioned). Among these factors are: the road and railway infrastructure, the access to modern trade, the access to education and culture (although, here, the differences between rural and urban are more obvious), the level of incomes (which influences the access to education and culture).

Roman and Roman (2004) shows, in the same matter, that „Romania was always characterized by important economic, but also social and cultural differences between its regions”.

Neculăesei and Tătărușanu (2008) formulate the hypothesis that the historical, ethnical, religious differences between the historical provinces of Romania lead to regional cultural differences. The two authors delimitate Moldavia, Transylvania and Walachia as regions of Romania between which cultural differences can be established.

We subscribe the aforementioned points of view according to which between the regions of Romania there are appreciable cultural differences and further on, following the aforementioned Weiss model, we try to identify the factors that can lead to these differentiations.

From a geographic point of view, Oltenia region is situated in the South-West of Romania, has a surface of 29.212 km<sup>2</sup> and comprises five counties: Dolj, Olt, Vâlcea, Mehedinți and Gorj.

The relief is equilibrated. In north the relief is mountainous and hilly (Carpathians and the subcarpathian region), with forests and mountain pastures. The plain region is one of the most fertile regions in Central Europe.

The hydrological network, mainly composed of Danube River, Olt and Jiu rivers, confers the main energetic role in Romania to the region (71, 57% of the whole hydroelectric production [64]).

The soil of Oltenia region contains resources of coal, construction materials (marble, granite and other ornamental rocks), ferrous and nonferrous minerals.

Further on we will try to present, as briefly as possible, the history of Oltenia region. We will not recur to an exhaustive presentation and we will not insist on the old history from which we will mention only a few reference points.



In Antiquity, in Oltenia there has been found (on the basis of archeological evidences) the presence of various Geto-Dacian tribes (mainly Burs). In the II<sup>nd</sup> century AC these tribes encounter the Celts (assimilated in time as indigenous).

After the transformation of Dacia into a Roman province, the entire Oltenia becomes a part of their organization. During 119-120 P.C. Oltenia was turned into an independent province – Dacia Inferior.

The passing of migratory people, until VI<sup>th</sup> century seem to have left no significant marks in Oltenia.

In the medieval age, the territory of Oltenia was an integrated part of Wallachia. The region had a special status, benefiting from a relative autonomy, being administrated by a ban (this is why it was known as Banat of Craiova). We consider that this kind of status is responsible of the disputing attitude which will characterize the population of the region in time (regardless the social category). In this period the nobility of Oltenia played an important decision-making role in the politics of Wallachia. This power was based on the superior economic condition of the other families of Wallachian boyars („the economic difference was generated by the fact that the nobility of Oltenia was richer due to the more numerous and vaster landed properties as well as due to the fruitful commerce with the Ottoman Empire”- Anton-Manea, 2003). Due to these reasons the boyars of Oltenia were, many times, in favor of the deals with the Great Gate.

We consider that in order to identify the dominant regional cultural values it is necessary to make a more detailed analysis of Oltenia history in the last 250-300 years.

After the Passarovitz Treaty, from 1718, Oltenia entered under Habsburg occupation. The Habsburgs wanted to turn it into an imperial province, with an independent administration, military supported. This fact led to strong movements of revolt, in all the social classes, from peasants to the great nobility.

Nicolae Iorga (quoted by Stoenescu, 2011) described the situation as follows: “Of one side, a fiscal state, with its conscriptions, registers and bureaucracy, of the other side, a traditional world, at all rectilinear, but, on the contrary, full of endless variety and complication, having, from a so long past, an organic result, which for imperials seemed a country lacking in order, an irregular Land”.

In this context, in Oltenia the outlawry intensifies, a social phenomenon mythicized in Oltenia (in general in Romania). After the Treaty from Belgrade (1739), Oltenia returns to Wallachia, but the anarchy continues, Oltenia becoming a territory controlled by outlaws.

With regard to this phenomenon, Stoenescu (2011) stated: “The imagologic model of outlawry is that of a young and brave peasant who, bearing no more the boyar’s exploitation, took refuge in woods, where he formed a group of other people dissatisfied and decided to fight. Then, he started to attack the boyars and merchants’ people, to rob them, to confiscate the tax in money and animals taken from the population, and to return them to all the poor peasants, making thus justice. For these acts, the outlaws were sheltered by peasants, defended by posse, helped with food and loved by people.”

In this case the fictionalization is extreme. In reality, the outlaws seem to be only thieves, the aspect of the social component is not written down in any document (namely there are not written down situations in which the outlaws helped the poor people) (Stoenescu, 2011)

The theft, with its different nuances, has not been the subject of any rigorous anthropologic and cultural analysis. A courageous approach, let’s say, certainly original, pertains to Bălașa (2007). He published series of eight editorials, in the magazine «Săptămâna financiară», one of the most

important economic newspapers of Romania, called « Popular economy of theft ». This meaning tries to analyze the phenomenon of outlawry on the basis of the popular Romanian literature.

The starting point is quite subtle:

“Not only the updating of the historical, classical, direct and clear forms of theft must be eradicated, but also their popularization, including the popularization of their masque, allusive, subtle or refined forms. Including the cult of the past heroisms, of the whole history, should be submitted to the critical nature of detachment towards any form of violence and towards the accumulation through any form of nonconsensual taking over or rape.”

The creation and the development of a heroic image of the outlaw and outlawry, in the popular Romanian literature, but also in the cultured one, amplified also by the communist propaganda, is, in the opinion of Bălașa (2007) a form of popularization of the outlawry economy.

Nowadays, at least at the level of Oltenia region, we believe that we can identify reminiscences of this excessive transformation into a myth, of the popularization of outlawry economy.

When we state this we think of hackers, considered modern outlaws many times in Romania, who are treated with indulgence at social level. Oltenia region is extremely known for its hackers. Râmnicu Vâlcea city is an example in this regard: in an article „Los Angeles Times”, from December 2007, it was considered „a global center of Internet and credit card fraud”; in „Le Monde”, in December 2011, the city is called „Hackerville”.

The social acceptance of the phenomenon is not though specific to Romania. Kshetri (2010) shows that in developing countries „cyber-crimes tend to be more justifiable in developing countries than in developed countries”. Between the factors that contribute to this fact are: the lack of economic opportunities, the high level of unemployment, the low level of salaries.

Following the same coordinates, Georgescu (2010) discusses the Romanian proverb „Uncaught thief is an honest merchant”, expression of a „deficiency of collective character”. Jean Valvis, a Greek investor in Romania, at a round table, hosted by the College “New Europe”, on 1 March 2006, stated that he was (negatively) shocked, in 1994, when he heard this proverb. We searched broadly in other cultures and we found out that there is no equivalent for this Romanian proverb (in English there is a possible correspondent: “A thief passes for a gentleman when stealing has made him rich”, but it is rather similar to the Romanian proverbs “A thief passes for a boyar when the richness riches him”, “Outlawry goes hand in hand with the reign”.)

Going back to history, Oltenia region was strongly marked by the revolution from 1821, 1848, but also by a peasant revolt from 1907. The fact that these were either initiated in Oltenia or had a dramatic evolution in the region (at the revolt from 1907, in Oltenia the artillery was used and some villages were bombed) shows a long militant tradition of the population.

The two world wars also leave traces on Oltenia. We must state that, for our study, the period of German occupation of Oltenia is important (1916-1918), when the population opposed resistance, refusing any collaboration with the German occupants.

After 1945 in Romania the communist regime installed. Firstly, until 1950, Oltenia remarked itself through the lowest percentages of accession to the collectivization process and through strong movements of resistance (Stoenescu, 2011). The fact that Nicolae Ceaușescu, native to Oltenia, came to power, had „negative imagologic repercussions on Oltenia” (the jokes with Oltenians, who were presented as stupid, started to circulate; there appeared and propagated the rather false rumor of a

privileged status). As positive effect we can mention: the quite accentuated urbanization and the build of some strong industrial centers at Slatina and Râmnicu Vâlcea.

In order to understand some elements of the regional culture we consider that it is important to outline the demographic profile of Oltenia region.

We consider that the first relevant aspect is the distribution of population on averages. At the level of 2009 we can notice the preponderance of the rural population with a number of 1.175.776 persons (52, 24 %, in comparison, at national level, 44,92% of the population lives in the rural area) [48].

The South-West Oltenia region (together with the South Region) is confronted with an accentuated phenomenon of ageing population, representing the most part of the stage of life over 65 years (16, 3% in 2009). Also, according to the National Institute of Statistics, in this region, in four of the counties (Dolj, Mehedinți, Olt and Vâlcea) the average age is over 40 years.

From an ethnic point of view, Oltenia is relatively homogeneous. According to the last census (made in 2002) the region has a percentage of over 97% of Romanian population. The rest of the population is formed of Greeks, Italians, Bulgarians, Albanians, Serbians, Jews, and Gypsies.

An analysis in time of the ethnical structure of the population of Oltenia can provide some interesting elements, although they are not spectacular. Thus in the period 1930-2002 the percentage of Romanians increased from 90,02% (in Romania the percentage was 71, 9%) to 97, 2% (89, 5% at national level). In 1930 the population's structure was as follows: Romanians – 90,02%; Gypsies – 2,4%; Germans – 2,16%; Jews – 1,61%; Hungarians – 1,44%; Serbians – 0,45%; Russians – 0,35%; other minorities – 1,57% (Iordache, Popescu, 2008)

The census from 2002 reveals the numerical regress registered by the majority of the minority ethnies (excepting the Gypsies whose percentage increased from 2, 4% to 2, 63%).

From a religious point of view, the confessional structure of Oltenia region is the following: orthodox -97,9%; Romano-Catholics – 0,4%; Adventists – 0,3%; Christians after the Gospel – 0,2%; Pentecostals – 0,2%; Greco-Catholics – 0,1%.

The final element, with a socio-demographic character, could provide clues on the specific culture of Oltenia region could be the population's level of education. The recent years have been marked by a drastic fall of the school population. Thus, while in the academic year 1990/1991 the school population in Oltenia was 519.128, in 2004/2005 it reached 452.674, registering a fall of 12, 8%. The school population represents about 20% of the total of the region's population (only the West region registered a lower percentage)[58].

These elements trace only general guidelines for the socio-cultural characterization of Oltenia region. Sandu (2010) goes deeply into these elements by trying to identify, at the level of the cultural areas, "specific structures of social relations, of forms of social capital".

A first indicator concerns the profile of tolerance (Sandu defines tolerance as „a way of social interaction based on the value of the equality of human affirmations rights and of the contextual relativity of values”).

At the level of Oltenia region it is noticed a slight discrepancy between the northern and southern area. Consequently, for Dolj, Mehedinți, Olt counties the medium index of tolerance is 0,84 (below the national average of 0,87), while in Gorj and Vâlcea counties it is of 1,09.

In what the profile of sociability is concerned there can be also signaled differences between the north and the south of Oltenia. In consequence, Gorj and Vâlcea counties are characterized through ethnic „Closure”, through a high ethnic intolerance and pronounced institutional criticism. Dolj, Mehedinți and Olt counties are characterized through institutional conformism, with a high level of confidence in all types of institutions and ethnic intolerance above average (Sandu, 2010).

Another analyzed indicator is the community traditionalism (identity) represented by „loyalties towards the natural groups who function as traditional agents of socialization: the family, local communities and the church”. If in the rural area Oltenia does not highly differentiate from the other regions, in cities a minimum of the community traditionalism is registered.

Sandu (2010), going deeply into the analysis, underlines that, when establishing the identity traditionalism, the variables of personal status are more important than the regional culture (excepting the population from Banat and Crișana-Maramureș).

The final element analyzed in the above quoted work is the regionalization of the social problems (Sandu, 2010). Three categories of problems are identified: prices and jobs; public services; crimes, corruption, homes, cleaning.

In Oltenia, the problems regarding the corruption and crime (which is more pronounced in the urban area) are the most felt problems.

In the same time in Sandu (1999) it is showed that the population of Oltenia, and as well of all the extra Carpathians regions, is more willing to give bribe in comparison with that of the intra Carpathians region (Transylvania, Banat and Crișana-Maramureș). Also the interpersonal and intergroup confidence (identified as being connected with the level of socio-economic development), but also the institutional confidence are very low.

Further on, we will emphasize some elements on the economic aspects specific to Oltenia region.

According to Eurostat (report made public on 24 February 2011) Oltenia is one of the poorest regions of Europe (and implicitly of Romania). Thus, Oltenia occupies the position 6 in the top of the poorest regions, being outrun by four regions of Bulgaria and by the North-East region of Romania.

The internal studies show that in the last 2-3 years the S-W region of Oltenia became the poorest region of Romania. Consequently, a study carried out by the National Trade Union Bloc (BNS), at the level of the South-West region of Oltenia, made public on 24 August 2010, confirmed that, having a GDP (Gross Domestic Product) of 10 milliards of euros, Oltenia is the poorest region of Romania.

With regard to the same subject, Sandu (2011) states (indeed with some reserves) that the pole of poverty moved from the East of Moldavia to the south of Muntenia and Oltenia. Two causes are identified for this change: the leaves abroad for work, realized earlier in Moldavia and the incomes from agriculture.

However, at the level of the region some paradoxes can be signaled. According to the previsions of the National Commission for Prognosis, the average net salary in 2011, in Gorj county, occupied the III<sup>rd</sup> position at national level (only in Bucharest and Ilfov this level was exceeded). The explanation is concerned with the high salaries (which exceed the national average) from the energetic and mining sector (well-represented in Gorj County). In addition, according to some processing made by “Capital” magazine, on the basis on the same data provided by the National Commission for Prognosis in 2011, in Olt and Mehedinți counties (as well as in Botoșani, Vaslui and Giurgiu counties), the Gross Domestic Product per inhabitant is inferior to the average income per inhabitant.

These aspects can, of course, bear certain nuances. In our opinion, these paradoxes being induced by the presence of some big state companies in the region, can cause some market perturbations (which can have as effects illegal/immoral actions of the private economic agents) and even some social tensions.

For a configuration as correct as possible of the economic environment of the South-West region of Oltenia, in the support of our scientific approach, we consider that an analysis of the SME sector is necessary because it can provide us some clues concerning the level of the entrepreneurial spirit.

Thus in the period 2004-2008 the region had the lowest number of SMEs among the regions of Romania (between 7 and 8% of the number of SMEs open at national level)[34].

It can be stated to a certain extent that Oltenia does not have an entrepreneurial tradition, if we refer to the interwar period, in which Romania had a relatively proper capitalist economy.

In Oltenia, the interwar period was characterized, from an economic point of view, through a mainly agricultural activity, the industrialization being a slow process, the important landlords from the region investing in monumental palaces, trade institutions and banks.

If we nuance a little the thing, the entrepreneurial spirit in Oltenia region had, in the interwar period a certain level. In 1900 Craiova owned 43,1% of the industrial enterprises of Oltenia, comprising 924 industrial enterprises (among which 20 pertaining to the big industry). In 1925 there were 40 big enterprises. In 1939, in Craiova, there were only 7 enterprises with more than 100 workers: Factory of cloth „Oltenia”; Scrisul Românesc (Romanian Writing); Factory of pasta „Concordia”; Factory of Bread and Pasta „Barbu Drugă”; Semănătoarea; Electrical Plant and Factory of Bread „Traiul”[59].

Home working, unorganized in enterprises was specific to the economy of Craiova (therefore our reticence to talk about a true entrepreneurial spirit).

Another economic element, likely to influence the regional culture (or at least the local business culture) is the foreign investments. Unfortunately, in comparison with other regions, Oltenia does not have a good situation in this regard. Consequently, in the period 2003-2010 the percentage (in comparison with the national level) of the foreign investments in the South-West region was [65]: 3,7% in 2010 (only the North West region had a lower percentage); 4,1% in 2009 (the North West regions had lower levels); 2,5% in 2008, 3,2% in 2007, 2,7% in 2006, 3,4% in 2005, 2,7% in 2004, 3,7% in 2003 (only the North-East region had, in this period, lower levels).

There are plenty of causes for this kind of situation and does not represent the subject of this study. We mention only one, which proves, at the first sight, valid in Oltenia too: there is a positive link between the direct foreign investments and the social capital (Guiso et al., 2009; Ang et al., 2010).

We can also make differences between the regions of Romania in what the political options are concerned. Thus according to Giugal (2009), starting from the results of the elections in the last 20 years, the following observations can be made: Transylvania (excepting Hunedoara, Harghita and Covasna counties), Banat, Crișana and Maramureș represent the feoff of the center-right political parties; with some small exceptions, in Oltenia, Dobrogea and Moldavia there is a left political orientation.

In Oltenia it can be observed a significant distinction between the options of the electorate from the rural area in comparison with that from the urban area. Thus, at the local elections from 2008, in the big cities of Oltenia (Craiova, Slatina, Râmnicu Vâlcea) mayors from PDL were elected (a party with

a right or center right political orientation, although in Romania the doctrinaire differentiations between parties are quite confusing).

We are not very sure that the political options for left or right are knowingly done in Romania. A study coordinated by Comşa (2009) [67] shows that the antagonism left-right hasn't been used until 2000 (the stress was put on the antithesis communism-anticommunism). The same study shows that the notoriety of the concepts left-right is relatively reduced in Romania.

Culcer (2008) puts these differences of political orientation to the history and geography of every region account. If we refer to the historical dimension, Transylvania and Bucovina pertained to the Austro-Hungarian Empire, an occidental state, and Oltenia, Muntenia and Moldavia were located in the influence area of the Ottoman Empire, an oriental state, which promoted „other methods of public behavior”. In the same time, if we refer to the geographic dimension, the closeness of Orient, for regions such as Banat, Crişana, Maramureş, Transylvania enabled the development of a different culture (at least in the business domain, valuating the entrepreneurial spirit, the communities' prosperity, the partnerships with the foreign investors).

Finally, we will make an analysis of the technological infrastructure in the South-West region of Oltenia. Firstly, we must underline that in 2009 the region registered the lowest level of the research-development expenses (75.738 thousands lei in comparison with, for example, Bucharest-Ilfov with a level of 1.357.602, which occupied the first place). Also in what the employees in the research domain are concerned the South-West region was among the last regions of Romania (with 2290 employees, only the South-East region had a smaller number with 1865 employees) [1].

According to an oldest report [66] (comprising data from 2005) this region together with the South-East region had the lowest number of research unities (4% of the unities of Romania). Also, in 2009, in the South-West region of Oltenia there were three operational parks (2 in Craiova, 1 in Sadu, Gorj county) and a greenfield park (at Corabia, in Olt county). Furthermore, five business incubators were functioning (2 at Craiova, 2 at Târgu Jiu, 1 at Râmnicu Vâlcea).

#### **4. CULTURE OF OLTENIA REGION – COMMON ELEMENTS AND PARTICULARITIES IN RELATION TO THE NATIONAL CULTURE**

Further on we will carry out an analysis of the specialized writings in the field in order to see to what extent the culture of Oltenia region is analyzed, namely to what extent it is different from the national culture and from that of the other regions of Romania. We also try to emphasize the manner in which the aforementioned factors can explain the particularities and the differentiations, if these are relevant.

The analysis of the national Romanian culture using the models formulated in the management literature was not the subject of too many studies in Romania. Mihaş and Lungescu (2006), apart from their determinations using the model of Hofstede, also carry out a synthesis of the previous studies (Table no. 1).

Littrell and Lăpăduş (2005), making a synthesis of some studies carried out by foreign authors, characterize the national Romanian culture as having: low individualism, high power distance, low masculinity, high uncertainty avoidance.

We can observe that there are no significant differences between the two categories of study. A single element is surprising: the low power distance resulted in Gallup study. Even the study's authors (Luca, 2005) consider that this result is distorted (in reality the index of the power distance being at least 70).

**Table 1.** National Romanian culture – comparative results

Study	Power distance	Individualism	Masculinity	Uncertainty avoidance	Long-term orientation
<b>Interact Gallup Ro</b>	33	49	39	61	42
<b>G. Hofstede Dimensions</b>	90	30	42	90	-
<b>Lungescu-Mihuț</b>	High level (>75%)	Low level (<30%)	Medium level (<50%)	Relatively high level (>65%)	Medium level (<50%)

A possible justification for this difference can be, in the authors' opinion, "the existence of some authority complex, which can explain the refusal with obstinacy and undeclared of the majority of the Romanians to comply with the laws and authority, and, in the same time, the express demand of laws and norms."

Aycan et al. (2000) obtained a similar result, thus revealing the weakness of one of the initial hypothesis. Their explanation concerns the economic and social changes occurred in Romania after 1990.

In our opinion, the economic and social changes couldn't find a so fast reflection in the national culture (even if they were highly deep, and, especially in the social domain, we do not believe that such mutations occurred).

Another possible explanation can be found at Mihuț and Lungescu (2006) who talk about an "inertial" and "kleptocratic" management whose exponents "mime the democratic behavior and style, their manifestations and exercise being specific to the past autocrat styles".

After this presentation of the studies on the national culture, we will carry out a comparative analysis of the studies (of these few studies) which focus on the regional cultures and of the cultural differences between the historical regions of Romania.

Neculăesei and Tătărușanu (2008) have carried out a study whose sample was represented by employers of the economic department from the Romanian universities. We observe from this study the following dimensions (of the seven included): distance power, individualism, masculinity, uncertainty avoidance, long term orientation. The results are presented in table no. 2.

Oltenia is geographically placed in Walachia region. Due to the socio-economic profile (as we previously underlined) is closer to Moldavia region. We observe that, between the two regions there are no significant differences and, consequently, we can characterize the culture of Oltenia region as follows: high power distance; low individualism; balance between the masculine and feminine values; high level of uncertainty avoidance; short-term orientation.

A rigorous analysis of the regional cultural differences is realized by A. N. Onea in his doctoral thesis "Valuating the cultural differences in the management of Romanian enterprises" (presented at Iași, in 2010).

At the level of Oltenia region, the study was carried out in 2009, on a sample of 140 students from the Faculty of Economics and Business Administration of Craiova (specialization Management, Marketing, Economy of Trade, Tourism and Services). From this point of view this study is more relevant for our approach.

**Table 2.** National Romanian culture – comparative results

Regions	Moldavia	Walachia	Transylvania	Romania
Cultural dimension				
<b>Power distance</b>	85,45	83,80	78,00	82,41
<b>Individualism</b>	30,70	31,75	34,55	32,30
<b>Masculinity</b>	47,00	43,25	45,80	45,35
<b>Uncertainty avoidance</b>	80,35	80,20	47,60	69,38
<b>Long term orientation</b>	29,00	35,15	43,65	35,93

Source: Neculăesei, Tătărușanu (2008)

Our conclusions are mostly consonant with those of the previous study, the regional culture of Oltenia being characterized through: high power distance; medium level of individualism (surprisingly, also for the authors of the study and for us, higher in Oltenia and Moldova in comparison with Transylvania); mixing between the masculine and feminine values (with a slight accentuation of feminine values); high degree of uncertainty avoidance; short-term orientation.

After the survey processing, the author considers that Oltenia region is characterized through a “hedgehog” culture (which “integrates conflicting values in a dissonant, spiky manner; it is a culture that harmonizes the antithesis”).

The dominant aspects (appreciated) of the culture in Oltenia region are: volunteering, richness, creativity, self-achievement, gregariousness, social contacts, suspicion, good of the community, uncertainty avoidance (structuration, instructions, prioritization, time pressure). On the contrary, the less appreciated values in comparison with the other regions are: competition, visible results, religious practice, harmony, sustainable efforts, tolerance, equality between sexes, saving, solidarity. (Onea, 2010)

The last study we will present pertains to Iosifescu (2004). Within this study, using the model of Hofstede, there has been analyzed the organization culture (and not the national culture or regional culture) from 28 schools, selected from one county representative for every region (namely Iași, Brașov, Constanța, Cluj, Dolj, Bucharest). The selected schools are mainly from the urban area.

After the data processing, the organizational culture specific to the institutions of education of Dolj county (a county from Oltenia region) is characterized through: high power distance (the highest average – 26,73, Brașov having the lowest average at this dimension – 23,55); collectivism (with an



average of 17,09, in comparison with Iași – 18,1 – and Brașov – 17,09); masculinity (an average of 22,96, between the two extremes Constanța – 23,8 and Brașov – 21,3); high degree of uncertainty avoidance (the highest average – 33,98, in comparison with Brașov that had the lowest average – 31,62).

Although the sample is not representative, the fact that the respondents are teachers (they are model for youngsters, transmitting them certain values) the study can provide us interesting reference points for our research.

Taking into account these studies, but also our personal experience, the culture of Oltenia region can be characterized through: high power distance (superior to the national average); moderate collectivism; balance between the masculine and feminine values (with a plus for the masculine values); high degree of uncertainty avoidance (superior to the national average); short-term orientation.

Further on we will try to find a justification, an argumentation of these elements.

The high power distance can have more or less closed determinants in time: the subordination or good cooperation reports, for a long period of time, with the Ottoman Empire; traditionalism; the relatively low level of economic development of the region; the population's high age (with the mentioning of some reflexes acquired in the communist period); orthodoxy<sup>39</sup>; maintenance of some big state companies (at the level of which the changes were minor, especially in what the working ethics is concerned); configuration and perpetration of a certain type of relationship parent-child (children are expected to be obedient and respect the parent's decisions until they are grownups) and teacher-student.

The moderate collectivism can be explained through the following factors: the low entrepreneurial spirit, the agricultural tradition, the higher percentage of the population who lives in the rural area, the predominance of the orthodox population, the experience of the communist period. We believe that, using the term proposed by Gavreliuc (2011), this high collectivism can be qualified (in Oltenia better than anywhere in Romania) as autarchic individualism which supposes: „boosting the individual resources in the self-accomplishment, but in a social context characterized by poor community solidarities, which refuses the idea of fair competition between the social actors who look at each other, with suspicion and lack of confidence, action with resentments and selfishly, understanding that the social opportunities are arbitrary and unpredictable, and when they come, we must make the most of them using any means, including non-ethical means”.

We consider that Oltenia has a moderate level of masculinity (higher than the national average) which is explained or reflected by: the predominance of orthodox population (who supposes a complementarity of sexes); the population's religiosity; the community traditionalism; the exacerbated pride of the inhabitants of the region, we believe that, among causes, we can mention the region's role or the distorted perception of this role in certain historical events.

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<sup>39</sup> Gheo (2006) states: „The type of civilization from the Eastern Europe has been built on a different model, one that is hierarchically strict, strongly centralized, in which the freedom of the individual was limited by the central or local authority, no matter if there was a tsar, voivode, pasha or a common boyar (...) The same hierarchical model was imposed in time in the orthodox church too, subdued to the reigns from those times. (...) Then the communism strengthened the authoritarian model which started to come apart in the interwar period. (...)” (p. 100)

The high level of uncertainty avoidance is determined by: the pronounced religiosity of the inhabitants from the region, the education received in the communist period, the high percentage of the ageing population; the character which is not at all cosmopolitan of the population of the region (from the point of view of the nationality respectively the religion).

We consider that our conclusions, partially supported by previous quantitative studies, should be gone deeply into. Further on, we will try to carry on some analysis regarding the interdependencies between culture (approached at regional level) and the ethics in decision-making at organizational level taking into account the proposed cultural profile proposed of Oltenia region (although we provided arguments to support it, since it is not statistically validated, we are open to any observation or criticism and we hope to check this profile through a further research).

##### **5. COMMENTS ON THE IMPLICATIONS OF THE REGIONAL VALUES UPON THE ETHICS OF DECISION-MAKING IN OLTENIA REGION**

In the recent years, the literature abounds in references to the report, to the conditioning of the ethics in decision-making by the cultural element. The concrete modality in which (national, regional) culture influences the ethics of decision-making is an aspect that is not completely clarified. (Vitell et al., 1993; Donaldson, Dunfee, 1994; Robertson, Fadil, 1999).

Synthetizing a part of these approaches, we consider that there are many approaches through which the regional culture can exercise its influence on the ethics of organizational decision-making: regional culture influences/conditions the architecture of the organizational culture which in turn influences the ethics of decision-making; the regional culture leaves its mark on the individual-decision-maker educated in that culture; every local culture has some specific moral values (different or appreciated in a different way from those with a relatively universal significance) which every individual relates, including as organizational decision-maker. In what the last two directions are concerned, Iluț and Nistor (in Rotariu, Voineagu, 2012) show that „implicitly and explicitly, the socio-cultural context proposes a model of personality, a typical basic personality (modal), representative for a culture”.

Further on we raise the following questions: although we had previously showed that we can discuss about a cultural differentiation between the regions of Romania, are these differentiations strongly to lead to significant differences concerning the ethical dimension of the organizational decision-making?; are the cultural elements a determinant important enough for the ethics of the decision-making processes within an organization of Romania?

Tow enquiries initiated during 2011 amongst 10 specialists in the issue of SME management and amongst 10 specialists in ethics, in business from the Romanian higher education lead to similar conclusions, but not at all to trenchant conclusions: one half of the specialists (in each of the two groups) considers that between the decisions taken at the level of the SMEs of different regions of Romania there are differences concerning the ethical dimension while the other half of specialist considers that the differences are not significant (we agree with the last point of view).

Amongst the non-specialists, there are certain stereotypes regarding the features, typology of the inhabitants of the different regions of Romania, including in what the behavior in the business world is concerned: „Managers of Oltenia are somehow smart, cunning, lousy, and able to turn any unpleasant situation in their favor. Do not expect to understand or to anticipate the behavior of an Oltenian manager, because he will always surprise you. Since they are persons who follow their own interest, you will hardly manage to learn something from a professional point of view.” You can find this

characterization on <http://www.alinablaga.com/diferente-inter-etnice-intre-manageri/>. Although the statements are not the result of an in-depth research, it is only a synthesis of the author's perception, as a consequence of her interactions in the professional environment, it is worth paying attention to the text since it reunites the main stereotypes concerning the Oltenians (not only the managers). On the contrary, for example, the managers of Ardeal are presented in the same stereotypical manner as: „slower, quite calm and sometime neglectful: “No, bine-i ș-așe” (Well, let's leave it like this)“. They are capable, open-minded, hardworking and honest persons. Since Ardeal was under Austro-Hungarian occupation, they seem to have taken the western customs and mentality”.

Further on we will try to see to what extent the aforementioned elements have certain coverage (in general we will refer to statistical studies) or they are indeed only stereotypes. Unfortunately, in Romania there are not enough studies to measure the intensity of certain ethical problems. Furthermore, when there are studies, they are carried out only at national level without any detail at regional level.

Firstly, we will present some arguments in favor of the idea that in Oltenia region we can talk about a non-ethical behavior more pronounced in business in comparison with other regions (or at least about some prerequisites which can predispose to this kind of behavior. In table 3 we insert a synthesis of a study on gender discrimination on the labor market of Romania.

However, we notice that Oltenia region does not significantly differentiate, in what the selected items are concerned, from the other regions of Romania. Two elements draw our attention: the lowest percentage of the persons who declare that they have been victims of sexual harassment (5,36% in comparison with, for example, the percentage of the Western region – 19,85%) and the lowest percentage, among all the regions of the country, who declare that women and men are equally treated at work (62,54% in comparison with the Western region with a percentage of 76,55%).

We are not surprised by the second number. Some comments are necessary in what the first number is concerned. We believe that reality is different. There are many factors which compete, in our opinion, at this result: the population's lack of education, the attitude towards women and the fear of losing the job, increased by the economic crisis.

Moving on to the second argument, Davis and Ruhe (2003) formulate and test the following hypothesis: the level of corruption (and non-ethical behaviors) is higher in the countries with a high power distance, with a high degree of uncertainty avoidance<sup>40</sup>, with a mainly masculine culture, a collectivist one<sup>41</sup>. Most of these conclusions are in consonance with the hypothesis formulated by Vitell et al. (1993), who had not tested them. In addition, the study of Moores (2008), concerning the link between the national culture and the rate of the software piracy mainly confirms the results of this study. We notice that this cultural pattern which favors corruption is quite well superposed on the cultural profile of Oltenia region.

The last argument in favor of the fact that the ethics in business could be affected in the organizations of Oltenia, can be developed starting from the study Transparency International (2011). This argument shows that in the Romanian business environment the concern for ethics' institutionalization “is the

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<sup>40</sup> Seleim and Bontis (2009) nuance the approach regarding this dimension.

<sup>41</sup> Robertson and Fadil (1999) are not so trenchant. They only underline that the managers from the individualist culture relates more frequently to the theory of the ethical egoism while the managers from the collectivist cultures relates especially to the utilitarianism theory in what the ethics of decisions is concerned.

result of the foreign company's presence and not of the awareness of the need of integrity". As we previously showed Oltenia region has a bad situation regarding the foreign investments. Moreover, another factor which could theoretically exercise a pressure on the ethical behavior of companies manifests with a low intensity in the region: Oltenia has the smallest number of NGOs among the regions of Romania (only 5% among the existing NGOs at national level – study FDSC, 2010).

**Table 3.** Indicators on gender discrimination on the labor market in Romania

	Bucharest Ilfov	West	South- East	South	North- West	North- East	South- West	Centre
Respondents satisfied or very satisfied with the safety of the workplace	50,95%	40,79%	34%	53,71%	-	54,07%	-	-
Respondents who consider that the salaries are transparent and equal for equal work	37,6%	58,8%	38,43%	28,1%	40,22%	47,07%	40,92%	41,75%
Respondents who declare that they have been victims of sexual harassment at least once	5,6%	19,85%	6,99%	6,06%	9,75%	7,42%	5,36%	8,78%
Respondents who consider that women and men are equally treated at work	63,64%	76,55%	68,08%	71,43%	73,3%	68,39%	62,54%	67,74%

Source: [http://www.bns.ro/wps/wcm/connect/bns\\_ro/downloads/info%20-%20studii%20rapoarte/93fb31a-2d2-513-b410-6d6840e416c7](http://www.bns.ro/wps/wcm/connect/bns_ro/downloads/info%20-%20studii%20rapoarte/93fb31a-2d2-513-b410-6d6840e416c7)

With all these argument, our point of view, previously highlighted, is that between the different regions of Romania there are no, at least in present, significant differences in what the business ethic is concerned (and not only in business). Although we consider that there is a cultural differentiation of regions, it didn't was reflected in the economic domain (or at least it is not very accentuated). The communist period has had as effect a deep moral crisis of the entire Romanian society. The crisis initiated during communism has been perpetuated and accentuated after 1989.

In an interview from 1988, published in 1992, Nicolae Steinhardt sated: „As I can see at Rohia and Maramureş (n.n. – a region from Ardeal, with a supposed high moral level), the style of life remained unchanged, but the moral values are down. The trickery reigns here too. The morality has been replaced with: «do it yourself». This is the new law, do it yourself! Maybe the left-wing communism

is the disease of communism. Maybe the imperialism is the final stage of bourgeoisie. One thing is for sure! The final stage of Marxism is the general trickery.”

Finally, we feel the need to make a distinction. In the business world of Romania we can speak, on one side, of real, severe problems of morality, but also of false problems (or at least excessively generalized problems), accordingly perceived by the population because of the education, intoxications from the communist period. Following this coordinate, Pasti (2006) stated: „in the public opinion, the new Romanian capitalists are simply and demandingly identified and explained as thieves” (p. 281). The bound, which sometimes is difficult to trace, between the two categories of problems, makes difficult even from the beginning, any study focused on these aspects.

## 6. CONCLUSIONS

This work was based on various research directions: the first one focused on the identification of the (social, economic, political, demographic, technological) factors specific to Oltenia, the region from the South-West of Romania; starting from various studies carried out at national level, taking into account also the factors anteriorly established, we intended to outline a cultural profile (on the coordinates of Hofstede) for Oltenia region; finally, starting from this profile we tried to check to what extent the fact that the decision makers of Oltenia are considered less moral (and even more, the decision-making processes from the enterprises of Oltenia are considered as being far away from ethics) in comparison with those from other regions of Romania can be sustained and explained through certain specific factors.

Although some specific elements of Oltenia region can predispose to unethical behaviors in business world, we do not believe that the differences from other regions of Romania are significant (although there are cultural differences between them). We consider that there are two causes: the first one, communism caused a generalized moral crisis in the Romanian society; the orientation of the Romanian companies towards ethics is determined by external factors (the pressure of competition, the presence of foreign companies, legal elements) rather than internal factors (determined by the organizational, managerial culture etc.).

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**THE CONNECTIONS OF MONETARY POLICIES WITH THE EVOLUTION  
OF INTEGRATION AND GLOBALIZATION**

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**Abstract**

*The last decades have marked a tumultuous acceleration of historical and political processes and this produced significant changes in the geopolitical sphere, which continues to influence the economy, the financial markets and international relations, with effects on the construction of a new global balance.*

*The unprecedented development of financial relations and monetary policies has contributed to their internationalization, to the homogenization of the financial markets and of some regulations regarding their efficiency.*

**Key words:** *Bilateralism, regionalism, globalization, financial and monetary volatilization, general and financial-monetary integration, efficiency of monetary policies, convergence club and optimal monetary zone*

**1. INTRODUCTION**

The economic and financial-monetary relations have long preceded the appearance of the first states. Especially commercial links are very old and at first they were completely independent of state social formations. Therefore, bilateralism as a relation between two economic operators is the concept with the longest history, daily needs requiring the exchange of products.

Despite these trends, autarchy dominated economic life from its beginnings to the great geographical discoveries and the Industrial Revolution.

Economic "coagulation" continued and widened gradually until today, reaching various forms, interconnected levels that were unbelievable some time ago, representing a balancing factor at regional and international level. Current developments confirm the old forecasts referring to the indissoluble relationship between the economic and financial-monetary factor and international stability.

One of the fundamental issues relating to the evolution of integration and globalization is the achievement of an economic and monetary convergence relying on economic liberalism concepts and close monetary policies. A convergence model and the optimal monetary zone are taken into consideration, academic debates being held in connection with economic integration and monetary integration in the context of globalization, by the economic structures' homogenization, which is a prerequisite for monetary integration and for imposing a unique monetary discipline.

The European monetary area contributes to the globalization of the financial-monetary markets by reducing financial and monetary volatility, eliminating the discrepancies in implementing monetary policies, decreasing the impact of external constraints and also by maintaining a certain degree of independence, particularly economic.

Globalization also has several strengths (liberalization of national capital markets, banking-financial services and the three production factors), but also many weaknesses, such as huge drops-back in economic development, gaps and discrepancies among countries and regions, poverty present all over the world.

## 2. DISCUSSION

### 2.1 *Integration, globalization*

One of the problems developed by economists and monetarists in the last decades is that of economic and financial-monetary integration involving the interests of states, classes, nations.

Etymologically “to integrate” means to include, to incorporate into a whole. The French economist Jean Weiller tries to broaden the definition of integration. For him, “integration is not simply an addition, but in a given space, it means increasing the possibilities for coordination of plans of decision centers, in order to form a single economic system. To study integration means to rise above the market and to focus the attention on decisions, expectations and intentions” (Weiller 1989). This definition takes into account the West-European integration and the “centers of decision” are the authorities and the bodies of different national states.

For some economists integration would be simply the bringing into contact of the economies by removing all barriers that stand in the way of their exchanges. This integration would be nothing else but the creation of a vast free market, formed as a result of the unification of two or more economies. In this case, as André Marchal considers, we can’t talk about integration, but about a juxtaposition of economies which keep their own character and become more or less independent, each of them undergoing consequences that appear in their neighbors’ countries. The real integration, as André Marchal says, is the one designed in the structural and voluntarist meaning of the word. “It combines various elements of an economic assembly so that it looks like a space of solidarity” (Marchal 1953).

François Perroux defines the concept of integration based on the Western European integration. “The integration act unites the elements to form a whole or enhances the cohesion of an existing whole. To integrate Europe will be, supposing that the elements of Europe are the nations, to gather them in a whole entity, that deserves by means of its cohesion, to be called European, or to increase the cohesion of an existing whole, that will be legitimate to be called Europe” (Perroux 1977).

In the economic field, Perroux considers that integration aims to replace the national balances established in each European nation, between each European nation and other nations in Europe and beyond, with a new balance of an assembly formed by the European nations, which is considered more favorable and stable for its own benefit (Perroux 1977).

André Marchal (Marchal 1959), starting from the definition of Western European integration based on solidarity, considers this could be of four kinds, namely:

- a) Economic, which, except from the coordination of national policies or the application of a common policy, can be the result of the many and complex economic ties woven over the borders between member nations producers: industrialists, bankers, merchants.
- b) Social, i.e. it appears what Myrdal called “equal opportunity” that involves, contrary to economic integration, the intervention of national and European public powers. If economic integration can be private in nature, social integration cannot be conceived otherwise than institutional.

- c) Political, when in Western Europe the management unity is achieved and the conditions for creation and operation of a supranational authority are met, the integrated whole will be structured as each nation is structured.
- d) Territorial, this is real integration because it is economic, monetary, social and political, all at the same time.

Unfortunately, we find that André Marchal, as other economists also do, omits one of the fundamental integrations which determine the four types, the financial – monetary one.

In this way, we consider that Perroux's considerations, namely that there are three forms of integration, are more comprehensive (Perroux 1960):

- a) market integration
- b) integration through investments
- c) integration by means of institutions

These forms are, ultimately, different steps in the integration process. Market integration is the simplest form of integration, which aims to create a common market - economic and financial-monetary - by removing the Customs barriers and ensuring the free movement of goods and money in the area. The financial and monetary integration has an important role in forming the common market, and its element of crucial importance is the free convertibility and movement of national currencies.

The unification of Western Europe, from an economic point of view, resulted in a vast market, which allows the existence of an economy on a higher level, similar to the American or Asian ones.

However, under the shelter of a formula like "the vast territorial unity", "the optimal size", they motivate and protect the greedy expansionist policy of large capitalist countries and imperialist monopolies against small countries, which, under the disguise of integration, seek to plunder the latter's natural wealth and subdue them economically and politically.

Another argument frequently invoked by economists to justify European integration is the development of productive forces, the very rapid contemporary technical progress.

Andre Marchal argues that in its structural sense, integration is impossible to occur unless the following conditions are met (Marchal 1959; Stoleru 1987):

- a) Geographic proximity - Statistics show that neighboring countries have a greater commercial exchange and that despite the progress of the means of transport, distance is an obstacle. He said that "here there is one of the irrefutable superiority of EMU on free trade area which groups seven countries geographically spread: Austria, Denmark, Norway, Portugal, United Kingdom, Sweden, Switzerland."
- b) Similar development levels and the homogeneity of the structures. After Andre Marchal "this means that territorial integrity must unite not complementary economies, but similar economies, with a view to restructure them in a broader framework - which undoubtedly arises numerous problems and obstacles, but which proves to be advantageous. While, on the other way round, the union of complementary economies, which do not arise any problem, seems to be of no utility, because it simply embodies the status-quo".
- c) Psychological conditions - The will to become united in order to form a balanced economic complex.

Listing these conditions that would make the economic integration sound and politically acceptable, Andre Marchal shows that it can't be extended to many countries. That is why no one can speak of global integration, but only of a regional one.

An extremely important observation and at the same time a correct one is made by Myrdal in connection with the worsening regional disparities in terms of integration, because of the mechanism of "circular and cumulative causation" (Myrdal 1957). The complete liberalization of trade following the completion of customs unity, labor force, capital, generates a double cumulative process of enrichment of the rich areas and impoverishment the poor regions.

We must understand that European integration does not take place in an international "vacuum". European Union countries are open economies with close links with the world. Therefore, the development of the European Union will be seriously affected also by economic, monetary and political events outside the Community. On the other hand, the EU is a major player on the world stage, an actor whose actions have a significant impact on the global economic system. All these challenges and evolutions are ultimately the key to progress and to the perpetuation of competition.

### *2.2 Economic and monetary convergence in the context of globalization*

The matter related to the convergence between the two sectors is fundamental in a compound economic and monetary globalization. The concept of optimal monetary zone within a globalization process is capable to take into consideration the connection between a global currency and the economic and social convergence.

As a matter of fact, it is impossible to envisage a sustainable globalization involving countries which are divergent in terms of the effect of idiosyncratic demand shocks. Everything is possible, however, when markets are in perfect competition. In fact, if economies are of liberal inspiration, what should be done is to apply a theory solidly adopted as a monetary liquidity theory, permitting to integrate the indicators of the convergence between the two sectors – economic and monetary – into a sound and relevant analytic framework.

#### *2.2.1 An examined model: convergence club and optimal monetary zone within the evolution of integration and globalization*

Certain models should be capable to take into consideration the convergence between monetary policies and globalization. These models are the object of academic debates on economic integration and monetary integration in the context of globalization, held between economists and monetarists. The first ones believe that monetary unification at international level should be enforced after a long period of economic structures' homogenization, whereas monetarists believe that a unique monetary discipline might prevent countries from accelerating the global economic integration.

*2.2.1.1 Subject to the hidden conditionalities of neoclassic macro-economy, convergence in a growth model as the one developed by Solow leads to a simple result: considering the same technology as the one described by a Cobb-Douglas production function, the same saving tendency, the same growth rate of active population, the countries with initial capital/labor ratios have differences related to the convergence to balance, or a capital/labor ratio with a convergent growth rate. The capital movements triggered by the marginal productivity differences serve as an engine for convergence.*

The first advantages of economic globalization are the country risks that explain why convergence goes unnoticed between poor countries and rich countries, the first ones being characterized by political instability which is rather unfavorable to attract capitals, despite the high an *apriori* rate of return. On

the contrary, the convergence club (Baumol 1986) permits to put together the economies that are convergent due to technology transfers, educational policies, stable political institutions, capital transfers etc.

If we introduce a normal imperfection over prices in the Solow neoclassic model, we get a model of Mundell optimal monetary zone (Mundell 1961). Inspired at first by Milton Friedman, who is an opponent of the global monetary system born in Bretton Woods and an advocate of the flexible foreign exchange rate, after 1950, Mundell had the ambition to propose an un-formalized framework that divides the global economy into sub-areas where the foreign exchange rate is fixed, because the negative demand shocks are absorbed not by the price variation, but by the movements of the active population. On the contrary, the foreign exchange rate is flexible when there is no mobility of the labor force. The flexibility of foreign exchange rates is a way of “offsetting” price rigidity.

The labor force decline triggers the mechanism of reducing the capital marginal productivity if the production function is of Cobb-Douglas type, according to Wicksell’s law (Cunningham 1994). Financial capitals are not spontaneously prompted to come to the region. Only public policies are capable to artificially increase capital return.

A macroeconomic model may be interesting, but it requires price flexibility on competitive markets, relevant in a long-term vision.

#### *2.2.2 A simple alternative OMZ (optimal monetary zone) model in an imperfect competition context*

*2.2.2.1 The starting point of the analysis was the standard model of macroeconomic and monetary balance, with several countries bound through a common global currency. The inflation rate is controlled by the central banks of the respective countries. A negative demand shock in one country does not permit a return to balance by the price flexibility and a positive supply shift, as it is the case in the countries with flexible foreign exchange rates.*

Therefore, in the case of flexible foreign exchange rates, the demand shock which determines the shift from the initial full-utilization economic and monetary balance to the sub-utilization balance triggers a return to the economic and monetary balance by increasing the long-term balance, after the supply reacted by becoming more competitive than the demand.

On the contrary, if a common global monetary policy is in place, the demand shock has no effect on inflation, but has a real effect on production. Loss is the new sub-utilization balance that functionally depends on the sustainable production decline relative to the initial prosperity of long-term growth.

As flexibility plays no extra role, full-utilization economic and monetary balance is a sustainable balance after the readjustment of the production capacity declines in economy; a new long-term growth system adjusts a lower increase in the active population rate and the balance between monetary mass and foreign exchange rate policies.

*2.2.2.2 We are going to transpose this dynamics into an imperfect competition macroeconomic framework, considering that economy consists of one single representative enterprise.*

The assumption of economic and monetary competition allows introducing some nominal rigidity over prices and the level of the currencies’ foreign exchange rate. The initial economic and monetary balance, before the adverse demand shock, is provided by  $(p_0, q_0)$  on the demand line. If prices were flexible, the balance is obtained by  $(p_1, q_1)$ . As the price is rigid, a

solution close to optimal is  $(p_0, q_0)$ . It provides a welfare loss for non-optimal causes. It is measured by  $p_0 - p_1$  price difference equal to  $f(q_2) - f(q_1)$  subtraction, where “f” is the demand function.

A development of the Taylor’s theory regarding  $q_1$  up to the second order of data is reflected by the following relation:

$$f(q_2) - f(q_1) = f'(q_1)(q_2 - q_1) + \frac{1}{2} f''(q_1)(q_2 - q_1)^2 \quad (1)$$

We assume that  $q_1$  is an average quantity  $\bar{Q}$  in OMZ, calculated between  $q_0$  which measures the quantity in shock unperturbed country A and  $q_2$  which measures the quantity in shock unperturbed country B.

By a generalization in “n” countries, the relation obtained is the following:

$$\sum \alpha f(q_i) = \sum \alpha_i f(\bar{Q}) + \sum f'(\bar{Q})(q_i - \bar{Q}) + \frac{1}{2} \sum \alpha_i + (q_i - \bar{Q})^2 f''(\bar{Q}) \quad (2)$$

with:

$$\bar{Q} = \alpha_1 q_1 + \alpha_2 q_2 + \dots + \alpha_n q_n$$

and

$$\sum_{i=1}^n \alpha_i = 1$$

If we take into consideration that demand function “f” is not linear, the result is a Marchalian demand function, which appears as:

$$f(\bar{Q}) = \frac{a}{Q}$$

This allows us to rewrite equation (2) as:

$$\bar{P} = \frac{a}{Q} + a \left\{ \frac{V}{\bar{Q}^3} \right\} \quad (3)$$

where:

$\bar{P}$  – aggregate average price for OMZ

$\frac{a}{Q}$  – aggregate demand function

$\alpha\left\{\frac{V}{Q^3}\right\}$  - weighted sum of average differences

R. Lipsey (1960, pp. 1-31) shows that the aggregation of non-linear functions leads to a more remote aggregate function, where dispersion of microeconomic functions is high.

Assuming that inflation is absent (price increase or expectation for monetary mass) and the price level is constant, we obtain a function between the production's variation, the level thereof and the level of the monetary mass in circulation.

### 2.2.3 The impact of the Monetary Union (MU) on the globalization of capital markets

The Capital Liberalization Directive, adopted in June 1988, is the document that governs the European Economic Community's full liberalization of capital movements.

EU Treaty agreed between Member States shall prohibit any restriction on capital movements and payments between Member States and shall, in principle, ensure the strength of the European integration, without which the single market cannot be fully supported and carried out (Bodrus 1998; Martin 1996).

The full harmonization of the capital market is also hampered by the national characteristics of money markets, resulting mainly from the level of inflation.

The expansion of world trade, seconded by the capital flows, the unprecedented progress of science and technology, the transition of the communist economic system to a market economy have generated the acceleration of the regional and global integration process, which basically represents increased business opportunities for the banks, financial institutions, firms and financial investors (Hayek and Mayer 1993).

A brief overview of these events relate to the expansion of the euro currency market, the birth and strengthening of the European Union, the growing importance of multinational companies, plus the financial crises, the oil shocks, the debt crisis, the collapse of communism in Russia and in Eastern Europe.

At the beginning of the third millennium, globalization has become a fact. In these circumstances governments, international financial institutions, businessmen /businesswomen will have to face challenges.

Globalization involves both a series of positive, innovative and dynamic aspects, but also many negative, disturbing and marginalized aspects. In terms of the positive effects, the relations between states and individuals are deeper than ever. World exports in the year 2010 were 14,5% of GDP, compared to an average annual growth rate between 1967 and 1973, which was 10%.

Direct investments abroad in 2010 were over 12 times higher than the level of the 70s. This process of global integration is the result of changes in the political view, namely: to promote economic efficiency by:

- a) The liberalization of domestic capital markets, financial services and the three factors of production;



- b) State disengagement regarding many economic activities although at the origin of the process there are recent innovations in communications technology, integration is still partial: borders remain a closed path, especially for low-skilled labor force.

However, these trends mask some differences: big progress, but also huge drawbacks, shortcomings and inequalities between countries and regions, poverty is everywhere today. In industrialized countries, poverty is still obscured by statistics and one in eight is affected either by long-term unemployment or a life expectancy below 60 years, or an income below the national poverty line and a brief training level without the possibility of overcoming the situation (Zainea 2000).

In some countries, human poverty indicator shows large disparities by regions, for example, in the case of India where the poverty level is twice higher in Bihar state, in comparison to Kerala region. At the same time, the inequalities between men and women are still striking. In many developed countries, women are almost totally excluded from political life. Women occupy more than 30% of parliamentary seats in only five countries in the world and in other 31 countries, their presence in the Parliament is below 3%.

If financial markets or the markets of crime collapse, in the case of AIDS transmission and of the greenhouse effect, the risk of propagation of disturbances is huge. Planetary hazards, such as the global financial crisis started in 2007, are growing beyond the national and international capacity of intervention or response.

The main feature of the economic and financial environment is the alternation of the phases of expansion with those of recession and the financial and monetary volatility.

The financial crisis in America, Europe and Asia has destabilized the lives of millions of people, reduced the prospects of economic growth in the world. The analysis of the crisis allows the release of some important conclusions as regards the financial market:

- a) First of all, the instability is the characteristic of globalized financial markets. A key element in triggering the Asian crisis, for example, was the instant and massive injection of capital for a short term, followed by an equally abrupt withdrawal.
- b) The second important conclusion that is released from the crisis is the increased caution with which the governments should open access to capital for the short term, highly speculative, especially when the regulatory institutions of the financial market are infantile.

How are we going to live with this node of divergence? Will globalization defeat with her good intentions of equilibrium in a kingdom dominated by the Faustian spirit and intelligence or terrorism? It remains to be noticed what will be the answer to these questions.

Who will benefit most from the change? This is not the case of European exchange offices. The sector of IT and business consulting companies will take full advantage of the integration and stability of the currency, as a consequence of a strong demand for the adaptation of information systems. Finally, the whole economy will benefit as a result of integration and currency stability, which is the fundamental goal of the project.

Capital markets have prepared themselves. The state bonds issued after 1999 have been issued in Euro and those in circulation have been converted. As regards the future of the financial centers, the opinions are divided and we cannot make reliable estimates yet. If Britain will enter the monetary union, London would be able to dominate the capital market. Smaller financial centers, for example,

Brussels and Milan will restrict its activities. Otherwise there is a risk that the offshore market in the UK to divert a portion of its profits volume of financial activities generated by the euro area. Competition among financial centers and institutions will increase, and the result will be the production of alliances on continental markets.

London has an advantage over the competition in terms of financial liberalization, and this allows it to exploit the natural tendency of concentration which is found in the finance industry.

Making use of the "opting out" clause, the UK yet avoids the rigorous monetary policy and the discipline imposed by the ECB, London still retaining its status of offshore center. At the same time, London's advantage is reduced, increasingly, in favor of Paris that offers superior security guarantees for financial transactions.

In terms of derived products from the capital market, the single currency triggers a uniformity of the futures contracts. At the same time, the listing of securities in euro allows a better comparison and creates new opportunities for arbitrage.

Potential efficiency and success in the financial sector depend, ultimately, on the ability of MU to achieve full financial integration of member countries, to create a more uniform system of practices on financial markets and achieve the fullest possible transparency in the system of quotation and evaluation.

The efficiency and the scope for monetary policy and the statute of the central bank are inseparable (Angheta and Orlean 1984).

The impact of external constraints should not be generalized: no country can completely abandon the wave of adjustments, operating continuously. It follows therefore that a certain degree of independence must be considered and maintained at all times, which does not mean isolation from the process of internationalization. Economic independence is now discretion and security, allowing us to retreat from the game when "cards are bad" and it also means maintaining the autonomy of decision. Independence is connected to the national interest and to the quality of the most precious capital, the human capital. A country that does not make any efforts in this direction, in terms of nutrition, health, education, comfort and civilization in general, everything that is related to the quality of life today, is likely to disappear sooner or later, from the geopolitical landscape (Marsbett 1989). Today, when we know too well how many forces are raging, many inequalities overwhelm us, and it is clear that this goal is not simple at all.

Two foreign policies are essentially required today:

- the competition policy;
- the cooperation policy.

The Competition policy is the cornerstone of the margin of maneuver. If we fail to provide a satisfactory level of competitiveness, we expect a dependent position, of a colony or satellite.

Although it was said from the beginning that once the currency are allowed to float freely, they will solve all the problems and the adjustments will be made by themselves, they arrived shortly afterwards to the flotation controlled by central banks, but still this was not effective (Waquet 1998). Then the coordination of monetary policies appeared, and at present we can also talk about the coordination of economic policies, within the EU and G7.

#### *2.2.4. The debut of EURO – in between success and skepticism*

"E Day", i.e. the euro day, on 1 January 2002, when over 300 million people in Europe began to have one thing in common: the same currency.

Conversion is the second part of a long process, conceived in two stages. The first step, respectively the introduction of electronic euro was made in January 1999, when imports and exports in and from the EU were calculated using the single currency. After 1 January 2002, consumers in 16 European countries and tourists visiting these countries stopped using the Franc, the Mark and the national Lira began to pay for food, train tickets or consumer goods with the new banknotes of the single currency. Moving to a single currency was not simply a matter of monetary logistics. The immediate or long-term consequences, good or bad, are enormous.

Skepticism and mistrust, this could be the position taken by the Western analysts as regards the shift to the single currency, after 1 January 2002.

- Skepticism, because almost 40% of the 300 million citizens of the EU member states do not realize that they do not have their national currencies anymore in their pockets. The same thing can be said also about small and medium enterprises. The managers of these companies have not tried too hard to understand the phenomenon of transition to the single currency. For them the critical moment came when they had to start paying salaries in euro.
- Lack of confidence comes today from gloomy forecasts regarding the economic growth, inflation and high growth of public debt ratio in GDP in the 16 Member States. A few months before "E Day" it was increasingly clear that Europe had problems.

For 2012, ECB forecasts an inflation rate between 1% and 2,4%. Available survey indicators confirm some tentative signs of a stabilisation in economic activity at a low level around the turn of the year, but the economic outlook remains subject to high uncertainty and downside risks.

In order to gain confidence in the single currency, it is important not to cause any syncope after switching from the national currencies to the euro, not to lead to delays in payments, and not be the case of temporary currency crises and to reduce the volatility of the exchange rate.

Of course, you can make a series of possible scenarios, based on the current regulations and the confidence in the single currency.

The European unification is more than an alliance or an association under the tutelage of a supernational authority. It is possible for it to exist only by self-limiting the proud movement of the national entities and by means of the conscious delegation of powers that belonged to the national entities.

## CONCLUSIONS

The monetary policies are proved to be a catalyst for general economic and financial stability – regional and global. The euro zone should regain its status of reliable and stabilizing factor in international financial-monetary relations.

The demonstration of economic and monetary convergence in the context of markets' integration and globalization, through an appropriate method, also in a macroeconomic framework of imperfect competition, reveals the need to determine and maintain economic and monetary balances that ensure a stable functioning of markets, price levels, foreign exchange rates, inflation etc.

The currency stability by balanced monetary policies, especially in “fragile” countries sensitive to the shocks of adverse demand (because their economic structures are remote from other countries), appears as a stabilizing and progress factor, meant to avoid any tension. Likewise, pragmatism in economic policy is a good strategy. However, the effect of markets’ aggregation is not a leading-edge law, it is the same if the effect is triggered by the category of the models where economy combines with turbulence. On the contrary, the effect may be enlarged by markets’ flexibility measures and/or redistributive structural policies.

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**THE FLEXIBILITY OF WORK MARKET IN TOURISM  
STUDY CASE – SARANDA’S TOWN**

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**Abstract**

*Our article is going to analyze the work flexibility in the touristic season at the region of Saranda. Saranda is located in the Southern edge of Albania, it’s a coastal town and it has 97 natural and cultural heritage objects. Under its jurisdiction it is the ancient cite of Butrinti, which is under UNESCO’s protection and the ancient town of Foinikes. In the post communist period the population of Saranda has tripled. The local economy is mainly depended on tourism, which is responsible for a great number of workers. The incomes from tourism form 10% of the GDP. In this article will be displayed the ways of employment in the sector of seasonal tourism of the region, in the branch of hotels and restaurants and even the work conditions included. At the first and second part of our project are given details in connection with the flexibility concept of the work market, the flexible ways of employment and the employment in the tourism sector.*

**Key words:** *The flexibility of work market, the seasonal employment.*

## **1. INTRODUCTION**

Nowadays, the application of flexible forms of employment has taken large size, as in the private sector and the public, with notice and an extensive use of them in the branch of tourism. The local economy of Saranda relies heavily on tourism, which is responsible for a large number of workforces. In this article an attempt will be made to highlight those employment forms that appear more frequently in branch hotels and restaurants. With the change of the political system in Albania and the transformation of economic system from a centralized system to a free market system and the opening of the economy and the resources to world markets, especially those communities, particularly its business and local governments, known as the challenge of building a local economy and its businesses structure is capable of adapting to a market and for a competition.

During the transition period in Albania, the business structure changed and continues to change at the national and the local level. Before the period of transition, large public companies dominated the market and now dominate the Small and Medium. The region of Saranda lies in the southern part of Albania. In post-communist period the population of Saranda has been multiplied. Tourism industry and construction industry received a big boom in post-communist years and especially last ten years. Now it is undisputed that tourism develops in the recipient countries that are in the transitional stage of

development, which means that other sectors of the economy tend to grow old before they mature. (Γ.Παυλόπουλος - Α.Κ.Κουζέλης, 1998)

Gross Domestic Product for the last 10 years had been doubled. GDP, in accord to the last decade it has been increased by 300% of the revenues derived from tourism account for 10% of domestic production. (Statistical Yearbook of Saranda 2011)

The number of tourists from 2000 in 2011 has been multiplied 10 times. Tourists are mainly from Kosovo, Macedonia, Montenegro, and Greece etc. During the last 10 years the number of cruise ships anchored in our city is multiplying and the number of daily visitors has been increased by 28 times. Visitors are from Western Europe and the USA.

## 2. FORMS OF EMPLOYMENT IN THE REGION OF SARANDA

The development of tourism brings in countries many economic impacts because it creates a satisfactory number of new jobs, full or partial employment, no matter even if they have in most cases seasonal character sets where other branches of economic activity such as industry, agriculture, etc. for reasons related to economies outside the country or region where the development of their default, is unable to establish. ( Ηγουμενάκης, Ν 2007 )

Development of tourism in the region is not so easy, because a prerequisite to achieve this is to create tourism infrastructure projects with funding from the state, creation of tourism superstructure investment with private initiative, and educational training of tourism managers and appropriate staff trained in the tourism sector to provide the required quantity and quality level of tourist' services. (Ηγουμενάκης, Ν (2000).

Perhaps the most positive contribution in tourism development lies in the employment sector. Beyond the jobs that are created in the tourism sector benefit there are and other sectors such as construction, transport, agriculture and trade. Greenwood, expressed the importance of tourism in LDCs and developing countries, he underlined, "the main effect of tourism over the past twenty-five years later may focus on just one word: Jobs. (Davydd J. Greenwood, 1977).

According to Daniel Stynes : A total economical impact of tourism is a summary of direct impacts, indirect and the induced in an area. Indirect effects and induced ones are sometimes called as secondary effects. One of these impacts can be measured as gross output or sales, as income, as employment, or as added value.

Three types of employment are created based on the development of touristic activities and mainly include: (Ηγουμενάκης,Ν.,Κραβαριτης,Κ.,Λυτρας,Π., 1999)

- a) Direct employment which comes from the realization of cost manufacturing facilities to tourists in the tourism industry
- b) Indirect employment which comes from the activities of touristic offers, but is not directly provoked by tourists spending
- c) The induced employment which is an employment that flows from the multiple influences (multiplier) of touristic incomes because the natives spent again what they have earned.

At this point you will need to pay attention that most measurable jobs that are created in tourism, refer only to direct employment, i.e. what derives as it has been specified from the spending made by tourists in productive objects of touristic industry.

Much of the direct employment has to do with the touristic hotels and mainly with that bigger and special. The number of employees varies depending on the importance of the tourism section. Factors that affect the number of directly employed in the main touristic hotels are:

- The type of tourist accommodation.
- The category of tourist accommodation.
- The capacity of touristic accommodation.
- Region and the location.
- Quality of service provided.
- The characteristics of the host country, such as salary levels of current tourism policy.

Therefore, a luxury hotel with a high capacity, which is located in a touristic spot and has a high occupation requires a greater percentage of employees per bed, in connection with a hotel of the same type with the same features but situated in a less developed touristic region, implies that the number of goods and services consumed increases with the number of nights of stay. In contrary, in the small hotels of family-type businesses are noticed that a small fluctuation in employment in the period that it operates.

In general for employment in the tourism there are arguments that allow to make some observations and mainly they are:

- a) Employment and income impacts are closely related among themselves but not completely.
- b) Impacts of tourism on employment are affected by the type of touristic activity.

Some forms of tourism are more "tense job" and some less.

This observation is applied especially to businesses that provide hotel accommodations and especially, for the hotel host which absorbs a significant percentage of the labor force of touristic destinations.

- c) Impacts of tourism on employment are affected by the types of skills that are available at the moment.

Tourism needs a large number of employees with adequate skills. (R Hudson - A. Townsend) 1992

In addition, high tourism seasonality, unemployment, low wages, unskilled, untrained as a characteristic of jobs that are offered, give a cause to fierce criticism by many researchers in other words to create same touristic layer with highlighted parasites. (Γ. Μ. Βενετσανο 2006)

- d) Impacts of tourism on employment often are hidden. By creating jobs, tourism is intended to attract working force from other branches of economic activity, particularly from rural areas. Also, is intended to attract people other than that they are not legally involved in the economic age of population i.e. pensioner, a housewife, student.

- e) Employment in tourism is in a large part of the season and influences in the decrease of unemployment in a host country and tourist accommodation in all levels and respectively at a national, regional and local level, especially when in the place for which the word "tourism" has a protagonist role in its economy.

- f) The multiple statistics on employment cover based on the law only employees in the tourism industry and not they self-employed in them, but not the owners.

It comes from the fact that the tourism industry consists of a great number of small touristic objects in which many people are involved in two categories that were mentioned above, i.e. self-employed and the owners.

Albanian tourism affects features directly in the tourism labor market and to reflect strongly the characteristics of employment in tourism this market is dominated by the small and the medium businesses. Saranda owns 131 hotels with 1430 rooms and 2727 beds. Hotels generally are employed by families. Only 10% of employees are the permanent ones, while the rest are partial employment and temporary. An important part of the work observed in the seasonal character of tourism and short term (2-3 months), longer (6-8 months), similar to that of the season represents each region. Only 11.4% of the number of hotels of Saranda continue to work throughout the year, while the rest suspend their activities and business activate early in the season the following year. (Statistical Yearbook of Saranda 2011)

### 3. FLEXIBILITY AND LABOR MARKET

Nowadays, in the context of policies for employment not only in European level but also in other nations the debate made on flexible forms of employment has become more powerful in order to fight unemployment. Referring to labor market flexibility, which means the ability of the labor market to adapt to internal or external changes.

Flexibility policies have resulted in a series of employment forms flexible - “ atypical “, different from the typical model of labor relations.

The Labor Flexibility appears in three main areas:

- In Employment
- Income
- Work time.

Within this project it interests us to refer to the flexibility of the framework of the employment in order to know more flexible forms of work that increasingly dominate even more in the general labor market, and more in the tourism sector which is the basis of this study. Illegal flexibility constitutes the extreme expression of flexibility under which the work is not operating within the rules defined by the law. The illegal data of flexible methods of employment of the relations such as the non-implementation of law and the social security payment or the amount of the rights arising from the wage relationship.

At this point there are some aspects of working time flexibility, which are increasingly found in labor market. Flexibility of working hours between work adaptations is expressed in variations of business activity, consisting of these individual adaptations to changes over time, however, maintaining the size of employment. The internal flexibility of companies represents and directly is related to the organization of work.

Overtime occupation is a traditional and widespread way of management flexibility of working time in which the increase of work time due to increased compensation business needs without taking on new staff.

-The total time of work-constitutes today and working time management consists of:

- 1) The calculation of work time at wide intervals (6, 9, 12 months).



- 2) Increasing the daily schedule and weekly employment which is based on businesses needs.
- 3) Maintaining the general working time based on space and time and calculating thought keeping the average hours of the week according to the laws in force.

-Time-flexible and circular: refers to a form of working hours according to the daily schedule which doesn't seem stable, but varies during the week, being mainly adapted to the needs of businesses.

-Daily schedule according to which the extracted work is full-time employees during the day into two time periods.

Job-shift is related to a flexible form in which the different groups of employees within a day covering the same job in a business that operates in the period of time. Flexibility of work time is based on the fact that these groups vary periodically in order not to have to employ a fixed daily schedule. The flexible forms of employment have both advantages and disadvantages, an advantage is that it provides employers in terms of labor costs and the disadvantage is that they are collected on the side of workers. ( Μουρίκη Α. 1991 ). Providing flexible forms of employment insecurity and labor unrest, in most cases it covers parts of the business needs. They refer mainly to those who do not require highly skilled workers, but mostly unskilled or semi-skilled, as a result they are not liked, but neither of the vocational training or career development. These forms of employment characterized by low pay they don't pay insurance, even parallel possibilities of representation and collective organization of workers' demands that they are very limited as a result they haven't entries for the application of their rights. Out of this we come to some disadvantages that have particularly women. An initially confirmed and additional extended feature of female employment is that employment of the case for women in productivity. Also, difficult conditions of economic and social life that prevail recent years to steer women dilemma "unsafe working and low-paid or unemployed" as a result of participation prevented the full right and power of their workers. Further, the high proportion of flexible employment empowers women and perpetuates the traditional distinction between works for men and for women, as well as new modes of labor market breakdown by sex criterion, training, schedule, etc.. Labor market threatens that are polarizing in a market of employees with secure employment, with higher training, higher wages, on the other side of unskilled workers and a lower wage, an update work for women. This situation attempts to create a parallel market for women with negative features highlighting their traditional roles.

Flexible forms of employment observed in the region are;

Partial employment

Temporary employment

Undeclared employment

Tourism Division is in a constant effort context of increasing the competitiveness of its flexible labor policies, labor cost reduction but also improvement of labor force level. The final price of the disposable is the most important factor in the decision to purchase products and tourism services, in order to take the decision to buy more and more approaching the time period of consumption. This means that added to it constantly by adapting to the needs of e tourism offer with the request. Demand is characterized by seasonality, periodicity, and especially last minute changes. So, it is necessary the existence of flexibility. Characteristic of tourism employment is seasonality, which compiles rises with the phenomenon of seasonality of tourist movement. The stable staff for internal period results in the firm to invest on the staff recruited is the risk of the end of touristic season, because it requires staff to

leave a permanent employment. This process brings lasting results that match the lack of specialization and the worsening of the economy due to the payment of financial assistance, but also high costs for the training of the personnel of tourism. Therefore the observed phenomenon of high unemployment outside the touristic season and the lack of qualified personnel during the tourist period. The negative impact of tourism development is that inflation creates "seasonal" tourist places, and in parallel leads to a very large increase in commodity prices and land. Seasonality of employment has negative effects in case of experienced manpower and specialized, which is not absorbed to an extent not sufficient by two main branches of the sector, hotels and agencies and often turns off the tourist market works employment. In contrast, a positive function in the case of unqualified staff requires casual job or additional income. It is well known and frequent phenomenon that farmers during the summer work in the tourism sector, or the unemployed from other areas relocate to major touristic centers seeking temporary for employment for tourism professions. Development of tourism sector in both industrialized countries and developing countries led to an increase in jobs of unskilled or semi-skilled, due to seasonal employment in tourism to oversized covers the unskilled or casual that simply requires second or additional income and not steady work.

Unskilled labor has always been characteristic of the labor market in the touristic sector, whose function relies on a small number of qualified employees. Overall, the tourism sector as a whole is not particularly demanding for specialized technical knowledge. (C.Cassimatis, M. Thanopoulou, P. Tsartas, 1995)

A large proportion of the workforce in the tourism sector, particularly in terms of mass tourism is unqualified or of low level qualifications. The quality of labor force and its efficiency depends to a great extent on the attitude of employees to task their organizational abilities. The employer requires the employee not a high degree of professionalism in a specific job but rather "a set of skills, to perform relatively simple tasks, which require and a satisfactory level of skills of self-organization". Since labor wages occupy a high percentage of total expenditure total tourist enterprises, the need for flexibility leads to the need to exert a pressure on labor costs. This pressure appears stronger for the work of unskilled and semi skilled. The need for cost reduction in combination with the lower needs of the sector for staff with advanced specialization, interprets and other composition characteristics of the workforce in the international field such as:

- In that way to increase the percentage of workers who work part time, especially in small and medium enterprises, whose financial requirements are relatively low.
- High percentage of employees who come from other areas or branches of economic activity, which also have relatively limited economic requirements or because employment has fallen in areas from which they come and are under the pressure of unemployment or suffer from lack of specialization.
- A large number of women are employed, but a very small percentage of them hold positions of responsibility. It is known that in many countries salaries for unskilled women are relatively low.
- Percentage of high participation in the general employment of young people age with low levels of training who agree to work with low wages happen due to lack of experience or for other employment.
- A large number of employees in the informal economy conditions, which limit the total cost of labor for the employer.
- Long hours of work, which tend to reduce the cost per unit.
- Participation in trade unions with low compared with other branches.

Despite this, in the recent years there has been a turning point in the atypical forms of unskilled labor, such as verbal agreement to provide labor, use of family members into the family businesses, contracts of short duration (1-4 months) and in the most works without social insurance. Many of these atypical forms of work are related to provide services to their businesses and hoteliers in restaurants or bars.

Also developed and presented significant percentage participation of women in part-time work, work on weekend's e.g., in restaurants, work in the afternoon in the shops, the provisions of appropriate services in hotels or works only during the "full season " July-August. In these cases is highlighted a very informal character. Often this characteristic is requested dominant motivation for such forms of employment.

In any case, the characteristic forms of employment mentioned above is that they tend to become a stable feature of Albanian development of tourism, which makes it harder than their statistical evaluation and assessment of employment as on tourism in general. It is clear that the addition of such forms of employment contribute to the continued devaluation and degradation of workers' rights raised from the labor laws, social security legislation and legislation on equal employment opportunities between women and men.

Employers use it as an important mechanism for reducing labor costs to avoid paying taxes and social security. New trends in the labor market and the promotion of a model for the liberation of labor relations that are characterized by flexibility had makes it easier for violation of labor laws and also had led growing network of undeclared work. (Ηγουμενακης.Ν.,Κραβαριτης.Κ,Λυτρας.Π, 1999)

A frequent phenomenon of the signing of contracts with part-time employment while in fact are full employment, or sharing the work between the period of undeclared and declared, is when the contract has seasonal character. Undeclared work usually stated as illegal way of flexibility appears increasingly in the labor market in tourism. Undeclared work with understand the term "all paid activities that are lawful as regards their nature but not declared to public authorities, taking into account of course the various regulations that apply in different countries." This definition of undeclared work connects with tax evasion and deception in the social security sector and covers a variety of activities, such as family service delivery. Talking about a complex phenomenon which is influenced by a wide range of economic factors, social, institutional and cultural, is known in general in the undeclared terms of works which tend to be an obstacle to the economic and social policies oriented in the budget towards achieving economic expansion.

Inherent difficulties to be measured in the undeclared work appeared in reality results in the existence of a limited number of studies for the registration of the problem. Numerous efforts with registration of this phenomenon of the informal economy and undeclared work ends in the estimates using different economic calculations of the size or applying macroeconomic econometric models, rather than accurate measurement of economic size of evasion or hours work and the number of workers employed outside the system of social regulation.

#### 4. CONCLUSIONS

The tourism industry is a branch looking for work , especially when it comes to cities such as Saranda, where the touristic season is small, which lasts only two or three months .. Existing pressure on the situation described above is the employment. Employees are requiring hours of tedious work, which are constantly changing depending on the load of work, without being able to obtain permission.

Noting that wages rarely meet with contracts, when this happens it has to do with the cooks, and seldom the receptionists, employees waiters or cleaners in the hotels and restaurants who agree to lower salaries, which might be daily or weekly wages.

The tourism industry in Saranda is a sector which apparently does not provide secure full employment. New forms of flexible work are shown as temporary work and mostly seasonal, part time, with continued changing in time, undeclared work (labor code violations) and in response with the global tendency.

To reduce costs work and increase business competitiveness which have important implications for employees, the shortage of needs for people who work in different jobs whom employ rights of young people have created also groups that have already been mentioned uncertainty about the future.

Non-compliance with legislation is evidenced in flexible employment sector of tourism; violation of rights of workers must stop, as well as undeclared work which undermines the tourism sector in the region.

Giving the seasonal nature of tourism in general in Saranda, demand for leaders to promote new forms of tourism, which can be distributed throughout the year, contributing in this way the convention of the continuous seasonal contracts and why not creation of new jobs. By implementing state policies the workforce should be protected, to avoid violations of fundamental rights by threats that are in this industry, we shouldn't forget that the promotion of flexible forms of employment aimed to increase competitiveness and reduce unemployment. Lack of control has led to irresponsible application. Taking into account the results of our research in this case-study format proved that employment in the region of Saranda and the flexibility of employment is directly impacting on sustainability and development of tourism sector. This section requires careful attention and a special government projects as well as private ones.

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**BUSINESS PERFORMANCE MANAGEMENT - VALUE STREAM MAPPING  
AND COSTING IN INDUSTRY COMPANY**

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**Abstract**

*Paper describes one innovate access methodology to the right calculation of the production performance and production costs. It offers a transparent way, how to calculate the lean indicators in the real industrial production. Traditional companies use standard costing as the primary method of production costs control process. Today's production environment enables a vitally mechanism in the area of monitoring of real production costs, because all types of wastes are undesirable and the motivation to cost decreasing is in according to the productivity improvement, higher efficiency and respectable cost level very important. This paper presents one of the most effective tools for enterprise processes cost reduction – value stream mapping and costing. This tool enables by lean metrics to improve not only the cost structure, but the system of cost calculation as a system for higher process profitability too.*

**Key words:** *costing, lean production, performance management, value, value stream mapping*

**1. INTRODUCTION**

The standard costing allocates all overheads to the product and these overheads relate to the amount of labor required to make the product. Some products appear to cost more than they really do and other products appear to cost less. These costs mislead people and cause them to make wrong decisions relating to pricing, profitability, make/buy and others. By this fact it doesn't motivate to lean behavior in production operations. Traditional companies use standard costing as the primary method of production costs control process.

Today's production environment enables a vitally mechanism in the area of monitoring of real production costs, because all types of wastes are undesirable and the motivation to cost decreasing is in according to the productivity improvement, higher efficiency and respectable cost level very important. The cost of the product varies according to the product volume and production mix, overhead costs are related to the value stream as a whole and the maximum profitability comes from the maximum production flow through the value stream (Rašner, Rajnoha, 2007).

In a competitive environment a firm must be able complexly to eliminate the non-value-added activities and to increase the number of value-added activities, especially from the customer profitability site. When we speak about sources of the non-added value activities, we mean on: producing to build up inventory, waiting for processing, spending time and effort to move products from place to place, transporting workers to work sites, producing defective products, realized

administrative processes with small efficiency, etc. Value Stream Costing is the continual effort that allows firm to achieve a lean status.

## 2. FUNDAMENTALS OF VALUE STREAM MAPPING AND COSTING

Value Stream Costing is than a suitable method, how to detect all necessary characteristics of the value stream in the company and consequently to use these data scans for monitoring and optimization of the production flows and costs.

Value Stream Costing is based on two key processes:

- monitoring of the real (actual) value stream process
- monitoring of the future state of the value stream.

Through value stream mapping can identify continued opportunities to enhance value, eliminate waste, and improve flow (Chromjaková, Rajnoha, 2007).

Production process is a stream of activities, which must be full realised, in according to the goal achievement – a final product. Right processing of the product is a basic assumption of the possibility to make some improvements from the cost reduction point of view.

Construction framework of the Value Stream Costing:

- definition of the goal of cost reduction system and obtaining of the final estimation that is lower than standard cost, allocated to the value stream,
- continuously looking for a waste points, their comparison with existing production conditions in order to reduce costs in the whole value stream and (monitoring of the real state),
- definition of the costing target by each production step that produced on non satisfied added value level volume,
- implementation of the proposed targets to the value stream steps and evaluating of the future cost reduction contributions (monitoring of the future state).

As a final result we should obtain the two key monitoring indexes, that inform us about the Value Stream Profit (in Euro) and ROS (Return of Sales in %). If value stream reduces some inventory (material, machine hours, labor etc.) by selling more than it makes, the value stream will show a higher profit and a lower average unit cost.

The principal question there is the identification of the key drivers in the processes of firm value creation, especially the definition of productive and non-productive part of each realized process from the value-added point of view. In a competitive environment a firm must be able complexly to eliminate the non-value-added activities and to increase the number of value-added activities, especially from the customer profitability site.

When we speak about sources of the non-added value activities, we mean on:

- producing to build up inventory,
- spending time and effort to move products from place to place,
- transporting workers to work sites,
- waiting for processing,

- producing defective products,
- realized administrative processes with small efficiency, etc.

Value Stream oriented firms operate by the cost reduction principle (internal elimination of waste), produce the highest quality, meets quality – cost – delivery requirements. Value Stream Costing is the continual effort that allows firm to achieve a lean status.

The standard costing motivates non-lean behavior in processes and operations. The key measurements by standard costing system include the personal efficiency of production workers, the utilization of machines/equipment, and the amount of overhead absorbed by production units – or cost drivers. The production managers, supervisors and operators recognize these results, but they cannot to say, which level of profitability they just have by the “actual cost level”. They can use standard cost metrics. Standard costing allocates the overhead to the product, which evokes it, not to the process – this is the conflict and the impulse to change the standard costing for value stream costing (Chromjaková, 2008).

The lean production and value stream costing means that the overhead and other costs are allocated direct to the value stream as a whole and not to the labors or other direct costs. The maximum of profitability comes from the productive production operations through the value stream at the pull of customer. The profit is primary dependent from the rapidity of process flow at the bottleneck operations within the value stream.

Value stream costing – is the mutual comparison of two basically parameters: productive (added value) and non-productive activities/cost drivers (non-added value). Principal question is the elimination of following activities - wastes:

- overproduction (a lot of purchase, inventory at the end of flow, bad production flow,...)
- inventory (bottlenecks, bad sale forecast, production planning, documentation - that nobody need etc.)
- waiting (acceptance of the purchase from the process/customer)
- unnecessary processes (transportation, jobs, service)
- corrections (“quality at the place and job”)
- workers (non ergonomically process, job standard)
- transport (information transfer, logistic)
- unusable worker (not physically by job, but his knowledge or skills).

### **3. IDENTIFICATION OF KEY PERFORMANCE METRICS BY VALUE STREAM COSTING PROCESS**

Two key evaluation metrics will be used by the value stream costing in according to the monitoring of real production costs:

- *LPI – Lean Performance Indicator* – enables a measurement as a consistent way to determine the effectiveness of our firm lean efforts; this index can replace direct/indirect hour measurements.



- *LMI – Lean Money Index* – describes the effectiveness of the production performance in real time period.

In according with the LPI and LMI must be arrange, that the reporting must be not by departments, but direct by value stream, than the people in the company must be assigned to the value stream with little or no overlap, the production processes must be reasonably under control and have a low variability in time period and the inventories of all factors must be under control, relatively low, consistent.

The more important parameters of value stream costing are:

- cycle time, changeover time → output: gross throughput time
- required time of equipment running → output: gross throughput time of product delivery to the customer
- size of production entity → output: stocks size and processing size entities
- number of workers → output: production entities amount
- product variants number → output: value added index
- amount of delivery losses → output: number of process steps, at which will be created the value for customer
- working time /without interruptions/ → output: added and non added value of operation on worker, worker productivity
- added and non added value of process step or activity
- cost calculation of value stream improvement
- number of non reduced wastes and the financial effects
- equipment reliability quantification
- continuous flow and pull production value

#### **4. STRATEGIC ASPECTS OF VALUE STREAM COSTING AND BUSINESS PROCESSES VALUE ADDED METRICS IMPLEMENTATION**

Calculation based on value added index (VAI) of processes is focused on surveying the value of total process cost flow (PCF) through production system for the total continuous production time and thus brings a real view of the total amount of process-generated costs by considering the actual tangible and intangible factors, participating on the production process.

Business process value added analysis is concentrated on surveying the costs of the entire value chain, i.e. since receiving production orders to sending the output to customers, and it strictly differentiates between costs incurred to generate added value and costs of non-productive, i.e. value-not-added activities and processes.

Economic Value Added (EVA) as the key performance indicator in business is not automatically generated only by a strategy appropriately designed and chosen (Vidová, 2004). This just defines the way to achieve it provided that there is an interaction between the underlying factors of success; a positive change of EVA can only be optimized intentionally provided that it becomes aligned with the knowledge of real added value of business processes (Figure 1). Combination of EVA and VAI brings

a brand new viewpoint the process of economic efficiency management of business process by means of actually showing the price and profitability of business assets based on the knowledge of actual inclusion of a certain volume of assets into the production process, and on the other hand it assesses effectiveness of the use of these assets through their actual workload within a clearly defined total continuous production period (Rajnoha, Chromjaková, 2008). It points out the fact that economic profit in realization of a production plan can be significantly different depending on actual production profit achieved, primarily affected by total production system flow (Figure 1).

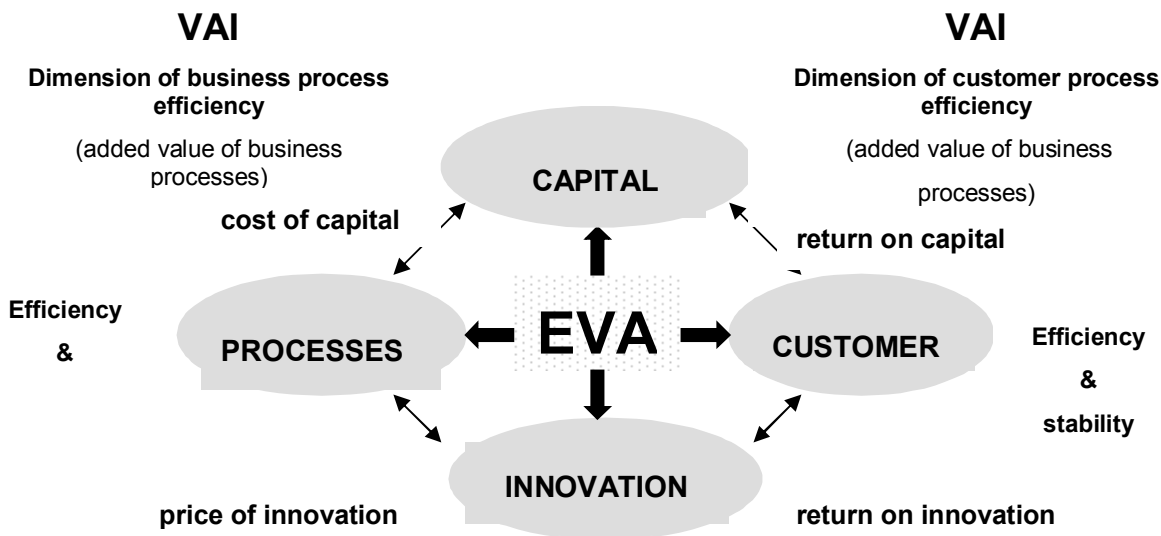


Figure 1 Two related dimensions of quantifying the value added in business  
(Rajnoha, Chromjaková, 2008)

In connection with the quantification of business process added value based on VAI as a value added in the production process of the company the key problem is being solved - how to set up a production process flow to generate an optimum return of value stream.

Process cost flow (PCF) is defined as a total amount of process units which flow through the production system per time unit, but always in relation to a selected product representative – holder and not a complex portfolio included in the production programme. It reflects the flow of process costs which are represented e.g. by purchase costs, costs of technical preparation of production, production organization and management, logistic processes, and on the other hand by cost flow associated with the product realized, such as material, labour and overhead costs in relation to the product representative - holder. Basic principle of process cost flow calculation is the fact that the production system input amount must be equal to the output amount, then the optimal profit of value flow at the level of 0 occurs. Theoretically, this means that the production value stream makes no inefficiency (e.g. excess inventory in store, excess time capacity of staff, poor operation layout, etc.). In real-world business experience, the figure is mostly in negative terms. The basic scheme for the calculation of the flow (PCF) is as follows:

$$\text{PCF} = \text{Process costs} + \text{Product costs} + \text{Value Stream Profit} \quad (1)$$

The need to increase the added value makes technologists, planners and managers in production, auxiliary, service as well as administrative processes, reflect on two crucial facts:

- What internal constraints occur in business processes, or is it possible to eliminate these constraints for the purpose of increasing the share of value added in the production process and increasing the efficiency of value stream?
- Which of these constraints have a major impact on increasing the flow and consequently on improving the value stream profit?

Primary concentration on increasing the share of value added to the total continuous production time results in quantifying Value added index - VAI. Just the value added index indicates the level which we achieve current efficiency and effectiveness of flow:

$$\text{Value added index (VAI)} \quad (2)$$

=

$$\frac{\text{Time when the product is added value}}{\text{Total continuous time during which the product is created}}$$

VAI knowledge is particularly important because of the flexibility of value stream cost control within which the production system should generate the highest added value possible without unnecessary wasting – i.e. it is primarily used to eliminate non-productive activities and to support the productive or value-adding activities and processes.

## 5. PROPOSAL FOR A METHODOLOGY OF BUSINESS PROCESSES VALUE ADDED MANAGEMENT

The text below points out the fact that the base for a comprehensive perception of the whole methodology is a proper understanding of the value stream throughout the process chain, i.e. the core of added value creation is not only presented by activities related to the processes themselves, but also resources supporting the implementation of these processes (capacity resources ready for use, delivery cycle of input, inventory of work in progress between processes, etc.). For the purpose of correct identification of the current value stream we will use the so-called Value Stream Mapping which clearly points to the specific context of value creation. Value stream is always oriented to one product – so-called product representative.

Value Stream Costing is primarily focused on monitoring the value created. The hallmark is division of costs into two basic categories:

- *costs of the productive tree* (i.e. value added)
- *costs of the non-productive tree* (i.e. value not added)

To assess the costs of value stream we define a variable indicator of so-called value stream profitability:

$$\text{Value Stream Profitability} = \text{Value Stream Income} - \text{Value Stream Costs} \quad (3)$$

Thus to calculate the value stream profitability it is crucial to know how much cost enters the stream, how much cost is consumed by the stream and what earnings emerge from the stream. In practice, to calculate the profitability we will use the two value stream maps – current value stream map and future value stream map, where the value stream profitability achieved will be compared on the basis of the value stream profitability improvements realized.

Value stream costing will be carried out in the following five steps (Chromjaková, Rajnoha, 2007):

- **Product costing** – calculation of costs, directly entering the product created by the stream; calculation of costs of work in progress ("stacks")
- **Process costing** – calculation of the amount of process costs caused by the active involvement of the process and its parts in product creation (material and labour costs of process of order acceptance, order preparation for production, organization of production, logistic processes and processes of communication with suppliers and customers, also process overhead costs are included which are counted as one unit for the entire value stream). The following process indicators are particularly relevant for the value stream costing:
  - total real disposable capacity of equipment for the value stream
  - real daily capacity of equipment for the process
  - time capacity for necessary technological breaks (casting, maintenance, other)
  - degree of equipment utilization
  - cyclical time, claimed by the value stream for individual processes and activities with connection to the overall production volume which is assigned to the value stream
  - cost of 1 process minute
  - total costs of the process
- **Value stream costing other costs** – the calculation of costs which are necessary for realization of the value stream as a whole but until now have never been counted (e.g. quality control, maintenance, license fees, software, etc.). This includes all costs that are directly related with the value stream, they can not be directly determined on one piece of product / or one process within the value stream but are necessary for manufacture of the product – i.e. all inputs which have to be, in addition to direct material and wages, available before the process starts, so that the product could be produced (production overheads, tools, contents, externally supplied parts for the product and other costs directly necessary for making the product).
- **Customer demand costing** – calculation of input costs for implementation of annual and daily customer orders
  - input costs: daily customer demand x total costs per unit
  - annual customer demand x total costs per unit
- **Final value stream costing** – will result in a complex cost calculation based on knowledge of value added created in the value stream – flow size, flow gain, coverage contribution to the process, WIP, and so on.

The whole methodology is based on a comparison of VAI - value added index which was acquired through the value stream mapping and costing in two forms – current and future state of value stream. As a result of optimizing the value stream there is a radical reduction of supplies in stocks, buffer

stocks, and a further improvement of the value added index by better management of inventories and production flow.

Table 1 shows the basic input parameters for the calculation of EVA and process value added quantified through VAI. The calculation also takes into account coverage contribution per 1 minute of continuous production time and also puts emphasis on real fixed costs used (not planned in general). Optimization of key production parameters (number and structure of units produced, the degree of actual utilization of fixed costs, variable costs, continuous production time, reduction of the volume of current assets, etc.) can influence the resulting value of EVA and VAI indicators in favour of increasing their value.

Table 1 Calculation parameters of economic value added (EVA) and value added to production processes (Rajnoha, Chromjaková, 2008 )

Production volume – plan [pc]	100	Total equity capital [€]	2000
Unit price [€]	500	Total loan capital [€]	1000
Number of units produced [pc]	65	Machinery, equipment [€]	10
Sales revenue (T) [€]	32500	Intangible assets [€]	3
Variable costs (VC) total [€]	28000	Claims [€]	600
Coverage contribution (T- VC) [€]	4500	Commitments [€]	700
Fixed costs used (FC) total [€]	3900	Current assets [€]	550
Operating profit (OP) [€]	500	Costs of loan capital (CLC) [%]	13
Total continuous production time [min]	700	Equity share of total capital [%]	66
VA index (value added index)	0,4	Internal rate of return (IRR) [%]	24
Coverage contribution per 1 minute CPT [€]	6,4	Effective costs of LC (CLC x(1-IRR) [%]	9,88
Fixed costs unused total [€]	2100	Commitment ratio in total capital [%]	23
Tax rate (TR) (19% of OP) [%]	9,5	Asset ratio in total capital [%]	39
NOPAT (operating profit x (1- TR) [€]	405	WACC (9,88 x 0,23 + 24 x 0,39) [%]	11,63
$\text{EVA} = \text{NOPAT} - (\text{total capital} \times \text{WACC})$ $\text{EVA} = 405 - (3000 \times 0,1163)$ $\text{EVA} = 56,1 \text{ €}$			

Key increase of business performance and value by means of simultaneous involvement of EVA and VAI indicators then lies in continuous improvement and optimization of individual production parameters, activities and processes. Note that, however, a necessary prerequisite for application of our model presented in company practice must be a prior implementation of process-oriented model of calculations and budgets (ABC - Activity Based Costing, ABB - Activity Based Budgeting).

The practical experience and results arising from our studies conducted in selected factories (see additional text below) shows that the highest savings - and hence improvement in the EVA and VAI indicators - can be achieved by optimizing inventories, reduction of continuous production time, slimming support and administrative processes, or better utilization of production capacities and product portfolio restructuring (Zaušková, Kusá, 2011).

## 6. CONCLUSION

Value Stream Costing is modern tool to precise quantification of production costs, with respect of added and non-added value by separate production steps. It schedules the information about direct cost in the whole process and provides excellent performance measurement. As the presented contribution implies, for the purposes of business process efficiency management it is not sufficient to monitor and manage only the economic value added (EVA), it is necessary to simultaneously confront it with efficiency and value added to processes, calculated on the basis of the value added index (VAI) which maps the real value stream in complex business processes. Paper describes one innovate access methodology to the right calculation of the production performance and production costs. It offers a transparent way, how to calculate the lean indicators in the real industrial production. Traditional companies use standard costing as the primary method of production costs control process. Today's production environment enables a vitally mechanism in the area of monitoring of real production costs, because all types of wastes are undesirable and the motivation to cost decreasing is in according to the productivity improvement, higher efficiency and respectable cost level very important.

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**USE OF TOOLS AND METHODS FOR MARKETING PLANNING**

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**Abstract**

*The starting step in any meaningful activity is planning future activities. Marketing planning is aimed at finding synergy between market opportunities and resources of organization. Marketing planning process defines the objectives and priorities of the organization and its culmination is a marketing plan. The marketing plan is one of the functional intermediate-term plans of the organization. It must form a symbiosis with other sub-plans in order to promote compliance with marketing strategy, but also the overall strategy of the organization. The marketing planning adhere to a particular sequence which is quite well-known from the literary sources. Even if there is inconsistency of opinions of authors, they agree on key steps and the differences are minimal. But what is not clearly established in literature and subsequently in practice are tools and methods that can be used in different stages of the planning process. The contents of my paper will be a draft of broader portfolio of well-known and less-known tools and methods which can be used at different stages of marketing planning.*

**Key words:** *methods, marketing planning, process, marketing communication, strategy*

Motto: **“Plans are nothing, planning is everything.”** (Dwight E. Eisenhower)

**1. INTRODUCTION**

Planning is one of the primary management functions. A need to plan all activities within the processes is equally important for small and medium-sized organizations, as well as for large corporations. It could be noted that planning is projecting of the future. On the basis of the objectives specified in advance, top managers may prepare an adequate marketing strategy. Marketing planning consists of two main areas, namely:

- a) strategic planning in the organization
- b) creating a specific concept of the marketing plan.

Strategic planning is characterized by an overall long-term direction of the company and it creates a long-term framework for corporate marketing activities so as to be consistent with internal and external environment. Strategic planning must deal with ever-changing marketing environment and its main task is to create and maintain balance. The author Kotler in his books “Marketing Management“ wrote:

Marketing planning has a special status in strategic planning resulting from the nature of marketing as a philosophy of customer-oriented organization. Marketing provides necessary market information for



strategic planning, helping to set business goals as well as suggestions of possible development strategies. This is the cause that the strategic plan of the development of organization is often designated as a *strategic marketing plan of the development of organization*. ( Kotler, P.: "Marketing. Management: Grada Publishing, 1998, p. 103).

As we view planning as a process, it consists of the following stages:

- a) Analyses of macro and micro environment
- b) A complete assessment of the opportunities and risks in the market in relation to company's strengths and weaknesses
- c) Analyses of markets following the creation of segmentation strategies and forecasts of demand
- d) Definition of basic marketing objectives
- e) Specific design of marketing strategies.

## 2. PLANNING OF MARKETING COMMUNICATION STRATEGIES

If we want to plan responsibly all activities leading to the establishment of a communication strategy, we assume the following sequence of steps:

1. *Assessment of options* - is a starting step in any planning process
2. *Definition of objectives and tasks* – this step is essentially independent of the fact whether the plans are long-term or short-term ones. Objectives predetermine the expected results and represent the final point to be reached, time when it should be reached and they condition the whole structure of planning documents.
3. *Assessment and evaluation of assumptions* – such assessment must be designed to assess the environment in which the planning process is to be implemented.
4. *Identification of alternatives* – each planning process, to be effective must be based on the assessment of multiple alternatives which can be taken into account. The aim of this step is to define such alternatives that are the most promising for implementing the designed objectives.
5. *Evaluation of the set alternatives* – this step is to answer the question which of the alternatives under consideration can provide the highest effect or, if the set objectives were met, which will lead to achieving the highest profit. This is the most complicated step in planning since this step is made under conditions of uncertainty. Uncertainty grows in proportion to the period for which a certain plan is made.
6. *Selection of the most appropriate option* – is a step which comes to a decision. The correctness of this decision determines the success rate of the planning process.
7. *Formulation of support plans* – these are intended e.g. to providing capacities – materials, the staff and technical facilities.
8. *Support of the plan by budget* – this relates to a budget expression of the necessary capital and operating expenses.

Following these steps we can plan specific business activities that are reflected in the so-called action plans. Action plans are now clearly specified and they should answer the following questions:

***What should be done?***

***When should it be done?***

***Who will do it?***

***How much will it cost?***

The practice of marketing planning is most often associated with the planning of the business portfolio. The idea is to search for new promising business areas, introduction of new products. Creating a business portfolio is essential for strategic planning. An effective marketing plan includes the following marketing activities:

- Adapting to the market characteristics
- Proportionality of resource allocation
- Logical link to meet the increased demands of the economically strong part of the population
- Flexibility in adjusting the marketing plan and the speed of adjustment to changes in the market

In practice the most common marketing sub-plans are:

- a) Marketing plan of the organization
- b) Marketing plan of production and organizational units of the organization
- c) Marketing plan of product groups and individual products
- d) Marketing plan of groups of markets and individual markets
- e) Marketing plan of areas of business
- f) Communication marketing plan

A good plan should

- contain clearly defined objectives
- be implementable and applicable
- react to real needs
- be comprehensible and addressable
- include a breakdown of responsibilities for the fulfilment of set tasks
- include a schedule of tasks
- mention the control mechanisms relating to feedback for monitoring the efficiency of scheduled activities

### 3. TOOLS AND METHODS USED IN INDIVIDUAL STAGES OF MARKETING PLANNING IN THE PRACTICE

Portfolio methods are considered the most important tools of strategic planning. A basic idea of portfolio methods lies in the definition of corporate strategic planning objects and in expressing these objects graphically in two-dimensional space. By using portfolio methods, the following three goals will be achieved in the organization:

- Application of portfolio methods enables a clear statement of the situation in the company at a given moment of strategic planning perspective.
- Application of portfolio methods enables to divide a set of enterprise-wide strategic planning objectives for individual planning objects
- Application of portfolio methods should enable to judge the business situation in terms of successful strategies.

The best-known portfolio methods for determining the basic condition are:

- BCG method
- ADL method
- Mc Kinsey's method
- Doglov's method

When monitoring or analyzing the initial condition of planning marketing activities, we may use another well-known and less-known tools and methods, e.g.:

- Value analysis
- Factor analysis
- Analysis of critical path
- Cost-benefit analysis
- Analysis of customers' requirements
- Simulation methods
- SWOT analysis
- Questionnaire
- Brainstorming
- Benchmarking
- Cause and effect diagram
- Prognostic methods
- Network analysis and others

Owing to the fact that during planning we predict the future situation, the so-called statistical forecasting methods are very popular, including, for example:

- Different types of expert methods

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- Extrapolation of trends
- Correlation of trends
- Economic modelling
- Cross impact analysis
- Risk prediction
- Time series analyses.

An integral part of the marketing plan is the setting of measurable targets. Models used in setting the objectives of marketing communication (this relates to gradual response models) may be defined as follows:

- AIDA Model
- Model of gradual steps
- Innovation-adaptation model
- Communication model

Every marketing plan must be supported by a budget. Methods used in preparing the total budget are:

- Method of options – leading to the approval of uncertain budget
- Method of the percentage of income
- Method of competitive equivalence
- Method of tasks and objectives

The control mechanism aimed at evaluating the effectiveness of marketing planning activities which should record a feedback may be based on the utilization of:

- Mathematical and statistical methods
- Measurements of customer's satisfaction – Index of customer's satisfaction
- Controlling
- Benchmarking
- Self-assessment
- Marketing audit
- Inspection journal, etc.

#### **4. EVALUATION OF THE EFFECTIVENESS OF PLANNED MARKETING COMMUNICATION**

The concept of efficiency can be defined as the relative quantity expressing the ratio of output and input. The basis for effective marketing communications is to identify measurable goals or

purpose for which the marketing communication is planned. In evaluating the effectiveness of communication with the external environment must be taken into account:

- a) Type of the market – in this case the use of communication tools varies depending on the customer and the type of business.
- b) Use of strategy pull versus strategy push – pull strategy is based on the manufacturer's marketing activities. The pull strategy is the marketing activity aimed to final customers.
- c) The stages of readiness of the customer to buy:
  - Stage aimed to get trust (promotion and publicity)
  - Stage of customer's tolerance to the product (advertising and personal selling)
  - Stage of acceptance of intellectual reasoning (personal sale)
  - The actual order of goods (personal selling and sales promotion)
  - Re-ordering of goods (personal selling, sales promotion and less of advertising)
- d) The stages of product life cycle – the effectiveness of communication tools will vary depending on the stage of product life cycle:
  - In the initial phase where the product is introduced to its market the highly effective tools are advertising, publicity, personal selling and sales promotion.
  - In the growth phase can be all tools of communication mix damped down because demand is supported by oral promotion.
  - In the stage of maturity have the most important role – sales promotion, advertising and personal selling,
  - During the stage of decline tends sales promotion to get stronger impact and vice versa advertising and publicity reduce its effectiveness.
- e) Placing the organization in the market – experience has shown that branded companies with better positioning in the market gain more benefit from advertising than from sales support. After the development of marketing communications plan is necessary in order to focus its impact on target beneficiaries. The task is to ask whether the message recipients know, if they remember the message, how many times they saw it. How they notified it, what they remembered from it and how they think about it.

## 5. CONCLUSION

In this paper we wanted to highlight the importance of planning of activities in marketing. Within the Juran's quality spiral, marketing is considered as one of the most important processes which contains a number of activities in the context of marketing and subsequently a communication mix. It is important that individual activities have been assigned responsibilities and it was possible to evaluate the planned objectives. For that purpose tools and methods should be used which must be applied very sensitively. Some are well known from the professional literature, but also from the practice, but they are not always applicable for all planned activities within the setting of narrowly specified marketing

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plans. Each marketing plan is essentially unique. The reason is the fact that there are not equally identical organizations in the practice, so it needs a tailor-made marketing plan.

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## PRIVATIZATION AND ITS IMPACT ON PROFITABILITY OF STOCK COMPANIES

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### Abstract

*This study sought to assess the impact of state shares on the private sector companies on their financial performance using profitability ratios include return on assets (ROA), return on equity (ROE) and return on sales (ROS) in Tehran Stock Exchange. For this purpose 29 companies which during the years 1996 to 2008 their governmental share were transferred to the private sector were reviewed in two sections which the first section includes two level of cession (more than 50 % and less than 50 %) by using A Wilcoxon rank regression model and the OLS method and the second section in three levels (less than 20 %, between 20 % to 50 % and more than 50 %) were evaluated using the Friedman test. The results of hypothesis testing in the 95% confidence level indicates that in the first section the financial performance of companies has been increased in the second section the financial performance is not significantly different between the three levels of transfer.*

**Keywords:** *Transfer of Public shares (privatization); profitability; return on assets; return on equity; return on sales*

### INTRODUCTION

Keynes believed that the recession has caused a shortage of aggregate demand in the economy and the market mechanism can not fix it, so there is need for government intervention. Thus, from 1930 to 1970 with the goal of elimination of market failure, the governments accepted the responsibility of creation of economic infrastructure, resource allocation, providing essential goods and services, to achieve economic goals and social and accelerate the development of economic activities. Gradually by the increase of the scope of government activities, some problems such as audit and evaluation weaknesses, lack of adequate incentives, multiplicity of objectives, strong administrative bureaucracy, the inaccurate measurement of monopolies, economic deficiency, lack of efficient use of resources... occurred and they caused that the liberalization policies of the 1980s and 1990s once again to be sought as a solution.

In Iran the policy of privatization and cession of governmental companies started in 1991 according to the approval of notification 32 of the law of first program for development of country that was ratified in 1990. In order to accelerate the economic growth, material resources to promote economic efficiency and operation from materialistic and manpower productivity, increase of competitiveness and private sector participation in economic activities and making the size of government as a logical size and reducing the financial and management costs in the enterprise businesses and it was more accelerated in 2001 by establishment of Privatization Organization.

In fact the main goal of the researcher is answering the fundamental question which is whether the cession of governmental shares have been able to have a positive impact on the financial performance

(profit) of companies? To answer this question, the financial criteria including three of the returns of assets (ROA), return Equity (ROE) and return on sales (ROS) will be used, so in the positive response, the government can continue to the policy of privatization with more confidence and on the other hand, those who still doubt about this issue and they watch the privatization programs, they can get familiar with this reality more and they can help the implementation of these policies by being consistent in this field.

### **AN OVERVIEW ON THE BACKGROUND OF RESEARCH**

Akinlo and Salawu believe that privatization includes the cancellation of government from owning all or some sections of the properties and other assets which are fully or partially owned by the government (Akinlo & Salawu, 2005, 171-180). The word privatization indicates the change in the balance between government and the market which is for the advantage of market. Privatization is a tool to increase operation (financial or social) of operation of an economic institute. Because it seems the demand and supply mechanism and market in the competitive condition cause the use of more production agents, increase of agent operations and as a result to have more and varied production and services for reduction of prices (Pomeranz, 1996, 31-35). Many university researches have been conducted in the field of the effect of cession on the operation of companies operations and some of them have been mentioned bellow:

One of the biggest researches which have been done in the field of privatization belongs to Narjess Boubakeri and Jean Claude Cosset (1994).

In this research, 79 companies from 23 developing countries have been selected and both their financial and operational turnover during the three years before and after privatization and during the years 1980-1992 has been evaluated. The companies of this sample, has been selected from countries with low economic income (Bangladesh, India and Pakistan), countries with average income (Argentina, Brazil, Greece, Malaysia, Mexico, Portugal, Singapore, Taiwan, Trinidad, Tobago and Venezuela). These samples include different industries with various dimensions. The objective of this study is to determine whether or not the implementation of privatization policy in developing countries has been optimal and it leads toward improvement of turnover or not, especially when it comes to profitability or not? To achieve this end, some profitability and operational indices have been used for determining change of turnover amounts. The research findings indicate that simultaneous with privatizing companies, their profitability has been also enhanced (Bobakari & Cosset, 1994).

In another study, Barberiz et al (1996) studied the turnover modification regarding 452 privatized Russian companies and found that modifying method of management and ownership will result in value maximization (Barberies et al, 1996).

In another study in field of privatization which undoubtedly is considered as one of the most widespread and most comprehensives studies conducted by the most skillful experts, has been made by a group of World Bank experts including William Magginson et al (1996). In this study, the financial operation and efficiency of companies during three years before and after privatization were studied. The financial and operational turnover of 61 companies including 18 countries (6 developing countries and 12 industrial countries) and with respect to 32 privatized industries was studied. In this study, the financial tools being used for analysis of turnover and obtaining results has been marked score of Wilcoxon-white- test. The research findings indicated the considerable increase of profitability, efficiency, investment and decrease of the financial leverage (Magginson, 1996).



In another study conducted by Bernardo Bortolotti et al (2000), the financial and operational turnover of 31 companies active in telecommunication industry in 25 developed and developing countries during the years 1981-1998 and during seven-year periods were studied. In addition, the evaluation criteria consisted of indices of profitability, operational efficiency and making investments during three years before and after privatization. The research findings, like the previous studies, have indicated the improvement of all indices mentioned regarding privatized companies. One of the most important findings of this research indicates that improvement of profitability is more as a result of major decline of the expenses rather than their increase. Also, increasing efficiency is caused by promotion of the staff's motivation and productivity (Bortolotti et al, 2000).

In other study, Kusenda and Esojennar (2002) dealt with studying the impact of ownership on the companies' turnovers during widespread plan of privatization in Czech Republic and evaluated the effect of various types of ownership and level of Ownership Concentration during the period after privatization. Variables which were studied include: Operating profit, sales revenue, cost of labor, debt amount in proportion to stockholders equity. The result of their study states that even after period of privatization, the private ownership gains higher turnover in comparison with the governmental ownership. In other words, the private ownership has better turnover and/or in some cases, similar turnover when compared to the governmentally concentrated ownership (Kocenda & Svejnar, 2002).

In other study, Akinlo and Salawu (2005) studied the level of privatization efficiency in Nigeria between the years 1978 till 2001. The results of this study indicate rising trend of growth after privatization based on ratios of ROE, ROA within period under study (Akinlo & Salawu, 2005, 171-180). In other study, Narayana (2006) has considered effect of privatization on financial indices, effects on costs, service quality, equality and feasibility of the supply of the services. He also indicates the positive effect of privatization in financial indices (creation of capital market), price and feasibility of service supply (Narayana, 2006, 46-70).

In other study, Kook et al (2006) studying 63 developing countries between the years 1997-1998 emphasized on the pivotal role of privatization in the economic growth of such countries. They believe that there is both a strong and a positive correlation between privatization and economic growth. However, privatization is realized during a long-term period and this necessitates re-modification of rules and regulations and setting out of new competitive laws. Privatization happens when it is followed by some optimal economic results so that structural modifications may work in these countries (Cook et al, 2006).

In other study, Ju Jiang et al (2006) evaluated the effect of privatization on profitability of privatized companies in China. In addition to studying fluctuations of profitability in privatized companies, they also took profitability of the public companies into consideration. For this purpose, they have evaluated the profitability of 149 privatized companies between the years 1999 to 2003, relying on return on sales variable (ROS) as a criterion for profitability. Findings of this research indicate improvement of profitability in privatized companies compared to the governmental ones. (Jiang et al, 2006).

## RESEARCH METHODOLOGY

### *The methodology*

Considering the issue being studied and evaluated where data are gathered in relation with those events which have happened in the past and the dependent variables both prior to and after inserting

independent variable, the after event method is the most appropriate method being applied for these research types. This method is also called the scientific-comparison method. The time scope for the current research includes years (1996-2008). The statistical society of the research is all companies registered in Tehran Securities Market which includes awarding governmental stocks to the private sector and totally it includes 29 companies. Considering the fact that in this study, whole statistical society is studied (statistic method), therefore, sampling is not the issue and all illegible companies are evaluated.

#### *Objectives and Research Hypotheses*

The main objective of the current study is evaluating allocation of the governmental stocks on financial turnover (profitability) of the companies registered in Tehran Securities Exchange Organization. In line with this, the secondary objectives are as follows:

A- Identifying mean of return on total assets (ROA), after privatizing companies.

B- Identifying mean of return on owner's equity (ROE), after privatizing.

C- Identifying mean of return on sale, after privatizing.

To achieve such goals, the following hypotheses consisting of two main parts, is put forwarded:

#### *Hypotheses of the first part*

##### *Research's main hypothesis*

After awarding governmental shares (more than 50 percent), financial turnover (profitability) of the companies registered in Tehran Securities Exchange Organization has been increased.

##### *Research Secondary Hypotheses*

**First Hypothesis** - After submission of the public shares (more than 50 percent), the average of return on asset of the companies registered in Tehran Securities Exchange has been increased.

**Second Hypothesis** – After submission of the public shares (more than 50 percent), the average of return on owners' equity (ROE) of the companies registered in Tehran Securities Exchange has been increased.

**Third Hypothesis** – After submission of public shares (more than 50 percent), Average of return on sale (ROS) of the companies registered in Tehran Securities Exchange has increased.

#### *Hypotheses of the Second Part*

##### *Research Main Hypothesis*

Submission of the shares of governmental companies (in three phases of submission) has a meaningful difference with respect to financial turnover (profitability) of the companies registered in Tehran Securities Exchange.

##### **Research Secondary Hypotheses**

**First hypothesis** – Average of return on asset in three levels of submission has a meaningful difference.

**Second hypothesis** - Average of return on Equity in three levels of submission has a meaningful difference.

**Third hypothesis-** Mean of return on sale in three levels of submission has a meaningful difference.

*Variable's Operational Definition*

**1- Independent Variable:**

The independent variable of the research is the type of ownership of the company divided into two types of governmental and non-governmental ownerships which we here define each one of them:

**A- Governmental Ownership**

In this type of ownership, government owns more than 50 percent of the total shares of company via the company. However, it should be mentioned that relying on the note under article no.4 of Public Audit Act, all the companies established by deposits of individuals into the accounts of banks, insurance and pension fund, are not considered as governmental companies. Therefore, all companies which are supported by banks, insurance organization and pension fund are non-governmental organs in accordance with this definition.

**B- Nongovernmental Ownership**

In this kind of ownership, if semi-governmental organizations and institutions such as Social Security Organizations, Astan-Ghods-e-Razavi and all real and legal persons which own more than 50 percent of the company's shares are considered as non-governmental companies.

**2- Dependent Variables:**

In order to estimate the financial turnover of companies, three financial indices has been selected as the agent of measurements for company's profitability which include:

**A- Return on Asset (ROA)**

Return on asset (ROA) is one of the profitability ratios and its main objective is measuring the amount of success or failure of organization with regards to making use of financial resources. The specific objective is estimating return on asset and measuring asset's total profitability. The equation is calculated as the following:

$$ROA = \frac{\textit{Profit befor taxes}}{\textit{Total of money}}$$

**B- Return on Equity (ROE)**

Return on equity determines that how much profit has been earned within one year against one portion of return on equity. In fact, ROE defines a profitability ratio for the company. This ratio has been made in order to show potential of profitability of company in comparison with working capital of shareholders. The ratio is calculated as follows:

$$ROE = \frac{\textit{Pr efered dividends}}{\textit{Total of salary of shareholders}}$$

**C- Return on Sale (ROS)**

Return on sale is also another profitability ratio the objective of which is to estimate and measure amount of profitability gained by sale. The ratio is calculates as follows:

$$ROS = \frac{\text{Profit prior to taxes}}{\text{Total of sales}}$$

#### METHOD OF DATA ANALYSIS

In order to evaluate the effect of submission of governmental shares on the financial turnover (profitability) of the companies registered in Tehran Securities Exchange Market, the data analysis has been made in two parts. In first part, the turnover for three years before and three years after submission for companies that more than 50 percent of their shares has been awarded to nongovernmental sector. After obtaining and extracting related data by using SPSS software and via all statistical methods and techniques, which is Wilcoxon White Test (Inferential Statistics) and using linear regression model as put forward as follows, we will deal with hypotheses test with a 95 percent confidence level. In second part, and in order to be informed about effect of amount of shares submitted on the profitability of companies registered in Tehran Securities Exchange Market, the companies are assessed at three levels and based upon the percentage of shares submitted and for maximum three years:

First Level:  $\leq 20$  percent of submission

Second Level:  $\leq 50$  percent of submission  $< 20$

Third Level:  $50 >$  percent of submission

After obtaining and extracting data by the use of SPSS software and via statistical methods and techniques or Fridman's Test (Inferential Statistics) we deal with test of hypotheses with 95 percent confidence level.

#### MEASURING REGRESSION MODEL

In order to assess variables affecting financial turnover (profitability), the following experimental regression model has been used.

$$DROA = \beta_0 + \beta_i \text{Ind}_i + \beta_{12} \text{Year} + \beta_{13} \text{Size} + \beta_{14} \text{Age} + \beta_{15} \text{S/D} + \beta_{16} \text{B/D} + \varepsilon \quad i=1, \dots, 11$$

$$DROE = \beta_0 + \beta_i \text{Ind}_i + \beta_{12} \text{Year} + \beta_{13} \text{Size} + \beta_{14} \text{Age} + \beta_{15} \text{S/D} + \beta_{16} \text{B/D} + \varepsilon \quad i=1, \dots, 11$$

$$DROS = \beta_0 + \beta_i \text{Ind}_i + \beta_{12} \text{Year} + \beta_{13} \text{Size} + \beta_{14} \text{Age} + \beta_{15} \text{S/D} + \beta_{16} \text{B/D} + \varepsilon \quad i=1, \dots, 11$$

Where:

DROA: ROA after submission minus ROA before submission.

DROS: ROS after submission minus ROS before submission.

$\beta_0$  : The fixed coefficient of regression.

Ind and  $i=1, \dots, 11$ : Industry type, which is a virtual variable.

- Industry (1) - Publishing and printing and copying, Industry (2) - Chemical products. Industry (3) - basic metals Industry (4) - Machinery and equipment. Industry (5) - Transportation Equipment. Industry (6) - non-metallic mineral products. Industry (7) - metallic mineral products. Industry (8) - Food. INDUSTRY (9) - paper products Industry (10) – vehicles Industry (11) - Manufacturing Radio and Television.

Year: It is a virtual variable which if the financial information of the previous and next term of transfer to be the same, the value of one and if it be something else the value zero will be presented.

Size: The size of the company, which is the natural logarithm of total assets before transfer.

Age: Company age.

S / D: ratio of capital to total assets after the transfer.

B / D: ratio of debt to total assets after the transfer.

By Regressing the profitability measure changes which means DROA, DROE and DROS on the size variables (Size), type of industry (Ind), year, age, ratio of capital to assets (S/D) and leverage (B/D) and the estimated regression coefficients by using estimation method of the ordinary least squares (OLS) and then their significant tests, differences between coefficients, changes in variables affecting profitability are examined. This method is followed with the two main problems of autocorrelation of disruption components and the inconsistency of variances. Any disruption that may be correlated causes that the static Durbin-Watson to go away from the desired level. Variance of the error may not be constant over time, in order to review this issue, the White test is used.

### **FINDINGS (PART ONE)**

In order to test the assumptions, the test signal test of Darol Kaison is used. This test is stated based on the following assumptions.

H0:  $\mu_1 \geq \mu_2$

H1:  $\mu_1 < \mu_2$

Table 1 shows the results of hypothesis indicate the level of  $\alpha = 0.05$ .

As it is observed in the table 1, the P-Value for the first and second hypothesis is more than 0.05, so the assumption H0 is accepted by 95 % confidence. It means the average of ROA and ROE of the companies after transferring have not been increase, but the P-Value for the third hypothesis is less than 0.05. So the hypothesis H0 is rejected by 95 % confidence. It means the average of ROS for companies after transferring has been increased.

**Table 1: the results of Assumptions Test for Part One**

Condition of $H_0$ Assumption	P-Value	Z	Research Hypothesis
Accepted	0/417	-0/811	First Hypothesis
Accepted	0/393	-0/854	Second Hypothesis
Rejected	0/033	-2/130	Third Hypothesis

### Fitting Regression model DROA

According to this issue that the initial assumptions are the least method of ordinary indicate the normality of dependent variable and also the lack of linear between independent variables, so hereby we test these two assumptions.

#### A - Kolmogorov–Smirnov test

The test has been conducted for normally distributed data with the following assumptions :

$H_0$ : the data are normally distributed.

$H_1$ : data are not normally distributed.

In order to test the abovementioned assumptions, we use the Kolmogorov–Smirnov test. The obtained results in the table 2 exhibit that according to the statistic P-Value= 0.582 and comparing it with the catastrophic value level of  $\alpha= 0.05$ , we can conclude that the dependent data are normally distributed.

**Table 2: the Results of Kolmogorov–Smirnov test (DROA)**

		DROA
N		29
Normal Parameters)	Mean	-.0221420
	Std. Deviation	.11494056
Most Extreme Differences	Absolute	.144
	Positive	.080
	Negative	-.144
Kolmogorov-Smirnov Z		.777
Asymp. Sig. (2-tailed)		.582

#### B - time-line test data

This test is conducted to check the linearity between the independent variables with the following assumptions :

H0: the data are linearly independent.

H1: the data are not linearly independent.

According to the results in Table 3, based on the test statistic value (Sig) and compared with the critical value at  $0.05 = \alpha$ . It can be argued that none of the independent variables are linear (strong correlation).

**Table 3: the results of the review test of the correlation between independent variables**

		Age	Size	S..D	B..D
Age	Pearson Correlation	1	-.076	-.064	-.086
	Sig. (2-tailed)		.697	.741	.656
Size	Pearson Correlation	-.076	1	-.136	-.183
	Sig. (2-tailed)	.697		.482	.343
S..D	Pearson Correlation	-.064	-.136	1	-.155
	Sig. (2-tailed)	.741	.482		.422
B..D	Pearson Correlation	-.086	-.183	-.155	1
	Sig. (2-tailed)	.656	.343	.422	

### Estimation of regression model DROA

For this purpose, we attempt to estimate the coefficients by using the spss software and stepwise method. The results are reflected in Table 4.

**Table 4: estimated results of regression model coefficients DROA**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Durbin-Watson
	B	Std. Error	Beta			
3 (Constant)	-.290	.128		-2.260	.033	1.901
Size	.023	.010	.347	2.363	.026	
Ind8	.137	.048	.419	2.853	.009	
Ind6	-.230	.086	-.371	-2.663	.013	
F=9.093		Sig.=.000		R Square= .522		Adjusted R Square= .464

D.W statistic has a value close to two, so it is not a disruption of autocorrelation.

Nevertheless, the multiple regression models which are indicated bellow exhibit that the size of companies and eighth industry, means food industry has a positive impact and the sixth industry which

means non-metallic mineral products has a negative impact on DROA. The model estimation is as follows:

$$\text{DROA} = -0.290 + 0.023 \text{ Size} + 0.137 \text{ Ind}_8 - 0.230 \text{ Ind}_6$$

### White test

This test has been conducted to review the non-homogeneity of variance of the error with statistical assumptions:

Homogeneity of variance of the error is: H0

Non-homogeneity of variance of the error is: H1

The results of the above tests have been performed by using Eviews software. The results are reflected in Table 5.

**Table 5: the results of White test in the regression model DROA**

F-statistic	19.6575	Probability	0.4559
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Test results show that the test statistic value of 19.6575 = F and significant level of 0.4559, compared with  $\alpha = 0.05$ , the assumption H0 is accepted. So the heteroscedasticity assumption is rejected.

### Regression model and DROS DROE

With a similar manner, the regression equations were estimated for DROE and DROS. The results of these operations can be seen in Table 6.

**Table 6: Results of regression model of DROE and DROS**

Segration Equations	White Test	K-S Test	D.W	R <sup>2</sup>
	Sig	Sig		
DROE= -.128+.860 Ind <sub>4</sub>	0.2371	0.078	2.095	0.137
DROS= -.365+.406 Ind <sub>6</sub> + .026 Size	0.3191	0.389	2.169	0.599

DW statistic in DROE and DROS has a value close to two, so disruption does not have autocorrelation.

According to the significant level of Kolmogorov–Smirnov test in DROE and DROS, related data have normal distribution. And ultimately results of White test in DROE and DROS show there is no the problem of heteroscedasticity as well.



### Research Findings (Part II)

Friedman test was used to test hypotheses. This is a test which is stated under the following assumption.

$$H_0: \mu_1 = \mu_2 = \mu_3$$

$$H_1: \mu_1 \neq \mu_2 \neq \mu_3$$

Table 7 shows the results of hypothesis test indicates the level of  $\alpha = 0.05$ .

As it can be seen in Table 7, the P-Value for the first, second and third hypothesis is more than  $\alpha = 0.05$ , so the hypothesis  $H_0$  is accepted with 95% probability. It means the average ROA, ROE and

ROS of companies in the three levels of transferring do not have significant differences.

**Table 7: the results of assumptions of the second part**

Condition of $H_0$ Assumption	P-Value	Chi-Square	Research Hypothesis
Accepted	0.814	0.413	First Hypothesis
Accepted	0.505	1.365	Second Hypothesis
Accepted	0.895	0.222	Third Hypothesis

### Analysis of Results (part one)

A - Results of the test for the first hypothesis suggest that after the transfer, the average of return on assets (ROA) of accepted companies listed in Tehran Stock Exchange has not increased.

Regression analysis showed a positive effect of firm size and the eighth industry eight, means the foods products and the negative impact of the sixth industry which means the non-metallic minerals products on profitability changes (DROA). This means that (according to variables coefficients) factors affecting ROA to test the second hypothesis are without prejudice.

B - Results of the test of the second hypothesis suggest that after the transfer, the average return on equity (ROE) for companies listed in Tehran Stock Exchange has not increased.

Regression analysis suggests a positive impact of the fourth industry which means the machinery and equipments industry on the profitability changes (DROE). This means that (according to variables coefficients) factors affecting ROE have caused no prejudice on the results of the second hypothesis.

C- The results of the test of third hypothesis exhibits that after the transfer, the ROS of companies listed in Tehran Stock Exchange has increased.

Regression analysis also suggests a positive impact of size and the negative impact of the sixth industry which means the non-metallic mineral products on changes in profitability (DROS). This means that (according to the variables coefficients), factors affecting ROS are without prejudice to the results of third hypothesis.

### Analysis of Results (part two)

A - Results of the test of the first hypothesis suggest that the average return on assets (ROA) in the transfer of three levels, do not have significant differences.

B - Results of the test of the second hypothesis suggest that the average return on equity (ROE) in the transfer of three levels, do not have significant differences.

C - Results of the test of the third hypothesis suggest that the average return on sales (ROS) in the transfer of three levels, do not have significant differences.

## CONCLUSION

Given the above, thus making explicit in the shares of government on financial performance (profitability), the companies face with problems. To fix these problems we have to base measure of profitability, namely ROA, ROE or ROS as a basis for conclusions. For this purpose statistically a variable could be interpreted as an appropriate variable which has lesser independent variables and at the same time to have higher determination coefficient too. So by a little thinking about the regression equation it can be seen that these conditions are available for return on sales (ROS).

Nevertheless, as it is observed in the analysis of results (Part one), the return on sales (ROS) for public companies which more than 50 % of their shares have been transferred to the private sector have been increased in comparison to before of transfer.

So it can be concluded that transferring of shares (more than 50%) of public companies to the private sector has a positive impact on their financial performance (profitability).

The results of the research results are consistent with the results of Jean Claude Cosset (1994), William Magginson et al (1996), Barberiz et al (1996), Tobins q.Earle (1998), Claude Lorraine and Wes Bozh (1999), Bernardo Bortolotti et al (2000) , Ramamurti (2000), MOhammad Omran (2003), Akinlo and Salawu (2005), Narayana (2006), Cook et al (2006) Guoha Jiang, Hong Yu and Lang Kai Zhu (2006).

However, according to the analysis of findings (part two) we can conclude that the transfer of public companies shares (in the three levels of transfer) has been accepted on the financial operation (profitability) and it does not have significant differences in the companies listed in Tehran Stock Exchange.

This result is inconsistent with the researches done by Narjess Boubakeri and Jean Claude Cosset (1994), William Magginson et al (1996), Barberiz et al (1996), Tobins q.Earle (1998) Claude Lorraine and Wes Buzh (1999), Bernardo Bortolotti et al (2000) , Ramamurti (2000), Mohammad Omran (2003), Akinlo and Salawu (2005), Narayana (2006), Cook et al (2006) and Guoha Jiang, Hong Yu and Lang Kai Zhu (2006).

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**„RULE-OF-THUMB“ CONSUMPTION IN THE BALTIC STATES**

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**Abstract**

*This article tests the life cycle–permanent income hypothesis for the three Baltic Economies: Estonia, Latvia and Lithuania. Aggregate quarterly data for the period 1996-2010 are used, and two time periods are compared, one including and one excluding the recent recession. GMM estimation technique on cross country time series is applied. The results indicate that about 40-90% of the population consumes their current income (“rule-of-thumb” consumers) while the rest smooths their consumption over longer horizon. This figure is larger in Latvia and smaller in Estonia and Lithuania. Analysis of asymmetric effects suggests that in Estonia and Latvia, liquidity constraints are the issue while in Lithuania the primary reason is the “opposite asymmetry”.*

**Key words:** “rule-of-thumb” consumption, liquidity constraints, myopia, “opposite asymmetry”

**1. INTRODUCTION**

In recent years, there has been an increasing interest in consumer choice in economics. Already since Hall (1978) suggested the modification of permanent income hypothesis by implying the random-walk results of consumption. He claims that the future consumption cannot be predicted from the past behaviour. In recent years the shortcomings of Barro-Ramsey and Diamond-Samuelson models have appeared in research (Elmendorf and Mankiw 1999; Mankiw 2000). These are the standard models that describe the behaviour of consumers. The first problem is that Barro-Ramsey and Diamond-Samuelson models give different results. Secondly it has been shown that empirical data does not support the results of these models. Most households do not save the income gained from tax cuts, but spend it on consumption (Souleles 1999; Carroll 1997; Shea 1995). The reasons vary: households with less income just don't have the funds for saving. Families are also optimistic about the future, hoping that their income and level of welfare increases. In light of these facts Campbell and Mankiw (1989) divided consumers into two groups: a) the rational consumers or savers (they use their extra income for saving), who follow the Life Cycle – Permanent Income hypothesis (LCH - PIH) (people divide their consumption between present and future, smoothing their consumption). They base consumption on what they consider their "normal" income. At the same time, they try to keep the standard of living, even though their incomes may vary considerably over different time periods; b) people who spend all their extra income. For the second group Campbell and Mankiw used the term “rule-of-thumb” consuming. According to the authors, approximately half of the income is consumed according to the “rule-of-thumb” consuming.

Hall (1978) solved the consumer's optimization problem using the rational expectation hypothesis (REH) which indicates that the consumption follows a random walk. He tested the model on US aggregate time series data from 1948 – 1977. Later, this model has been used in a large number of empirical papers and often the results indicate that consumption depends on disposable income. The

reason for failure of the LCH-PIH in aggregate data is not clear. Empirical studies show that consumption is clearly predictable. Possible explanations include liquidity constraints, myopia or “opposite asymmetry”.

Flavin (1981) empirically rejected the PIH and suggested that consumption is sensitive to income because of liquidity constraints. Research tested the alternative hypotheses of liquidity constraints and got different results. Flavin (1985), Altonji and Aloysius (1987) and Zeldes (1989) found evidence for liquidity constraints. But some studies do not support it (Flavin, 1991; Shea, 1995).

The Baltic States, Estonia, Latvia and Lithuania, provide a good platform for analyzing economical models as the countries share many similarities: they are located geographically close to each other, their size is similar and they share a common history. All three countries gained independence after the collapse of the Soviet Union in 1991 and this provided a similar “starting point” for all three economies. The size of the economies and its structure was, and still is, relatively similar. The post-communist economic development and cultures differ slightly, but not so much as to make the economic processes in different Baltic countries un-comparable.

The purpose of this article is to test the LCH-PIH to explain the consumption behaviour in the Baltic States. The approach of Campbell and Mankiw with the two groups of consumers is used. As the main result of this paper some evidences of “rule-of-thumb” consumption decisions in the Baltic States for the period 1996 – 2010, are found. During this time the countries experienced both rapid growth (1996 - 2007) and a recession (2007 - 2010). Also the possible reasons for LCD – PIH failure in these countries, namely liquidity constraints, myopia and “opposite asymmetry”, are analysed. To the best of the author’s knowledge, this is the first paper to investigate aggregate consumption behaviour by testing the LCH – PIH using the data from the Baltic States.

This paper is divided into four sections. The first section introduces consumer behaviour and the second discusses the underlying research problems in the literature. The third section presents the data, methodology and empirical results. The fourth contains the conclusion.

## 2. RELATED LITERATURE

The research of consumer choice is important because the share of household consumption is about 65% of GNP in Baltic states. In 1957 Milton Friedman developed the permanent-income hypothesis. The hypothesis states that the choices made by consumers, regarding their consumption patterns, are determined not by current income but by their longer-term income expectations (Romer 2006).

Two canonical models, the Barry-Ramsey model of infinitely-lived families (1974) and Diamond-Samuelson’s model with overlapping generations (1965), are used by many researchers. According to the Barry-Ramsey model the tax burden is divided between different generations through government debt policy. Families however, hoping to approximate consumption, do not spend the increased income gained from decreased taxes on consumption, but save it for future generations. According to the Diamond-Samuelson’s model people distribute their spending during their lifetime.

The standard overlapping generation’s model was analyzed by De la Croix and Michel (2002). In their analysis they looked at policy implications like the pension funding and the debt policy. They also presented a complex analysis of the dynamic structure generations approach in their research of economic growth. However there are several issues, related to the intergenerational redistribution that are specific for the overlapping generations approach. They influence social security, educational policy and public debt related questions. It is possible to consider the model with a representative

infinitely-living agent as a special case of the overlapping generation's model. This holds true in the case if households of the overlapping generation's model are altruistic and care about their future. It can be shown that if all generations are altruistic and leave positive bequests, then these models have the same properties (De la Croix 2002).

Numerous attempts have been made to analyze overlapping generation's models with two-period-lived agents. In these attempts the timescale considered has been two or three decades. The overlapping generation's models have three important properties: 1) non-neutrality of debt; 2) the possibility of asset bubbles; 3) the possibility for competitive equilibrium to be ineffective. The model of n-period-lived agents is a more general one. Therefore not all properties of a model with two-period-lived agents need to hold true for the n-period-lived agents. Besides these models a model of three-period-lived agents can be found in the literature (De la Croix 2002).

Mankiw suggested that in both Barro-Ramsey and Diamond-Samuelson models, consumption smoothing (the standard deviation of the change) and the assumption that households use financial markets to smooth consumption over time are not perfect. For example, Robert Hall's empirical studies (1978) demonstrate that consumer spending tracks current income far more than it should.

The idea of Hall (1978), Mankiw and Campbell (1989) considered that the world is populated with two types of consumers. Some people follow the permanent income hypothesis and others follow the simple "rule-of-thumb" model in consuming their current income. The permanent income hypothesis was tested in a more general model, in which the share of income  $\lambda$  applies to persons who consume their current income and other income  $(1 - \lambda)$  applies to persons who consume their permanent income. For testing, they used aggregate postwar U.S. quarterly time series data, obtained from the Data Resources, Inc., data bank. Data set runs from 1948:1 through 1985:1, but they started from 1953:1 to avoid the influence of the Korean War. Mankiw and Campbell found evidence against the implication of the permanent-income hypothesis, but established that changes in consumption are predictable. They concluded that predictability of consumption can be explained by a model in the spirit of Flavin (1981), in which part of the income  $\lambda$  goes to agents who consume their current income rather than their permanent income. And this more general model is not statistically rejected. Estimates also suggest that  $\lambda$  is approximately 0.5, indicating a substantial departure from the permanent-income hypothesis (Campbell and Mankiw 1990).

Comparisons of the previous estimates of  $\lambda$  by different authors are provided by Weber (2000). He argues that most have used log-linear Euler equations:

$$\Delta c_{t+1} = \mu + \Delta y_{t+1} + \sum_{i=1}^k \gamma_i X_i + \varepsilon_{t+1},$$

where  $\Delta c_{t+1}$  is the change in log consumption spending,  $\Delta y_{t+1}$  is the change in log disposable income, the  $X_i$ 's are other variables included in regression, such as real asset returns, and the  $\gamma_i$ 's are slope coefficients,  $\mu$  is the intercept and  $\varepsilon_i$  is the random error (Weber 2000). Different researches estimated the value of  $\lambda$  for different countries and for different periods and found that the values of  $\lambda$  are between 0,114 and 0,843 (see for example Weber 2000).

Subsequently, various papers have confirmed the great influence of current income on consumer spending. In the last few years a number of research papers about the empirical change of "rule-of-thumb" spenders in different countries have been published. With the help of the Generalized Method of Moments (GMM) it is estimated that the share of "rule-of-thumb" consumers in the US is 29%. By the Full Information Maximum Likelihood (FIML) method it is estimated that it is 26%. (Fuhrer

2000). Evidence for “rule-of-thumb” consumers is also provided by Shea (1995), Souleles (1999) and Kiley (2010). Empirical evidence is provided by Sahm et al. (2010). They analyzed fiscal stimulus packages in 2008 and 2009 and found that 25% of households increased spending due to spring 2008 tax rebate and 13% due to spring 2009 tax rebate. One explanation of the variation of the “rule-of-thumb” consumption is recession. The share of “rule-of-thumb” consumers may be higher due to higher credit constraints or lower due to expectations of lower life-time income.

The estimate of  $\lambda$  also indicates differences across countries in the effect of disposable income and consumption. Estimations of “rule-of-thumb” consumers for simple model for United Kingdom with the sample period 1957-1988 (seasonally adjusted)  $\lambda = 0,203$ , for Canada with the period 1972-1988 (seasonally adjusted)  $\lambda = 0,225$ , for France with the sample period 1972-1988 (seasonally adjusted)  $\lambda = 0,401$ , for Japan with period 1972-1988 (not seasonally adjusted)  $\lambda = 0,035$  and for Sweden with the period 1972-1988 (not seasonally adjusted)  $\lambda = 0,357$  (Campbell and Mankiw 1991). For Japan, using the same model with annual data and the different sample period of 1957-1990 and different instrument set, Chyi and Huang got another estimation of  $\lambda = 0,685$ . They also got the estimates of  $\lambda$  for some East Asian countries. For Korea with the annual sample period of 1966-1989 they got  $\lambda = 0,333$ , for the Philippines with the period of 1970-1990  $\lambda = 0,443$ , for Thailand with the same period  $\lambda = 0,412$  and for Taiwan with the sample period of 1961-1990  $\lambda = 0,275$  (Chyi and Huang 1997).

Sarantis and Stewart (2003) expanded the LCH – PIH representative agent model for 20 OECD countries. They found that presence of “rule-of-thumb” consumers is the major factor for the rejection of the basic LCH – PIH model in all OECD countries, which is firstly due to liquidity constraints and to a lesser extent to precautionary saving. The share of current income consumers varies across countries with the minimum of 44.2% for the UK and a maximum of 94.4% for Finland. The average proportion of current income consumers was calculated to be approximately 71% from time series estimates and 67% from panel estimates. Real per-capita total consumer expenditure was used in the estimates.

Gomes and Paz (2010) checked the aggregate consumption behaviour in four South American countries: Brazil, Colombia, Peru and Venezuela. They used “rule-of-thumb” consumer’s approach of Campbell and Mankiw and followed Shea’s estimation model using total consumption data. Following the assumption of Sarantis and Stewart (2003) that the proportion of durable to non-durable expenditures is relatively constant through time, they found that the estimation  $\lambda \in [0.828, 0.906]$  for Columbia is statistically significant at 5% level for different instruments. In Brazil authors got the similar result:  $\lambda \in [0.734, 1.063]$  is statistically significant at 5% level, while the estimation  $\lambda = 1.063$  had a big standard error of 0,318. They noted that similar results for Brazil were also presented by other authors like Reis et al. (1998):  $\lambda = 0.8$ , Issler and Rocha (2000):  $\lambda = 0.74$ . Gomes and Paz displayed very surprising results for Colombia:  $\lambda \in [1.245, 1.502]$  for all instrument lists at 5 % level of statistical significance. All estimates of  $\lambda$  are larger than one that is not consistent with Campbell’s and Mankiw’s approach. They suggested that equation (7) (see p. 6) for total consumption has a specification problem, or alternatively, the predictive power of instruments is low. The statistically significant results they got for Venezuela, where  $\lambda \in [0.703, 1.043]$  were also statistically significant at 5% level.

### 3. ECONOMETRIC ANALYSIS

The following aggregate consumption model has been combined from the models described by Hall (1978), Campbell and Mankiw (1990), Chyi and Huang (1997), Shea (1995 a), Sarantis and Stewart (2003) and Gomes and Paz (2010).

Following Hall (1978), the model is derived as the optimization problem of consumer's behaviour of the rational and forward-looking consumer (see Appendix).

In the paper of Campbell and Mankiw the economy with two groups of agents is considered. The agents belonging to the first group consume their current disposable income  $Y_{1t}$ ; and the agents from the second group consume their permanent disposable income  $Y_{2t}$ . The change of consumption of agents in the second group ( $Y_{2t}$ ) is not predictable according to Hall's random walk hypothesis of consumption (Hall 1978). The total disposable income  $Y_t$  is the sum of two types of incomes, i.e.  $Y_t = Y_{1t} + Y_{2t}$ . If the share of "rule-of-thumb" consumers is  $\lambda$ , then  $Y_{1t} = \lambda Y_t$  and  $Y_{2t} = (1 - \lambda)Y_t$ . The change in consumption of agents, who consume current disposable income, is  $\Delta C_{1t} = \lambda \Delta Y_t$ . According to Hall's hypothesis (see also Flavin (1981)) the change of consumption for another group is

$$\Delta C_{2t} = (1 - \lambda)\varepsilon_t \quad (1)$$

The total change of aggregate consumption can now be written as

$$\Delta C_t = \lambda \Delta Y_t + (1 - \lambda)\varepsilon_t, \quad (2)$$

where  $\Delta C_t$  is the change of consumption spending and  $\Delta Y_t$  is the change of disposable income (Campbell and Mankiw; 1990).

The specification of the "rule-of-thumb" consumption model is linear, but empirically it can be seen that consumption series are closer to the log-linear model. If we assume that real interest rate is not constant then the period utility function takes the following form:

$$u(C_t) = C_t^{1-\gamma} / (1-\gamma), \quad (3)$$

where  $\gamma$  is the coefficient of relative risk aversion. The change on consumption can be presented to satisfy

$$\Delta c_t = \mu + \lambda \Delta y_t + \phi r_t + \xi_t, \quad (4)$$

where

$$\Delta y_t = \log Y_t - \log Y_{t-1}, \quad \Delta c_t = \log C_t - \log C_{t-1},$$

$\mu$  is the intercept and  $\xi_t = (1 - \lambda)\varepsilon_t$  is the random error,  $\phi = (1 - \lambda)/\gamma$  and  $\xi_t$  is not correlated with the information in period  $t - 1$ , but may be correlated with  $r_t$  and  $\Delta y_t$ . Under LCH-PIH  $\lambda$  should be equal to zero.

The model suggests that if the share of "rule-of-thumb" consumers exists,  $\lambda$  should be greater than zero, if three alternative hypothesis: myopia, liquidity constraints and "opposite asymmetry" are considered. Under the hypothesis of myopic consumers, agents consume a fixed share of current income and consumption should respond symmetrically to increases and decreases in the predictable income. Under liquidity constraints; agents cannot borrow; when income decreases, and consumption



should respond more strongly to income increases than decreases. Following Shea (1995a) the presence of myopia or liquidity constraints can be tested by the equation

$$\Delta c_t = \mu + \lambda_1(Pos_t)\Delta y_t + \lambda_2(Neg_t)\Delta y_t + \phi r_t + \xi_t, \quad (5)$$

where  $Pos_t$  is a dummy variable for periods in which  $\Delta y_t > 0$  and  $Neg_t$  is dummy variable for periods in which  $\Delta y_t < 0$ . The LCH-PIH implies that  $\lambda_1 = \lambda_2 = 0$ . Under myopia,  $\lambda_1$  and  $\lambda_2$  should be equal, and significantly larger than zero. Under liquidity constraints  $\lambda_1 > \lambda_2 > 0$  must be true at statistically significant level. The opposite case, when consumption is more sensitive to decrease rather to increase, i.e.  $\lambda_1 < \lambda_2$ , presents “opposite asymmetry”.

In the Mankiw’s model it is assumed that current income consumers spend all their income on non-durables. Sarantis and Stewart suggested that the model could allow those consumers to have a durable consumption component:

“We would be surprised if they did not spend a small proportion on durables, such as televisions, etc.” (Sarantis and Stewart 2003, p. 1155)

There is also a practical reason for using total expenditures. For example, for some countries non-durable consumption series are not available, following Sarantis and Stewart (2003), with the assumption that the proportion of durable to non-durable expenditures is relatively constant through time, a reasonable approximation of the total consumption is

$$TC_t = C_t^{\eta_1} CD_t^{\eta_2}, \quad (6)$$

where  $TC_t$  is the total consumption,  $C_t$  is the consumption of non-durables and  $CD_t$  is the consumption of durables,  $\eta_1$  is the share of non-durables, and  $\eta_2$  is the share of durables (see Appendix).

Thus, following Gomes and Paz (2010), equations (4) and (5) the following can be estimated for the total consumption:

$$\Delta \ln TC_t = \mu + \lambda \Delta \ln Y_t + \phi r_t + v_t + \xi_1 v_{t-1} + \xi_2 v_{t-2}, \quad (7)$$

$$\Delta \ln TC_t = \mu + \lambda_1(Pos_t)\Delta \ln Y_t + \lambda_2(Neg_t)\Delta \ln Y_t + \phi r_t + v_t + \xi_1 v_{t-1} + \xi_2 v_{t-2} \quad (8)$$

Equation (7) was used to find out the share of current consumers in Estonia, Latvia and Lithuania. The share is described by the coefficient  $\lambda$  and the hypothesis (LCH - PIH) implies that it should be zero. Under the assumption that instrumental variables are orthogonal with the residual the instrument’s sets are used in this article that have lags of  $\Delta c_t$  -s order is greater or equal to 3, since MA(2) process is estimated and the random error is correlated with  $\Delta \ln TC_t$ . The five lists of instruments were used:

INST1: (constant,  $i_{t-3}, \dots, i_{t-6}, \Delta c_{t-3}, \dots, \Delta c_{t-6}, \Delta y_{t-3}, \dots, \Delta y_{t-6}, r_{t-3}, \dots, r_{t-6}$ );

INST2: (constant,  $\Delta y_{t-3}, \dots, \Delta y_{t-6}, r_{t-3}, \dots, r_{t-6}$ );

INST3: (constant,  $\Delta c_{t-3}, \dots, \Delta c_{t-6}, r_{t-3}, \dots, r_{t-6}$ );

INST4: (constant,  $\Delta c_{t-3}, \dots, \Delta c_{t-6}, \Delta y_{t-3}, \dots, \Delta y_{t-6}, i_{t-3}, \dots, i_{t-6}, c_{t-3} - y_{t-3}$ );

INST5: (constant,  $\Delta c_{t-3}, \dots, \Delta c_{t-6}, \Delta y_{t-3}, \dots, \Delta y_{t-6}, r_{t-3}, \dots, r_{t-6}, c_{t-3} - y_{t-3}$ ),

where  $i_t$  – nominal interest rate and  $r_t$  – real interest rate.

All results are shown according to the set of instrumental variables that were used in the estimation. In this paper the empirical analysis follows this approach.

### 3.1. Data

In this research aggregated quarterly data from the period 1996 Q2 - 2010 Q4 are used. To avoid seasonal impact, the data of the real disposable income were adjusted seasonally and adjusted by working days (SWDA). The data were in millions of euros for Estonia (EE), Latvia (LV) and Lithuania (LT) and it was downloaded from Eurostat. To convert the data into per capita form, the quarterly population data, available from Eurostat, were used. Seasonally adjusted (SWDA) final consumption expenditures of households ( $TC_t$ ), in millions of euro, were converted to per capita form.

The total consumption is converted into real terms using consumer price indices. For Estonia, the nominal interest rates on one-year time deposits were obtained from the Bank of Estonia. For Latvia and Lithuania, one-year nominal interest rates that are used were downloaded from DataStream. All nominal interest rates were converted into real returns according to the equation:

$$1 + r_t = (1 + i_t) / (1 + \pi_t),$$

where  $i_t$  is the nominal interest rate.

Due to one structural break in this period two periods are analyzed: firstly the period between Q2 1996 and Q1 2007 with the recession period excluded; secondly the period between Q2 1996 and Q4 2010 with the recession period included.

### 3.2. The dynamic characteristics of aggregate data

For the period 1996 Q2 - 2010 Q4 we can use 59 observations in total and Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test was applied for aggregate data of consumption, income and nominal interest rate. Test shows that the data for consumption and income are not stationary in levels and stationary at the first difference I(1). Interest rate data is stationary in levels I(0) for Latvia and Lithuania and stationary at the first difference I(1) for Estonia (see Table 1).

In the unit root tests for aggregate data the usual OLS estimates are inconsistent and instrumental variable (IV) methods should be used. Usually it is difficult to find valid instruments that work and at the same time do not correlate with the residual. To find out the share of current income consumers in those three countries the IV-GMM (general method of moments) method was implied.

Table 1 Unit Root Tests for total consumption, disposable income and interest rate in Estonia, Latvia and Lithuania

Variable	level	1 difference	Process I(=)
$TC_t$ EE	0.7885	0.2374	I(1)
$TC_t$ LV	0.8426	0.1366	I(1)
$TC_t$ LT	0.7726	0.1319	I(1)
Income EE	0.8533	0.2064	I(1)
Income LV	0.8912	0.1108	I(1)
Income LT	0.8419	0.1836	I(1)
$i_t$ EE	0.5678	0.1074	I(1)
$i_t$ LV	0.4330	0.3982	I(0)
$i_t$ LT	0.2405	0.1894	I(0)

Note: in the analysis, Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test is used.  $H_0$ : data is stationary. Critical value at 1% significance level is 0.7390, at 5% significance level it is 0.4630 and at 10% significance level it is 0.3470. The grey colour denotes the area where data are stationary (data stationarity hypothesis not rejected (KPSS)) at 5% significance level.

### 3.3. Results

In this subsection the results of the estimation of equation (7) are presented in tables 2 and 3. The analysis of asymmetric effects is given in tables 4 and 5. Column 2 in tables 2 and 3 demonstrates the estimates of OLS and columns 3-7 give the GMM estimation with the instruments that were presented above. The Sargan's test of overidentifying restrictions was used for GMM. The first row of these results describes the point estimate of  $\lambda$  from equation (7). The second row characterizes the standard errors in parenthesis, and  $\phi$  is the coefficient before real interest rate and is used like a control variable with standard error in parenthesis. The results in tables 2 and 3 are calculated using different time periods.

In Table 2 the period is 1996 Q2 – 2007 Q1 and in Table 3 1996 Q2 – 2010 Q4. The different periods are used due to the fact that from the data it is clear that there exists one structural break in year 2007. After that year the recession period started in those three countries, which may affect the share of current income consumers. For analysis of “rule-of-thumb” consumer's share it is also interesting to compare results with and without the structural break.

In the Sargan's test of over identifying restrictions, all instruments are valid. During recession the share of “rule-of-thumb” consumers ambiguously increased.

Table 2 Estimates of equation (7) in period 1996q2 – 2007q1 for Estonia (EE), Latvia (LV) and Lithuania (LT)

	Instruments					
	None (OLS)	INST1	INST2	INST3	INST4	INST5
$\lambda$ (EE)	0.3290 (0.2064)	0.4919** (0.0794)	0.2740 (0.1836)	0.2226* (0.1498)	0.4295** (0.0936)	0.4123** (0.0921)
$\phi$ (EE)	-0.0013 (0.0017)	-0.0026** (0.0005)	-0.0024** (0.0011)	-0.0023* (0.0012)	-0.0022** (0.0005)	-0.0021** (0.0005)
J	-	8.5468	3.2414	4.0710	8.1645	8.0116
Jp		[0.8589]	[0.7780]	[0.6671]	[0.6985]	[0.7122]
$\lambda$ (LV)	0.2225 (0.2708)	0.7460** (0.1363)	0.6784 (0.5813)	0.9073* (0.4968)	0.9069** (0.2017)	0.8258** (0.2637)
$\phi$ (LV)	-0.0027 (0.0039)	-0.0072** (0.0010)	-0.0088** (0.0023)	-0.0077** (0.0069)	-0.0092** (0.0027)	-0.0104** (0.0031)
J	-	6.2647	3.8816	1.4279	4.3459	4.2989
Jp		[0.9750]	[0.6927]	[0.9641]	[0.9587]	[0.9603]

$\lambda$ (LT)	0.2623** (0.1207)	0.4539** (0.1099)	0.1290 (0.1437)	0.7291** (0.2708)	0.4922** (0.1584)	0.4753** (0.1764)
$\phi$ (LT)	-0.0019 (0.0008)	-0.0023** (0.0009)	-0.0030** (0.0008)	-0.0025** (0.0012)	-0.0024** (0.0009)	-0.0024** (0.0009)
J	-	9.7436	7.5705	6.5937	9.5721	9.5646
Jp		[0.7807]	[0.2564]	[0.3601]	[0.5692]	[0.5699]

Note: the test of restrictions is Sargan's test of overidentifying restrictions ( $H_0$ : instruments are valid) with J-statistic and p-value in square brackets with the chi-square distribution. Robust standard errors are in parenthesis, \* marks  $\lambda$  and  $\phi$  with statistical significance at 10% level, \*\* with statistical significance at 5% level.

In table 2  $\lambda$  (EE) for Estonia ranges from 0.2226 to 0.4919 for GMM and  $\lambda$  is 0.3290 for OLS. The share of „rule-of-thumb“ consumers becomes statistically insignificant for OLS and INST2. Considering only significant regressions at 5% level,  $\lambda \in [0.2226, 0.4296]$  with the average 39% of current income consumers.

For Latvia  $\lambda$  varies from 0.6784 to 0.9069 for GMM and is 0.2225 for OLS. The estimated values of  $\lambda$  are statistically insignificant at 5% level for INST2 and for OLS similar to Estonia. The range of  $\lambda$  is  $[0.7460, 0.9073]$  with the average 85% of current income consumers.

The results for Lithuania are statistically insignificant at a 5% level for INST2 and  $\lambda$  (LT) ranges from 0.1290 to 0.7291 for all instruments and is 0.2623 for OLS. If only statistically significant results are included to the range of  $\lambda$ , it starts from 0.4539 and reaches 0.7291 with the average 54% of current income consumers in Lithuania. It seems that instrument set 2 has low predictive power for the period 1996 Q2 – 2007 Q1 in the Baltic States due to all results for  $\lambda$  becoming insignificant.

The coefficient of the real interest rate in table 2 is negative and significant for all instruments and for all countries. It shows that consumption decreases with the increase of the real interest rate.

Table 3 Estimates of equation (7) in period 1996q2 – 2010q4 for Estonia (EE), Latvia (LV) and Lithuania (LT)

	Instruments					
	None (OLS)	INST1	INST2	INST3	INST4	INST5
$\lambda$ (EE)	0.9531** (0.1109)	1.0338** (0.0705)	0.9460** (0.1558)	0.9340** (0.1511)	1.0678** (0.0756)	1.0648** (0.0741)
$\phi$ (EE)	0.0006 (0.0016)	-0.0008 (0.0012)	-0.0006 (0.0011)	-0.0002 (0.0013)	-0.0005 (0.0011)	-0.0006 (0.0011)
J	-	10.3511	7.2959	7.0171	8.9156	8.9713
Jp		[0.7361]	[0.2435]	[0.3193]	[0.6297]	[0.6245]
$\lambda$ (LV)	0.7627**	1.1252**	1.0186**	0.9729**	1.0601**	1.1029**

	(0.1474)	(0.0966)	(0.2547)	(0.1820)	(0.0834)	(0.0825)
	-0.0012	-0.0060**	-0.0057**	-0.0063**	-0.0081**	-0.0089**
$\phi$ (LV)	(0.0033)	(0.0022)	(0.0033)	(0.0032)	(0.0032)	(0.0042)
J	-	6.2379	4.8571	4.8786	5.7716	5.7813
Jp		[0.8570]	[0.5623]	[0.5595]	[0.8882]	[0.8875]
$\lambda$ (LT)	0.9360**	1.0700**	1.0390**	1.4357**	1.1794**	1.1183**
	(0.0896)	(0.0832)	(0.2421)	(0.2063)	(0.1531)	(0.1673)
	-0.0004	-0.0018	0.0000	0.0008	-0.0004	-0.0004
$\phi$ (LT)	(0.0011)	(0.0012)	(0.0016)	(0.0018)	(0.0014)	(0.0013)
J	-	10.9050	7.8765	7.0562	9.5655	9.8780
Jp		[0.6934]	[0.2473]	[0.3157]	[0.5698]	[0.5414]

Note: the test of restrictions is Sargan's test of overidentifying restrictions ( $H_0$ : instruments are valid) with J-statistic and p-value in square brackets with the chi-square distribution. Robust standard errors are in parenthesis, \* marks  $\lambda$  and  $\phi$  with statistical significance at 10% level, \*\* with statistical significance at 5% level.

For the longer period including the recession (table 3), results are completely different for all countries. This illustrates the fact that the share of current income consumers is very sensitive to the estimated period. In this case it is quite complicated to compare results between different studies with the same countries but with different time periods.

In table 3 for Estonia  $\lambda$  (EE)  $\in$  [0.9460, 1.0678] for GMM and  $\lambda$  is 0.9531 for OLS for the period 1996 Q2 – 2010 Q4. The share of current income consumers increased to average 100%.

For Latvia  $\lambda$  ranges from 0.9729 to 1.1252 for GMM and  $\lambda$  is 0.7627 for OLS. For INST1  $\lambda$  becomes a bit greater than one.

Table 4 Estimates of equation (7) in period 1996q2 – 2010q4 for Estonia (EE), Latvia (LV) and Lithuania (LT)

	Instruments				
	INST1	INST2	INST3	INST4	INST5
$\lambda_1$ (EE)	0.615**	0.571	0.414**	0.566**	0.543**
(Std. Error)	(0.107)	(0.559)	(0.172)	(0.115)	(0.111)
$\lambda_2$ (EE)	-0.728	-0.873	0.304	-0.424	-0.328
(Std. Error)	(0.673)	(3.373)	(1.882)	(1.445)	(1.127)
F-test	2.124	1.561	1.275	1.489	1.403
p-value	[0.113]	[0.215]	[0.2967]	[0.233]	[0.257]
$\lambda_1$ (LV)	1.824**	-0.921	1.076*	0.517	0.549

(Std. Error)	(0.338)	(0.634)	(0.637)	(0.330)	(0.332)
$\lambda_2$ (LV)	1.214**	1.739**	1.709	1.484*	1.504*
(Std. Error)	(0.977)	(1.024)	(1.780)	(0.806)	(0.788)
F-test	2.364	1.172	2.882	2.123	2.114
p-value	[0.088]	[0.333]	[0.048]	[0.112]	[0.113]
$\lambda_1$ (LT)	0.908**	0.450	-0.707	0.423**	0.418*
(Std. Error)	(0.367)	(0.376)	(0.939)	(0.210)	(0.234)
$\lambda_2$ (LT)	-0.869	-2.442	3.763	0.752	0.656
(Std. Error)	(0.706)	(2.284)	(2.730)	(0.657)	(0.616)
F-test	0.877	1.335	1.201	3.637	3.444
p-value	[0.463]	[0.278]	[0.322]	[0.021]	[0.026]

Note:  $\phi$  included, not shown. F-test: ( $H_0: \lambda_1 = \lambda_2$ ). Robust standard errors are in parenthesis, \* marks  $\lambda$  with statistical significance at 10% level, \*\* with statistical significance at 5% level.

For Lithuania  $\lambda$  varies from 1.0700 to 1.4357 for GMM,  $\lambda$  is 0.9360 for OLS and becomes essentially larger than one for INST3. This makes the result similar to the estimates of Gomes and Paz (2010), calculated for Colombia. This indicates that equation (7) might have a specification problem. This might be so even though there were no rejections in the over identification tests. The sample sizes of this research and the research of Gomes and Paz were similar.

The coefficient on interest rate becomes insignificant and/or negative for all three countries. The model without interest rate was also estimated and the results for  $\lambda$  were almost equal.

The cross-country estimates imply that (LCH - PIH) can be rejected due to the range of  $\lambda$  being bigger than zero. To find the reason for this we use the Shea's approach. Estimates of equation (8) in period 1996 Q2 to 2007 Q1 are presented in table 4 above.

Table 5 Estimates of equation (8) in period 1996q2 – 2010q4 for Estonia (EE), Latvia (LV) and Lithuania (LT)

	Instruments				
	INST1	INST2	INST3	INST4	INST5
$\lambda_1$ (EE)	0.674**	0.262	0.188	0.462**	0.459**
(Std. Error)	(0.164)	(0.422)	(0.184)	(0.153)	(0.143)
$\lambda_2$ (EE)	1.566**	1.776**	2.174**	1.813**	1.813
(Std. Error)	(0.168)	(0.621)	(0.579)	(0.336)	(0.342)
F-test	24.784	11.156	9.185	19.737	19.386
p-value	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
$\lambda_1$ (LV)	0.936**	0.625	0.913**	0.872**	0.833**

(Std. Error)	(0.283)	(0.462)	(0.456)	(0.297)	(0.283)
$\lambda_2$ (LV)	1.328**	1.164**	0.993**	1.260**	1.298**
(Std. Error)	(0.244)	(0.482)	(0.447)	(0.245)	(0.243)
F-test	12.003	2.693	4.630	11.729	11.568
p-value	[0.000]	[0.055]	[0.006]	[0.000]	[0.000]
$\lambda_1$ (LT)	0.481**	-0.073	0.776	0.537*	0.475*
(Std. Error)	(0.144)	(0.302)	(0.578)	(0.277)	(0.271)
$\lambda_2$ (LT)	1.322**	1.292**	1.514**	1.420**	1.409**
(Std. Error)	(0.054)	(0.252)	(0.302)	(0.187)	(0.179)
F-test	46.786	11.753	16.730	19.608	18.005
p-value	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]

Note:  $\phi$  included, not shown. F-test: ( $H_0: \lambda_1 = \lambda_2$ ). Robust standard errors are in parenthesis, \* marks  $\lambda$  with statistical significance at 10% level, \*\* with statistical significance at 5% level.

For Estonia the estimated values of  $\lambda_1$  (EE) in table 4 are all positive and statistically significant at the 5% level, but the estimated values of  $\lambda_2$  (EE) are never statistically significant. The values of  $\lambda_1$  and  $\lambda_2$  are positive only for INST3 and this result suggests a liquidity constraint for failure of (LCH - PIH). For other instrument sets the values of  $\lambda_2$  are negative and therefore it is not possible to conclude the reason of the (LCH - PIH) failure. The null hypothesis  $\lambda_1 = \lambda_2$  of F-test is not rejected for all lists of instruments that in turn weakens the results in favour of the liquidity constraint.

The estimated values of  $\lambda_1$  (LV) in table 4 for Latvia are positive except INST2. The value of  $\lambda_1$  is significant at 5% level for INST1 and at 10% level for INST3. The estimated values of  $\lambda_2$  (LV) are all positive and insignificant only for INST3. The results for INST1 and INST3 support the liquidity constraint hypothesis. The F-test is rejected at the 10% significance level for INST1 and at the 5% level for INST3 and not rejected for specifications INST2, INST4 and INST5. This confirms the liquidity constraint hypothesis for specifications INST1 and INST3. It appears there is "opposite asymmetry" for INST4 and INST5, but the F-test does not support this. Hence, for Latvia it is possible that the failure (LCH - PIH) is due to the liquidity constraints.

For Lithuania the estimated values of  $\lambda_1$  (LT) in table 4 are positive except INST3. It is statistically significant at the 5% level only for INST1 and INST4 and significant at the 10% level for INST5. All estimated values of  $\lambda_2$  (LT) are statistically insignificant and positive for specifications INST3, INST4 and INST5. The null hypothesis  $\lambda_1 = \lambda_2$  of the F-test is rejected for instrument lists INST4 and INST5. The possible explanation of the failure of (LCH - PIH) in Lithuania is "opposite asymmetry". This is also supported by the F-test.

For the period with recession in table 5 the possible explanation of failure of (LCH - PIH) for all three countries is "opposite asymmetry": the aggregate consumption is more strongly correlated with the decrease of predictable income than with the increase of predictable income. For Estonia  $\lambda_1 < \lambda_2$  for all lists of instruments and it is supported by the F-test. For Latvia and Lithuania it is the same reason like for Estonia. But for Lithuania it is not possible to claim it from INST2, where  $\lambda_1$  is negative.

#### 4. DISCUSSION AND CONCLUDING REMARKS

The Campbell's and Mankiw's model of "rule-of-thumb" consumption was examined empirically using aggregate data for Estonia, Latvia and Lithuania for Q2 of 1996 to Q4 of 2010 and Q2 of 1996 to Q1 of 2007, with recession in those countries excluded. From the calculations it can be concluded that (LCH - PIH) was rejected for both periods.

For the period excluding recession the share of "rule-of-thumb" consumers in Estonia was 39%, in Latvia it was 85% and in Lithuania 54%. For the period including big recession, the share of current income consumers increased to almost 100%. The coefficient  $\lambda$  was even bigger than one for Lithuania which is comparable with the results of Gomez and Paz for Colombia (2010). 1996-2007 was a period when loans, especially home mortgages and car leasing, become very popular in the Baltic States. Unfortunately the model does not take loan data as direct input and therefore might not give the most accurate picture of the economical processes.

It is also important to note that relatively short period was taken under the investigation. Traditionally such research has been done for periods lasting many decades. However in our case due to the historical reasons the period was only 14 years. Therefore the instability of our results was quite high.

The cross country evidence rejected the Life Cycle – Permanent Income hypothesis for the Baltic States. For studying the reasons behind the rejection of (LCH - PIH) the Shea's (1995a) model with three alternative hypothesis: myopia, liquidity constraints and "opposite asymmetry" was considered. The results for Estonia for the period of Q2 1996 to Q1 2007 suggest a liquidity constraint motive for failure of (LCH - PIH). But this result is weakened due to the fact that the F-tests null hypothesis  $\lambda_1 = \lambda_2$  cannot be rejected for all instrument lists. One of the possible explanations of this is the large standard error of  $\lambda_2$ . This period does not present any substantial decrease of consumption and disposable income. The results for Latvia indicate that there is a sign of liquidity constraints. This was also supported by the F-test's null hypothesis rejections of two instruments. The "opposite asymmetry" indicates two lists of instruments for the reason of failure of LCH - PIH, which is also supported by the rejection of null hypothesis of F-test.

The analysis of the longer time period shows that in all three countries the "opposite asymmetry" takes place and the consumption is more sensitive to decrease rather than increase. It also demonstrates very big asymmetric effects for Estonia, Latvia and Lithuania in this period, that can be explained by the existence of big fluctuation in consumption and income due to economic crisis of 2007-2009 and the absence of such substantial fluctuations before it.

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#### APPENDIX:

Following Hall (1978), the model is derived as the optimization problem of consumer behaviour of the rational and forward-looking consumer:

$$\max_{\{C_{t+j}\}_{j=0}^{\infty}} E_t \sum_{j=0}^{\infty} (1 + \rho)^{-j} u(C_{t+j}) \quad (\text{A.1})$$



$$\text{s.t. } W_{t+1} = (1 + r_{t+1})(W_t + Y_t - C_t),$$

where  $C_{t+j}$  denotes the real consumption at time  $t+j$ ;  $\rho$  the rate of subjective time preference;  $r$  is the real rate of interest with  $r \geq \rho$ , assumed to be constant over time;  $u(\cdot)$  is one-period utility function with  $u' > 0$  and  $u'' < 0$  (strictly concave);  $W_t$  is non-human assets held by the consumer at the beginning of period  $t$  (wealth);  $Y_t$  is labour income at time  $t$ .

The solution  $\{C_t^*\}_{t=0}^{\infty}$  of the above optimization problem is described by the Euler equation:

$$u'(C_t) = \left[ \frac{1+r_{t+1}}{1+\rho_{t+1}} \right]^{t+j} E_t[u'(C_{t+1})], \quad j = 1, 2, 3, \dots \quad (\text{A.2})$$

With assumptions  $r = \rho$  and  $u(\cdot)$  is quadratic, the Euler equation of the optimization problem becomes

$$C_t = E_t C_{t+j}, \quad j = 1, 2, 3, \dots \quad (\text{A.3})$$

It implies that the optimal consumption is a random walk and future consumption change is not predictable. The change of consumption can be derived as

$$\Delta C_t = r \sum_{j=0}^{\infty} (1+r)^{-(1+j)} (E_t - E_{t-1}) Y_{t+j} = \varepsilon_t, \quad (\text{A.4})$$

where  $\Delta C_t = C_t - C_{t+j}$  and  $\varepsilon_t$  is a random error term. Hence, the consumption change is unpredictable.

In Mankiw's model according to Hall's hypothesis (see also Flavin (1981)) the change of consumption for another group is

$$\begin{aligned} \Delta C_{2t} &= (1-\lambda)\Delta Y_t = r \sum_{j=0}^{\infty} (1+r)^{-(1+j)} (E_t - E_{t-1}) Y_{2,t+j} = \\ &= (1-\lambda)r(1+r)^{-(1+j)} (E_t - E_{t-1}) Y_{2,t+j} = (1-\lambda)\varepsilon_t \end{aligned} \quad (\text{A.5})$$

The total change of aggregate consumption can now be written as

$$\Delta C_t = \lambda \Delta Y_t + (1-\lambda)\varepsilon_t, \quad (\text{A.6})$$

where  $\Delta C_t$  is the change of consumption spending and  $\Delta Y_t$  is the change of disposable income (Campbell and Mankiw, 1990).

Following Sarantis and Stewart (2003), with the assumption that consumers react to shocks slowly, flow of durables can be presented as follows:

$$\Delta \ln CD_t = \mu^D + \frac{1}{\gamma} r_t + v_{t-1}^D + \xi_1^D v_{t-2}^D, \quad (\text{A.7})$$

where  $v_t^D$  is an innovation. Similarly the consumption of non-durables can be presented by the relation:

$$\Delta \ln C_t = \mu^N + \frac{1}{\gamma} r_t + v_t^N. \quad (\text{A.8})$$

From equation (6) we get with the help of (A.7) and (A.8) that

$$\Delta \ln TC_t = \mu + \phi r_t + v_t + \xi_1 v_{t-1} + \xi_2 v_{t-2}, \quad (\text{A.9})$$

where

$$\mu = (\eta_1 \mu^N + \eta_2 \mu^D), \quad \phi = (\eta_1 + \eta_2) \frac{1}{\gamma}, \quad v_t = \eta_1 v_t^N, \quad \rho = v_t^D / v_t^N, \quad \xi_1 = \rho \eta_2, \quad \xi_2 = \rho \eta_2 \xi_1^D.$$

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**E-COMMERCE AND SMES IN DEVELOPING COUNTRIES: JORDAN CASE STUDY**

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**Abstract**

*With the direction of major companies to online transactions and the growth of electronic commerce accelerating growth and entering the world economy, as one of the most important features of the modern digital economy, SMEs are still lagging behind larger organizations in the adoption and evaluation of e-commerce despite the benefits it offers. small and medium sized companies(SMEs) that have limited opportunities and strengths when trying to compete against the large organizations may find a way to overcome the obstacles incurred by their small size through the multiple benefits that EC offers.*

*In most developed countries SMEs constitute a highly dynamic and important sector of the economic activity that, nevertheless, has to deal with high competitive pressures and scarcity of resources. Information and communication technologies (ICT) offer SMEs significant opportunities to grow and to compete in the current business environment.*

*This study aims to determine the current level of e-commerce adoption by SMEs in Jordan and examines the benefits that are received from the use of ecommerce then clarifies the major barriers facing organizations. Moreover, it gives a clarification of how organizations responses to these barriers . This was achieved by circulating a questionnaire to test the perception of e-commerce benefits and e-commerce adoption levels among SMEs from various sectors in Jordan. It goes further to provide SMEs with business services that could make their trading activities. This study also elucidates these expected benefits from ecommerce and compare them with traditional SMEs to encourage all organizations to adopt and use of e-commerce in their businesses to remain competitive in rapidly changing environment The results of this study indicate that even though a majority of respondents use the Internet in business activities, the adoption of the Internet as a business tool is limited to a brochure where Web site which primarily provides one way. As such, there wasn't interactive information about the company and its products and services.*

**Key words:** *E-commerce, SMEs, EC applications. E-commerce adoption.*

**1. INTRODUCTION**

E-commerce is fundamentally changing the economy and the way businesses are conducted today (Barua, et al, 2001. 36-44). It forces firms to find new ways to expand the markets in which they compete, to attract and retain customers by tailoring products and services to their needs, and to restructure their business processes in order to deliver high quality products and services more efficiently and effectively (Chan, S., and Davis, T. 2000. pp. 58-64) (Shin, N. 2001. pp. 34-41). E-commerce allows organizations to access potential customers and suppliers via the Internet. Some of the major benefits of e-commerce offers expanded marketplaces, potential cost reductions, productivity improvements, customization of products and services, 24 hour trading and information

exchange and management (Du Plessis, M. and Boon, J. A. 2004. 73-86)(Raisinghani, M. et al 2005. 16-36) (Marguerite Lipscomb and Anne Marie McEwan, 2001). This expansion of e-commerce has led to growing research into the impact of new IT investments (Raisinghani, M. et al 2005. 16-36).

E-commerce can be defined as the buying and selling of information, products and services with the assistance of computer technology and the Internet( Greenstein M, Feinman TM, (2000). 115-124).This basically involves the exchange of electronic information between parties, normally followed by the exchange of goods and payment transactions. E-commerce has entered various firms particularly the small and medium enterprises ,as such there is a twin relationship of e-commerce and those enterprises .The sector of small and medium

sized enterprises (SME's) is an important factor in most economies and considered to be the life blood of modern economies. There is no unique definition for Small and medium-sized enterprises. According to Pobobsky, a study conducted by the International Labor Organisation (ILO), more than 50 definitions were identified in 75 countries, with considerable ambiguity in the terminology used. The enormous variety of criteria applied includes size of workforce or capital, form of management or ownership, volume of sales, production techniques, client numbers and levels of energy consumption.

SME's are considered as key feature in the economies of every country. This crucial sector plays an important role in the development of economy's infrastructure by providing employment generation, innovation and wealth creation. The implementation of new technologies, use of ICT (information and communication technologies) and electronic commerce in SME's with their operational environment

has provided numerous organizational opportunities. Akkeren and Cavaye (Akkeren J, Cavaye A, (1999)state that e-commerce improves an SME's ability to compete with larger organizations and operate on an international scale. They also see e-commerce as a tool for providing cost effective ways for SME's to market their business, launch new products, improve communications, gather information and identify potential business partners. The Internet allows small businesses to enter the domain of larger business and compete with them. Moreover, the use of e-commerce enables small businesses to achieve the same efficiencies as large businesses. In spite of this, previous studies suggest that the adoption of web-enabled transaction processing by small business has not been as widespread as would have been expected (Stockdale, R. / Standing, C. (2006): pg.381).

## 2. LITERATURE REVIEW:

The widespread of the Internet and its entering the world economy, finance and trade, and the adoption of various companies and institutions in its electronic services at the international level, led to the emergence of electronic commerce as one of the most important characteristics of the modern economy in recent years. With the heavy dependence on the Internet to manage global trade in larg organizations, there has been a need to evaluate the effect of e-commerce on **SMEs** and clarify the benefits it offers. There have been many studies in the area of evaluating e-commerce in SMEs as one of the most important issue in recent times. Many of the studies have addressed evaluating e-commerce in SMEs from several points of view. Moreover the World Wide Web has given the opportunity to firms, irrespective of their size, to enter the fields of international marketing and trade their products and services on a global scale regardless of geographical, national, financial or other limitations. e-Commerce has the ability to change the way companies compete with one another, since the new technologies influence the strategic plans of organizations and they offer competitive advantages on both local and global level(Doukidis, et al (2001).

Luisa Piris, et al (Luisa, et al, 2005) in their study strategic motivators and expected benefits from e-commerce in traditional organizations, their study aimed to identify the strategic motivators and expected benefits related to the implementation of e-commerce infrastructures in traditional “brick and mortar” organisations. they chosen six representative organisations from different sectors to explore their rationales for their e-commerce strategies. One of the main benefits reported is to increase the focus

on the customer and improving internal communications. Additionally, obtaining competitive advantage was found to be a powerful motivator. According to Currie (Currie, W. 2000), there are several cost/performance benefits of Ecommerce :The first benefits are based on reduction of external and internal communication expenses, such as: the speed-up businesses processes and reduced administrative tasks. The second benefits are the revenues generated either from current business or from new initiatives. Theses can also serve to enhance the company’s visibility and extend customer and supplier networks. The third group of benefits are tangible benefits; such as reduced costs and more flexible working practices. Finally, there is a group related to intangible benefits, such as enhanced competitive positioning and enhanced customer relationships.

Mirchandani and Motwani (Mirchandani and Motwani, 2001, 70-73). investigated factors that distinguish small businesses that are adopters of e-commerce from non adopters. Factors that were considered not important include lack of managerial time to plan e-commerce, cost, the nature of the company’s competition and the degree of the company’s dependence on information. Among the relevant factors there are employees’ IT knowledge, top management support, e-commerce compatibility with the business the company is in,

and perception of e-commerce relative advantage. Scupola (Scupola, A. 2003pp. 51-71). in his study The Adoption of Internet Commerce by SMEs in the South of Italy: An Environmental, Technological and Organizational Perspective found that competitive pressure, customer and supplier pressure, role of government, quality of access to e-commerce related services were important factors influencing ecommerce adoption. Innovation champion, financial resources and employees’ IS knowledge were among the most important organizational characteristics. Regarding Web Auctions - The Benefits of E-commerce to Small and Medium Jordanian Enterprises the technological context he found three groups of factors influencing e-commerce adoption: e-commerce barriers, e-commerce benefits and e-commerce related technologies . Poon & Swatman (Poon S, Swatman P, 1999, 9-18). identified short-term and long-term benefits for companies using e-commerce. Short-term benefits should be realised within months whereas long-term benefits may take longer and are normally fairly unpredictable. Their research showed that SMEs are not reaping significant short-term benefits from ecommerce and for those that did, the benefits were marginal and inconsistent. They identified long-term benefits as being the key motive for ongoing Internet activities The study of Pauline (Bui T.X., Sankaran S. and Sebastian I.M. 2003, pp. 3-22) examined perceived versus realized benefits in ecommerce adoption using three in depth case studies. The study attempted to show the distinction between perceived versus realized benefits in three areas namely; technology use, business operations, and relationships with their trading partners. The findings provided evidence on the importance of top management commitment. The study contributes to theory by providing a scale of measurement for both perceived and realized benefits that future researchers can apply and contributes to practice by increasing the awareness of e-commerce practitioners on the importance of top management commitment, and maintaining relationships with their customers and trading partners. More importantly the lessons learned by these organizations is that e-commerce is unique for each organization and it is not something any organization can follow from their competitors.

Syed Shah Alam, et al (Syed Shah Alam, et al 2005, 188-193) explained the major benefits that motivating to adopt ecommerce in the electronic manufacturing companies in Malaysia. The major benefits of e-commerce adoption include improved customer service, better inventory control and lower marketing and distribution costs, reduced cycle time, increased market reach and reduced operation costs. Despite the hype of the ecommerce business, the benefits realized from e-commerce adoption among firms is unclear in terms of perceived versus realized benefits. The study examined the perceived benefits of ecommerce usage by the electronic manufacturing companies in Malaysia. Also differentiates the perceived benefits between the different demographic groupings. The study showed that Internet communication costs, ease link with suppliers and customers, as a tool for future business, omitted of time barriers and global presence are the major factors affecting the adoption of EC in the business in Malaysia.

Cloete, et al (Cloete, et al, 2002, 1–13). In their study of SME adoption of e-commerce in South Africa found that adoption is heavily influenced by factors within the organization. Lack of access to computers, software, other hardware, and telecommunications at a reasonable cost; low e-commerce use by competitors and supply chain partners; concerns with security and legal issues; low knowledge level of management and employees; and unclear benefits from e-commerce were found to be the major factors that inhibit adoption. Another study of ecommerce in China by (Sussan, A. P. & Johnson, W.C. (2003) found that there are many significant barriers to e-commerce adoption. Limited diffusion of computers, high cost of Internet access, and a lack of online payment processes were found to directly inhibit e-commerce. Inadequate transportation and delivery networks, limited availability of banking services, and uncertain taxation rules indirectly inhibit e-commerce .

Mahesha, and Robyn (Mahesha Kapurubandara, and Robyn Lawson 2006). presented a model for barriers to adoption of ICT and ecommerce, collected from the available literature and the results of an exploratory pilot studies and subsequent survey. In addition to the barriers facing SMEs, the research identifies the relevant support required by SMEs in a developing country, Sri Lanka. The preliminary study helps draw some conclusions. Adoption of ICT and ecommerce in SMEs developing countries is different from the developed countries. Another factor that emerged in this study was the level of ICT adoption. Timmers (Timmers, P. 1999). suggested nine key characteristics of the Internet which can provide advantages for businesses: 24-hour availability, ubiquity, global connectivity, reinforcement of local presence and relationships, digitisation, multimedia, interactivity, one-to-one relationships, network effects, and integration of information. Clearly.

Honghong Sun ( Honghong Sun (2002). in his study Impact of E-Commerce in China find that the Ecommerce has brought several of changes in these ten years. Firstly, it changes people's life style and shopping fashion. Secondly, it changes different types of companies, such as SMEs, retail enterprises, post companies and logistics enterprises. Thirdly, it changes advertising and promotion ways. However, there are still several lacks of development of E-Commerce in China, such as Lacks of Credit System and Banking Services, Lack of equality Development in Different Parts of China, Lack of Freedom of Internet in China and Lack of Education on E-Commerce. If we want to make the environment of E-Commerce better, we should control these lacks. Quayle (Quayle M. 2003: pp. 41-52) notes that the awareness and level of implementation of e-Business in European Small and Medium Enterprises (SME)'s differ in some aspects from larger organisations. He argues that the issues of highest importance are leadership, time to market, marketing and financial management and a narrow vision of business survival. He further states that small firm's perception of quality, price, production reliability, service reliability and capability to provide support are normal buyer's demands. Nowhere is the aspect of value from IT investments reflected. The idea is that the cost to execute transactions be reduced. He states that developing e-Business expertise is essential to sustain

the competitive advantage. SME's must be aware that some aspects such as financial management could impact on their future plans.

Traditionally, SMEs have faced a number of barriers to the adoption of ecommerce. Chau and Pederson (Chau, S. & Pedersen, S.G. (2000) list the following barriers: General lack of resources, Lack of cost-effective e-commerce enabled software, Lack of technical skills and training Complications in implementing change, On-going support costs, Computer apprehension. , Inter-organisation motivation. And Giving priority to e-commerce initiatives.

### 3. METHODOLOGY

The study followed several stages beginning with initial interviews of SMEs experts. After these discussions an initial survey was developed, the survey was revised and then distributed to a group of (10) SMEs from various sectors in Jordan as a pilot sample to further refine the survey. Our target population was the SMEs from various sectors in Jordan. The population includes both e-commerce adopters and non-adopters. The population was stratified into those firms having 10 to 19 employees, firms having 20 to 99 employees, and firms having 100 to 400 employees. The survey sample consisted of representatives from three major groups, namely: the Manufacturing Sector, the Service Sector and the banking Sector. These sectors were selected because they were considered as key features in the economies of every country. These crucial sectors play an important role in the development of a country's infrastructure by providing employment generation, innovation and wealth creation. Our population strata contained 30 firms with 10 to 19 employees, 45 firms with 20 to 99 employees and 47 firms with 100 to 499 employees. A random sample of 122 firms, proportionately based upon the underlying state demographics, was drawn from each stratum. A survey packet was prepared that contained a personally addressed cover letter, the questionnaire, and a prepaid business reply envelope. The questionnaire contained a control number that enabled matching the questionnaire responses to the demographic data in the SMEs. The completed packet was mailed to the presidents and owners of SMEs. After one month, a second mailing of the survey packet was completed.

### 4. PRESENTATION AND DISCUSSION

It is interesting to examine some of the responses to this point. This section will present some preliminary observations about the initial respondents. Three hundred usable responses were obtained initially. This analysis addresses these three hundred usable responses. In this section, demographic data will first be presented. Descriptive statistics for some of the key questions will then be presented to provide a foundation for the future studies and analyses.

Sector	Number of SMEs	Percentage
manufacturing	50	41%
service	42	34%
Banking	30	25%
Total	122	100%

Table 1. Number of SMEs in multiple Sectors



The survey sample consisted of representatives from three major groups, namely: the Manufacturing Sector, the Service Sector and the banking Sector. The results showed that most firms in the sample belong to the manufacturing sector. Of the 122 respondent firms, 41% (50 firms) belong to the manufacturing sector, 34% (42 firms) belong to the service sector, and 25% (30 firms) belong to the banking sector.

#### 4.1 Demographics

Table 2 shows the results of the respondents are from a diverse group of small and medium enterprises.

Demographic	N	Mean	SD
Number of years in business	73	30.05	21.06
Revenues	46	11,364	25,586
Fulltime employees	82	68.14	107.51
Advertising expenditures	61	52,332	18,9051
Internet related expenditures	67	32,231	93,511

Table 2. Basic demographics of initial respondents

The respondents include new businesses and well established businesses. They also cover all extremes of the definition of a SME with the smallest having 9 employees and the medium having the maximum of 400 employees.

EC applications	Total companies	Percentage %
Buying	43	0.352459016
Selling	43	0.352459016
E-mail	110	0.901639344
Seeking Information	86	0.704918033
Distribution	61	0.5
Direct Marketing	62	0.508196721
Advertising and Promotion	76	0.62295082
Public Relation (PR)	59	0.483606557
Customer Services and Support	61	0.5

Table3: E-Commerce applications

Respondents were asked to indicate the EC application used by the companies in multiple sectors in Jordan. For this study 10 activities were considered and they are as follows: Off all the respondents more than 90% (110 firms) indicated e-mail as the main activities used by them. 70% (86 firms) respondents indicated that, they were using Internet based EC for seeking information purposes. A total 61 company (50%) indicated were using EC for customer service and support purposes. The 35% (43firms) used EC for buying raw materials from other businesses or suppliers. Out of 122 companies 43 companies (35%) used both for selling and buying purposes. Total 76 companies of 122 ( 62%) used EC as a medium of advertising their goods and services. Out of 122 companies, 61companies used EC as a tool for Customer Services and Support, distribution and direct marketing 50%. Followed by 48% (59 firms), 31% (39 firms), used EC for public relations (PR)and transactions respectively

<b>Response</b>	<b>Number</b>	<b>Percentage %</b>
None	20	0.163934426
1-20%	70	0.573770492
21-40%	13	0.106557377
41-60%	10	0.081967213
61-80%	6	0.073770492
81-100%	3	0.049180328

Table 4. SME business benefits from e-commerce activities

Building off the activities that the respondents undertake are the business benefits. The above table summarizes the respondents' perceptions of the percent of activities within their individual organization that benefit from the use of e-commerce. One means of receiving a benefit from a system is its ability to interact with existing system an SMEs.

#### 4.2 Initial Items of Interest

The focus of this study is the benefits that SMEs achieve through e-commerce. A key to this question is the level of e-commerce activities in the organizations. Table 5 presents a summary of the respondents' activities.

Activity	N	Yes	Percentage%
Provide information about company	122	85	0.696721311
Allow suppliers to interact electronically with company	122	34	0.278688525
Provide information about products or service	122	38	0.31147541
Allow customers to place or request orders online	122	48	0.31147541
Allow customers to interact electronically with company	122	32	0.262295082
Integrate with back office systems	122	15	0.12295082
Other	122	9	0.073770492

Table 5. SMEs e-commerce activities

Table 5 displays the results of number and percentage of firms that percept the benefit of e-commerce. In this regard, it appears that the first question has the highest rate then followed by the third question. However; it shows that the percentages in other variables are low. This may due to the fact that large portion of respondents of this study said the primary benefit of Internet use was information about company and efficient communication.

#### 4.3 Barriers to adoption of electronic commerce

Furthermore, we ask the question “what is the major roadblock when you think of adopting e-commerce? The various factors or roadblocks to the adoption of electronic commerce have been identified as under: Financial shortage and e-commerce not suited to our customers and suppliers rank as the top two barriers to adoption of ecommerce by SMEs in Jordan. Followed by concern over security of payments. Also it shows that the percentages in other variables are low.

Finally, table 7 presents a summary of the respondents’ perceptions of their company’s e-commerce applications interaction with other company systems. One means of receiving a benefit from a system is its ability to interact with existing systems and commitment to e-commerce will be directly related to the belief that ecommerce will be important to the overall business

Ranking	Number of responses	Percentage
Financial shortage	112	0.918033
Concern over lack of IT employees	75	0.614754
Internal resistance	70	0.57377
Concern over security of payments	80	0.705902
e-commerce not suited to our customers and suppliers	84	0.745902
lack of popularity for online marketing and sales	42	0.31250

Table 6: Barriers to adoption of E-commerce

Response	No#	N	Percentage
No Interaction	1	24	47.06
	2	16	31.37
Extensive Interaction	3	7	13.73
	4	2	3.92
	5	2	3.92

Table 7. E-commerce applications interact with other applications

## 5. CONCLUSIONS

With the direction of major companies to online transactions and the growth of electronic commerce accelerating growth and entering the world economy, as one of the most important features of the modern digital economy, SMEs are still lagging behind larger organizations in the adoption and evaluation of e-commerce despite the benefits it offers. small and medium sized companies(SMEs) that have limited opportunities and strengths when trying to compete against the large organizations may find a way to overcome the obstacles incurred by their small size through the multiple benefits that E-commerce offers.

This study has highlighted the critical role of the E-commerce to SMEs in several sectors in Jordan and clarifies how SMEs in particular may benefit from it. Ecommerce makes it easier for many SMEs to maintain contact with their customers. They can use the Internet for transnational marketing and transactions, thereby globalizing their sales and allow SMEs to improve relations with their suppliers and customers, whilst also creating the potential for collaboration with other SMEs. Also it showed that Internet communication, ease link with suppliers and customers, as a tool for future business, and financial shortage, Concern over security of payments barriers are the major factors affecting the adoption of EC in the business in Jordan.

The results of this study indicate that even though a majority of respondents use the Internet in the business activities and their own Web site. The adoption of the Internet as a business tool is limited to a brochure ware Web site which primarily provides one way, non-interactive information about the company and its products and services.

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**CENTER OF EXCELLENCE AS A NEXT STEP FOR SHARED SERVICE CENTER**

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**Abstract**

*In this paper I disclosed what means center of excellence (CoE), which are the main characteristics of it, what are the connection and what are differences between CoE and shared service center, why could be a good step of progress for shared service centers.*

**Key words:** *shared service center, SSC, captive center, center of excellence, CoE, center of competence, CoC, center of expertise, CoEx*

**1. INTRODUCTION**

The classic shared-service model was created to achieve savings. It is reached by creating economies of scale and enhancing of efficiency, so delivering services for more and more customers but with the same resources. It was available mostly at the services with high volume and many transactions where it could be minimized the number of interactions with customers. The high number of transactions is important because these functions could be standardized quite well and that is one of the sources for cost-cutting. Beside it the key of the success are process-automatization and technological improvements. It is well prescribed for the workforce employed in the shared service organizations (SSO) in case of different events which process should have to follow. It is called event-management. The work of employees in these organizations is very similar to classic industrial assembly or manufacturing model but interpreted for services. That is why it is called process-driven organization.

The most frequent appearance of shared service model is captive center that is an organizational unit with the aim to re-manage certain services – that delivered for a broad scale of organizational units – in a specific service center. (Bodnár,2006:277)

Captive centers were originally established for getting cost-benefits and lately they were one of the main drivers of offshoring projects. Captive centers deliver internal services exclusively only for units of parent organization. However there are similar organizational units that deliver services not only for internal units but for external partners, it is called shared service center.

As I mentioned earlier the original target of using shared service model was cost-cutting but nowadays its judgment had been changed greatly. They are considered such strategic business units those aim to reach service and operational excellence. In line with it the service portfolio of shared service centers were also extended. These days centers include more complex and knowledge-based processes like R&D, sales or marketing which are closer to traditional core business. There are a lot of drivers for establishing of shared service center but the most important are the followings:

- improved services, reduced costs;
- standardized services and processes;

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- diminished administration costs;
- supporting corporate strategy;
- grouping similar tasks and demolishing redundant processes;
- favoring progress;
- facilitating introduction of new technologies;
- improving working capital.

Shared service centers could be realized in many forms. They could be regional or global, could have one or more functions, could be co-local or virtual, could operate on onshore or offshore location. According to market-experts (Tracy, 2012) shared service model includes many kind of service delivering models where the model-choosing depends on the nature of service delivered. The most notable ones are the followings:

- Center of scale: high volume, routine transactions through standardized processes.
- Center of excellence: delivered services need deep and specialized knowledge. Typical services: internal bank services, risk management, external reporting, procurement, etc.
- Business partnership: delivered services need high communication and coordination skills, decision-sensitive and based on local/specific knowledge. Typical services: internal finance reporting, earning analytics, business analytics and human resource support.

So according to Tracy the center of excellence (CoE) model is one of the shared service forms. However according to other experts (Garg, 2012) the conception of CoE was emerged in line with the shared service model and focusing on the abilities and professional knowledge. Center of excellence model could be interpret as next step for shared service centers. This organizational model differs mainly in employing of talents and exploring sources of added value.

## **2. THE PURPOSE OF THE RESEARCH**

The aim of this research is to explore the role of center of excellence on the global sourcing market. I collected the differences between SSC and COE. Finally I want to discover the main characteristics of it and make order in the mess around the many types of center.

## **3. METHODOLOGY**

Besides the literature review I collected some global center of excellence case studies (Aviva, Infosys, Boeing) to discover the real results of establishing and operating centers. I analyzed the case studies to draw some conclusions about the criteria of success and the main challenges.

## **4. CHARACTERISTICS OF COE**

The concept of center of excellence is nowise new on the global business service market. CoE strategy had already been used in favor of different aims in the last decades but mainly for the sake of establishing centers that shares accumulated knowledge and builds capacity on different fields like pharmacy, car industry, telecommunication or for such an areas like innovation, technological



improvements, R+D, testing, etc. In the business service sector using of CoE model contributes to improve flexibility, productivity, cost and resource-efficiency.

Center of excellence is an organizational unit that embodies a set of capabilities that has been explicitly recognized by the firm as an important source of value creation, with the intention that these capabilities be leveraged by and/or disseminated to other parts of the firm. (Frost, 2002)

Earlier companies had to choose between in-house and third-party solution. Formerly means company consolidates and standardizes processes by own, the latter one means company outsources it to an external partner. By maturing of service market the decision moved to direction of value creation. In line with it companies began to experiment with several different organizational models (captive center, outsourcing, shared service, BOT, etc.).

During their operating shared service centers could accumulate huge amount of knowledge on the field of process optimization and dispose such as technologies that are applicable for other service areas of the company perfectly. Nowadays those companies that utilize shared service model for consolidating back-office functions recognized that it is worthy to use shared services centers on such areas that are more close to the core business functions. Delivering not only traditional supporting functions but such ones that could foster growth, improve global efficiency and reduce costs and therefore connect to the main targets of company. Extension of shared service center functions makes further cost-cutting possible, enhancing service level, improving organizational control and higher corporate consistency. Centers could integrate services that have higher positions in supply chain.

Managers of shared service centers are also aware of it and the traditional process reengineering and continuous improving are not enough to reach further cost-cutting. It needs to establish radical innovation. Radical innovation means changing value creation. Company have to turn to radical process innovation-based saving from the scale-based saving. It is not about improving administrative processes but reforming commercial processes. There are considerable unexploited efficiency improving sources on the field of sales.

Shared service center could position itself within the company as an efficiency-center or innovation center. This thinking could alter key players of model. Not chief financial officer but sales manager should be one of the main stakeholders of shared service model. Therefore the commodity will also alter and no more services but efficient improving knowledge will be sold by the company. (Daleske,2012)

#### 4. COMPARING SSC AND COE MODEL

Center of Expertise (CoE) that called many times as “knowledge center” makes for organization possible utilizing its knowledge to contribute cost cutting and service level improving. Similar to shared service centers CoE also simplify working, so fewer person also could do it and reduce the fragmentation of it to enhance productivity of companies while using less resources. Distinctly from shared service centers that create value in reducing cost of service delivered to organizational units, center of excellences aspire after exploiting capacities rather necessary cost-cutting. So many times center of excellences augment expenses in favor of utilizing knowledge and experiences for reducing total cost. (Hogan,2011)

Nowadays several companies deliver services to other companies from their center of excellence. This model combines outsourcing and shared service with center of excellence model to deliver higher value-added services.

According to some points of view the main differences between of shared service centers and center of excellence are concluded in the next table.

**1. table: comparing shared service center and center of excellence**

	Shared Service Center (SSC) model	Center of Expertise (CoE) model
Philosophy behind the model	Center of scale, industrial production model	Advisory organization, consultative service relationship
Nature of services	Rules-based	Judgment-based
Value proposition	Lower cost, greater efficiency	Improved business outcomes
Process of value creation	Focus on optimization and efficiency, asset consolidation, lower cost location	Access to otherwise unavailable capabilities, higher level skills and experience
Criteria for choosing location	Cost is primary	Cost is secondary
Criteria for labor selection	Availability is primary	Capability is primary, cost is secondary
Organizational structure and governance	Service levels, customer service procedures and costs are negotiated directly with internal customers, self-contained organization	Service levels and customer service procedures are negotiated between functional heads and internal customers, usually reports to functions
Measurement systems	Quantitative, output-based	Evaluative, outcome-based
Ensuring customer service	Account managers, service desk and/or call centers	The actual professional who do the work
Demand for services	Continuous	Episodic, event-driven

**Source: (Hogan, 2011)**

Center of excellence is an organizational unit that during doing its own work – as a secondary task – improves its knowledge and experience. It fosters the work of other units and contributes to the progress of the whole organization. Center of excellence consists of functional or cross-functional teams that endeavor to gain new knowledge or experience inside or outside of the company. Teams could be physically or virtual but they exist mainly permanent rather like project. Knowledge-management is a significant characteristic for center of excellence.

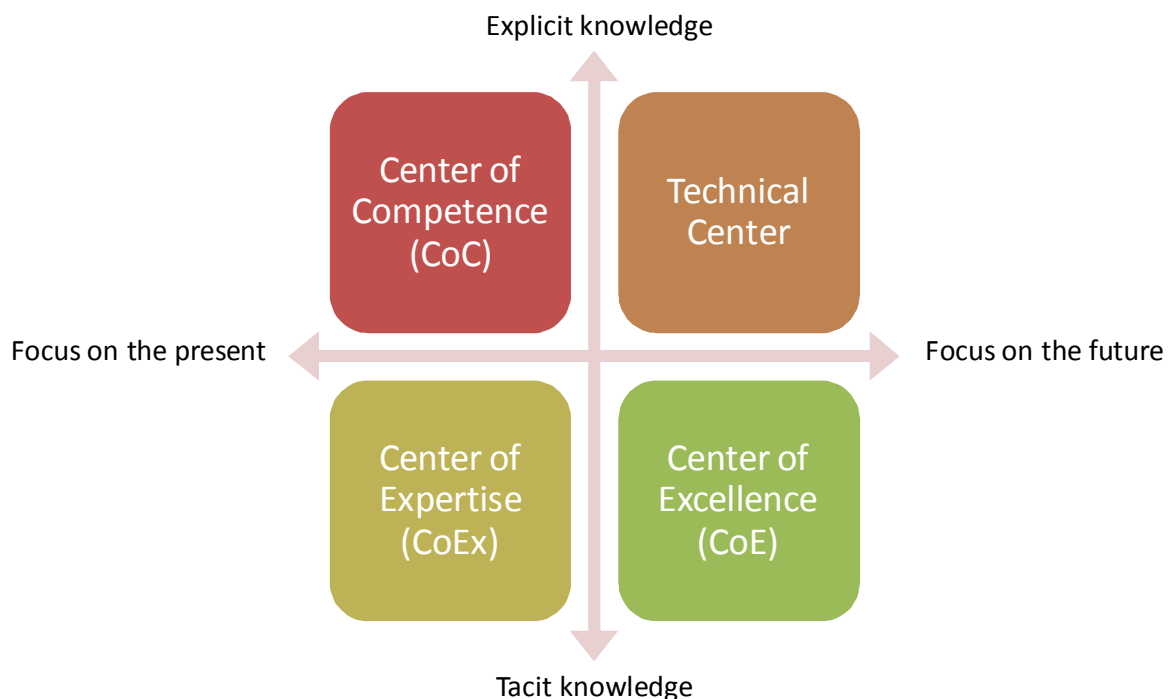
Term of CoE does not mean that the work of other organizational units is not important or maybe less valuable. These units also have to fulfill the prescribed service level but there is no plus task of developing. Over doing own work CoE has to elaborate good practice and disseminate it among the other units of organization.

## 5. GROUPING OF CENTERS

In the literature there are a lot of centers that have similar title to CoE like center of competence, center of expertise and technical center. I found a huge mess around these centers so I tried to clarify the difference among them.

These centers could be categorized by two axes according to focusing on the present or the future and the knowledge is explicit or tacit. (Bryan, 2011)

### 1. figure: grouping of centers by types of knowledge and time-focus



Source: (Bryan, 2011)

The main expectation of the employees in Center of Competence (CoC) is following the regulations and solving problems as quickly as it possible. So these employees concentrate on the present and use mainly explicit knowledge. In favor of developing human resource is motivated to consult with the experts of CoE if they meet new or odd problems. It is also advocated to give feedback about their work to utilize it lately for the sake of organization. Sharing of problems and experiences and creating new knowledge is mainly ad-hoc. Routine procedures explain only the work processes and do not answer the “why”. Human resource has the competence to carry out the work and can work on different fields but they are not specialists and subcontractors may be part of work force.

In the technical center employees have to absorb tacit knowledge from the field and using the field documentation to codify this to explicit knowledge for the future. Problems are formally recorded and there is mainly explicit knowledge sharing. There are structured researches on the existent work fields. Employees who work here could think on more abstract way and could work with huge amount

explicit data. The delivered services of technical center are drawn on by other organizational units or external partners. Processes and procedures are refresh according to industrial practices and expectations. Employees focus on the future and often work like a project.

In the Center of Expertise (CoEx) employees could deal with more complex and unique problems. Problems and experiences are usually shared within the center. Employees are motivated to be creative and knowledge creation as it is a tacit knowledge. Employees also follow regulations but could see big picture as well and solve more complex problems. They have to possess better interpersonal skills in the sake of professional supporting within the organization but because of customer service as well. Team could be physical or only virtual. Teams consist of experts who need special trainings. Center of expertise has clear product and service focus. Knowledge of center utilizes by experts that could be also external partners. Procedures explain work processes and systems with specialized details. Centers are characterized by open organization culture that focuses on the present

In Center of Excellence (CoE) employees have extensive capabilities, important professional experiences that make them possible to deal assignments as practical as on abstract ways. These centers play important role in identifying decisive problems and preparing avoidance of them in the future. Creating new knowledge total freedom is essential for center of excellence. Problems and experiences are collected from all units of organization. Employees share their knowledge within center of excellence but with employees of CoC and CoEx as well. Tacit knowledge is articulated in the whole organization. There are successful knowledge management systems where processes and procedures are changed according to uncover new knowledge. Intra-organizational communication is very often among business units and departments. Employees could recognized whether a problem-solving need codify in regulations and prescriptions or it is enough if disseminate it on the next meeting or training. Workforce could adjust to new systems easily because it consists of high-skilled specialists. Experts create physical or virtual teams that managed by a coordinator. Organizational culture motivates team-work and the emphasis is on the innovation, creativity and future improving.

In center of excellence utilized structures, systems and work-methods foster intra-organizational communication and the sharing of results in problem-solving. They also contribute to create unique and local problem-solving to create explicit and tacit knowledge and help in disseminate them in the organization. Through the process of sharing problem-solving solutions employees could learn from each other and have possibility to improve themselves and the organization. Wenger (Wenger, 1998) described it as a professional community (community of practice – CoP). Center of excellence could operate as a community of practice.

Used the experiences of establishing transactional shared service centers it could be determined several challenges that could be useful at extension or rebuilding them as a center of excellence. These are the followings (Bryan, 2011):

- Organizational culture is key to the efficient transition.
- The extension of change, the fear of loss of control and the resulting level of resistance will increase in direct proportion to the proximity of the function being shared to customer-facing and core functions.
- Understanding of real cost of investment and time that is necessary to realize it could help to make better expectations.
- Effectiveness of implementation is directly correlated with amount, quality and consistency of leadership support.

- Sticking to executive decisions is essential keeping organization focused.

Establishing a center of excellence it is worthy to listen to the following factors (Hogan, 2011):

- Center of excellence efforts could not be successful without participation of stakeholders. Stakeholder education and communication is essential, especially for leaders on fields may be affected.
- Executives should be aware that greater initial investments required to establish a center of excellence than a setting up a transactional shared service center.
- Attraction, retention and engagement of talents are key issues for center of excellence to employ high educated and skilled workforce.
- Creating knowledge-based and analytical service, defining clear and measureable performance metrics and service-level agreements mean great challenges. It is vital to measure all of functions regularly, define the goals of CoE carefully, establish appropriate customer expectations and enable meaningful customer feedback by applying performance measurement tools.
- It is required to use of highly sensitive data for certain knowledge-based functions that could contribute the competitive edge of company. Protecting this data is vital for center of excellence, especially if it operates on an offshore location or it is outsourced.

## 6. CONCLUSION AND SOME CASES

Establishing center of excellence could be effect apparently a win-win situation but there are several challenges that could come up during operating a successful center of excellence. Companies that establish CoE need making a long term, comprehensive cost-conscious business plan to determine how could transform a profit center from a cost center.

There are more success stories about using center of excellence to improve organizational efficiency. In 2004 Aviva insurance company made a BOT (Build-Operate-Transfer) deal with three Indian BPO service delivery companies (24/7 Customer, WNS Global Services, EXL Service) for offshore financial services. According to the agreement the companies established, operated and in 2007 transferred this financial center as center of excellence to Aviva global insurance business unit. Center of excellence centralized successful the resources, standardize the processes, shared the strategic knowledge and contribute remaining and improving operating excellence.

As Bank of America faced with the challenge of disparate IT systems, adopted Infosys' Testing Center of Excellence to improve the effectiveness. Over three year the CoE enabled the client to scale up existing services and offer new services with higher quality, lower cost and shorter delivery time. The testing cost savings was about 45%, but economies of scale lead to further incremental unit cost decreasing.

Boeing dealt with HP to improve availability of business critical applications, enable availability of best practices and empower applications teams to take ownership of system availability and performance. HP succeeded to reduce service time by 90%, number of employees by one-tenth, annual labor cost by about 1 million US dollar.

These cases show clearly there is a huge potential in center of excellence. All those companies that used shared service centers for supporting functions may be a good option for further progress.

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**INFORMATION BASE OF ECONOMIC SECURITY OF REGIONAL ECONOMY:  
MODERN PROBLEMS OF FORMING**

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**Abstract**

*The article is devoted to the questions of formation of information base for the aim of providing economic security of regional economy. The author gives the classification of information sources by level of receiving and collection of information and origins of information. The analysis of the basic problems of official information sources is made, including inconsistency and infringement of system principle.*

**Key words:** *economic security, regional economy, information base, origins of information, receiving and collection of information*

**1. INTRODUCTION**

For the Russian Federation increase of distinctions between subjects of the Russian Federation on a standard of living that can lead to increase of social tension in society is characteristic, to aggravation of the international relations. At this conjuncture problem economic safety gets paramount value, becomes core of all economic policy the states, forms priorities of political and economic decisions, among which to the person the place borrows stimulation of development of economy subjects of Federation.

Problems of economic safety are widely discussed in modern economic literature (L.Abalkin, A.Gorodetsky, V. Senchagov, E.Bukhvald, etc.), however the majority of researches of problems of economic safety is devoted to studying of its national level. At the same time it should be noted that a basis of national security of the country is social and economic safety and a sustainable development of subjects of Federation. That development of the Russian regions is in a stage of emergence and increase of new threats of safety that is in many respects caused by a federal state system is important also.

The analysis of standard and legislative documents in the field of economic safety testifies that the regulations devoted to ensuring of economic safety, both on national, and on regional levels in recent years are adopted. However the administrative aspect of ensuring economic safety continues to remain insufficiently studied. Besides, regional authorities have no sufficient scientific and methodical and information base, have no sufficient practical mechanisms of management of social and economic processes that considerably reduces efficiency of economic safety at regional level. It does necessary consideration of information base and information sources as basis for improvement of a control system by economic safety of the region.

## 2. LEVELS OF INFORMATION BASE OF MANAGEMENT IN RUSSIAN REGIONS

The system approach in ensuring effective management with economic safety of the region assumes: to define system of the governing bodies which activity influences economic safety of the region, to reveal interrelations between them; to create information base of management; to establish information interrelations between various levels of management; to develop a complex of operating influences and the monitoring system of their results.

The important place in management of economic safety at regional level belongs to formation of information base. Collection of information, its processing and the analysis should be carried out in volume and a look, sufficient for disclosure of a condition of security of economic safety of the state from destructive influence of factors. Requirements to contents of monitoring information should consider a wide range of her consumers at federal, regional and municipal levels [1].

For the Russian economy high level of differentiation of level and potential of development of separate regions therefore for regional level of an assessment of economic safety it is necessary to consider volume and structure of investments into regional economy, including capital investments in fixed assets, volume of own agricultural production, a standard of living, an employment rate, number of small enterprises and other indicators characterizing a social and economic situation of the region [2] is characteristic.

Problem of municipal monitoring of economic safety is providing information to local authorities about number of the unemployed and unemployment structure, a monthly average salary and the added pension, structure of educational space and its quality, quality and availability of services of health care within obligatory medical insurance and on a paid basis, development of system of social protection, about a crime rate and other factors characterizing social and economic well-being of local community and a condition of economic safety in it [3].

## 3. CLASSIFICATION OF ORIGINS OF INFORMATION

As information sources at management of economic safety of the region various databases can act. Sources of information can be classified on different signs. On collecting and receiving level:

- information of the international level (data of the international researches, rating agencies, etc., socio-economic indexes providing an external assessment and economic processes of the Russian economy);
- information of federal level (data of the federal ministries and departments, federal funds of mass information, sociological polls in scales of the country, researches at federal level of the independent organizations);
- information of regional level (data of regional governing bodies, regional public organizations, regional mass media, expert community on a condition of economic safety of the region);
- information of municipal level (data of local governments, public organizations, municipal mass media on a condition of economic safety in municipality).

By origin information:

- official information (given standard acts, the concept, the state-of-the-art reviews, proceeding from federal, regional state governing bodies, and also local governments, including placed on official sites);



- information of public organizations, mass media and expert community (such information can have not always objective character, but thus reflects moods of certain sectors of society);
- information proceeding from citizens (the letter, addresses, information in Internet blogs etc.).

The information base which is available now in official sources, is rather extensive and covers wide aspects of a social and economic condition of the country as a whole, subjects of federation, municipalities. So, for example, data on number and structure of the population are formed by Federal service of the state statistics on the basis of the All-Russia population censuses [4]. The federal migratory service owns information on volume and migration structure. Including in a regional cut. Ministry of health and social development accumulates data on level and quality of medical and social services, incidences, disability, about employment and unemployment. The Ministry of Education operates with information on structure and quality of educational space, an education level of the population of Russia, on the state and private educational organization: general educational, initial, average and the highest professional, and also postgraduate education. It is possible to judge level and quality of regional development according to the Ministry of regional development. Data on realized economic programs, investments into economy, development of economic activity gather the Ministry of economic development. Sources of information on scale of impact of economic activity on environment and the natural resources defining ecological safety, are data of the Ministry of Emergency Situations on failures of technogenic character, fires, natural disasters and other abnormal natural phenomena, and also data of ecological services on level of pollution of surrounding environment. Data on offenses and crimes of an economic orientation are formed by the Ministry of Internal Affairs. As sources of information on financial safety data of the Ministry of Finance, etc. [5, 6] can serve.

However from system positions this information is very separated, often data of the ministries and departments aren't connected among themselves. Therefore formation of complex information base in which the indicators characterizing economic safety, from all ministries and departments would arrive is necessary. In this base it is necessary to provide the accounting of these informal sources (look the classification offered above). Thus it is necessary to define the accurate list and structure of indicators for all levels of management. Governing bodies of regions and local governments should have the right to expand this list, and also it is necessary to provide a duty of providing such information in federal information base with a certain periodicity (not more rare than once a year). Probably, creation of the Ministry of economic safety, or formation of information base of economic safety within the Ministry of economic development would be expedient.

It should be noted that the structure of observable socio-economic indexes is rather wide now that provides ample opportunities for the all-round analysis by means of which it is possible выявить for a tendency, to construct forecasts, scenarios social and economic development, to state an assessment of influence of administrative decisions on economic safety. The economy is difficult system, therefore, can be described by a set of indicators. As the most indicative example it is possible to address to official tables of a forecast of social and economic development of Russia for 2009-2011 [7]. There contains more than 300 indicators relating to various fields of activity, from which, according to the Center of financial and bank researches of Institute of economy of the Russian Academy of Sciences, the most significant are 19 indicators [8].

#### 4. TREATS OF ECONOMIC SAFETY OF THE REGION AND INFORMATION

Criteria of economic safety reflect those indicators of social and economic development of the region which form concept of economic safety. Criteria are formed proceeding from allocation of the main risks or threats of economic safety of the region. Threshold values are necessary to define, as far as the economy of the region is close to that level when economic safety is absent (the region is in economic danger).

As threats it is possible to consider the negative tendencies destabilizing economy of the region:

- decline in production and loss (concession) of domestic market;
- curtailment of research and development, disintegration of research teams, reduction of orders for hi-tech production, domination of raw branches at reduction of a share of the finishing;
- loss of food independence;
- growth of unemployment and weakening of labor motivation;
- corruption, bribery, economy criminalization;
- environment degradation;
- constant disproportions in financial security of territories;
- loss (concession) of foreign markets [13].

Crisis situations are the main source of threats of economic safety of regions which do vulnerable national safety of the country and can threaten it in cases:

a) when action of separate factors of destabilization (or their sets) reaches such degree of a sharpness at which can be observed

irreversible changes in these or those spheres of an economic complex of the region that affects, first, economy of adjacent territories, and, secondly, on economy of the Russian Federation and demands long-term and highly expensive efforts of the center;

б) when elimination of a crisis situation in the region becomes possible only at intervention of federal bodies and superlimit financing from the centralized sources (the federal budget) [12].

From the point of view of regional the same management it is possible to tell about crisis situations in municipalities. It should be noted that for municipalities – mono-cities increase of threats of economic safety can demand intervention not only regional, but also the federal authorities (we will remember, for example, a situation in the city of Pikalyovo of the Leningrad region).

Positive experience of separate regions in the field of monitoring of the indicators characterizing social safety, their experience in creation of concepts of economic safety, monitoring, collection of information, should be used for formation of uniform information base on management of economic safety. It is necessary to give special attention to the accounting of opinions of citizens, experts, mass media, public organizations and other institutes of civil society.

It is necessary to define the list of indicators, the indicators forming information base of management of economic safety.

## 5. REQUIREMENTS TO INFORMATION BASE OF DECISION-MAKING TAKING INTO ACCOUNT ECONOMIC SAFETY

Formation of information base is necessary for carrying out taking into account its distribution on spheres and economy sectors. So, it is necessary to form databases about economic growth in real sector of economy, dynamics of investments into fixed assets; about a condition of a financial system at federal and regional levels; about a level of development of economy of public sector; about an assessment of volume of shadow economy.

Information on a condition of real sector of economy should gather both on municipal, and at regional level, with the subsequent association to federal information base, taking into account these informal sources, including external. The possible structure of indicators was noted earlier. Sources of information are: Ministry of economic development of the Russian Federation, Ministry of Finance of the Russian Federation, Ministry of health and social development of the Russian Federation, Ministry regional development of the Russian Federation, Ministry of transport of the Russian Federation, Ministry of Internal Affairs of the Russian Federation, Ministry of Communications and mass communications of the Russian Federation, Federal Treasury and other authorities, and also information of independent analytical agencies, experts etc. Carrying out the sociological polls allowing in due time to reveal new threats to economic safety, including at regional level (connected, for example, with economic crimes of managing subjects, development of schemes of leaving from taxes, etc.) is expedient.

Regional economic security forms national economic security therefore alignment of social and economic development of separate regions lowers level of threats for the country as a whole. «Regional features predetermine all set of threats and the dangers influencing not only safety of this region, but also the country as a whole» [12].

It is necessary to take also into consideration ecological safety as it is directly connected with economic activity, besides ecological safety can't be completely reached within one country (a problem of cross-border pollution). The ecological doctrine of the Russian Federation [13] as a strategic objective puts preservation of natural systems, maintenance of their integrity and providing functions for a sustainable development of society, improvement of quality of life, improvement of health of the population and a demographic situation, ensuring ecological safety of the country. Therefore collection of information about emissions of polluting substances in environment and construction of treatment facilities, proceeding from data of the relevant ministries and departments, and also the ecological organizations is necessary.

Important feature of the Russian economy is the shadow sector which forms numerous threats of economic safety of the state in all spheres of economy. Therefore it is necessary to include in information base data on shadow economy, including expert estimates.

In summary we will note that formation of uniform information base of management of economic safety on the terms of continuous updating will allow to increase considerably efficiency of administrative decisions, makes active their preventive character.

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**MANAGEMENT OF SUSTAINABLE RURAL TOURISM DEVELOPMENT  
IN THE COUNTY OF ISTRIA**

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**Abstract**

*The County of Istria is the leader in the Croatian rural tourism offer. In order to remain the leader in the future, analysis of the achieved results should be conducted, and guidelines should be proposed for improvement and development of the offer in the rural Istria. Special attention should be devoted to the fact that the Istrian Peninsula is a single territorial unit divided among three countries: Slovenia, Croatia, and Italy. Since the Republic of Croatia is about to become a European Union Member State, it is necessary to design a joint development strategy and marketing activities with the goal to ensure sustainable development of border areas and rural tourism of Istria in the new – European environment, which will provide the possibility of new economic and sociodemographic prosperity of the inland and border parts of Istria.*

**Key words:** *sustainable development, rural tourism of Istria, tourism of the Republic of Croatia*

**1. INTRODUCTION**

Ensurance of sustainable development has become a basic goal of contemporary society, because there are doubts that previous, in many aspects unplanned, development has led to disbalance between the use of resources and development potentials. This is especially visible in spatially limited areas such as, for example, the Istrian Peninsula, mostly located in the Republic of Croatia, while a smaller part of the Peninsula is located in the neighbouring countries Slovenia and Italy. Istria can achieve its sustainable development through further development of its rural tourism offer; it has become the Croatian leader in this segment. When the Republic of Croatia joins the European Union, there will be new development possibilities, as well as improvement of the rural tourism offer through more active co-operation with cross-border municipalities of the Istrian Peninsula located in Slovenia and Italy. Creation of a joint offer, standards, uniform quality of service, through stimulation of balanced development of rural areas of the Peninsula, will achieve further strengthening of competitive advantages of the Istrian Peninsula in relation to the neighbouring tourist regions, as well as sociodemographic and economic revitalisation of rural, mostly underdeveloped areas. Istria, in many aspects, represents a unique space, with various possibilities for developing different forms of the selective tourism offer, from health-, hunting, religious, sports, marine, ecological, cultural, to rural tourism, which represent a unique tourist blend in the form of an integrated offer. It should be included in all development and marketing programmes of the Istrian Peninsula and the respective home countries. A joint development and marketing strategy will prevent imbalance in development plans

and processes in the neighbouring areas, the potential implementation of which would lead to disruption of landscape and of sociodemographic unique characteristics of the Istrian Peninsula.

## 2. THE FOUNDATIONS OF RURAL TOURISM DEVELOPMENT IN CROATIA

Rural tourism in Croatia started developing over the last decade of the 20<sup>th</sup> century, when, after a few failed attempts of development of the rural tourism offer, at the beginning of the 1990's, legislation prescribing tourism activities was adopted on the initiative of the Croatian Peasant Union, Institute for Tourism and the company Hrvatski farmer d.d. According to the definition of the Council of Europe, rural tourism is tourism in a rural area accompanied by all the activities which take place in this area. Advantages of rural tourism are peaceful environment, absence of noise, preserved natural resources, communication with the hosts, home-made dishes, learning about farmwork.

(<http://www.geografija.hr/clanci/347/ruralni-turizam-u-istri-dokaz-da-hrvatski-turizam-moze-i-na-drugi-nacin>). Rural tourism is very significant for Croatia. Since Croatia is predominantly a rural country, i.e. 91,6% of the total surface of the Republic of Croatia is classified as a rural area, as much as 88,7% of the settlements are located in rural areas, while 47,6% of total population lives in rural areas. (<http://www.odraz.hr/media/50356/ruralni%20razvoj%20i%20leader%20u%20hrvatskoj.pdf>). Development of Croatian rural tourism offer has provided, or has, all the development possibilities for future economic sustainability of rural areas, providing the population the possibility of employment in tourism and education for tourism, which has indirectly influenced improvement of the population's standard of living, sustainable development of rural areas through their revitalisation, preservation of local traditional heritage (construction, customs, crafts), etc. Unfortunately, the Republic of Croatia is still recognised around the world as a mass tourism destination, based on the sun-and-sea offer, and this product has reached its peak. Its negative features were especially manifested during the Croatian War of Independence. This is why development of the selective tourism offer, which also includes rural tourism, represents a new development possibility for the entire country, especially its rural areas.

**Table 1:** Tourists' Arrivals and Overnights in Types of Accommodation Facilities – peasant farms ( )

	ARRIVALS						OVERNIGHTS					
	I-X.2011.	2010.	2009.	2008.	2007.	2006.	I-X.2011.	2010.	2009.	2008.	2007.	2006.
<b>Peasant households – total number of</b>	4.616	3.703	4.340	4.091	2.666	$\frac{2.884}{3.011^*}$	13.193	9.298	12.654	14.268	10.834	$\frac{12.616}{12.847^*}$
<b>Peasant households – domestic tourists</b>	2.736	2.206	2.664	2.047	1.301	$\frac{1.223}{1.328^*}$	7.423	5.087	6.670	6.126	4.909	$\frac{4.049}{4.241^*}$
<b>Peasant households – foreign tourists</b>	1.880	1.497	1.676	2.044	1.365	$\frac{1.661}{1.683^*}$	5.770	4.211	5.984	8.142	5.925	$\frac{8.567}{8.606^*}$

Source: HGK, data obtained via E-mail, received on: 10/01/12 -lmiscin@hgk.hr

The above table 1. shows increasing number of visitors over the past five years, except in 2010, when a decline in the number of visitors and the realised overnights was recorded on the national level.

The problem in designing future rural tourism development on the national level is non-existence of information on the number of tourist peasant farms, i.e. the last available data date from 2007 (according to the data by the Croatian Chamber of Commerce).

### 3. RURAL TOURISM OF THE COUNTY OF ISTRIA TODAY

Istria is the largest Croatian peninsula in the Adriatic Sea. It is located in the northern part of the Adriatic on the territory of Slovenia, Croatia, and Italy. Geographical border of Istria follows the line from the Milja cove (Italian Muggia), to the Preluka cove. The Croatian part of Istria comprises about 86% of the territory of the entire Peninsula. The western part of the Kvarner Bay was in 1993 administratively separated from the rest of the Istrian Peninsula in the Republic of Croatia, so that Istria is divided between two counties: the County of Istria and the County of Primorje-Gorski Kotar (adapted according to: <http://hr.wikipedia.org/wiki/Istria>). Rural tourism development in the County of Istria became stronger in the 1990's, when numerous foreign experiences were used in rural tourism offer development, especially from the neighbouring Italy. Rural tourism development in the County of Istria was initiated with the goal to disburden coastal and urban centres, and with the purpose to strengthen rural economy and provide new programmes for cultural and historical heritage. The publication „Agrotourism“ was promoted by the Department of Tourism and Trade in the County of Istria in 1997. At the same time, financial support was ensured by contracting a credit line with Raiffeisen bank Austria d.d., with the purpose to adapt all buildings for tourism. In 1999, promotional material 'Agrotourism – Rural Tourism – Ecotourism' describes 27 facilities classified in rural tourism categories. Except for tourist peasant farms, they also include taverns, restaurants and similar facilities. (Adapted according to: <http://www.geografija.hr/clanci/347/ruralni-turizam-u-istri-dokaz-da-hrvatski-turizam-moze-i-na-drugi-nacin>).

Existence of the Ruralis - Association for Development of Rural Tourism of the County of Istria proves that the County of Istria has made progress in rural tourism development. Ruralis was founded with the goal to stimulate and support suppliers of Croatian rural tourism. A special evaluation system of individual facilities was designed; they are classified according to the asparagus mark. Conditions for categorisation of the facilities are synchronised with those of the European Federation for Farm and Village Tourism, Eurogites

(<http://www.eurogites.org/member.php?lang=EN&id=HR>). The Association for Rural Development of the County of Istria has developed a marketing typology for rural tourism accommodation facilities in Istria, which differentiates between the accommodation offer on peasant farms – agrotourism, rural vacation houses, rural family hotel and boarding houses, rural B&B, and holiday on wine roads (<http://www.ruralis.hr/>). According to the Ruralis<sup>42</sup> data – Association for Development of Rural Tourism of the County of Istria, as much as 81,6% of the territory of the County of Istria is rural area, on which there is 81,9% of the settlements, inhabited by 36,3% of the population. Rural tourism makes about 1,6% of the total tourism of the County of Istria, in 420 households with 3100 beds.

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<sup>42</sup> Data obtained by direct contact with the Agency for Rural Tourism Development of Istria – Ruralis were used in the paper. The contact was made via E-mail on 11/01/12 and 22/02/2012. – the contacted person: Robert Baćac, [office@ruralis.hr](mailto:office@ruralis.hr)

**Table 2:** Types of Accommodation and the Number of Beds in Rural Tourism of the County of Istria, in accordance with the RURALIS' marketing typology in 2011.

TYPES OF ACCOMMODATION (in accordance with the RURALIS' marketing typology)	NUMBER OF HOUSEHOLDS	NUMBER OF BEDS	NUMBER OF BEDS /HOUSEHOLD
PEASANT FARM (agrotourism)	58	254	4,38
RURAL VACATION HOUSE	322	2.359	7,33
RURAL FAMILY HOTEL/BOARDING HOUSE	10	238	23,80
RURAL B&B	23	211	9,17
HOLIDAY ON WINE ROADS	5	22	4,40
"STANCIJA" <sup>43</sup>	2	16	8,00
TOTAL	420	3.100	7,38

Source: Ruralis, data obtained via E-mail, received on: 11/01/12 and 22/02/2012.

In the County of Istria in 2011, the most represented accommodation facilities were rural vacation houses. There are 322 vacation houses, or 76,66% the total accommodation facilities, while the number of beds amounts 2359, or 76,09% of total accommodation facilities. There are 58 tourist peasant farms in Istria (agrotourism) with 254 beds, 10 rural hotels/boarding houses with 238 beds, 23 rural B&B's with 211 beds. Holiday on wine roads is offered in five facilities, which have at their disposal 22 beds, while in the entire County of Istria there are only 2 "stancije" with the total of 16 beds. The average number of beds in accommodation facilities, in accordance with the marketing typology of the Ruralis, amounts 7,38 beds. (Table 2)

**Table 3:** Changes in the Number of Overnights, Tourists and Revenues (in mil.€) of Rural Tourism in the County of Istria in the Period from 2008 to 2011

INDICATORS PER YEAR	INDEX						
	2008	2009	2010	2011	2009/2008	2010/2009	2011/2010
OVERNIGHTS	111.350	124.712	133.441	142.781	112,00	107,00	107,00
TOURISTS	15.627	17.502	18.727	20.037	112,00	107,00	107,00
REVENUES (IN MILLIONS OF EUROS)	5,1	6,2	6,7	7,3	121,57	108,06	108,96

Source: Ruralis, E-mail received on: 11/01/12 and 22/02/2012.

<sup>43</sup> Stancija - renewed and reconstructed old huge country rural farm with a goal of providing tourist services. Usually, it is separated from the village and inhabited areas with all the necessary infrastructure. It is characterised by a big estate with a building for stay (the main house) and agronomic buildings and again started agricultural production of one or more products typical for Istria.) Source: Adapted according to: [http://www.ruralis.hr/hr/standardi\\_klasifikacija\\_stancija.html](http://www.ruralis.hr/hr/standardi_klasifikacija_stancija.html) (20.03.2012)



The number of tourist stays in rural accommodation facilities in the County of Istria has been continuously on the rise. In 2011, there were 20,037 visitors who realised the total of 14,2781 overnights, while the average stay of tourists in rural Istria amounted 7,13 days. Increasing number of tourists is accompanied by increasing number of overnights, and in 2009, it amounts 12% more in relation to 2008, while increase in the number of tourists and the number of overnights in 2010 and 2011 amounts 7%. Revenues from rural tourism were continuously rising in the analysed period, and in 2008, they amounted 5,1 million euros, and 7,3 million euros in 2011. Thus, it may be concluded that revenue growth of 28,23% was recorded in the analysed period from 2008 to 2011. Analysis by years shows that the most significant revenue growth was realised in 2009 in relation to 2008, and amounted as much as 21,57%, while revenue growth in the following period was reduced. Revenue growth rates of 8,06% were recorded in 2010, and of 8,96% in 2011 in relation to the previous year.

By nationality, the greatest number of tourists in rural tourism of Istria, is that of German tourists with 65%, tourists from Great Britain with 10%, Austria and the Netherlands with 7%. Tourists from the neighbouring Slovenia participated in the total number of tourists of rural Istria with only 5%, the French make 4% of the visitors, and Italians 1%, as well as other tourists with the share of 1%.

In relation to sales of rural tourist services in Istria, according to data provided by the Ruralis Association, tour operators participate with 80%, Internet with 15%, brochures and catalogues 2%, while other sales channels (reports, advertising, specialised guides) have a share of 3%. (Table 3.)

#### **4. STRENGTHENING OF RURAL TOURISM IN THE COUNTY OF ISTRIA THROUGH ESTABLISHMENT OF JOINT CROSS-BORDER DEVELOPMENT STRATEGY**

When the Republic of Croatia joins the European Union, the entire historical area of the Istrian Peninsula will become a single territorial unit, which will especially be pointed out when Croatia joins the so-called Schengen area, when the borders, which divide Istria among the three neighbouring countries, will also be symbolically removed. The Slovenian part of the Istrian Peninsula comprises coastal municipalities Izola, Kopar, Piran, and municipalities of Milje and Dolina are located in the Italian part of Istria (<http://hr.wikipedia.org/wiki/Istria>). In the new context, it is necessary to design the new joint development programme for the Istrian Peninsula in general, which includes tourism, and selective tourism offer, especially Istrian rural tourism, which has its development possibilities in the entire inland area of Croatian, Slovenian and Italian Istria, providing a unique possibility to connect the rural tourism offer with marine tourism offer. Rural tourism represents upgrade of the marine tourism offer, because inland parts of Istria are within reach in a relatively short period of time. The possibility of using cohesion funds of the European Union will also serve as stimulation for development of a joint tourist offer, which would be used to finance all the activities of joint tourist repositioning of Istria in Europe and the world. Neighbourly relations and cross-border co-operation are some of the basic development priorities of the European Union, through stimulation of the use of renewable energy sources and upholding sustainable development principles, all of which is manifested in Istria. Cross-border co-operation will provide the following advantages to the development of rural inland areas of Istria, which are:

- Forming of a joint working group – cluster for rural tourism development and cross-border co-operation Istra-Istria.
- Joint marketing strategies and implementation activities

- Stronger economic development based on sustainable development principles of the entire Peninsula
- Stopping negative demographic trends – especially in Croatian rural Istria
- Joint candidature of new original products, plants and animal species in the European Union as a special value of the Istrian Peninsula
- Forming of a recognisable brand of Istria as a unique tourist destination which promotes sustainability, tradition (through rural tourism), intercultural and international dialogue and co-existence, using the advantages of contemporary ICT technology and e-marketing through a joint website (colours, fonts, etc.), IPTV (programmes, blogs about the famous characteristics of Istria, etc.).
- Forming of a joint tourist offer: tours, creating a joint network of wine roads and olive oil roads, historical paths of rural Istria, joint gastronomic offer, etc.
- Synchronisation of development strategies of neighbouring countries in this sensitive Adriatic area
- Eliminating and minimising disputes which emerged in the course of history
- Possibilities of using financial resources by development- and commercial banks from the three countries, EU funds, and private investors

In order to achieve all of the above, it is necessary to stimulate co-operation on development of inland – rural Istria from national and local administration in all the countries. Technological and financial support must be provided to the above-mentioned projects.

SWOT analysis, which will provide an insight in the possible strengths, but also possible weaknesses of designing a joint tourist offer of inland – rural Istria, is presented below. (Scheme 1)

STRENGTHS	WEAKNESSES
<b>Increasing confidence between the population of border regions</b>	<b>Current lack of understanding and insufficient co-operation</b>
<b>Preservation of the environment, biodiversity and unique characteristics</b>	<b>Discrepancy between development and marketing plans</b>
<b>Creation of a joint rural destination brand of the Istrian Peninsula</b>	<b>Lack of political understanding between the countries</b>
<b>Improvement of living conditions of local population</b>	<b>Different development levels of the tourist offer in rural parts of Istria</b>
<b>Ensuring preconditions for improved business environment</b>	<b>Non-existence of joint projects in rural tourism in the past</b>
<b>Differentiation of the offer on the tourist market – achievement of competitive advantages</b>	
<b>Sociodemographic revitalisation of the inland – rural Istria</b>	

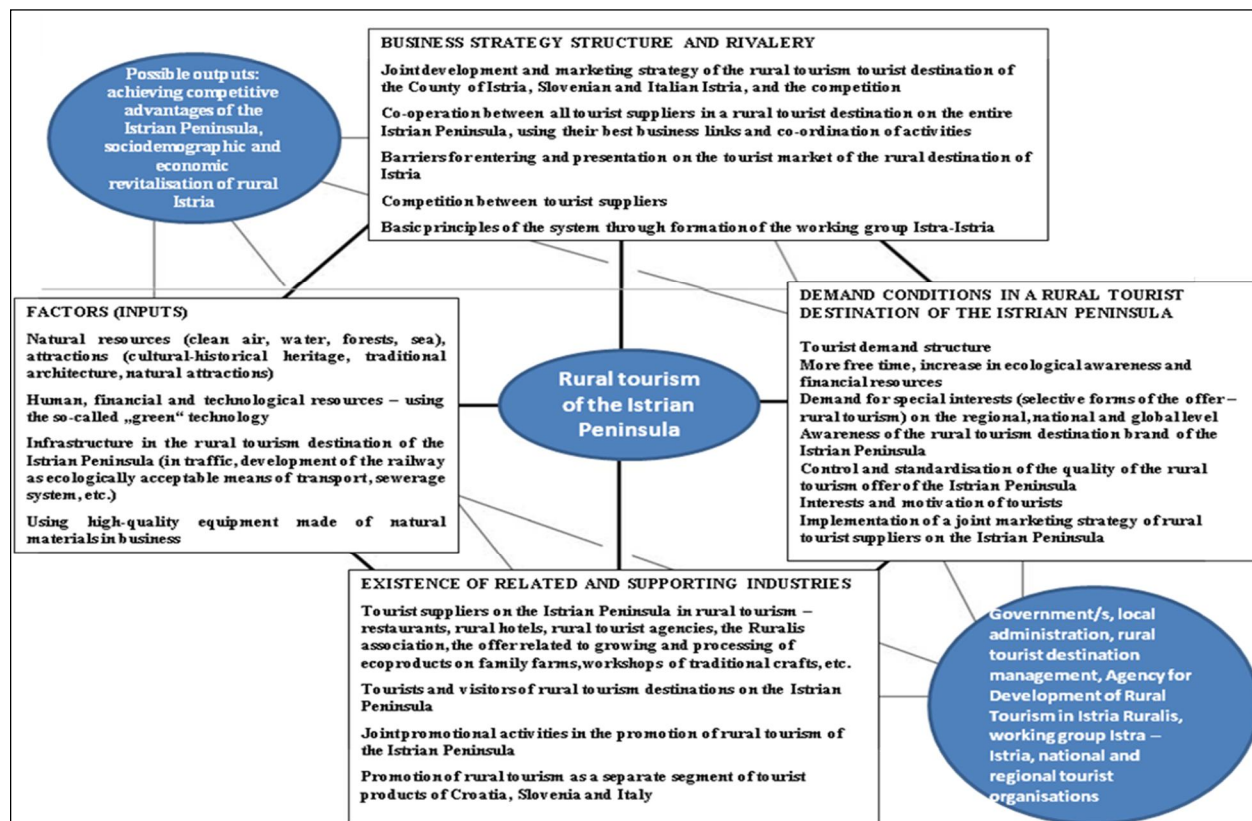
OPPORTUNITIES	THREATS
<p><b>Financing of rural tourism development projects in Istria through EU cohesion funds and commercial banks, and private entrepreneurs</b></p> <p><b>Joint marketing and development strategy – using contemporary ICT technologies in marketing</b></p> <p><b>Stimulation of investments in rural tourism development in Istria as a unique tourist destination of the Mediterranean through forming of a joint working group Istra – Istria</b></p> <p><b>Raising awareness of citizens and businesses, if necessary</b></p> <p><b>Strengthening of co-operation, confidence, preservation of unique landscape, traditional architecture</b></p> <p><b>Strengthening of the offer – joint marketing performance – rural tourism branding of the Istrian Peninsula</b></p> <p><b>Creation of equal development opportunities in the entire area of Istria</b></p> <p><b>Creation of joint business projects and offer</b></p>	<p><b>Lack of understanding of the local and business community for development of joint projects of rural Istria</b></p> <p><b>Growth of nationalisms</b></p> <p><b>Non-existence of co-ordination between project partners in individual countries</b></p> <p><b>Straining of relations</b></p> <p><b>Insufficient education of staff</b></p> <p><b>Insufficient financial support</b></p> <p><b>Insufficient use of EU cohesion funds</b></p> <p><b>Postponed accession of Croatia to the EU or the Schengen area</b></p>

**Scheme 1:** SWOT Analysis of Designing Joint Projects of Rural Tourism Development on the Istrian Peninsula

Source: Authors' adaptation

The SWOT analysis shows that this is a single territory located in the vicinity of the emitive tourist markets. It has been well-preserved ecologically, has rich cultural-historical heritage, pleasant climate, it is well-connected and the inhabitants have co-operated throughout history. Possibilities provided by a joint development and marketing strategy of rural Istria are numerous, and are primarily reflected in the preservation of the existing natural resources, traditional architecture, stimulation of sustainable economic development, and socio-demographic revitalisation of rural areas of Istria. Possible disadvantages of the above-mentioned development and marketing strategy, i.e. potential threats are lack of understanding and imbalanced development policies, strengthening of nationalisms, disinterested offer suppliers, inconsistent legislations, unfair competition, etc. These threats will be avoided by establishment of a joint development and marketing strategy and by forming a joint working group – cluster for rural tourism development and cross-border co-operation Istra - Istria. In order to develop a successful tourist development strategy in any tourist destination, including the Istrian Peninsula, as a unique European rural tourism destination, it is necessary to design a series of interdisciplinary activities through involvement of experts in a number of fields in designing sustainable and innovative projects of rural tourism development (it is necessary to include economists, engineers, geographers, landscapers, builders, marketing groups, etc.).

Porter's diamond of competitive advantages is presented below, which clearly shows the advantages of forming of a joint working group for rural tourism development of the Istrian Peninsula. (Scheme 2.)



**Scheme 2:** Porter's Diamond of Competitive Advantages of Joint Marketing and Development Strategy of Rural Tourism of the Istrian Peninsula

Source: Adapted according to: Porter, 1998

Design of the competitiveness diamond of rural Istria and strengthening of the rural tourism offer, which will be the anticipated result of establishing mutual co-operation of cross-border areas and creation of a joint development-marketing platform, will open the way for all the factors which are important for achieving competitive advantages of the Istrian Peninsula, as one of the future leading rural tourism destinations in the world, the area of a unique and attractive offer. Its unique characteristics will be visible in a unique message of tolerance, respect for mutual differences, and preservation of traditional infrastructure, traditional way of life, rich gastronomic and wine offer, etc. This will also facilitate the implementation of activities organised by the working group for rural tourism development of the Istrian Peninsula Istra – Istria. This working group would include representatives of the County of Istria, municipalities of the Primorska region in Slovenia, and officials of the bordering municipalities of Italy and the City of Trieste. The goals of introducing the competitiveness diamond are, among other things, strengthening of mutual co-operation among all tourist suppliers in the inland part of Istria, especially in border areas through exchange of experiences, technologies and innovations, when mutual differences will become key developmental strengths instead of factors of separation and misunderstandings. It is thus desirable to include all the

interested parties in the joint development of rural parts of Istria (tourist suppliers, local authorities, local community), which will enable realisation of further sustainable development of the Istrian Peninsula and provide unique development opportunities to inhabitants in any of the countries, while preserving the resources and key particularities. The competitive advantages diamond leads to promotion of all the Istrian strengths, as the Peninsula which is a meeting point of three countries and three nations in terms of natural, technological and human resources, which enables design of a quality, unique, rich and diverse tourist offer of rural parts of the Istrian Peninsula based on application of high business standards, „green“ technologies and responsible business activities of all the participants. This offer will, except for its own innovative solutions, be based on international experiences and world practice.

## 5. CONCLUSION

Implementation of the principles presented in the paper, designed through formation of a joint working group – cluster for rural tourism development and cross-border co-operation Istra-Istria, will ensure further sustainable development and progress of the entire Peninsula, along with upholding high ecological standards and sustainable development principles. This will result in numerous benefits for the entire Republic of Croatia, because Istrian rural tourism will become a recognisable brand outside of Croatian borders, and become a synonym for tradition, co-existence, peacefulness, modern man's return to the nature, ecological awareness and high quality of the offered programmes. Strengthening of the co-operation between cross-border municipalities of the Istrian Peninsula will enable international exchange of positive experiences, maximisation of strengths and minimisation of the weakest development links, through facilitated access to innovations, financial resources and knowledge in general. Istria will become a representative example for other border areas of Croatia and Europe, as a sort of a benchmark for all the benefits for such areas, from the accession to the European Union.

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**SUSTAINABLE RURAL TOURISM IN CROATIA AND THE ROLE  
OF CULTURAL RESOURCES**

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**Abstract**

*In the past few years, rural tourism in Croatian areas has been developing significantly, and greater significance to this form of tourism has been given through various research and development strategies. These areas used to be very lively, and therefore possess valuable cultural (material and non-material) heritage and preserved natural resources. Cultural-historical heritage represents a valuable factor of development of a quality tourist offer, which enables development of other selective forms of tourism, among which also rural tourism. Creation of rural-cultural tourist offer will be achieved through the project called "Integration of Culture and Rural Tourism". Through this project, culture will become a significant factor of rural tourism development, and enable preservation of rich, unfortunately neglected cultural-historical heritage of the Republic of Croatia. For these purposes, it will be possible to use the EU pre-accession and cohesion funds.*

**Key words:** *cultural tourism, rural tourism, rural areas, sustainable development*

**1. INTRODUCTION**

In order to achieve balanced development of the Croatian territory, it is necessary to devote special attention to development of rural areas, for they are mostly underdeveloped, although rich in natural resources and cultural-historical heritage. Rural and cultural tourism development provides possibilities for successful development of rural Croatia, as well as preservation of rich, so far neglected and insufficiently valorised material and non-material cultural-historical heritage. In order to achieve this objective, it is necessary to analyse the structure of the visitors in rural tourist destinations, as well as their wishes, needs and habits, and propose possible development guidelines for the Republic of Croatia as a destination of rural-cultural tourism.

**2. CHARACTERISTICS AND SPECIFIC FEATURES OF RURAL AND CULTURAL TOURISM IN THE CONTEMPORARY TOURIST OFFER**

Basically, rural tourism represents all the activities in a rural area which may satisfy tourists' needs for peacefulness, recreation and active open-air vacation. Rural tourism provides visitors with the possibility to feel the tradition and the way of life of the local community. Rural tourism includes staying on tourist family country farms and the surrounding area, with active participation in the daily activities of the country farm and the local community.

Investments in rural areas may result in preservation of historical buildings and traditional customs characteristic for a certain country. Accommodation facilities have to be modernised in accordance with contemporary tourists' needs, provided that original experience is preserved, and rural area should be used for organisation of various activities, sports recreation, organisation of events, etc. The objective of tourism development in a rural area is to enable visitors to come into contact with nature and to fully experience the atmosphere of a rural tourist destination.

According to Ružić, rural tourism is a collective name for various activities and tourism forms which emerge outside of the urban and mass tourism areas. The importance of rural tourism is reflected in highly significant interaction of agricultural production of traditional products, presentation of tradition, traditional gastronomy and tourist services, and use of the existing resources. (Demonja & Ružić, 2010, 12)

Except for accommodation on family country farms, rural tourism also includes *local cultural offer* (local traditions, festivities, events, folklore), *gastronomy* (home-made dishes, wines, brandies and juices, which is also a connection to agrotourism); *enology* (a country farm offers visitors wines manufactured in their own vineyard); *experiencing specific landscapes of rural areas* (protected natural areas); *hunting tourism* (visiting the surrounding hunting lodges, game watching, etc.). All of the above must develop on sustainability principles, provided that socioeconomic and ecological characteristics of the area are not disrupted. Rural destinations should become destinations which uphold high ecological standards, tradition and its specific characteristics.

Advantages of rural tourism in relation to other kinds of the tourist offer are the following:

1. Dwelling in nature. Nature is a great attraction for development of various tourism forms: rural, ecological, hunting tourism.
2. Sense of tradition. Rural areas managed to preserve a great share of characteristic material and spiritual heritage (country architecture, sacral facilities, ethnological museums, traditional crafts and manufactured products, agricultural products, folk costumes, local customs, and festivities).
3. Hospitality of the hosts and historical atmosphere felt on country farms. Family atmosphere represents the basic, and one of the greatest advantages of rural areas (kindness of the hosts, hospitality and family atmosphere).

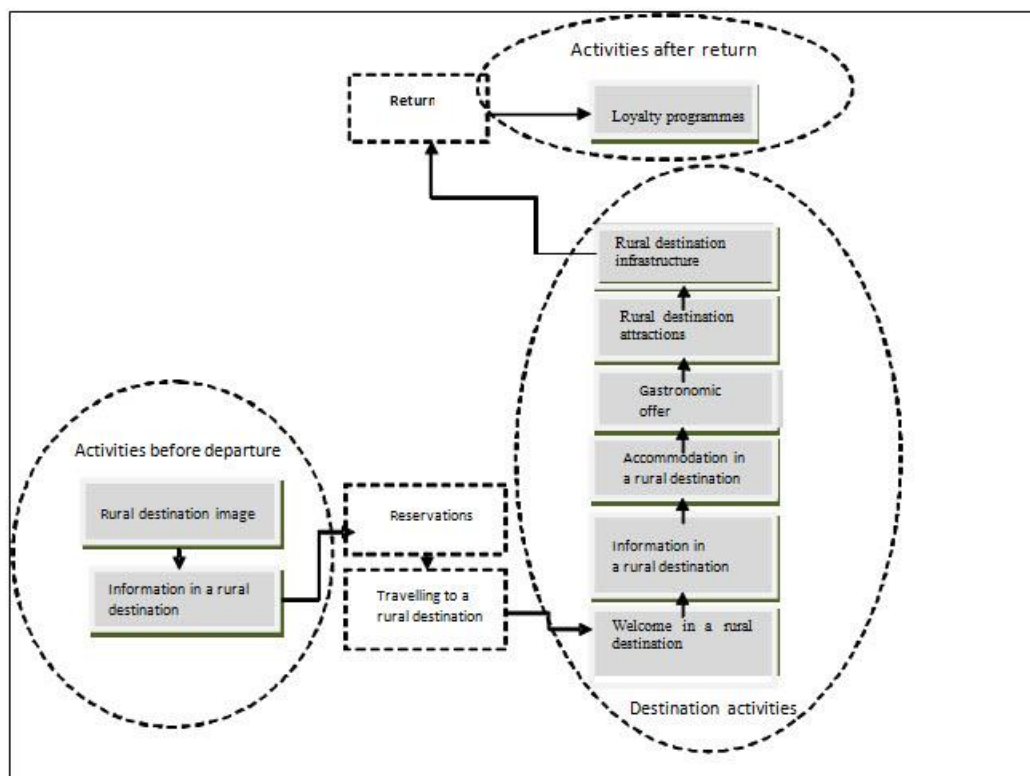
The chain of values in rural tourism is presented below. Its application realises increase in quality, and the tourist destination achieves competitive advantages on the world tourist market.

The above figure 1. shows that rural and cultural tourism are strongly interrelated and that they can be found in almost all links of the chain (from the rural destination image, arrival, accommodation, gastronomic offer, attractions, until departure of the guest).

### 3. DESCRIPTION OF RURAL AND CULTURAL TOURISM DEVELOPMENT IN THE REPUBLIC OF CROATIA

According to the UNWTO data, rural tourism has been growing at the annual rate of 6%, which exceeds the overall tourism growth rate. It is estimated that at least 3% of international travels occur in the rural tourism sector, i.e. tourists spend their holiday primarily in rural areas. Visiting rural areas does not occur in passing; it is rather the primary motive of the travel. (<http://academic.mintel.com/>) In the past two centuries, there have been significant economic, social, demographic and other changes in the Croatian rural area. Although there are plenty rural areas in Croatia (as much as ¾ of the total

surface of Croatia), they are insufficiently developed in relation to their real potentials for rural tourism development. It is necessary to create new rural area products and services through inclusion of the above-mentioned area in rural tourism. Since these areas are very rich in material, but also non-material cultural heritage, there is a possibility for revival of rich cultural and historical heritage of the Croatian villages, along with tourist development based on sustainable development principles. SWOT analysis of rural tourism in the Republic of Croatia is presented below. (Table 1)



**Figure 1.** Chain of Values in Rural Tourism

Source: Author's analysis according to Module Management and Tourism on Country Tourist Farms, <http://www.pannoniantourism.hu> (15/09/2011).

**Table 1.** SWOT Analysis of Rural Tourism in the Republic of Croatia

STRENGTHS	WEAKNESSES
- Share of rural areas in Croatia	- Unrecognisable offer of rural Croatia
- Vicinity of emitive tourist markets	- Unbalanced quality of the offer
- Traffic infrastrucure	- Insufficient number of educated human resources
- Climate	- Non-existence of quality promotional
- Preserved nature	



<ul style="list-style-type: none"> <li>- Rich sacral monuments heritage</li> <li>- Rich traditional heritage (folklore, songs, music...)</li> <li>- Well-preserved traditional architecture</li> </ul>	<p>strategies</p> <ul style="list-style-type: none"> <li>- No quality projects for additional offer development</li> <li>- Insufficient number of tourist country family farms</li> <li>- Insufficient co-operation between tenderers in rural areas</li> <li>- Abandoned fields, villages, forgotten traditional crafts</li> </ul>
<b>OPPORTUNITIES</b>	<b>THREATS</b>
<ul style="list-style-type: none"> <li>- Creation of additional tourist infrastructure in rural areas (walkways, cycling paths, walking corridors)</li> <li>- Connecting the offer into "rural tourist stories"</li> <li>- Revival of cultural-historical material and non-material heritage in rural areas</li> <li>- Possibility of subsidies for decoration of traditional homes, promotion of crafts, etc.</li> <li>- Theme restaurants and bars, gastronomy and enology</li> <li>- Strengthening – developing the "Zelena brazda"<sup>44</sup> programme by the Ministry of Tourism</li> <li>- Pre-accession and cohesion EU funds</li> <li>- Improvement of legislation for accommodation offer in rural tourism.</li> </ul>	<ul style="list-style-type: none"> <li>- Too strong competition of the neighbouring countries</li> <li>- Easy access to competitive destinations</li> <li>- Insufficiently developed awareness of the necessity for tourist valorisation of Croatian rural areas</li> <li>- Non-stimulating legislation, bureaucracy and corruption</li> <li>- Uncontrolled housing construction</li> <li>- Disregard of traditional architectural specific characteristics in the construction of facilities</li> <li>- Insufficient interest of the local authorities and the Ministry of Tourism</li> <li>- Pollution of water, air, rivers</li> </ul>

Source: authors' analysis

The presented SWOT analysis points to significant advantages of Croatian rural areas, which are: preserved natural resources, rich cultural-historical heritage, traditional way of life of the local community. Despite all of the above-mentioned advantages, rural tourism development also has significant weaknesses, which are: insufficient number of educated human resources for working places in tourism, but also in promotion and marketing of rural areas, and adequate valorisation of rich cultural-historical heritage. Opportunities of Croatian rural areas will be fully presented through tourism development, and designing of the overall tourist offer through development of tourist stories, theme restaurants and bars, building of additional tourist infrastructure on the principles of sustainable

<sup>44</sup> See more : *Program poticanja razvoja posebnih oblika turizma na kontinentu „Zelena brazda“*, Ministarstvo turizma, <http://www.mint.hr> (28.9.2011.)

development and ecology. Croatian rural tourist offer is in its initial development stage, while the neighbouring countries (Slovenia, Austria, Hungary, etc.) have made significant progress in rural tourism development. Each development should be designed carefully and based on sustainable development principles, with the goal to maximise benefits for the local community residing in the rural area. It is necessary to strictly monitor and limit spatial urbanisation with the goal to preserve autochthonous landscape and the way of life of the local population.

Cultural tourism development has become very significant in Croatia in the past few years; therefore, Croatian Cultural Tourism Strategy was adopted in 2003, as well as other significant documents. The Strategy defines cultural tourism as "people's visits to areas outside their permanent residence, completely or partially motivated by their interest in history, art, heritage, or the way of life of the local community, region, group or institution". (Strategija razvoja kulturnog turizma: od turizma i kulture do kulturnog turizma, 2003, 5) The WTO defined cultural tourism as "people's movement because of basic cultural motivations, such as study tours, art and cultural tours, travelling to festivals and other cultural events, touring historical areas and monuments, travelling in order to explore nature, folklore or art, and pilgrimage. This kind of tourism fulfills the needs for a different cultural experience and seeking opportunities for upgrading one's cultural level, knowledge, experience and socialising". (Pančić Kombol <http://hrcak.srce.hr/8702>). According to the WTO, around 60% of all international travels includes some form of cultural tourism. (Cultural and Heritage Tourism – International, 2004,1) Therefore, rural tourism, as one of the selective tourism forms, includes cultural attractions, as well as events which fulfill tourists' stay in rural areas. Cultural tourism in rural areas may be elaborated on and explained as rural tourism complemented by various cultural resources which are thematically bound to the rural space. Distribution of cultural heritage may be used in the elaboration of certain cultural resources forms, according to the Law on the Protection and Preservation of Cultural Heritage from 1999. (<http://www.zakon.hr/z/340/Zakon-o-za%C5%A1titi-i-o%C4%8Duvanju-kulturnih-dobara>)

A rural area may offer tourists an attractive tourist product designed to satisfy the variety of their needs, but the initial guideline must be that the rural area as such does not have such cultural attractions as other destinations, like various cities. Existence of cultural resources does not mean that the destination also has a cultural attraction which would be attractive to tourists. Cultural resources must be adapted to tourist demand.

Cultural-historical heritage may be included in the tourist offer of rural areas primarily through three basic forms:

1. Organisation of *various traditional and cultural-artistic events*.

Rural areas offer a variety of events connected to the rural area in which they take place (folk costumes parade, various folklore events, various autochthonous customs, religious customs, etc.). It is necessary to understand which events will be included in the rural tourist offer, and which traditional events will not be promoted. All rural area events do not necessarily have to be adapted to the tourist demand. According to Moutinho, in the use of culture for tourist promotion in a destination, one has to be careful, especially in the context of growing global interest for characteristic national and regional culture in many areas (Moutinho, 2005, 43) which could be a reaction to increasing globalisation of the products market). (Commercialisation of cultural life in a certain area may lead to deprivation or alienation of the inhabitants who have the basic and greater right to product and express their culture than visitors and tourist marketing managers who are at their service.

2. *Stimulation of preservation and presentation of traditional crafts and cultural-historical heritage.* A rural area must preserve its cultural-historical heritage for future generations. Rural and cultural tourism development must be stimulated on sustainable grounds (for example, various decorations of ethno-villages, demonstrations of traditional crafts and sale of their products, different urban environments in a rural area, tool collections used in rural areas, old way of fishing, etc.). Croatian rural areas are rich in traditional culture which has not been sufficiently recognisable in the tourist offer, and its integration in the tourist offer should be improved (for example, *bećarac*, harmony-singing, singing "in small and large" in Istria, traditional instruments: tamburitza, reed-pipes, twin-reed, bagpipe, etc.).

3. *Creating gastronomic and enologic image of rural destinations.*

Throughout history, various characteristic food products developed, as well as eating habits of the people residing in rural areas. Rural destinations should create a gastronomic offer which will be based on the new trends in food preparation.

Gastronomic offer has great significance in rural tourism. Lebe states that gastronomy is a significant base of cultural tourism offer because it provides completely new products in small countries and in smaller or less-known tourist destinations. These products are equally valuable as the offer found in big cities. Folk gastronomic offer is often the best in small communities, because it is frequently a result of continuous demonstration of tradition. (Lebe, 2008, 43)

From the gastronomic point of view, rural areas have become interesting for potential tourists. Tasting of autochthonous meals and wine became the primary motive of tourist movements in the past few years, but also daily visits to rural areas from urban centres. Significant characteristics of modern regional cuisines (with special emphasis on the rural area) are:

- Authentic character of the meal (based on historical recipes)
- Adaptation to modern eating habits (taking into consideration distribution of calories)
- Use of fresh, seasonal ingredients grown on a country family farm
- Processing of ingredients manufactured in the region which develops its gastronomy.

Steinecke states that there is great interest for regionalisation of meals, by local population and the tourists alike. (Steinecke, 2007, 237) Regional rural area meals provide experience of the rural areas, and many tourists decide to buy specialties of the rural area in which they are staying (for example cheese, dairy products, meat products, marmelades and honey, spirits, wines, etc.). Various enogastronomic events, and events developed by certain rural destinations, contribute to tourist offer development. In order to successfully create the tourist offer in a rural-cultural tourist destination, it is necessary to be in line with contemporary preferences of modern tourists. Results of the survey conducted on the sample of users of Croatian rural-cultural tourism offer are presented below.

#### **4. RESULTS OF THE SURVEY CONDUCTED ON THE SAMPLE OF USERS OF CROATIAN RURAL-CULTURAL TOURISM OFFER**

A questionnaire was sent to 400 selected e-mail addresses in the Republic of Croatia covering the subject whether the visitors, during their holiday, stayed in Croatian rural destinations in the past period. 346 answers were received, from which 150 respondents stayed in Croatian rural tourist destinations, mostly in Istria and Hrvatsko Zagorje. The questionnaire was forwarded to 150 E-mail addresses in the period between September and October 2011. The response was received to 113

questionnaires, or 75,33% of the respondents. Social-demographic characteristics of the selected group are the following: according to gender, 39 men participated in the survey (35%) and 74 women (65%). According to age groups, most responses came from the respondents between 25 and 34 years of age. According to education level, the most respondents were college graduates, 43,36%, and high school graduates and associate degree holders 30,8%. The respondents were interviewed on whether they are familiar with sustainable development principles, to which 47,8% of the respondents answered that they are not sufficiently familiarised with sustainable development principles, and think their knowledge is insufficient, while 50,44% respondents believe they are well-acquainted with this subject. There is a certain correlation between education degree and being familiar with sustainable development principles. Therefore, increasing education level also increases the degree of familiarisation with sustainable development principles. Respondents between 18 and 24, and 25 and 34 years of age are the ones with the highest knowledge on the above-mentioned principles, although they also rate this knowledge as average. For example, 65% of high school graduates, 33% associate degree holders, 34,7% of university degree holders, 28,6% masters of science, 25% doctors of science recorded insufficient knowledge on sustainable development principles, like all the participants of lower educational structure. 55% of the respondents think that sustainable development is the only possible form of future development of the Republic of Croatia and its rural areas, where limited natural resources will be preserved in each example. Reasons for upholding sustainable development principles stated in responses are: they have to be implemented in order to preserve life on Earth, Croatia will gain additional importance when it accesses the EU, it is necessary to work on strengthening ecological awareness of each individual, sustainable development will lead to balanced development of all areas. Other respondents, i.e. 45% of the respondents, think that all kinds of development should be enabled. This is the opinion of the most high school graduates, 43,14%, associate degree holders and 35,9% of university degree holders. When questioned on the share of cultural resources in the tourist offer of Croatian rural destinations, 3,54% respondents think that they do not participate in the tourist offer of rural areas at all, 70,80% think they are represented poorly, while 25,7% think they are represented well. Based on these information, it is necessary to additionally integrate cultural attractions and events in the tourist offer of Croatian rural areas. During their holiday, 74% of respondents visit historical monuments, 37% shows and events, 30% museums, while 12,3% of the respondents visit other cultural events, which means summer festivities. In terms of the visited rural destination, 56,63% of respondents are satisfied with the cultural tourism offer, while 43,36% think the offer is insufficient. In the elaboration of their response, the respondents mostly complain about insufficient promotion of culture in the destination they visit, and think that better inclusion of cultural tourism in the offer of each destination would significantly increase competitive advantages of the Republic of Croatia, citing examples of competitive foreign destinations which use their cultural-historical resources to the extent that they represent the basic and only tourist attractions for tourists. Likewise, the respondents think that cultural-historical heritage provides the possibility for complementation of the offer in all forms of the tourist offer, not only in rural tourism. As much as 92,92% of the respondents think that cultural-historical heritage is important in the rural tourist offer, stating that cultural-historical heritage represents the base of existence of the space and society, that it is a personal identification card, which becomes a true rural tourism promotor if the promotion is designed in the right way, taking into consideration stories and legends. As much as 84% of the respondents think that rural tourism can ensure sustainable development of underdeveloped parts of the Republic of Croatia. The respondents obtained information on cultural attractions in rural tourism destinations in different ways. It is worrying that, in their elaboration of the response, many pointed out insufficient synergy between a local tourist organisation and carriers of the offer, which results in low interest and insufficient use of all the cultural resources and comparative advantages.

They also state the fact that they mostly found attractions on their own, 11,50% obtained information via local tourist agencies, 51,32% by recommendation by the family/relatives, talking to the locals 31,85%, talking to through employees in various facilities 7,08%, over the Internet 46,02%, via brochures/leaflets 23,01%, and through other sources. The results indicate the necessity to direct promotional activities online, where information are available 24 hours a day. Potential visitors may experience the atmosphere offered in a rural tourist destination over video links, cameras, etc. They can hear the local tunes, read everything about local sights and events, take a virtual walk, ask questions and make direct reservations. It is necessary to ensure permanent co-operation between rural tourist destination management, which will include a special department for the promotion of cultural heritage, and their co-operation with the carriers of the offer in the sense of special arrangements, at favourable prices, and bringing cultural resources closer to potential visitors. In web design, special attention should be devoted to the concept. It is desirable that all carriers of the offer use the same colours, fonts, links, promotional slogans, which will point to a certain cultural region, its specific characteristics and competitive advantages. It is possible, and desirable, to create the cultural tourism cluster in rural Croatia (between museums, tourist boards, family country tourist farms, entrepreneurs, marketing and PR agencies, etc.), which will integrate their activities and thus enable cultural heritage to "come to life" in each Croatian rural area through more efficient marketing and promotion, easier access to the emitive markets, creation of stories and legends, etc. Satisfaction with overall services in the rural tourist destination was expressed by 31,85% of the respondents, partial satisfaction 58,04%, while 9,73% of the respondents were not at all satisfied with the rural tourist destination offer. In the attached elaborations of responses, the most significant was non-existence of continuous promotion, quality standardisation and monitoring the quality of the service offered on country farms. The Republic of Croatia will have the possibility for more efficient development of the rural-cultural tourist offer by using the resources from pre-accession and cohesion EU funds.

##### **5. FINANCING POSSIBILITIES OF RURAL-CULTURAL TOURISM DEVELOPMENT OFFER FROM PRE-ACCESSION AND COHESION FUNDS OF THE EU**

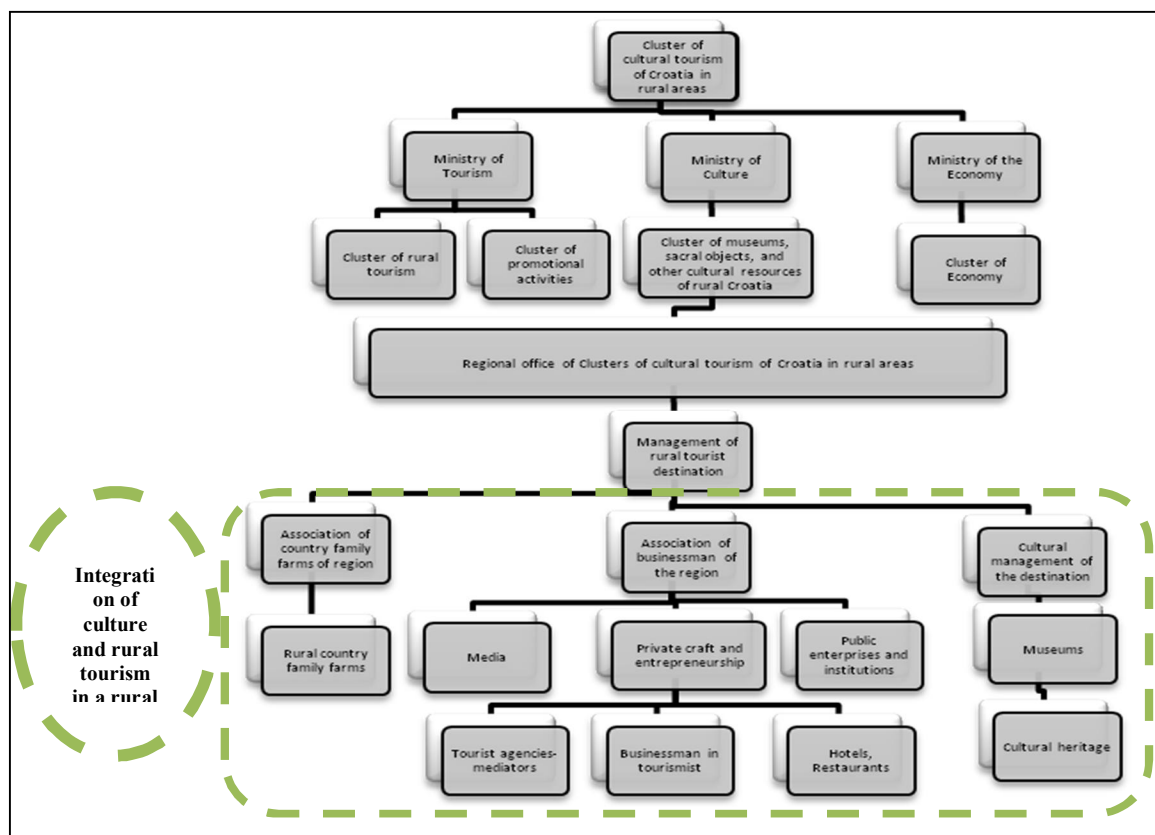
European Union adopted the *Culture 2000* financing programme, in which they stated the priority fields; cultural heritage is one of them. *Culture 2000* was followed by a new programme for the period between 2007 and 2013, (<http://eur-lex.europa.eu>) as its continuation. The *Culture 2007-2013* programme finances cultural co-operation projects in all kinds of artistic and cultural work: performing arts, visual arts, literature, cultural heritage, history of culture, etc. The programme supports three groups of activities: cultural activities, European authorities in the culture and activities of analysis and dissemination. Transnational funds are also Media Plus, Leonardo da Vinci, Socrates, Youth, Life III (environment), New Technologies and Research. Rural and sustainable tourism development is one of the foundations of EU development; therefore, it is necessary to design development programmes which will be financed through development projects from the pre-accession and cohesion funds. Since 2007, the Republic of Croatia is entitled to use the resources of the IPA programme, which comprises five parts: Transition Assistance and Institution Buildings (35%), Cross-Border Cooperation (7%), Regional Development (32%), Human Resources Development (8%) and Rural Development (IPARD) (18%). Rural tourism is also financed from Cross-Border Cooperation and Rural Development (IPARD). Of the total financial resources allocated for Croatia, 129,40 million euros is allocated for rural tourism development. (<http://www.mps.hr/ipard/>). From the day of Croatian accession to the EU, it will have at its disposal significant resources for rural area development. For example, in 2013 alone, Croatia will have at its disposal the amount of 27.700.000,00 euros.

(<http://www.mvep.hr/custompages/static/hrv/files/111201-Ugovor%20o%20pristupanjuHR.pdf>)

Therefore, it is necessary to ensure support to the users of the resources and the interested entrepreneurs, in order to use the available resources to the highest extent possible. Rural tourism development in the Republic of Croatia is stimulated through the programmes by the Ministry of Tourism of the Republic of Croatia "Zelena Brazda" - a rural tourism crediting programme. The objective of the "Rural Tourism Development programme" is to enrich the tourist offer on country family farms.

## **6. PROPOSAL OF STRATEGIC GUIDELINES OF RURAL-CULTURAL TOURISM DEVELOPMENT IN THE REPUBLIC OF CROATIA**

Rural tourism development, especially development of its offer through integration with the cultural tourism offer, is just beginning in Croatia. The only possible sustainable progress and positioning on the global tourist market lies in mutual integration of rural and cultural tourism with the objective to create new, competitive, innovative tourist products and services, which will differentiate the offer of Croatian rural tourism destinations from the competition. The concept of rural tourist destinations in integration with cultural tourism perfectly fits the cluster concept in economic development of the Republic of Croatia. Many destinations have significant natural and other resources, which are important for tourist cluster development. This is, most frequently, the initial value which should be complemented by formal organisational, managerial, innovative, manufacturing social capital building measures, competitive measures and other measures. The basic purpose of cluster existence in a rural tourist destination is linking of the public sector, small and medium-sized entrepreneurship, and craftsmanship, through the application of contemporary technologies, combined with the synergy of suppliers of products and services and marketing agencies, as well as tourist mediators in the region(s), achieving competitiveness on other receptive markets. Rural tourist destination will develop its key competencies by using contemporary methods of communication with the market, innovative production technology, and provision of tourist products and services, as well as through local entrepreneurs' investments in different fields and different clusters. It will also position itself on the global tourist market. On the other hand, this concept helps entrepreneurs (public and private sector) to develop more rapidly within the cluster, by applying modern technology in their work and employing highly educated and motivated company management, with which they can draw the maximum from the market. Thus, the rural tourism destination will gain significant competitive benefits in relation to others. (Horvat & Kovačević, 2004, 7) In order to enable this kind of synergy in rural tourist destination development, it is necessary to ensure constant supervision, which will manage rural and cultural tourism cluster (in this case) in Croatian rural areas, which will direct and stimulate activities within rural region cluster. Introduction of the cluster is a financially challenging process, but it has multiple benefits. Therefore, in the financial framework, it is necessary to use the opportunities provided for the Republic of Croatia as a future EU Member State through EU cohesion funds, but also through the credit lines by the Croatian Bank for Reconstruction and Development. Project financing should be conducted by commercial banks, as well as the interested local community, which will allocate resources from the local budgets (collected, for example, by the charge paid for stimulation of rural/cultural tourism development, which could be symbolic). The cluster will enable closer relationship between individual business entities in a destination (both public and private institutions – small and medium-sized enterprises and craftsmen), who will join forces to achieve maximum benefit for themselves, but also for the community, and minimise their weak links.



**Figure 2.** Proposal of the Organisation Chart of the Croatian Rural-Cultural Tourism Cluster in the Rural Areas – the TOP DOWN

Source: Author's interpretation

The presented cluster on the above Chart (Figure 2) represents one of the possible scenarios for organisation of the subject matter. It shows the top-down organisation, i.e. presents the cluster organised on the level of the state, region and a tourist destination. Naturally, everything starts from, and leads towards, the family country farm. All the parts in the cluster, in fact, represent a complementation of the offer which will, through synergy, provide every family country farm successful and continuous development. There are possibilities for designing thematic clusters, with application of the so-called "cross selling" approach (the cluster may comprise other interested ministries, several rural regions, cross-border cooperation between countries). It is a living organism which constantly changes in order to achieve the set goal, i.e. integrate the rural and cultural tourism offer in Croatia with the goal to create permanent recognisability and successful market position on the world tourist market, which is also the purpose of this paper.

## 7. CONCLUSION

The Republic of Croatia is a country rich in natural resources, which are crucial for rural tourism development, and it is also rich in cultural-historical heritage necessary for cultural tourism development. These forms of tourism, despite great interest of the tourists, are insufficiently developed in the Republic of Croatia. Designing of the cluster presented in the paper will achieve improvement

of competitive advantages of rural Croatia and enable preservation of natural-ecological resources. This will also ensure stronger inclusion of cultural-historical heritage in the tourist offer. Resources obtained in this way will enable maintenance and restructuring of material heritage, which should be revived. It is necessary to conduct serious activities regarding tourist offer improvement, which will be achieved through further tourist market research, and through benchmarking analysis of the offer in European rural-cultural tourist destinations. Such activities will enable successful promotion and repositioning of rural Croatia as a successful sustainable tourism destination. The results of the conducted survey indicated the necessity to undertake great efforts in offer development, education of citizens on sustainable development, and, especially, integration of cultural-historical heritage of the rural areas, which could be significant alleviation in the use of financial resources from the pre-accession and cohesion EU funds.

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**COMPARISON BETWEEN THE REAL PRICE FOR MEDICAL SERVICES IN THE MULTI  
PROFILE HOSPITAL FOR ACTIVE TREATMENT AND THE PRICE, PAID BY THE  
NATIONAL HEALTH INSURANCE FUND\***

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**Abstract**

*With changes in health legislation in Bulgaria and the introduction of health insurance funding principles, the role of prices of medical services is increasing dramatically. In time of economic and financial crisis, hospitals work at conditions of a chronic shortage of funds. The National Health Insurance Fund constantly increases requirements to contractors, while the prices of many of the clinical paths are underrated. The article indicates how much the treatment of patients costs from surgery and gastrointestinal department at City Multiprofile Hospital for Active Treatment and a comparison between the prices of clinical paths, which are paid off the National Health Insurance Fund to hospitals.*

**Key words:** *prices of medical service, Multiprofile Hospital for Active Treatment, clinical paths, National Health Insurance Fund*

From financial point of view the hospital system makes part of one of the most significant costs in the entire system of healthcare. There may be no other effort which imposes so great burden on the economy nowadays, as the effort to influence the costs for improvement of the healthcare value.

From organizational point of view the hospital has dominated and still dominates over the other elements of the healthcare system.

The hospitals are often subject to reforms with the aim of achieving higher efficiency, equality, improvement of the access and quality. The environmental factors leading to changes in the hospital scheme are as follows:

- pressure from the demand (for example the aging and the increase of healthcare needs or the amendment of the type of diseases – diminishment in the number of infectious diseases and increase in the share of non-infectious chronic diseases);
- pressure in the field of supply – shortage of resources with regard to the new technologies in the field of healthcare, allowing for transfer of treatment out of the hospital, even at home, migration of experts to a market with higher salary percentage;
- the changed public expectations for the role of the hospital institutions in the context of the broader social and economic changes (McKee&Healy, 2002).

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The enforcement of the healthcare policy in the hospital sector depends on many context factors – macroeconomic situation, political system, social values and the institutional structure of the healthcare system.

According to Harding and Preker (2001) one of the main trends of the organizational reform in the hospitals, often determined with the term market reform, is the market influence.

The market influence in Bulgaria is difficult to achieve because of the one and only main payer (NHIF), which pays in a mixed principle, i.e. dualistic – according to the so called delegated (forecast) budget), a form of global budget determined on grounds of the achieved results in the previous year and the clinical paths, as the trend for 2008, 2009 and especially for 2010 is for limiting unilaterally by NHIF on basis of funding. As far as the achieved results, namely the number of clinical paths, performed and paid, are a reason for a global budget of the corresponding hospital, one could assume, that this factor determines (despite of the regulation by NHIF and the Ministry of Healthcare) the market influence.

The right of the hospitals to keep the rest at the end of the year (other main directions of organizational reform in the hospitals) depends on the decisions of the owners, but according to the Law on the Medical Institutions (special or sector law), a rest should not be formed, since that law provides that the public hospitals should not have the purpose of making profit, regardless of the fact that according to a higher placed law – the Commercial Law (main law), all hospitals are commercial companies and should have profit or loss. This is one objective contradiction.

The practice shows that because of the insufficient funding of the clinical paths and hence the lower value of the global annual budget, which is not in conformity with the healthcare needs of the people, forces the hospitals to make debts, because of

imperfections, and because of non paid by the NHIF activity, and also because of activity, which has been paid but is insufficiently funded.

The Fifth Multi Profile Hospital for Active Treatment Sofia is the biggest municipal hospital, which provides diagnostic and treatment activity on a very broad spectrum of subjects. One has built the necessary block structure with rational and legal distribution of the beds and the human resource. The high qualified personnel (almost all of the doctors have a subject, 26% of the doctors with a subject have acknowledged second and third subject), the presence of habilitated persons, as well as the continuous improvement of the qualification of the experts on healthcare create good conditions and important prerequisites for providing quality in the hospital activity. The base is very good maintained, clean and in good order, with proper infrastructure. In a number of subjects for which there are medical standards, there is equipment provided on a higher level than the required one, and the activities done are in compliance with the ones on IIIrd level.

The reasons for discussing in the scientific printed media of the issues for the measurement factors, the costs and the value of the hospital product are from the one part the huge increase of the costs of the hospitals and the care of the funding bodies to have a clearer insight for what their funds are spent. From the other part the hospitals more and more start to use the established in the industry methods for financial management, therefore their managers are highly interested in the measurement of the product of every single structural unit in the huge hospital management area.

From particular significance is to establish on what level and for what purposes one shall determine the costs for hospital services.

The average costs could be specified on grounds of data processing from the individual costs, as far as they are registered. Provided that they are not registered, one applies the methods for determining the average costs.

On grounds of these average costs in the developed countries one develops the so called “prices”. This is a way to determine the amounts, which a particular financing institution negotiates with the hospital management for payment of a specific nomenclature of hospital services.

On a single hospital level one puts also the question whether a difference could be established between the real costs for a unit of hospital service and the received for it “price” from a particular financing institution. The difference between both values determines the profit and loss of the hospital with the “production” of the specific hospital service.

The healthcare activities always have a particular value, as far as for their “production” there have been put specific resources. (B. Davidov)

In the Bulgarian health economy statistics from the beginning of the seventy years one has started an experiment on the separated accounting of the costs and the determination of the values of health activities. From the beginning of the eighties one starts annual registration and researching the value of healthcare activities. One uses the “classic” units for measurement of their value “value of patient gone through it”, “value of bed day” and many others (authors D. Borisov 1982, Z. Bosilkova 1989).

From 1992 on one has started a next stage of this activity – with „new version of „Methods for separated accounting of the costs of the healthcare institutions...” from Kr. Radev (1993) and automated system – B. Davidov (1993). In the NCHR one collects, processes and publishes the accounting data on the activity of these (and many other) indicators at national level.

As it is clearly seen, the problem with the determination of the values from the healthcare activities is not a newly emerged one and unknown to the healthcare experts.

**The importance of the information on the costs per unit of medical activity is expressed in the following directions:**

***1. The information on the costs or prices per unit medical activity allows reaching a new level of economic and health-economic analysis.***

- at ***macro economical*** level – the national consultants and other national experts and institutions, directed towards different medical subjects and types of diseases, could lead dialogues on clarification and optimization of proportions in the capacity, cost of financial and performed activities (services patients) between the different types (or subjects) of hospital departments.

Of particular size is the interest from the part of the healthcare managers towards the comparative analysis of the costs (value) in their institution with regards to the costs in the other institutions. There is also another discussion reason – the countries with biggest healthcare costs, measured as a percentage of the Gross Domestic Product (USA, Sweden, Germany, Netherlands, Austria etc.) are strongly concerned by the growth of these costs. In some of them (USA, Germany, Netherlands) the health and economic researches are maybe at the highest level possible. In Bulgaria, a country with highly limited healthcare resources, one should put even more strictly the question about their maximum efficient spending.

These and many other disproportions could be researched both at national level and for each of the different groups of hospitals (B. Davidov, 1996).

- at *micro economical* level – at the level of management of the particular hospital.

The information provides opportunities for “dialogue” of the medical manager with any of the heads of department/clinics or cabinet in a particular hospital institution. In the basis of this “dialogue” there is the information over the average values of a particular activity (treatment of a patient gone through, bed day etc.) in other departments of the same type (clinics) and cabinets. These average values are at hand – on groups of hospitals of the same type, average for the country, for the region etc. In these dialogues one could discuss questions of the type: “Why the local indicators of the department (clinics) are lower (or higher) than the corresponding average ones?”, “What is this a sign for: good or bad work; shortage or surplus of finances; problems in the provisioning of personnel, medicines, equipment, consumables etc?” and “What should and could be done?”.

In the last years one becomes more and more aware of the need of the Bulgarian experts from taking into account the value of healthcare services at all levels – of the healthcare service as a whole, of the separate healthcare institute, of its clinics (department), of a particular expert or of a team, of a separate patient. By means of a good information system one could determine if the growth in costs of a department by  $x$  % for one year is due to an amendment of: the type of diagnoses of the patients treated, the amount of the patients treated, the used therapeutic procedures, the prices of labour, the materials and other goods, and the efficiency – usability of the resources.

### ***2. Information about the prices ensures a new approach in the “dialogue” between the managements of the medical institutes with the funding bodies.***

With the presence of detailed information over the costs or prices, the dialogue between the parties becomes better grounded and more specific.

As B. Davidov marks, the available information over the “producers” and “buyers” improves the awareness of both parties and provides cooperation for making a competitive environment in the field of the medical services. And from the literature and the practice one knows, that such environment helps for minimization of the costs.

### ***3. Information of the costs could serve as a base for preparing prices for the healthcare activities.***

The presence of such prices and their use in the relations „producer” – „buyer” creates real competitive environment and market of healthcare activities.

From the methodological problems a main one is the problem about the unit of measurement of the healthcare activities – in the context of determining their value. The mentioned units „value of a patient gone through” etc. have particular advantages, but also disadvantages – these are mean values, which have specific application for statistical analyses but mainly in economic aspect. Even it its biggest desaggregation – at level “stationary department” these units could not reflect in details the value of the clinical behaviour. For taking into account the value of treatment for a particular patient with particular parameters (age, gender etc.) and particular diagnosis, one puts another diagnostic method.

In „purely” economical plan there is the methodic issue over the composition of the value elements – i.e. which types of costs shall be included in this value.

The next extremely important issue is **for what prices and how should one use these values**. The one approach is orientated towards the use of these values for the purposes of the statistical accountancy and analysis (specified as “retrospective”). The other approach (“prospective”) is their use in the processes of planning and management – of the healthcare institutions and of the medical service as a whole.

**4. The information could serve as output for analysis of the clinical behavior of the healers. (B. Davidov)**

The doctors are healers, and not “economic subjects”. But they guide the medical process in which one spends many resources.

Provided that this information proves the presence in a particular department of costs (per bed day, per patient gone through, per bed), and of average duration of the stay, significantly different than the average ones, this could be observed as a signal for the necessity of more profound research of the performed healing activities in this department.

In this way one puts the questions about the research of the “good medical practice”

The need of economic information for management of the healthcare on national, regional and local level is not subject to discussion. The macroeconomic operative and strategic planning, operative management, design of new methods of funding the medical institutions, the health insurance system, the management itself of the medical institutions etc. are impossible without a reliable and actual economic information.

**METHODS AND SET UP OF THE RESEARCH:**

**Main purpose of the research:** Determination of the costs for treatment on the separate clinical paths as a method for improvement of the management of first surgical and second surgical departments as well as in the gastric and enteorological department with haemotologic sector with Fifth Multiple Profile Hospital for Active Treatment Sofia.

**Object of monitoring** are indicators, which are monitored and registered in the internal hospital accounting system. These are the indicators “discharged patients from a particular clinical path”, as well as the indicator “average costs for a patient gone through”.

According to the purpose and the tasks of the research we assumed to observe the information about hospitalized on clinical paths persons in first surgical and second surgical, as well as in gastric and enteorological department with haemotological sector with Fifth Multiple Profile Hospital for Active Treatment Sofia for a one year period from 1<sup>st</sup> January 2010 until 31<sup>st</sup> December 2010.

When determining the costs for unit of hospital product of hospital unit we use the method of **step distribution\***.

For better reflection of the specifics of the products of the separate units we group them here into six blocks: hospital departments, consultative cabinets, paraclinics, pharmacy, economy block and administration. We work with accounting data for Fifth Multiple Profile Hospital for Active Treatment Sofia for 2010.

The approaches and steps for establishing and distributing the costs for unit “Clinical laboratory” are specified in details. The discussed approaches are applicable for all other units, too, for which in the following summary we present the calculated data.

We determine the costs for unit of product by means of the weight coefficient.

This is not so correct, but significantly more easily to apply method.

The unit “Clinical laboratory” produces products A, B, C and D in amounts, specified in Table 1.

The total costs for the unit are determined – BGN 392 629.

*Step 1*

To every product there is assigned a coefficient of costs Kr – expressed in points.

We assume, that product A has costs equal to 1. One makes expert assessment and specifies how many times the costs of products B, C and D is bigger (smaller) than the one of product A.

So if one assumes that product A has Kr 1 point, for product B one determines Kr 2 points, for product C – Kr 4 points and for product D – 7,5 points – see Column 2 of Table 1.

*Step 2*

One multiplies the coefficient Kr by the quantity of the products from column 1. One obtains a number of points for every product – see Column 3 of Table 1. Under row “total” one sums all points. One obtains the total value in points for all products – 166 544 points – row “total” of Table 1.

*Step 3.*

One determines the average costs for one research by means of dividing the total cost on the number of researches from a particular group.

Table 1. Determination of the costs for the products of unit “Clinical laboratory”

Type of product	Number	Coefficient of value Kr	Total value	Total cost	Average cost for 1 unit
			in points	in BGN	in BGN
	1	2	3	4	5
A	43 130	1	43 130	103 779	3
Б	33 168	2	66 336	141 068	5
B	11 322	4	45 288	115 467	10
Г	1 572	7,5	11 790	32 315	20
<b>TOTAL:</b>			<b>166 544</b>	<b>392 629</b>	

Indicators, included in the group A – blood sugar, electrolytes, urine.

Indicators, included in the group B – haematology, blood coagulation, substrates, metabolites, enzymes

Indicators, included in the group C – gas compounds and general examinations.

Indicators, included in the group D – hormones, tumour and hepatitis markers.

Assigning to every patient of the costs for the used by him intermediary products

After the distribution of the costs to the intermediary medical products and the value of unit intermediary product is determined, the next step is their assignment to the *final medical product* of the hospital – the patient.

The last step for achieving a cost for a patient gone through is the accumulation of all costs for the used by the patient intermediary products. The total cost for every single final product /patient gone through/ for the hospital is the amount of the costs for types of medicines provided, food, manipulations, researches, procedures, cares etc. At the end of the period for calculation against every single final product one puts the amounts for the activities done in the hospital. In this way the medical institute gets an idea about the full costs which it has for every patient.

One sums all provided intermediary products for every patient and one assigns to them the calculated costs for them.

The application of the method “step analysis” provides the hospital management with a number of possibilities:

- To get a more clear idea about the volume and structure of the own costs of every single hospital unit.
- Allows (imposes) the determination of the quantity of intermediary and final products, produced by every single unit, as well as the consumption of these products by units in and out of the hospital.
- Allows the determination of own and added costs for every hospital unit.

By means of the method one could get an idea for the product and financial flows inside the hospital area. From here one formulates more clear tasks for the information provisioning of their management.

From the specified data one sees that first surgical department works on 29 clinical paths (CP). With 3 CP one sees almost equal average value for treatment of the patients in Fifth Multiple Profile Hospital for Active Treatment Sofia and the price, paid by the National Health Insurance Fund. 4 CP are overestimated. 20 CP are underestimated, which is a relative share of 68.97%, from which 16 are heavily underestimated in the range from 30.82% to 68.94%. Two CP have only 1 patient each, what is the reason, that for them one could not make statistically true conclusions.

According to the presented details second surgical department works on total of 30 clinical paths. With 2 CP one sees almost equal average value for treatment of the patients in Fifth Multiple Profile Hospital for Active Treatment Sofia and the prices, paid by the National Health Insurance Fund. 7 CP are overestimated in the range from 16.21% to 43.80%. 20 CP are underestimated, which is a relative share of 66.67%, from which 12 are heavily underestimated in the range from 31.75% to 74.65%. One CP has only 1 patient each, what is the reason, that for it one could not make statistically true conclusion.

**RESULTS AND DISCUSSION:**

Table 2. Comparison of the average values of the clinical paths of first surgery department of Fifth Multiple Profile Hospital for Active Treatment Sofia and the prices, paid by the NHIF

Nr. of clinical path	Highest value (BGN)	Lowest value (BGN)	Average value (BGN)	Number of patients, recorded on clinical path	Price paid by the NHIF (BGN)
26	1 407.96	407.29	659.86	29	642
30	1 466.27	93.13	590.45	82	600
31	3 368.43	190.53	631.84	61	550
33	1 492.60	351.49	672.35	24	1 010
74	816.61	81.46	291.05	13	116
153	7 961.63	2 291.93	4 592.82	16	1 540
156	9 656.21	1 321.86	4 083.01	22	2 239
158	3 304.71	1 488.37	2 332.62	4	1 440
160	15 476.26	586.29	4 053.72	93	2 200
162	6 174.35	1 252.74	2 688.46	29	835
164	1 868.51	276.39	531.96	16	556
165	4 689.97	2 260.25	3 130.84	5	624
166	2 833.37	63.49	507.40	136	624
167	3 009.81	222.86	800.98	123	578
168	2 793.24	184.27	868.71	38	601
169	5 607.57	964.12	1 845.16	41	858
171	5 373.83	474.77	2 727.24	21	2 102
174	6 916.87	2 617.44	3 968.59	7	3 696
175	4 899.53	1 551.10	2 730.67	6	1 234
178	4 171.32	267.17	1 828.75	32	617
179	2 491.63	343.27	891.71	55	821
180	1 479.25	67.15	332.45	42	230
181	5 080.99	2 144.76	3 733.28	4	1980
182	3 885.91	2 074.12	2 570.09	4	990
183	1 501.13	210.91	617.96	5	867
184	4 684.98	187.19	808.01	56	462
185	1 116.72	1 116.72	1 116.72	1	387
194	2 768.90	250.45	626.58	100	474
214	577.17	577.17	577.17	1	1 432



Table 3. Comparison of the average values of the clinical paths of second surgery department of Fifth Multiple Profile Hospital for Active Treatment Sofia and the prices, paid by the NHIF

Nr. of clinical path	Highest value (BGN)	Lowest value (BGN)	Average value (BGN)	Number of patients, recorded on clinical path	Price paid by the NHIF (BGN)
26	1 140.95	391.23	687.40	14	642
30	2 602.23	391.23	778.59	76	600
31	1 201.61	265.13	620.58	30	550
33	2 330.56	296.20	776.00	59	1 010
74	932.66	96.91	389.66	13	116
156	8 317.22	1 705.95	3 741.43	16	2 239
158	4 124.08	731.12	2 305.31	3	1 440
160	8 589.35	1 250.91	3 132.17	63	2 200
162	16 215.73	666.06	2 751.96	26	835
164	1 667.87	175.97	478.43	25	556
165	4 301.18	655.21	2 461.84	6	624
166	2 017.65	95.14	567.87	62	624
167	3 017.40	190.30	846.94	179	578
168	691.28	393.18	542.23	2	601
169	3 934.32	1 100.16	2 160.96	20	858
170	3 006.64	227.05	1 090.94	86	936
171	4 345.00	1 828.24	2 869.10	19	2 102
172	6 171.83	1 373.69	3 189.84	3	2 449
173	3 175.87	3 175.87	3 175.87	1	968
174	9 014.03	1 812.21	4 173.63	7	3 696
175	6 377.43	515.17	2 946.06	6	1 234
178	4 477.73	469.52	1 151.45	37	617
179	2 541.68	248.21	924.96	67	821
180	1 210.62	78.25	350.41	98	230
181	2 374.05	1 283.52	1 840.67	4	1980
182	691.09	691.09	691.09	1	990
183	2 105.13	285.43	602.92	8	867
184	2 150.59	169.23	750.96	48	462
185	1 155.35	197.45	687.92	6	387
194	2 648.39	391.23	645.78	163	474

As one clearly sees the costs for hospital treatment on the surgical clinical paths are in their bigger share between 66.67% and 68.97% more than the incomes, which the health insurance fund pays. Therefore this method is not sufficient for funding the hospital aid.

One sees the big difference in the costs for operative treatment of a patient with the observed clinical paths. The values vary in a broad range depending on the complexity of the operative procedure and the follow-up treatment of the patient. Big influence in the raise of the costs for hospital treatment is done by the accompanying diseases and the complications, which he/she receives during the hospital stay. Last but not least as a significant factor for the raise of the costs for hospital treatment are the nasal and comial infections.

The clinical paths are not a financial tool and do not take into consideration the presence of accompanying diseases and complications. There is a growth in the necessity of implementing the diagnostically related groups as a more appropriate method for funding the hospital aid, as well as the strengthening of the role of the additional payment by the voluntary health insurance funds.

In order to make a comparison with the surgery treatment we consider also the value of the treatment of patients in the internal department, namely in the gastric enteorological department and the price for this treatment on clinical paths from NHIF.

Table 4. Comparison of the average values of the clinical paths of second gastric enteorological department of Fifth Multiple Profile Hospital for Active Treatment Sofia and the prices, paid by the NHIF

Nr. of clinical path	Highest value (BGN)	Lowest value (BGN)	Average value (BGN)	Number of patients, recorded on clinical path	Price paid by the NHIF (BGN)
26	2 945.51	288.27	844.96	184	642
27	1 283.18	144.15	507.66	225	308
28	2 142.04	174.08	661.24	351	1 375
29	1 438.80	536.82	982.00	9	990
30	1 569.40	74.03	832.76	44	600
33	1 176.99	406.22	739.18	22	1 010
34	2 537.76	183.32	1 048.56	138	1 295
36	2 057.80	288.27	776.37	45	723

From the data presented it is to be seen, that from 8 clinical paths in total, on which the gastric enteorological department works, 4 are underestimated with the payment by NHIF within the range of 6,87 % to 39,33%; 3 clinical paths are overestimated and one is with average value, approximately equal to the price, paid by NHIF.

#### CONCLUSION:

The research has been done in first and second surgery department with Fifth Multi Profile Hospital for Active Treatment Sofia, since there one works on the biggest number of clinical paths, for which the hospital has a contract concluded with the SHIF, as well as in the gastric enteorological department, in order to make a comparison between the surgery and internal department. This gives us reason to consider the results, obtained by us, as applicable both in the other departments of the hospital and in the other hospitals in the country.

On grounds of the data obtained we have drawn the following most important conclusions:

1. The comparison of the performed costs of the departments as part of the hospital for the examined 2010 and the obtained incomes shows, that the costs for hospital treatment on surgery clinical paths in their biggest part are between 66,67% and 68,97% more than the incomes, received by the healthcare fund. Therefore this method of payment on the clinical paths is not sufficient for funding the hospital aid.
2. In the field of funding the hospital aid one could find the following disadvantage: “the prices” of the clinical paths are most often not in compliance with the real costs as a significant part of the clinical paths are “underestimated”. Very often the value of the clinical paths is not in relation with the burden of the disease, the accompanying diseases and the quality of treatment provided.
3. The calculations made by us on the real value of the surgery clinical paths imply the necessity of introducing a brand new method for payment of the providers of hospital help – DSG, by means of which one aims at providing real funds for real costs. It is of extreme importance to increase the participation share of additional ways for funding the hospital care, one of which is the additional funding by voluntarily healthcare funds.
4. The strive towards calculating the costs with the treatment of patients is a way to perform a reasonable control on the dynamics of these costs. In this situation the method of calculation of the costs on processes should be such, that with as less efforts as possible one could be able to determine deviations in the different parts of the production process, and the person in charge to control them should have the right to take efficient measures for correcting these deviations.
5. It is necessary to take into account the role of the personnel when forming the costs. The effective doctor as main source of costs shall diagnose the disease of the patient and shall treat him/her with as less costs as possible. The doctor decides which shall be the means, which shall be used for making the diagnosis and for treatment of the disease. This fact together with others such as the difficulty to assess correctly the influence of the technical advancement on the behavior of the personnel and the necessity of tools, which shall allow objectivisation of the service quality, make necessary the search for paths for stimulating experts – doctors, medical nurses and other medical experts, so that they could be used towards rational use of the resources in all processes of medical services.

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## IMPACT OF MARKETING ON THE LIFECYCLE OF SMALL BUSINESSES IN RUSSIA

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### Abstract

*Current economic crisis adversely affects small businesses. Such influence prevents creation of new companies and increases the quantity of companies, which wind up their operations. Winding-up of small businesses is often explained by insufficient "entrepreneurship talent" of their owners. At the same time, marketing (as a research and practical field) is seen only as a supplement to business. However, marketing is not just a functional component of the business; it is also the basis of its organization and philosophy. This article describes the influence of marketing on small businesses, researching the hypothesis of a link between the stages of the lifecycle of small businesses and certain components of marketing.*

**Key words:** *SME, enterprise lifecycle, marketing, Adizes development stage, key business competence, business marketing strategy, enterprise growth rates, market growth rate.*

### 1. INTRODUCTION

Marketing is an important factor for successful existence and development of any enterprise, which makes it possible to select and understand target customer groups for a certain company, and the factors, which contribute to its competitiveness. Nevertheless, small and medium enterprises (SME) do not pay proper attention to marketing. In many respects, such situation was caused by insufficient understanding by the management and/or business owners of the role of marketing. In order to study the role of marketing in small and medium enterprises, we need to focus on the influence of marketing on SME development. And here we need to rely on two main directions: the role of marketing in entrepreneurship and the influence of marketing at various stages of the enterprise development. Focusing on the first direction, it is important to distinguish between the two terms: *entrepreneurship* and *marketing* (Sidorchuk, 2009a). Miles, Russell and Arnold (Miles, Russell & Arnold, 1995) compared the marketing-based and the entrepreneurship-based approaches. They conclude that bias towards entrepreneurship results in improvement in the customer satisfaction, focusing on the customer's needs, summing the marketing-based approach with innovativeness, pro-activeness and risk appetite. However, D. Carson, Professor at the University of Ulster (Carson, 1993) believes that there are common features and differences between the entrepreneurship-based approach to decision-making as compared to formal marketing planning, management competence and enterprise communications. Therefore, entrepreneurial decisions are viewed as informal, occasional, creative, adapting and reactive, while marketing decisions are formal, consistent, systemically oriented, organized and structured. On the other hand, there are common features in existence and use of personal communications between entrepreneurs and marketing managers. Some skills are equally necessary to entrepreneurs and marketing managers, for example use of analysis, positiveness, innovativeness and creative thinking. Professor Omura suggests his approach to the issue of differences between marketing and entrepreneurship. In their research, Omura et al (Omura,

Calantone & Schmidt, 1994) considered the approach, which assumes that marketing is present in entrepreneurship, though in different forms. In their turn, Hills and LaForge (Hills and LaForge 1992) suggested that when defining the mission of a new company, we need to take into account at least two factors, which are located right on the border of marketing and entrepreneurship disciplines. The first factor is represented by the impact of the entrepreneur's personal aspirations and goals on the company mission (Sexton and Bowman-Upton 1987), while the second factor is represented by the role of the marketing concept (Kotler 1972). While studying growing SME, Hills interviewed executive directors, who specified the strongest factors, which affect successful development of a company: quality of the commodity/service and openness to the customers' desires (Hills and Narayana, 1990). In his turn, Gardner (Gardner, 1983) studied the issue of the marketing concept / creation of new enterprises based on the example of 15 existing companies (with sales ranging from 1 to 30 million dollars). He concluded that distributors are less eager to use the marketing concepts (which means that they are more reluctant to take into account the customers' needs and desires with their subsequent satisfaction) as compared with other types of companies. Manufacturers know their customers better and pay more attention to their requests. Peterson (Peterson, 1989) asked the owners of small businesses to formulate the philosophy of their companies, using the key indicators: marketing, sales and focus on the needs. Marketing focus was selected mostly by retailers (50%), sales-based philosophy was chosen by service providers (42%) and wholesalers (57%), manufacturing-based philosophy was chosen by manufacturers (58%). This result brings us closer to the second direction – impact of marketing on the company development. And here we need to pay attention to an important aspect of “marketing management”. Marketing management can be defined as the process, which provides to the company an opportunity to generate necessary revenues in order to achieve its goals. Various factors of the external environment represent an important group, which affects the company business operations, which are often described by the cyclical nature. The nature and the society are described by various cycles, which affect the company and the interaction between the elements of the macro- and microenvironment. As you know, marketing strategy reflects anticipated market development and changes in the market situation, and first of all changes in the demand/supply ratio. In their turn, such interactions affect pricing and investments in the company operations. When considering various ways of adaptation of the company to external impacts and when determining the directions of changes in the internal organization in order to ensure reasonable business operations, it is necessary to establish a link between the development trends of the macroeconomic processes with the operations and development of the company. Analysis of various cyclical processes makes it possible to formalize forecasts to a certain degree. Therefore, in order to identify and take into account the factors, which determine the impact of the market situation on the company operations, Aniskin and Moiseeva (Aniskin, Moiseeva, 1996; Aniskin, 1998) suggest starting from the cyclicity concept. Economic waves (cycles), which affect the demand and supply, result from interaction between the cycles of various nature. Various cycles, which are present in the nature and the society, affect the company as the manufacturing and distribution system (structure, functions, ways of their implementation) and the interaction between the elements of the macro- and microenvironment. The objective nature of oscillatory processes in economics are confirmed by several studies, for example Schumpeter's three-cycle scheme, which allows to combine in a consistent manner Kondratiev's cycles (50-55 years) with Juglar's cycles in the banking and credit system (10 years) and Kitchin's cycles (3 years and 4 months). Impact of the factors, which determine these cycles, may take various forms (Moiseeva, 2002):

- cyclicity of crises (which are described by mismatch between sales and purchases in time and in space, gap between the links in the price of sales and purchases etc.);

- structural crises (which result in price increases, excessive demand, lag between demand and supply etc.), which are often do not coincide with the cyclical crises;
- periodic crises (which are described by conflicts, collapse of systems etc.; interacting with the two previous cycles, they play the main role).

Determining the current level of business activity, explaining its progress and forecasting its further condition are possible only if the market situation and the company lifecycle are viewed as the oscillatory system. Being under the influence of changes in the macro- and microenvironment, companies have to assess critically their opportunities, as well as new threats and risks, which slow down or accelerate implementation of earlier plans and transformations. Comprehensive impact of the factors of the internal and external environments creates risky situations, which result in unjustified losses. Various tools (and, first of all, marketing tools) may be used in order to mitigate the market risks. They include marketing studies of the macro- and microenvironments, marketing assessment of the company internal environments, analysis of consumer preferences and their trends, analysis of the market situation. The extent and efficiency of these tools are determined by the infrastructure and the company internal specifications, which urges us to consider the marketing activities as the element of business operations. We believe that the organizational development cycles (which describe the creation and lifecycles of the companies) are most important for small enterprises. Very often enterprises are compared with biological organisms in the form of a sequence of events, during which organizations are born, grow, get older and die. According to Semenov (Semenov, 2001), half of U.S. companies cease to exist during less than 5 years, only 4 out of 10 companies operate during 10 years, and only 3 out of 10 companies celebrate their 15<sup>th</sup> birthday. Even 50% of large corporations cease to exist before they are 40 years old. Long before the complete collapse, the company may receive sufficient signals, warning of its moving towards the crisis, but the company itself can not realize the threat. In order to simplify the analysis of these problems, company organizational development stages are often tied to the stages, which are similar to the lifecycle stages of the biological organisms: formation, maturing, maturity, old age and death. This sequence of stages is known as the company lifecycle. For the purpose of further analysis of the factors, affecting business operations of SME, we need to consider the companies' lifecycles. The company lifecycle was initially developed by researchers as an extension and adaptation of the product's lifecycle concept from the marketing theory to analysis of the companies' development. Later on, this direction became an independent area for development of various approaches and theories. The company lifecycle in most cases can be understood as the period of the company operations (Shestopov, 2007). We should mention that "cycle" implies recurrence of similar events. Despite the fact that each company may have its own way of development, we may speak about the patterns of development, which are known as the company lifecycle. We believe that the most successful model of the company lifecycle was suggested by Adizes (Adizes, 2007). He identifies three phases of the organization's development: growth, stabilization and aging. Growth phase starts with the birth, followed by courtship, infancy, go-go stage, adolescence. Stability stage means prosperity. And stabilization. Third phase includes aristocracy, early bureaucracy, bureaucracy and death. We used this model in order to study the impact of marketing on the lifecycle.

## 2. PROBLEM DESCRIPTION

The impact of marketing on the lifecycle of small businesses requires further research (Sidorchuk, 2009b). As part of our research conducted in 2010, we analyzed some SME with various specifications. The purpose of the study was to determine the role of marketing in existence and

development of small businesses Our survey covered 400 managers and owners of small businesses in various parts of Russia: Moscow and Saint Petersburg, as well as in Moscow, Novgorod, Novosibirsk, Sverdlovsk, Tomsk and Chelyabinsk oblasts, and Krasnodar Krai. Selection of the above regions for the survey was caused, mostly, by availability of significant data, which makes it possible to identify small enterprises. We did not try to achieve regional or industrial representation. We also did not distinguish between the form of incorporation (JSC, CJSC, LLC, sole proprietor) and the type of small enterprise (small enterprise or macro-enterprise). The main criteria for making the selection included the quantity, year of creation, annual turnover (up to 400 million roubles) Additional limitation, which is connected with formation of the sample, is represented by the companies' electronic communication means (website and/or email), which is caused by the need to conduct research using electronic communications. We should mention that the issues, which are considered as part of the research, belong to professional competencies of the small business manager/owner. Therefore, the manager/owner of a small business may be viewed as an expert. We may assume that, when making his or her judgment, an expert relies on a group of causal factors, which operate in terms of a certain scenario, estimating the probability of their realization and their probable effect on the studied indicator (Golubkov, 2000). Expert judgments are widely used in marketing studies. They are often used for studies, if statistical data are insufficient. They are also used for quantitative measurement of such events, which can not be measured in any other way, for example when estimating the importance of goals and preferred organizational conditions of enterprises. In other words, methods of expert estimates are used both for quantitative measurement of present events and also for forecasting purposes. Business Card Companies Database was used to create the sample. Creation of such database implies personal involvement of the companies' representatives in providing the data on their companies. Besides, the data from this database are checked for their validity on a regular basis. 13,100 companies meet the main criteria according to the Business Card Companies Database. Only 7,954 companies out of them provided director's email. The managers'/owners' reluctance to participate in the survey became a serious restriction in this research. Due to the above reason, the research did not include special restrictions based on the quantity of enterprises, their specifications and business areas (except for the above parameters) in the sample. Answers were provided by 327 managers/owners of the companies. After reviewing the provided questionnaires, only 300 questionnaires were used for research purposes. The remaining questionnaires were rejected for their non-compliance with the research criteria or for their incompleteness (less than 80% of answers to the questions).

### 3. DESCRIPTION OF THE RESULTS

The variables, which were used in the research, include: quantity of employees of a small business at the time of study; main operation; period of the business' existence; Adizes development stage; key business competence, selected by the enterprise; marketing business strategy; enterprise's growth rates; market growth rates. The survey gave us answers to the questions, and such answers were processed using SPSS software. Since it was a multipurpose survey, we will analyze the answers regarding the hypotheses of a link between the lifecycle stages of a small company and some marketing parameters. Such parameters include a link between the chosen key competence and the marketing strategy, on one hand, and the small enterprise's lifecycle stage on the other hand. We believe that the standard profile of a company is determined by 4 parameters: quantity of employees, period of the company existence, type of operations and taxation system.



Diagrams 1, 2 and 3 describe frequency distributions of these variables for these companies, which were involved in the research. In order to determine the link between the indicators, we used  $\chi$  (chi)

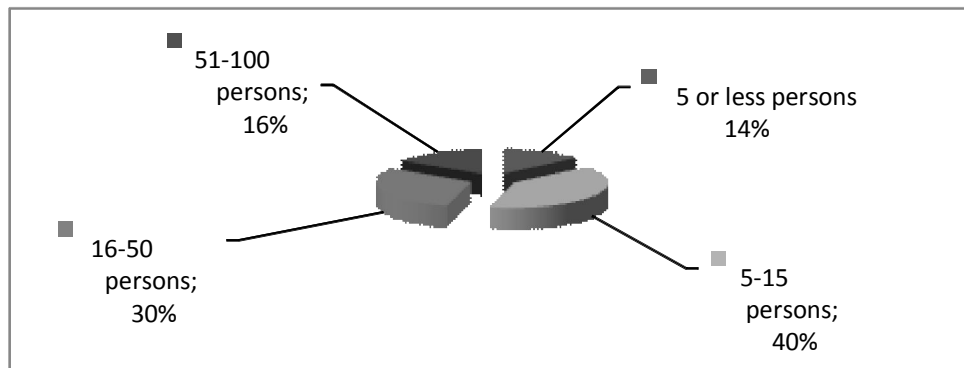


Diagram 1. Number of employees of small businesses, which are involved in the study

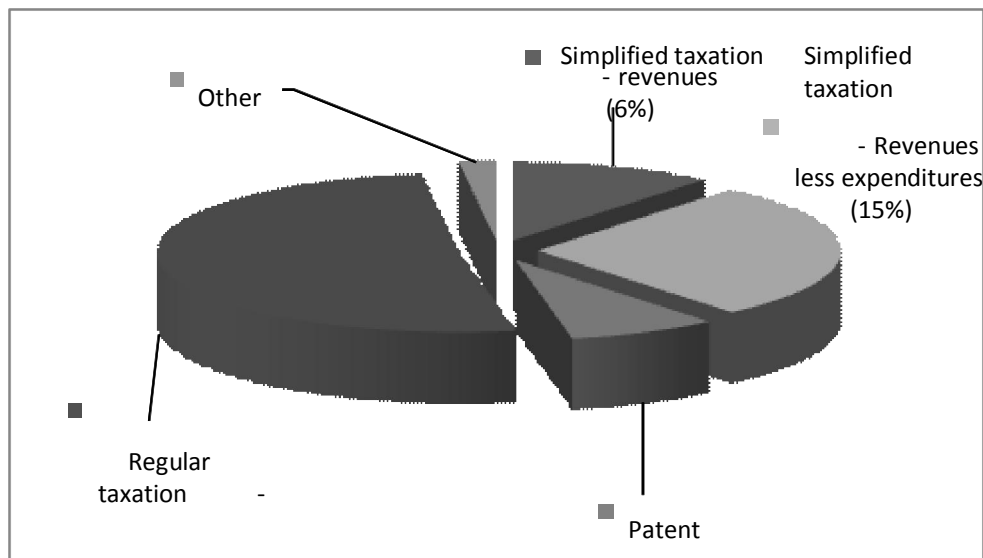


Diagram 2. Taxation, applied to the employees of small businesses, which are involved in the study

squared ( $\chi^2$ ) and  $\phi$  (phi) significance coefficients. If chi squared is less than 0.05, then we may say (with 95% probability), that the hypotheses regarding absence of the link between the variables, is rejected; therefore, a link between these variables exists.

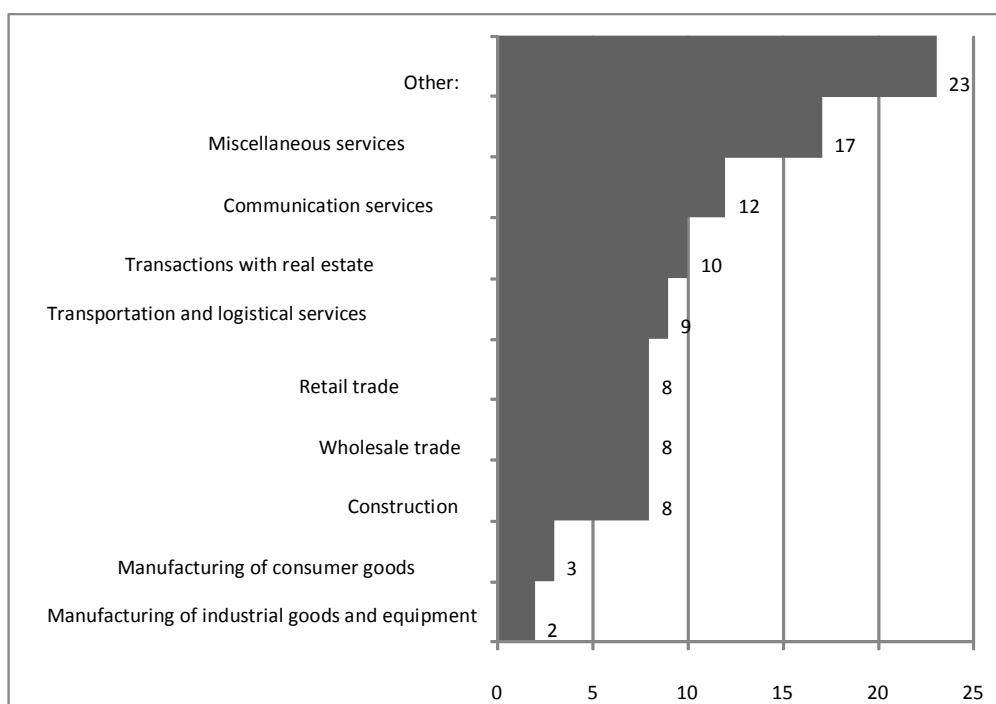


Diagram 3. Distribution by type of operations of small businesses, which are involved in the study

Based on the analyzed data, we may say that there is no link between the following variables (Table 1). We used phi coefficient in order to measure the strength of the statistical link between the variables. Phi values range from 0 to 1. Table 2 presents the results of the analysis. Interpretation of data from table 2 shows no link between the period during which the business exists and the key competence. An important aspect, revealed in this study, may include absence of the link between the key competence, chosen by the company, and types of the company operations. We may assume that the specifications, which distinguish the respondents from competitors (i.e. their distinguishing competence) may be successfully used in various industries in terms of the suggested options. Analysis of data in Table 2 is also interesting.

The revealed link between the number of employees and the company development stages, as well as the strong link between the market growth rates and the company growth rates point to obvious dependency of these indicators. This may be used as an indirect proof of other revealed links. One of the most important links is represented by the link between the variables of the company development stage with the marketing strategy and selected exceptional competence. Taking into account strong

**Table 1.** Variables, between which a link exists

Variable 1	Variable 2
Period during which the business exists	Key competence
Operations	Key competence
Operations	Stage of the company development
Company growth rates	Period during which the business exists

**Table 2.** Results of the analysis of links between the variables

Variable 1	Variable 2	Phi coefficient	Interpretation*
Quantity	Stage of the company development	0,593	Moderate link between the variables
Period during which the business exists	Stage of the company development	,676	Strong link between the variables
Stage of the company development	Marketing strategy	0,908	Strong link between the variables
Stage of the company development	Company growth rates	0,583	Moderate link between the variables
Stage of the company development	Key competence	0,796	Strong link between the variables
Market growth rates	Stage of the company development	0,690	Strong link between the variables
Market growth rates	Company growth rates	0,758	Strong link between the variables
Market growth rates	Key competence	0,715	Strong link between the variables
Company growth rates	Key competence	0,672	Strong link between the variables

\* All  $\phi$  (phi) coefficients have at least 95% significance levels.

correlation between the company growth rates and the selected exceptional competence, we may speak about the impact of marketing on the company lifecycle stage and (which is not less important) on its growth rates. Therefore, we may assume that if a small enterprise implements marketing function, especially in the area of selection of the marketing strategy and the company exceptional competence, high growth rates of a small company may be achieved, and they may affect the company lifecycle stage and the company development. One more proof of the role of marketing may include the revealed strong link between the market growth rates and the selected key competence. This link shows to us the importance of implementation of the marketing's research function in small companies. More detailed results of the study are described in my monograph (Sidorchuk, 2012).

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**COUNTRY BRANDING AND EXPERIENCE MARKETING:  
A PERSPECTIVE ON SENSEMAKING AND COGNITION THEORIES**

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**Abstract**

*In a globalized world countries compete with each other to attract the attention, preference and trust of investors, international media, tourists, and talented people. A powerful and positive place brand provides a crucial competitive advantage. Branding is a popular strategy for countries to differentiate themselves on the world stage, promote investment and strengthen commercial performance. The purpose of this paper is to fulfill a perceived gap in research by exploring the possibility to apply experience marketing as a central marketing approach to the country branding process. This work concentrates on examining place branding and experience marketing concepts in association with cognition and sensemaking theories. The central argument of the study is that countries using experience marketing techniques in branding might be more successful than those that use traditional marketing methods. With this in mind, the paper attempts to provide a theoretical overview for creating a model of country branding.*

**Key words:** *country branding, place branding, experience marketing, cognition, sensemaking*

**1. INTRODUCTION**

In an increasingly globalized world, all places (countries, nations, regions, cities) compete fiercely to attract the attention and trust of tourists, investors, international events, clients for their products and services, international media and talented people of other countries. Competition takes place at every level. Although we all know that a powerful and positive place brand provides crucial competitive advantage, it is difficult for small countries (or cities) to compete with big well-known countries and the topic is currently “hot.”

Many terms in this field are used interchangeably, but place branding is the umbrella term, that is preferred in marketing literature (e.g. Gould & Skinner 2007; Hankinson 2004; Hanna & Rowley 2008; Kavaratzis 2005; Kotler & Gertner 2002; Papadopoulos 2004, Pike 2009; Rainisto 2003). Place branding is one of today’s ‘hottest’ topics among place marketers – from New Zealand and Switzerland to Las Vegas and Helsinki. It is essential for countries to understand how they are seen by others and how their achievements and failures, people and products are reflected in brand images. More countries around the world nowadays use place branding in order to differentiate themselves on the world stage and to strengthen their economic performance, primarily in terms of exporting, inward investment and tourism.

Place/country branding refers to building and managing the image and reputation of the country as a whole. In place marketing, the brand is normally a country, nation or city. Marketing practitioners have come to realize that understanding how consumers experience brands is critical for success and developing marketing strategies. Hence, most of the research on experiences to date has focused on

utilitarian product attributes and category experiences, *not on experiences provided by brands* (Brakus, Schmitt & Zarantonello 2009). Country branding is more complex than product branding, and it has to be dealt as corporate branding because they are similar in many ways. This is why research on this field is very much needed.

Although experience marketing could help to support the economic, social, and cultural development of a country, research has been insufficient. Fulfilling this gap requires consideration of the experience marketing options, to find the one that would suit best for managing and promoting a given place brand identity. Further, it could lay the theoretical grounds for managing brand experience in particular cases, such as Estonia, a small country facing tough competitors.

The purpose of this paper is to construct and present a conceptual model of country branding which takes into account experience marketing and the cognition and sensemaking theories' perspective. Country/place branding is examined with the methods applicable to experience marketing and according to cognition and sensemaking theories. These organizational theory concepts have been useful to analyze corporate branding, and in this study help also supporting the argument that analogical interpretation is valid and place brand identity can be seen as organizational identity.

The main argument of this study is that countries that use experience marketing as their central marketing approach of place/country branding, and concentrate on developing a country brand are more successful than those using traditional marketing methods. Consequently, the next stage in development and promotion of country brand identity is experience marketing.

To achieve satisfactory results, and propose the use of experience marketing to refine and develop a country brand further, the following research questions need to be addressed: 1) what are country branding and experience marketing?, 2) how the theories of country branding and experience marketing are related to cognition and sensemaking theories?, and 3) how to conceptualize country branding?

Place branding in experience marketing from the cognition and sensemaking theories perspective is a novel contribution to the field, and has not been studied so far. In the following pages the hypothesis proposing country brand's competitiveness through experience marketing will be studied, synthesized to a point where further research challenges can be identified. In a first section, an overview of the basic terms will set the foundation for the optimal elaboration of a conceptual model of place/country branding, one that can also incorporate the organizational theories relevant. Ultimately, this paper can be used as a reference to overview what has been learned as it assembles data in a way that continuing research challenges can be clearly identified.

The conceptual part is followed by the selection of the theoretical tools applicable and an explanation on the way they relate to each other in the formation of place/country branding. The last section explains the proposal of a conceptual model of place/country branding analysis that would help to understand the essence of country branding and pave the way for further research.

## 2. COUNTRY BRANDING

### 2.1. Definition of country branding and place branding

There are different terms to refer to place/country branding in marketing literature and authors are often engaged in definitional debates. Fetscherin (2010) reports that, the terms of nation and country

branding are used interchangeably in the literature. Pasquinelli (2010) notes the many different ways in which place brand is presented, according to the specific aspect that is taken into account.

The literature of place branding reflects a picture of separation between place branding, country branding, city branding, destination branding, and region branding; but they should not be separated. According to Herstein (2011), despite the differences, marketing a place (country, region, or city) depends mostly on understanding how people *perceive* one another. The perception is related to cognition theory.

In any event, „place branding” is the umbrella term preferred by marketing professionals and scholars. *Within* place branding, some studies focus on country/nation branding (e.g. Dinnie 2008; Endzina & Luneva 2004; Gilmore 2002; Wetzel 2006), region branding (e.g. Andersson 2007; Hall 1999; Hornskov 2007; Szondi, 2007), and city branding (e.g. Ashworth & Voogd 1990; Hospers 2003). Tourism studies and vacation marketing tend to use the term destination branding (e.g. Morgan, Pritchard & Pride 2004; Therkelsen 2003). Garcia, Gomez and Molina (2012) argue that a more general theoretical framework approach underpinning place branding is attributable to researchers such as Kotler and Gertner (2002) and Hankinson (2004, 2007, 2009), and to the attempts of establishing relationships between literature on place branding with classical branding theory and new marketing paradigms (relational and emerging Service Dominant Logic).

According to Kavaratzis (2005), the trends in place branding are: place of origin branding (e.g. Kotler & Gertner 2002; Papadopoulos & Heslop 2002), nations branding (e.g. Anholt 2002; Van Ham 2001; Gilmore 2001), culture/entertainment branding (e.g. Greenberg 2003), destination branding (e.g. Morgan, Pritchard & Pride 2002), and place/city branding (Kavaratzis & Ashworth 2005; Hankinson 2004; Kavaratzis 2004; Trueman, Klemm & Giroud 2004; Rainisto 2003).

Place/country brand may be defined as “the unique, multi-dimensional blend of elements that provide the place with culturally-grounded differentiation and relevance for all of its target audiences” (Dinnie 2008, p. 15). It is a subjective mental picture shared by a group of consumers or audience (Riezebos 2003). Anholt (2007) defines place/country brand as the perception of the place (brand) that exists in the mind of their audiences. Jaffe and Nebenzahl (2001) see it as the impact that generalizations and perceptions about a place have on a person’s evaluation of the place’s products and/or brands.

There is no single definition of place/country branding. Country branding refers to building and managing the image and reputation of the country as a whole. Nation branding considers how the nation as a whole behaves, interacts, presents and represents itself to other nations. Defining the nation branding, Fan (2006) argues that it concerns applying branding and marketing communications techniques to promote a nation’s image.

Braun and Zenker (2010, p. 5) define a place brand as “a network of associations in the consumers’ mind based on the visual, verbal, and behavioral expression of a place, which is embodied through the aims, communication, values, and the general culture of the place’s stakeholders and the overall place design”.

Place/country brand building requires a long term commitment. Places/countries need to adopt a long term, strategic view when building their brand. Country branding is not merely creating an attractive logo, an advertisement or a political campaign, but is a comprehensive national effort from all country’s stakeholders to build and manage the image and reputation of their country in front of their target audiences.



Blain, Levy and Ritchie (2005, p. 337) propose a revised definition for place/destination branding and define it “as the set of marketing activities that (1) support the creation of a name, symbol, logo, word mark or other graphic that readily *identifies* and *differentiates* a destination; that (2) consistently convey the expectation of a memorable travel *experience* that is uniquely associated with the destination; that (3) serve to consolidate and reinforce the emotional connection between the visitor and the destination; and that (4) reduce consumer search costs and perceived risk”. Collectively, these activities serve to create a destination image that positively influences consumer destination choice.

When Fan (2006) focuses on the question what is being branded, he states that nation branding and nation brand are two different concepts. “A nation has a brand image with or without nation branding” (2006, p. 5). It is important to mention what Herstein (2011) characterized as having two dimensions: representational (attributes linked to the individual’s way of self-expression, analogous to intangible characteristics) and functional (utilitarian aspects of the destinations – sun, reefs, sky, culture, and so on, analogous to tangible characteristics).

According to Kavaratzis and Ashworth (2005), there are at least three different sorts of place branding which are often confused in the literature but are quite different operations conducted by different producers for different objectives. The first is geographical nomenclature, the second product-place co-branding and the third branding as place management.

Destination marketing organization (DMO) is any organization, at any level, which is responsible for the marketing of an identifiable place/destination (Pike 2004). DMOs jurisdictions may cover a country, state/province, region, or specific city or town (Blain, Levy & Ritchie 2005), and they are a critical component for the place/country.

## 2.2. Country branding and corporate branding

Aaker (2004) defines a corporate brand as a brand that represents an organization and reflects its heritage, values, culture, people, and strategy. A corporate brand is defined primarily by organizational associations, and thus can develop and leverage organizational characteristics, as well as product and service attributes. According to Hankinson (2009, p. 98), „recent literature with regard to corporate brands in particular, suggests that they have several characteristics that align them with place/destination brands and that managing place brands might therefore be much *like managing corporate brands* (Hankinson 2007; Karavatzis 2004; Trueman et al. 2004; Rainisto 2003)“.

Marketing specialists acknowledge place branding’s importance and the applicability of the general branding principles to cities, regions, and countries (e.g. Keller 2008; Kotler & Gertner 2002). Anholt (2004) states that countries, cities, and regions behave like product brands. Kotler and Gertner (2002) suggest even a place/country without a brand marketing strategy still behaves as a brand and evokes images influencing people’s decision to visit or buy products originating from there. Papadopoulos and Heslop (2002, p. 308) claim that „a country is like a corporation that produces many products“. Nikolova and Hassan (2011) state that despite their specifics, place/country brands compete globally on equal footing with consumer and service brands. Pasquinelli (2010) claims that product and corporate marketing have been deemed a source of tested logics and techniques, which can be translated into tools for place management.

It is widely accepted (e.g. Trueman et al. 2004) that places are very complex and varied brands, serving varied aims and targeting varied groups and individuals at the same time, which makes them much more difficult to control than conventional product brands (cited in Kavaratzis 2005, p. 334). But, Kavaratzis (2005) argues that as some commentators have noticed (e.g. Trueman et al. 2004; Kavaratzis 2004; Rainisto 2003), there are significant similarities between corporate brands and place

brands, which bring the two concepts close and provide a starting point for a better understanding of place branding. Also in 2009, Kavarazits (p. 27) notes that „a recent stream of publications has specifically dealt with the concept of corporate branding, attempting to adjust its basic elements and specific methodologies in place branding (Rainisto 2003; Hankinson 2007; Trueman et al. 2007)“. According to Kavarazits (2009, p. 26) „corporate-level marketing is suggested as the closest that marketing theories have ever come to addressing the distinct demands of cities, ...concentrates on the similarities between these two forms of branding and extracts major lessons from corporate level marketing concepts“.

Anholt (2002) points to the relevance of the „metaphor of *place as corporate brand*“. According to Kavarazits (2009, p. 29) „they both have multidisciplinary roots, both address multiple groups of stakeholders, both have a high level of intangibility and complexity, both need to take into account social responsibility, both deal with multiple identities, both need a long-term development. ...It could serve as a basis for the refinement of place/city marketing theory“.

Hankinson (2007) provides five guiding principles for destination brands *based on corporate branding theories*. He argues that there are sufficient similarities between these two types of brand to allow useful lessons to be drawn and suggests that efficient destination branding depends upon (a) a strong, visionary leadership, (b) a brandoriented organisational culture, (c) departmental coordination and process alignment, (d) consistent communications across a wide range of stakeholders and (e) strong, compatible partnerships.

Kavarazits (2005, 2009) tries to develop a place marketing theory; Hankinson (2004, 2005, 2009) lays the foundation for the systematic development of a theory of destination brand management.

### 3. EXPERIENCE AND EXPERIENCE MARKETING

Experiences are regarded as key concepts in marketing today. Experience analysis is essential for understanding consumer behavior, and according to Pine and Gilmore (1998), even a foundation for the whole economy. Experience is the main component of experience marketing and according to LaSalle and Britton (2003) and Schmitt (2003) the marketing of the future. During the past years, experience marketing has become an important topic also in the branding world.

As a conceptual and empirical phenomenon, experience is not as established as other consumer and marketing notions, such as choice, attitudes, consumer satisfaction, or brand equity (Schmitt 2010). Poulsson and Kale (2004) observe that no systematic attempts have been made to define what constitutes an experience in marketing terms or context. The lack of clarity lies in different ways in which the term “experience” can be understood. Tynan & McKechnie (2009) explain that experience is both a noun and a verb and it is “used variously to convey the process itself, participating in the activity, the affect or way in which an object, *thought* or emotion is felt through the senses or the mind, and even the outcome by way of a skill or learning.”

Experience represents a relation of significance between a person’s perceptual activity and a life situation and is of particular significance to the person (Perttula 2007). Tarsanen and Kylänen (2007) state that an experience is a holistic experiential feeling, that may lead to changes in personal opinions and attitudes of a consumer. Experience is composed of feelings, new knowledge and beliefs acquired by the consumer through an experiential service or an event (Same 2012).

Experience in its most general and broadest use is the mental state that occurs in any individual, at any conscious moment (Poulsson & Kale 2004). Pine and Gilmore (1999) explain that "while commodities

are fungible, goods tangible, and services intangible, experiences are memorable”. An experience is a result of the interaction between the customer and the experience provider (e.g. destination marketing organization (DMO)), and the act of co-creation between the two. On the consumer’s side, we need to consider the preconditions the consumer brings to the experience and feelings and sensations that take place in the customer during the experience. On the provider’s side, we need to examine the tools and processes that are used to create those feelings and sensations. In doing so, we provide meaningful and relevant experiences (Poulsson & Kale 2004).

Experience marketing differs from traditional marketing because traditional feature-and-benefit (F&B) marketing is designed to appeal to rational buying side of the target audience. Traditional marketing is hardly a psychologically-based theory about customers and how they view and react to products and competition (Schmitt 1999). Experiential marketers view consumers as rational and emotional human beings who are concerned with achieving pleasurable and memorable experiences. There are five different types of experiences that marketers can create for customers: sensory experiences (sense); affective experiences (feel); creative cognitive experiences (think); physical experiences, behaviors and lifestyles (act); and social-identity experiences that result from relating to a target group or culture (relate). These experiences are implemented through so-called experience providers such as visual and verbal *identity*, communications, product presence, electronic media, etc. (Schmitt 1999). The main question in experience marketing is *what do you know, feel and want?* (Same 2012).

Experience marketing is generally based on the theory of experience economy (Pine & Gilmore 1998, 1999), which encompasses the most developed theoretical discourse about experience marketing (Gilmore & Pine 2002; Schmitt 1999, 2003).

To broaden the understanding on what exactly constitutes experience marketing the definition of *experience marketing* as “strategic (customer-centered) and holistic marketing of relevant (and meaningful) experiences that takes into account the affective, cognitive and conative perspectives of consumption experience” (Same & Larimo 2012) is preferred. For an experience to provide meaningful utility, it should also be perceived as personally relevant and include elements of novelty, surprise, learning, and engagement (Poulsson & Kale 2004).

Schmitt (2003) asserts that experience marketing can deliver sensory, emotional, cognitive, behavioral and relational value to customers, to which social and informational based value can be added. Customers obtain value from *sensory meaning* through sight, sound, touch, taste and smell associated with the experience (Schmitt 1999), while *emotional meaning* extends to incorporate different kind of emotions attached to the experience (Richins 1997).

The need for differentiation which drives much of experience marketing and the requirement to facilitate a dialogue between customers, the organization (or in this case place/country) and its network members and the brand, together with the need to build strong and positive impressions to communicate the experience to customers, all point to the *centrality of branding in the experience process* (Tynan & McKechnie 2009).

Brand experience is conceptualized as sensations, feelings, cognitions, and behavioral responses evoked by brand-related stimuli that are part of a brand’s design and identity, packaging, communications, and environments (Brakus, Schmitt & Zarantonello 2009).

Customer experience originates from a set of interactions between a customer and a product, a company, or part of its organization, which provoke a reaction (LaSalle & Britton 2003). This experience is strictly personal and implies the customer’s involvement at different levels (rational,

emotional, sensorial, physical, and spiritual) (Gentile, Spiller & Noci 2009). This response may be multifaceted: cognitive, affective, emotional, social and physical, as Verhoef et al. (2009) delineate it.

The essence of experience marketing has a history within the specific services marketing fields of retailing (Pine & Gilmore 1998, 2002; Verhoef et al. 2009), tourism, entertainment and the arts (Holbrook & Hirschman 1982; Pine & Gilmore 1998), branding (Brakus, Schmitt & Zarantonello 2009; Gentile, Spiller & Noci 2007), and hospitality, etc.

Many authors (e.g. Blain, Levy & Ritchie 2005; Hankinson 2009; Hudson & Ritchie 2009; Nikolova 2011) who study place or country branding have already pointed out the importance of experience marketing. As the competition is high, future research needs to identify how experience marketing can more effectively support the branding of a (small) country on the international market.

#### 4. COGNITION AND SENSEMAKING THEORIES PERSPECTIVE

##### 4.1. Cognition and sensemaking theories

The essence of a brand is a rich source of sensory, affective, and cognitive associations that result in memorable and rewarding brand experiences. Today, customers take functional features and benefits, product quality and a positive brand image as a given. What they want is products, communications, and marketing campaigns that „dazzle their senses, touch their hearts, and stimulate their minds“ (Schmitt 1999).

Marketing is a battle fought inside the consumer's mind (Ries & Trout 1986). Whenever you create your own meaning or grasp someone else's, you make things, feelings, ideas, experiences, values, and expectations into ideas or concepts. In doing this you explain yourself and your world (Hatch & Cunliffe 2006). Cognition is the scientific term for "*the process of the mind*", i.e. how humans perceive, remember, learn and think about information. According to the cognition theory, cognition means the processes of knowing (including attending, remembering, and reasoning); also the content of the processes, such as concepts and memories. Cognition is used to refer to the mental functions, mental processes (thoughts) (Smith & Hitt 2005).

Sensemaking is the process by which people *give meaning to experience*. Sensemaking is about "placement of items into frameworks, comprehending, redressing surprise, constructing meaning, interacting in pursuit of mutual understanding, and patterning" (Weick 1995, p. 6). Sensemaking is the construction of reality, understanding and negotiation, creating understanding between people.

Sensegiving is giving meaning to an object (such as people trying to make sense to the organization, which, in turn, to society) (Gioia & Chittipeddi 1991). It is seen as social process, its cognitive aspects and its usage in construction of meaning for symbols and action that inform change (Weick, Sutcliffe & Obstfeld 2005; Maitlis 2005). Sensegiving is also defined as "the process of attempting to influence the sensemaking and meaning construction of others towards a preferred redefinition of organizational reality" (Gioia & Chittipeddi 1991). A place or a country may be also seen as an organizational reality.

Sensemaking is connected to understanding and cognition; while sensegiving is related to influence and action (Gioia & Chittipeddi 1991).

The concept of sensemaking is well named because literally it means the making of sense (Weick 1995). The seemingly transient nature of sensemaking belies its central role in the determination of human behavior. Sensemaking is central because it is the primary site, where *meanings* materialize that inform and constrain *identity* and action (Weick, Sutcliffe & Obstfeld 2005).

Sensemaking is, “importantly, an issue of language, talk, and communication. Situations, organizations, and environments are talked into existence” (Weick, Sutcliffe, & Obstfeld 2005). In the same way, places/countries are also “talked into existence.” From this perspective, sensemaking is a shared and communal activity that produces knowledge appropriate for action, but biased heavily on the “individuals doing the sensemaking – each group of people who have the various sensemaking conversations will “talk into existence” a very different set of situations, organizations, and environments” (Kolko 2010).

A number of researchers investigate sensemaking, coming to various and abstractly consistent but specifically different conclusions. Some of the views are tied to individual problem solving, while others focus on the organization and its ability to make meaningful decisions. Some of the views describe sensemaking as an activity that has a start and end, while others view it is a long-term approach that serves as an underpinning for other activities (Kolko 2010).

Sensemaking postulates making people’s ideas and points of view the focus of organizing and managing (Weick 1989). Some major tenets of sensemaking are: 1) that it is grounded in identity construction; 2) enactive of sensible environments; 3) social; 4) ongoing; 5) focused on and by extracted cues; 6) driven rather by plausibility (Smith & Hitt 2005).

A main point arising is that organizational behavior is the result of how organizations channel and distribute the attention of their decision-makers. What decision-makers do depends on what issues and answers they focus their attention on (Ocasio 1997). Also a place/country branding depends on decision-makers.

The findings from Gioia and Thomas’s (1996) study suggest that during change, top management members’ perceptions of identity and image (especially a desired future image) is the key to the sensemaking process and serve as important link between the organization’s internal context and the members’ issue *interpretations*.

Lounsbury and Glynn (2001) propose a relevant discussion that focuses on how stories facilitate the crafting of a new organizational *identity* that serves as a touchstone upon which legitimacy may be conferred by investors, competitors, and consumers, opening up access to new capital and market opportunities. Stories help to create competitive advantage also for countries.

#### 4.2. Sensemaking and identity

Identity construction is seen by many to be one of the two basic properties that differentiate sensemaking from basic cognitive psychology (Gililand & Day 2000). The other property is the use of plausibility as the fundamental criterion of sensemaking. Mills (2003) made a similar point when she organized her study of culture change around identity construction, which “is at the root of sensemaking and influences how other aspects or properties of the sensemaking process are understood”.

Discussions of organizational *identity* tend to be anchored by Albert and Whetten’s (1985) description of identity. From the perspective of sensemaking, *who we think we are (identity)* as organizational actors shapes what we enact and how we interpret, which affects *what outsiders think we are (image)* and how they treat us, that in turn stabilizes or destabilizes our identity. Who we are lies importantly in the hands of others, which means our categories for sensemaking lie in their hands. If their images of us change, our identities may be destabilized and our receptiveness to new meanings increases. Sensemaking, filtered through issues of identity, is shaped through the question “*how can I know who*

*we are becoming until I see what they say and do with our actions?"* (Weick, Sutcliffe & Obstfeld 2005, p. 416).

The pathway from image change to identity change is discussed by Gioia and Thomas (1996). Their work suggests that if managers can change the images that outsiders send back to the organization, and if insiders use those images to make sense of what their actions mean, then these changes in image will serve as a catalyst for reflection and redrafting of how the organization defines itself.

Gioia and Chittipeddi (1991) set the stage for many of the current concerns with identity and image in their early findings that sensemaking is incomplete unless there is sensegiving, a sensemaking variant undertaken to create *meanings* for a target audience. The refinement of this demonstration is the finding that the content of sensegiving affects how people interpret the actions they confront. Yet to be examined is the effect of efforts at sensegiving on the sensemakers. In the sensemaking recipe "how can I know what I think until I see what I say?" sensegiving corresponds to the saying. When you hear yourself talk, you see more clearly what matters and what you had hoped to say. Sensegiving therefore may affect the sensemaker as well as the *target*.

It is clear that the stakes in sensemaking are high when issues of identity are involved. When people face an unsettling difference, that difference often translates into questions such as *who are we, what are we doing, what matters, and why does it matter?* As Coopey et al. (1997, cited in Brown 2000) note, the "efficacy of established patterns of *meaning* and associated behavior, individuals attempt to make sense of ambiguous stimuli in ways that respond to their own identity needs". They are able to draw creatively on their memory – especially their personal *experience* – in composing a story that begins to make sense of what is happening while potentially enhancing their feelings of self-esteem and self-efficacy. The story is a sufficiently plausible account of "what is happening out there?" that it can serve as a landscape within which they and others might be able to make commitments and to act in ways that serve to establish new *meanings* and new patterns of behavior" (Weick, Sutcliffe & Obstfeld 2005).

## 5. CONCEPTUAL MODEL OF COUNTRY BRANDING

### 5.1. Country brand identity and image

*Identity* and image are two basic concepts to understand country branding. Identity refers to what something truly is, to its essence (reality). We could say that brand *identity* originates from the place whereas brand *image* refers to consumer perceptions. This can be applied to the case of places (nations, regions and cities). In other words, brand identity originates from the place or organization, whereas brand image refers to consumer *perceptions*. Identity and image are thus distinct, but related concepts. Place/country branding activities attempt to *reduce the identity-image gap*.

Fetscherin (2010) argues that there are four main marketing fields which relate to country branding: „country of origin“ (Roth & Romeo 1992; Shimp et al. 1993; Nebenzahl & Jaffe 1996), „destination branding“ (Hankinson 2007), „country image or country-product image“ (Parameswaran & Yaprak 1987; Agarwal & Sikri 1996; Brown et al. 2006), and „country identity“ (Hall 2002; Keillor & Hult 1999; Anholt 2007). These fields are important for this research.

Place/country brand identity plays a fundamental role in building and managing the country brand. The essence of any country brand derives from its "culture" in the broadest sense – land, history, people, language, literature, music, architecture, cuisine, traditions, pop-culture, education, heritage, visual symbols, etc. – the aspects that represent the "soul" of a country. The place/country brand must

be rooted in the reality of the place’s culture which is the most authentic and genuine element of differentiation that a brand can have. The factual presentation of a place is called a place’s identity. Barke & Harrop (1994) indicate the factual presentation clearly: “the ‘identity’ (of a place) may be regarded as an objective thing; it is what the place is actually like.”

Kotler, Haider and Rein (1993) believe that places’ decision makers can create and design identities for places. Although there are certainly elements of a city’s factual presentation that can be influenced by civic leaders, such as the physical environment or the people, one could easily argue that it is nearly impossible to design a complete new identity for a place. Because that factual presentation is so widely accepted by the place/country communities, and rooted so deeply in their beliefs, expectations and daily routines, that changes in the identity will occur slowly. Country branding is a long-term approach and the results in perceptions or in the decisions of potential consumers cannot be guaranteed. The change takes a long time.

In branding theory there are three key elements of the brand: Brand identity, Brand positioning, and Brand image (see also Pike 2004). The following model (Figure 1) displays the multidimensional nature of identity and image constructs in a place-brand context.

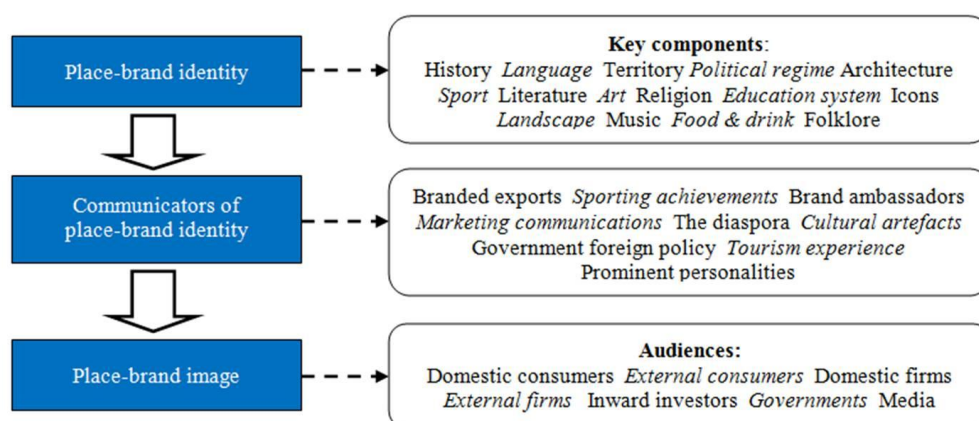


Figure 1: The conceptual model of place-brand identity and image (Dinnie 2008)

Identities play a vital role in socio-economic development, being “people’s source of meaning and experience” (Castells 2004). The image reflects how the target groups or consumers see or perceive the country and it has of great importance for every place or country.

### 5.2. Conceptual model of country branding

The conceptual model that this research proposes is put together for country branding taking into account experience marketing, from the perspective of cognition and sensemaking theories. The model (Figure 2) explains identity, image and value issues of a country. On the left side of the figure is country/place brand and on the right side the target audience. There is a wide range of *target audience* or as Hatch and Schulz (2003) call them – stakeholders – investors, suppliers and other business partners, regulators, special interest groups and local communities. In the middle of the figure are *experiences* that can be perceived on different dimensions: sensory, affective, intellectual, or behavioral.

While there are added pressures and *challenges* in place marketing (challenges of creating differentiation, place product, external environment, politics etc.), effective branding can still be accomplished. Gilmore (2002) draws attention that, in the countries context, the use of the positioning diamond makes brand *positioning* easier when taking its four factors into consideration: macro-trends, target audiences or stakeholders, competitors, and core competencies. Like brands, also places satisfy functional, symbolic and emotional needs (Rainisto 2003) and “the attributes that satisfy those needs need to be orchestrated into the place’s unique *proposition*” (Ashworth & Voogd 1990; Kavaratzis 2005). Also Blain, Levy & Ritchie (2005) indicate that effective place branding gives visitors an assurance of quality experiences, reduces search costs, and offers a way for places to establish a unique selling proposition. According to Morgan, Pritchard & Pride (2002, p. 21) “whatever proposition is used it must also have the potential to last, to grow old and to evolve in a long-term branding campaign, so it is essential to get it right. However, the point of differentiation must reflect a promise which can be delivered and which matches *expectations*”.

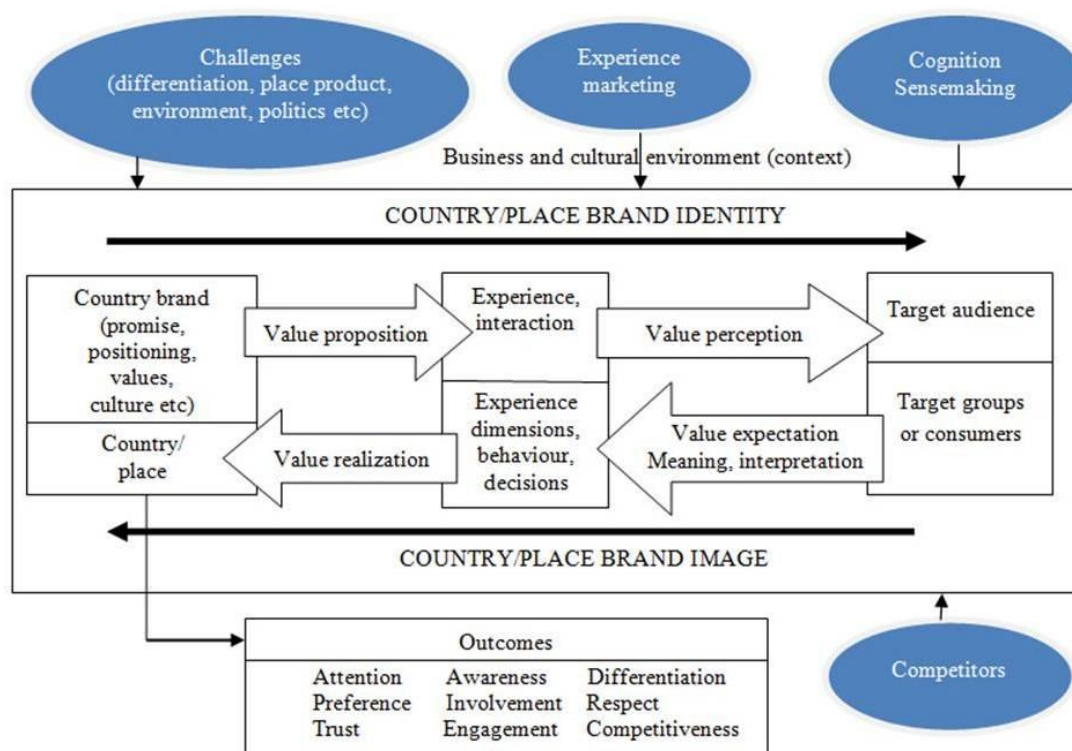


Figure 2: Conceptual model of country branding (adapted from Gentile et al. 2007, Same 2012)

According to Anholt (2007, p. 5), the place brand managers can influence the brand *image* – “the perception of the brand that exists in the mind of the consumers or audience”. According to Kotler and Gertner (2002, p. 249), „brands incite beliefs, evoke emotions and prompt *behaviours*“ and „place/country images are likely to influence people’s *decisions* related to purchasing, investing, changing residence and travelling” (p. 250). All that influences the *outcomes* seen on Figure 2.



One factor “identity” is connected to sensemaking theory; the other “perception” to cognition theory. Attention (noticing, encoding, interpreting and focusing of time and effort on both issues and answers (Ocasio 1997) is also a key term in these theories. The same applies to the concept of experience. In Consumer Culture Theory (that is related to experience marketing) *value* is created in the process of meaning creation (sense making), which is above all culturally bound.

The variables in the model are taken from various sections of the paper, where they are marked in Italics.

## 6. CONCLUSIONS AND FUTURE RESEARCH

The aim of this paper was to provide a theoretical overview of country branding, experience marketing and cognition and sensemaking theories, and to create a new model. Cognition and sensemaking theories are good focal points for researching issues related to experience marketing and place's identity. The cognition and sensemaking theories focus on individual's abilities on making and giving sense of various events surrounding them. In these pages it is suggested that bringing cognition and sensemaking, and identity views together through the study of place branding can usefully broaden our understanding of how we should use experience marketing in the place branding process.

The proposal presented in this paper of implementing the principles of experience marketing into place branding, is coherent with the natural evolution of the discipline towards a more experiential practices. Strategic management of experience marketing as a concept is one proposition countries may find useful when confronted with complexity and instability of their environment and overall economic situation in the world.

One of key implications of this paper is that DMOs need to become skilled cultural operatives who can develop stories about the place/country (who they are) and how their resources or ideas will lead to future benefits for consumers and society. Lounsbury & Glynn (2001) assure that in constructing a story, it is important “to balance the need for legitimacy by abiding by societal norms about what is appropriate with efforts to create unique identity that may differentiate and lend competitive advantage”.

The findings of this study are therefore important in determining future research perspectives in the field and inquiring whether and in which direction the country branding concept has to be developed further. Three theoretical propositions inviting future research, result from this paper as follows:

- P1: Experience mediates between country brand and target groups (or customers)
- P2: Experience dimensions and attitude mediate between the target groups and the outcomes (e.g. attention, preference, trust).
- P3: Experience dimensions mediate between value expectation and value realization.

Other promising research questions to continue with this topic may be: how does experience marketing help to promote the identity of a place/country brand? What kind of experience do we want to create in the long-term for our consumers, and how can we get it done in an unusual, interesting, eye-catching way? How does experience marketing promote the branding efforts of a place/country? How does experience marketing promote competitiveness of a place/country brand on the global market?

The study continues onto three particular tasks: 1) to study the relationships between place brand identity (promotion) and experience marketing; 2) to propose alternative and additional possibilities to achieve competitive advantages of place brands on the international market (especially for a small country); 3) to test the model in analyzing or measuring place/country brand experiences. Finally, the proposed conceptual model of country branding should be tested empirically.

In contrast to more analytical and quantitative methodologies of traditional marketing, the methods and tools of experience marketing are eclectic, diverse and multi-faceted. Experience marketing is not bound to one methodological ideology, it is interdisciplinary. Thus, qualitative methods for experience marketing research are needed, including the verbal methods (e.g. in-depth interviews, focus groups) and visual materials (photographs, videos).

Changing the place/country reputation and building country brands are difficult, complex and long-term challenges which require above all an (empathetic) understanding of the consumers' mind space. Clear vision is vital in terms of place's marketplace, competitors and consumer targets.

Place branding could provide a crucial competitive advantage for countries and is therefore a very important topic. Country branding and experience marketing offer new opportunities (also thanks to the Internet-driven media revolution), so that even the smallest countries can benefit from these strategies.

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**CREATIVITY AND BUSINESS CONSULTANCY**

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**Abstract**

*This paper aims to outline the particular importance of the creativity process in the business consultancy activity. The analysis of the demand to supply ratio on the Romanian business consultancy market proved that there are neither regulations regarding the professional training of business consultants nor an appropriate institutional structure able to provide such services to the business consultancy field.*

*For any consultancy company acting in Romania, the recruitment of well trained professionals is one of the major problems faced. For this reason, we decided to design a business consultancy masters program within the Faculty of Administration and Business. We started with the accreditation of the Romanian language variant of the program and, beginning with 2012, of its English language version, the latter being also destined to the graduates of Central and Eastern European and Asian universities.*

**Key words:** *business, consultancy, creativity, masters program*

**1. INTRODUCTION**

Until 2000, Romania had no masters programs specifically tailored for the needs of the consultancy market; based on the analysis of the business environment, we concluded that there is a real demand for such program in our country. The statement made in the Abstract that “*there are neither regulations regarding the professional training of business consultants nor an appropriate institutional structure able to provide such services to the business consultancy field*” describes the context of the Nineties. Starting with those years, once the privatization process initiated, the need for finding creative solutions to the specific problems manifested on a continuously degenerating market emerged. In our view, creativity holds a key role both in creating these masters programs and in defining the consultancy market as a whole. Imagination, creativity and innovation, all of them were considered while setting the syllabi for the two masters programs. Creativity, seen both as a mental and a social process, having involved new ideas and concepts, enabled us to create original contexts allowing students, teachers and business professionals to exchange ideas and to find new ways for developing the business market in Romania. There is, without any doubt, an important connection, that we are going to highlight in this article, between the potential of students, the calling of teachers and the experience of consultants and business man.

The period ranging from 1990 to 2011 represented a time of major socio-political and economic changes for Romania, as for many Central and Eastern European countries. The passage from a communist regime, based on an over-centralized system of power, to a democratic one, grounded on private initiative, has reflected, from the economic perspective, into the transition from large state companies without delegation of authority to relatively smaller privately owned companies having to



survive in a free-market economy. This process, far from being ended, continues to have various negative consequences on both the social and political environment, on the general well-being of citizens as well as on the competitiveness of the country at the global level.

We will briefly render hereinafter the evolution of the Romanian economy during the above mentioned period, highlighting some of the key moments of its development, along with the specific challenges and problems faced. We will talk about consultancy, as a key sector of economic growth, evidencing its progress in Romania, for the said period, while focusing on its main stages and future perspectives.

We will describe the Business Consultancy masters programs created within the Faculty of Administration and Business, University of Bucharest, and the manner of transforming it into a bridge between the business environment, the consultancy firms and the academic community, therefore improving their co-operation.

We will present the role of creativity in consultancy and the ways to stimulate it, but also its importance at macroeconomic level, in view of ensuring the progress towards an *“innovation driven economy”*.

## 2. ECONOMIC EVOLUTION AND CONSULTANCY MARKET IN ROMANIA

The analysis of the evolution of GDP from 1989 to 2011 (Figures 1 and 2) proves that there was a dependency between its levels and the variation of the consultancy market and companies. As it can be seen, between 1991-1995 and 1997-2001, the increases of GDP have positively influenced the consultancy activities and the number of consultancy firms. At the same time, the evolution of Direct Foreign Investments (Figure 3) has either encouraged or discouraged the development of the consultancy market. This period, we assisted to the emerging of an important category of professionals, having studied at well-known universities from abroad, but also of practitioners, having graduated from prestigious MBA programs. We cannot ignore the quality of various graduates of national universities or the formation of self-taught individuals who created very successful companies. Some of them became managers in multinational companies, established their own business, became consultants in branches of international consultancy firms or local companies and set up AMCOR (Association of Management Consultants in Romania).

The shift from a planned towards a free-market economy one is always a complex and a long process, with serious consequences at the level of the entire society. For Romania, it was even more difficult, as the original tendency was to totally dismantle the existing system without proceeding to an appropriate replacement of the old structures with new ones, suited for an open-market environment, even at the risk of a total economic collapse. During these years, the companies have tried to solve the problems they faced, by resorting to their own experts. The increasing complexity of economic phenomena and the globalization of markets have forced managers to look for solutions to their problems outside the firms (we can talk about externalization of consultancy services as their own experts could no be any longer so objective as to capture “the whole picture” of the organization and the connection between processes).

The analysis of the main stages runs over by Romania after 1989:

- the privatization or dissolution of various state companies;
- the negotiations with the European Union, and the adhesion to such structure;

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- the need for harmonizing the national legislation and policies with those of the EU;
- the effort to attract European funds;

has highlighted the necessity of a national network of consultants (and consultancy firms) able to solve both the specific problems of each sector, as well as the general problems of the social and economic system.

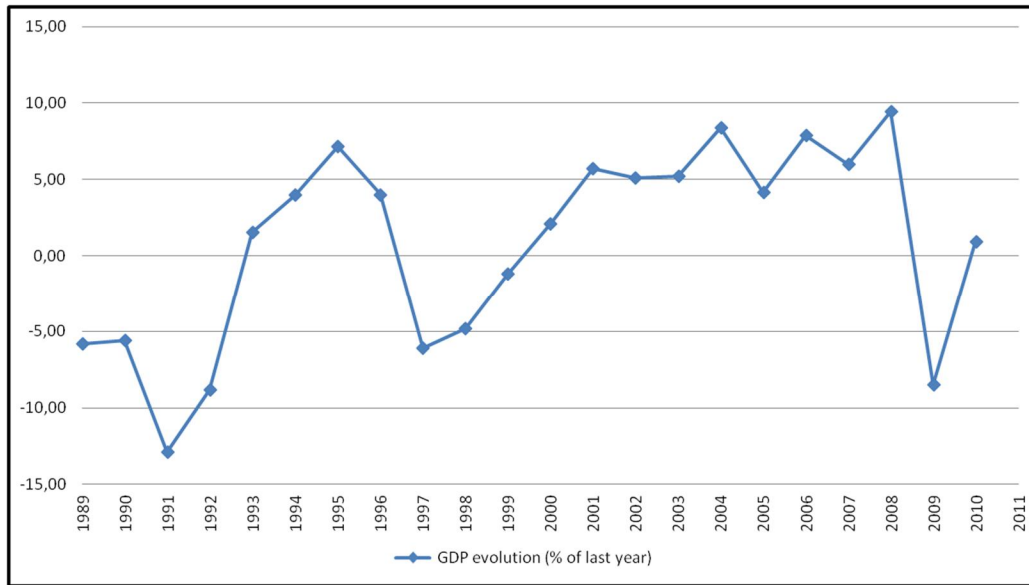


Figure 1: GDP evolution as to the previous year ( $\pm\%$ )

Data source: The World Bank

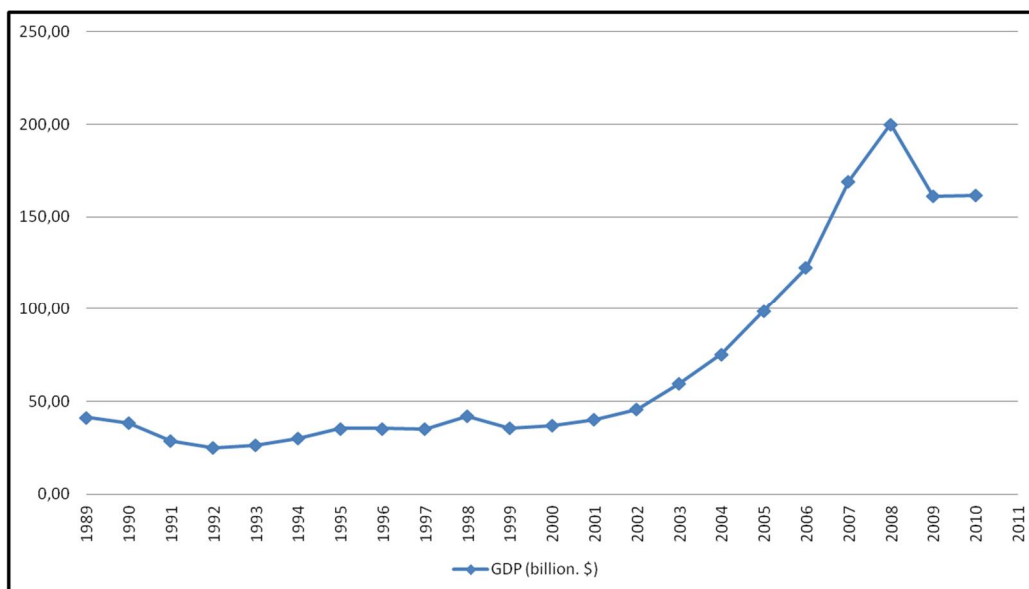


Figure 2: Value of GDP (billion US dollars)

Data source: The World Bank

The accelerated rhythm of changes was beyond the stakeholders' capacity to adapt, especially in the absence of proper domestic consultancy. If we also consider the relative instability, having caused, many times, abrupt changes in the legislative and fiscal policy, we have the image of an environment less than optimal for economic growth.

As we can see in Figure 1, the first three years post revolution brought about successive drops in GDP relative to the previous years, 1993 being the first year of slight increase and, although the trend for the following years was generally positive (with 1997, 1998, 1999 and 2009 being exceptions, the latter in the context of a global recession), the evolution was far from encouraging.

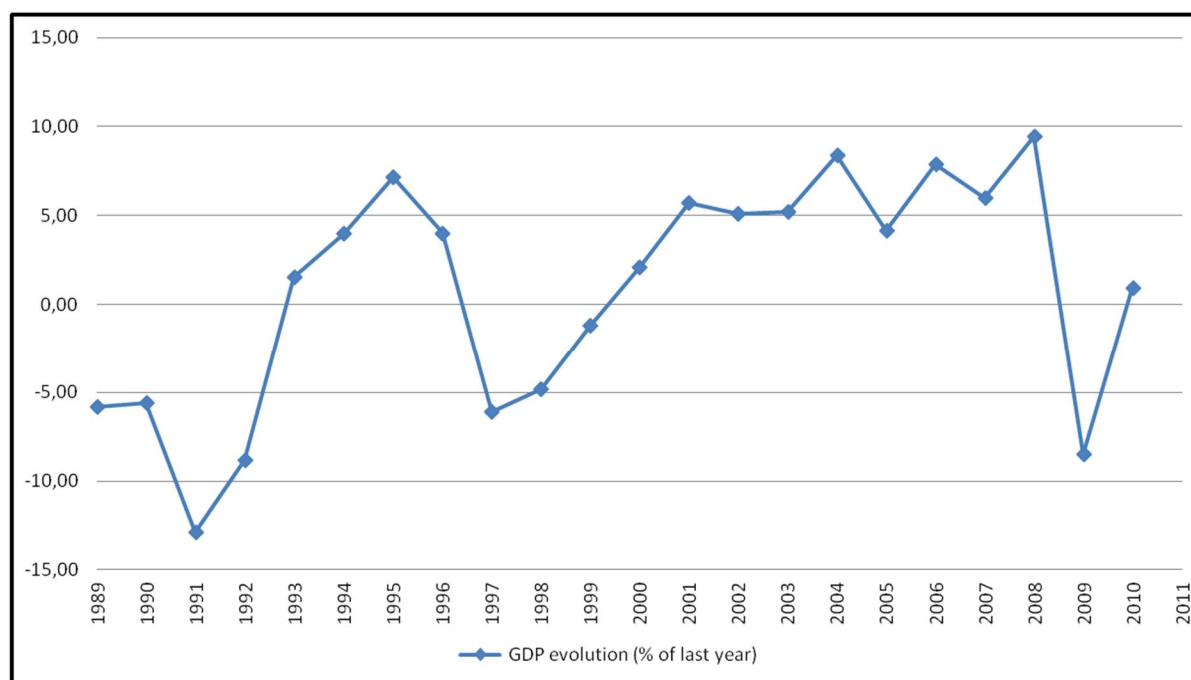


Figure 3: Value of Foreign Direct Investments (billion US dollars) Data source: The World Bank

If we consider the level of GDP in 1989, expressed in current USD, as a reference point, we can observe that until 2002, save for 1998, the yearly values of such indicator were constantly lower, 2002 marking the start of a successive and continuous increase of GDP. The causes for such evolution are various, but without any doubt, one of them was related to the lack of domestic consultants able to understand the particularities of our market.

In the early nineties, the entry of foreign consultancy firms on the Romanian market has not necessarily solved the specific problems of the Romanian companies as, at first, these firms lacked a thorough understanding of the realities of the business environment.

Consultancy is defined as the professional activity that provides specific assistance in various fields; we can therefore talk about specific consultancy in any field in which there is simultaneously a need for assistance and people that have the necessary know-how to provide it.

Three issues on the business consultancy in Romania have to be highlighted:

- the existence, in the early nineties, of domestic consultants with the necessary knowledge would have greatly helped the transition towards an open-market economy;
- the existence of a structure prepared to train consultants has an invaluable role in the evolution of the business environment;
- the creativity that the domestic consultancy could bring in solving the challenges faced by both individual companies and the economic environment as a whole, could help Romania in “burning” some of the steps towards achieving a level of general prosperity, desired by all its citizens.

A major challenge that Romania, as well as other Central and Eastern European countries, faced in the transition from a centralized economy toward an open-market after 1989, was the lack of experts able to combine the knowledge of the rules and mechanisms of a free-market economy with the specificity of the local economic environment. The process of finding and recruiting such professionals was also rendered more difficult due to the lack of institutions capable of training them.

In analyzing the evolution of consultancy in Romania after 1989, two main stages can be identified:

- the first stage when Romania had to rely mostly on foreign expertise, both for consultancy services as well as for training services; of course that there were also domestic experts working with them. In areas in which the Romanian experts managed to adapt the solutions given to the specificity of the local context, the results were generally positive. There were however certain fields (ex. the restructuring and optimization of associative forms based on group ownership) in which the existing structures were dismantled without managing to replace them with viable ones in the new economic context. One of the advantages of this early stage is that it has laid the grounds for a first generation of domestic consultants, some of them becoming later trainers;
- the second stage, which, in our opinion, is still in progress, when the training and recruiting of consultants began to come to maturity. This stage was certainly accelerated by the adhesion of Romania to the European Union, the entry of multinational companies on the market, and the need of the local investors for consultancy services in certain key areas of their businesses in order to maximize their profits. The experience of developed countries shows that the process of training, recruiting and specialization of consultants is a continuous one that requires assistance from both the public institutions and the business environment.

One of the key aspects of the business as well as of the consultancy market, during this period, was that the problems, occurred both at the level of individual firm and at the level of the entire economy, demanded creative solutions. This was less the result of a conscious choice but rather a consequence of the conditions existing at the time on the market. In the case of newly created companies, this creative approach was called for by the lack of management and entrepreneurship experience, while at the level of the entire economy, this approach was dictated by the lack of efficiency in adapting the „ready made” solutions imported from other countries. Whether it is about the evolution of certain indicators, as the above-mentioned, that called for flexibility in making the strategic and tactical decisions, or about the lack of predictability which characterized the financial and legislative policies, or even about the immaturity of the business environment, the decision makers have been forced to resort to creative approaches, having to act like „doctors”, trying to find the medicine for an unknown disease. The experience gained during this early period determined some experts and managers to slowly move towards the consultancy market, making use of the instruments they acquired while solving the problems already faced.

As for consultants, creativity was also particularly important, because the models for diagnosis and “treatment” discovered in the international professional literature or within the training programs had to be adapted to the specificities of the local market, and also, because such creative approaches proved to be vital in defeating the initial skepticism of many Romanian managers as for any consultancy services external to their firms.

### **3. CONSULTANCY FIRMS AND AMCOR (ASSOCIATION OF MANAGEMENT CONSULTANTS IN ROMANIA)**

According with the Romanian law, management consultancy is classified as a liberal profession but, unlike the majority of professions in this category, it has no barriers regarding the required training or the compulsoriness of pertaining to a certain professional organization in this field as, for instance, lawyers do.

This had both advantages, consisting in negligible barriers to enter the market, and disadvantages, such as the lack of a professional association that impeded the emerging of an official training institution, therefore causing problems to the companies as for recruiting new employees and for the sometimes questionable professional ethics of some “consultants” who placed the entire profession in a bad light.

Once the offer of consultancy services increased, the companies existing on the market felt the need for a professional association that could answer the needs of its members, offer legitimacy to a profession that just few of the potential clients could understand, and be able to bring some regulations to the field. Thus, in 1990, the AMCOR (Association of Management Consultants in Romania) was established. In time, this organization grew, reaching in 2010 more than 80 members, consultancy firms and, since 1997, being affiliated to UPLR (Union of Liberal Professions in Romania) and becoming a full rights member of FEACO (European Federation of Management Consultancies Associations).

At present, AMCOR encompassed in its articles of association the segmentation of the management consultancy market, in accordance with the FEACO classification as of 2005:

- Business Consulting (with the following areas: Strategic consulting, Organizational/Operational management, Change management, Human Resources management);
- IT Consulting;
- Development and integration (with areas: Application development – software exclusively, Application installation and integration);
- Outsourcing (IT management services, Business Management services, Business processes outsourcing);
- Other consulting services.

The classification above offers both a clear understanding of the differences between two terms that are usually considered inter-changeable (business consulting and management consulting) and a clear view of the main areas where consultancy can help an organization.

This is of course just one of the many possible classifications as, even among experts, there is some controversy over what is and what is not consultancy (we can mention in this regard the debate about the status of the large auditing companies „*the Big Four*”).

Because of the attributes of freedom and openness generally held by the consultancy market, the need for a professional association came early on, the first such organization being AMCE (Association of Management Consulting Engineers), which was established in 1929, in the United States of America. This association model quickly spread all over the world, in 1990, the consultancy market worldwide being estimated at around 25 billion USD, while the number of consultants was about hundreds of thousands.

The advantages that a professional association provides to both its members and clients are obvious, such an organization usually developing a set of good practices and professional standards, which in some countries (like Austria for example) can even become mandatory for accessing the market. By this process, the consultants are protected against having their image seriously affected by the lack of professionalism of some firms or individuals providing such services, while clients may benefit from easily finding the suitable consulting services, usually at better prices, and with the guaranty of a reasonable level of professionalism.

Another important advantage that the consultancy associations bring to their members is that they are usually affiliated to international organizations and can therefore provide access to international certification programs.

One of the best known associations is ICMCI (The International Council of Management Consulting Institutes) set up in 1987 as an association of national consultancy institutes or associations, and having, at present, 47 member states. By analyzing and selecting the best practice guidelines of the member states, ICMCI created a „Code of Conduct” for consultants, which is recognized worldwide, as well as an international certification program - „CMC” (Certified Management Consultant), which can be obtained by individual consultants, being recognized by all member states.

As stated earlier, AMCOR is a full rights member of FEACO and is recognized by ICMCI, being allowed to hold CMC certification sessions; a study made by AMCOR places the level of transactions on the Romanian management consulting market at more than 400 million Euro yearly. At present, there is a real potential for creating a partnership between the business environment in Romania, AMCOR (Association of Management Consultants in Romania) and the two Masters in Business Consultancy programs.

#### **4. MASTERS IN BUSINESS CONSULTANCY PROGRAMS**

The opportunity for creating the Business Consultancy masters programs became obvious after having discussed with several members of the business community and after having consulted different companies, on the occasion of various partnerships developed in time by the Faculty of Administration and Business, University of Bucharest.

One of the biggest problems that the consulting firms in Romania have to face is the difficulty in finding professionals trained according to the particular needs of this sector, in many cases the firms having to invest a lot of time and effort in training junior consultants only to have them leave the company or even the country once they reach a certain level of expertise.

The same kind of problems have been signaled by the business environment, especially as for the lack of relevant skills, such as teamwork, creativity, leadership, communication and negotiation, proved by many university graduates.

The creation of a masters program in Business Consultancy that addresses such issues emerged as a necessity; by working in collaboration with consultancy firms and members of the business environment, this program is meant to create a synergic effect, with benefits for all parties involved (Figure 4).

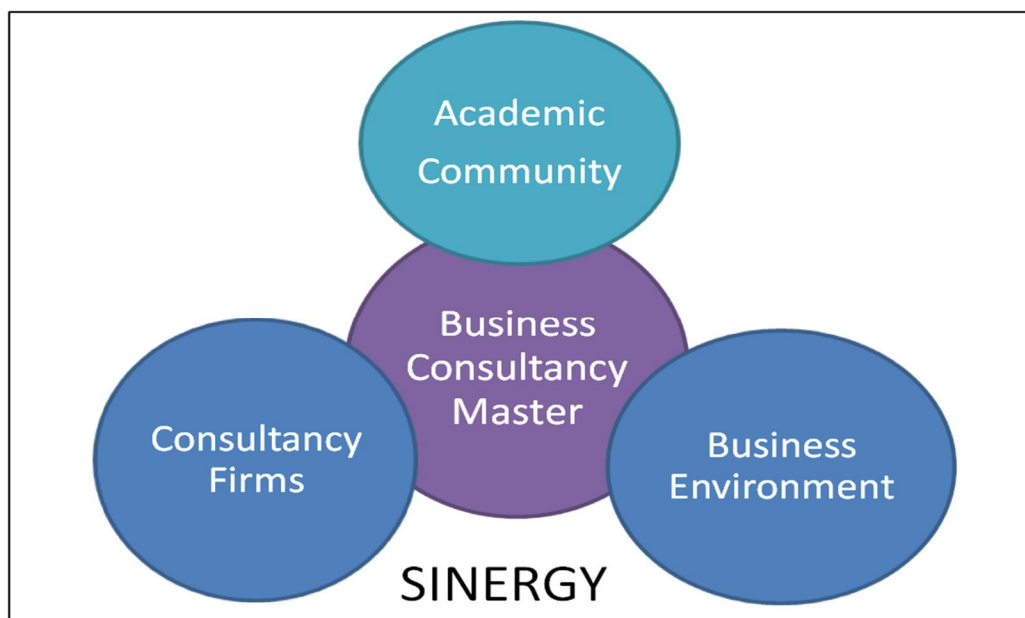


Figure 4: Synergy effect

The creative methods and techniques, the personal experiences, but also the attention to details enabled us to find the right contexts putting altogether events of the academic community with events of the business and consultancy environment, therefore creating opportunities for such masters programs. As for this “leverage” effect, we have in mind the cooperation between the entities presented in Figure 4, by which businessmen and consultants share their professional experiences and students acquire the opportunity of internships in the respective companies, as well as the status of potential employees.

The structure of the two masters programs (Romanian and English) was designed with the help of several specialists from the business world and after a careful analysis of similar programs in countries with tradition in this area, so as to obtain an equilibrium between theoretical knowledge and case studies; by this, we facilitate their understanding and assimilation of theoretical concepts and the use of direct or indirect practical experiences, helping the internal and international players active on the Romanian market to better understand its particular contexts.

The masters in Business Consultancy are structures that aim to offer professional qualification specific to the sector of business administration. The graduates of this program will gain competencies and abilities specific to business consultancy such as: teamwork, leadership, communication and negotiation, knowledge of relevant legislation, business diagnosis, cost calculation, use of software solutions in simulating business processes, as well as designing consulting programs.

The syllabus approaches the vast area of business administration, based on the requirements expressed by the business environment in Romania, including subject matters like: Creative Methods and Techniques in Consultancy; Project Management in Professional Services; Consultancy in Integrated Management Systems; Controlling and Managerial Accounting Consultancy; Business Consultancy; Business Diagnosis; Consultancy in Automated Business Process Modeling; etc.

The disciplines are taught by experienced professors from the Faculty of Administration and Business, Sociology, Psychology, Mathematics and Foreign Languages, from the University of Bucharest, as well as from the Academy for Economic Sciences of Bucharest. During the classes, special lectures are held by experienced practitioners working in Romanian or international consultancy firms, as well as by respected professors from international universities.

Considering that, since the academic year 2012-2013, the Business Consultancy Masters program in English will be also launched, it being addressed to both Romanian and foreign university graduates coming mainly from Central Europe and Asia, the masters students will have the opportunity to interact in multi-disciplinary teams. Within the classes and workshops, the activity is going to be organized in project teams, designed to maximize the inter-cultural diversity. By using this work-group approach (Project Management) the students will gain experience in working in an inter-cultural environment, an essential skill in the context of the increasing globalization of markets.

The two masters programs (Romanian and English) will form specialists in the business field, provided with the necessary abilities and competencies to work in: consultancy firms, small and medium enterprises, non-profit organizations, public institutions, etc.

The masters programs are tailored for university graduates with business consultancy potential, employees in business consultancy firms, multinational companies, small and medium enterprises with higher education studies, etc.

The coordinators hope that the masters programs in Business Consultancy will form a pole of interest for the academic and business communities alike. According to the analysis performed, at present there are no similar programs in Romania, neither from the point of view of the subjects studied nor as regards the organization of the activity carried out within the related workshops - team projects are required for each discipline, the students being thus stimulated to learn how to work as a team, therefore improving their skills and abilities we talked about before.

The syllabus of the programs is designed in such a way as to provide students with a complete overview of the consultancy field and to help them in mastering creative methods and techniques, by extensively using processes like brainstorming, lateral thinking and other similar techniques, with the aim of helping them to create connections between fields that would otherwise seem unrelated, a skill that is extremely valuable in the "real" business world.

From this perspective, it is impossible to understand the essence of consultancy without first decoding the mechanisms of the business management process, the tools used in the diagnosis of the potential problems issued at the level of an organization and without observing the role of creativity in tackling these problems, as well as in preparing the changes that become inevitable as the economy grows ever more complex and unpredictable. The structure of the masters programs was designed first and foremost for offering various learning and educational opportunities in both formal and informal contexts.

The feedback received from students, the enthusiasm with which they take part in the proposed activities, the competitiveness as well as the self-motivation manifested in the teamwork dynamics, are



all indicators that this approach is a competitive one and could become a source of inspiration for other programs at national or international level.

The masters programs are organized in accordance with the criteria, standards and performance indicators set by the Romanian Association for Quality Assurance in Higher Education (ARACIS). The programs are in full accordance with the requirements of the Bologna process and are structured on four semesters, assuring the professional training, theoretical knowledge and competencies needed for the full enrolment of graduates in the business environment. The programs represent the second stage of higher education, ensuring the thoroughgoing study in the business administration field. They have a dynamic character by continuously harmonizing with similar master programs from other countries and by promoting a network of partnerships with similar faculties in Europe.

## 5. CREATIVITY IN CONSULTANCY

Creativity can be considered to be a catalyst of the management consultancy activity along with solid theoretical knowledge and a rich and relevant professional experience.

In the context where, in an ever-changing global economy, few of the rules considered unchangeable until recently are still able to offer viable solutions to ever more complex problems. Only a creative approach that embraces new challenges through the acceptance of such “awkward” concepts as *“funky business”* and *“innovation-driven economy”* becomes viable and able to ensure the development and, more often, the survival of a business. Suggestive in this respect are the problems recently generated by companies like Nokia and Kodak, by their incapacity to foresee the abrupt changes on the world market. We can easily see that other companies like Apple or Samsung have been able to anticipate the role of creativity and innovation in finding surprising, yet efficient, solutions for producers and buyers alike, to the problems at hand. A work like - Matsushita Leadership - can help us in better understanding the normal link between rigor and creativity, between close and distant horizons.

If concepts like “lateral thinking”, “creative thinking”, “brainstorming”, “associations in ideas propagation”, the use of NLP techniques in management activities or the importance of multiple intelligences were subject of mockery for those managers that considered that “truth” is grounded exclusively on financial forecasts, today every self-respecting manager knows that success often lies in “unseen places”.

Even since 1999, the Swedish authors Jonas Ridderstråle and Kjell Nordström warned in their work *„Funky capitalism”* that the model based solely on benchmarking and on the duplication of the best practices of competition is a risky one that can lead to a dead-end because while innovation, a process that depends fundamentally on creativity, can generate new answers to existing problems in any organization, using ready-made solutions can lead to the loss of the capacity to innovate at organizational level and finally to losing the battle with the competitors. From this perspective, we fully intend to capitalize on the use of creative techniques and methods in the context of the masters programs.

The classification made by the World Economic Forum, by the series of yearly publications *„World Competitiveness Report”*, where economies are classified in three main categories: factor-driven economies, efficiency-driven economies and innovation driven-economies (Figure 5), is suggestive in this regard.

Based on this classification, the objective of each country should be to strive towards an innovation-driven economy, one that creates value through the use of highly qualified human resources. It is

obvious that the consultancy masters programs answer to the needs of such an economy, which evolves by the use of innovation and creativity and stimulates them.

Consultancy firms can help a national economy, both directly and indirectly, make the transition from a factor-based economy (focused on infrastructure, institutions, macroeconomic environment, primary education and healthcare), via an efficiency driven-economy (focused on higher education and training, the goods market efficiency, the labor market efficiency, the financial market development, technological readiness, market size), to a innovation-driven economy (characterized by business market sophistication and innovation)- Figure 5.

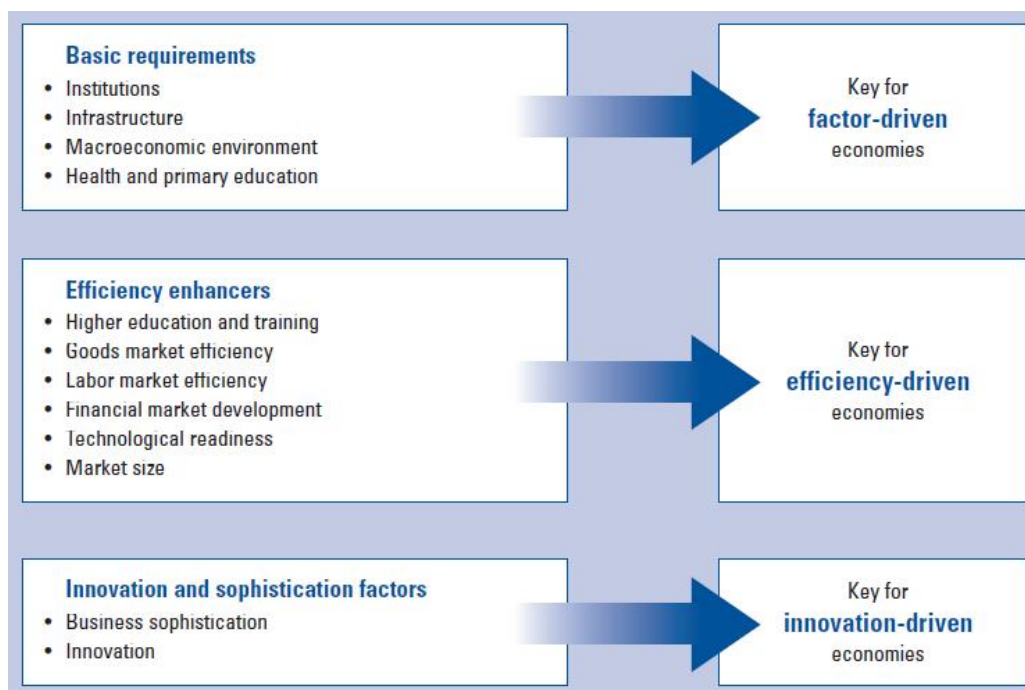


Figure 5: Economy types and key factors

Source: World Economic Forum

## 6. CONCLUSIONS

In the evolution of present world, creativity and innovation are not aims but rather means by which individuals and companies alike can find, beyond the road towards survival, the road towards excellence.

The heart of the system presented in Figure 6 is creativity as it is the channel via which the activity of the three systems pulsates: the national business network, the national consultancy firms network coordinated by AMCOR and the academic world represented, for the purpose of this paper, by the Business Consultancy masters programs.

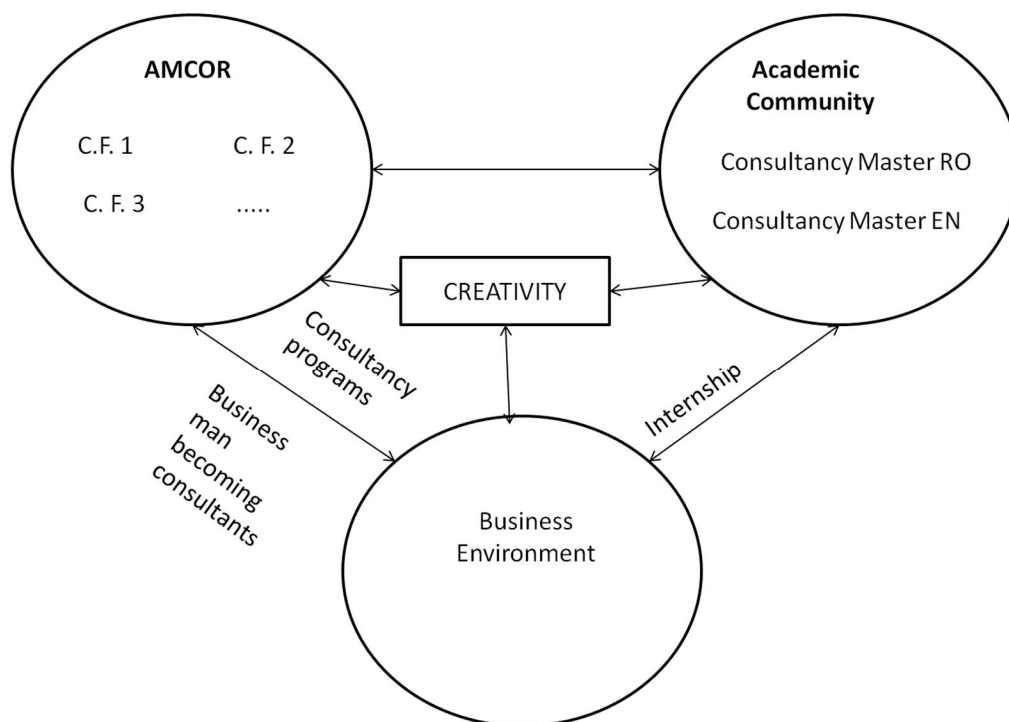


Figure 6: Connection between business, consultancy and university through creativity

“The process of creating a relation between things or ideas between which no connection existed before” represents creative thinking from the perspective of J. Geoffrey Rawlinson’s work - Creative Thinking and Brainstorming.

Within the three systems presented in Figure 6, it is very important to eliminate the barriers that stand in the way of creative thinking. As regards the masters programs, we tried to eliminate the “self-imposed barriers, patterns, unique answers, conformities, instant evaluations and fear of ridicule”.

Even in designing the masters programs in Business Consultancy, we used creative techniques and brainstorming, by inviting experts from the three systems presented in Figure 6 to informal meetings where a lot of ideas were circulated, the one related to the creation of these masters programs being selected.

The experience of two years of this master program proved us that the architecture of such a system is in continuous transformation and this is why creative techniques and innovation have to be permanently focused on in any debates regarding education.

Creativity is beyond “knowing” because it forces us to make unexpected connections by “doing” and to permanently transform our mentality while “being”.

This masters programs will become an integral part of an international network of similar masters programs in which experiences will be shared, students and professors will take part in professional traineeships, and papers relevant to this field will be published.

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**THE SOCIAL RESPONSIBILITY OF ORGANIZATIONS, A KEY DRIVER  
OF SUSTAINABLE DEVELOPMENT**

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**Abstract**

*Sustainable development and social responsibility represent two of the most debated subjects in the literature. In the past decades, the social responsibility of organizations has become one of the main drivers of sustainable development. Our paper seeks to provide a better understanding of the strong connection between sustainable development and the social responsibility of organizations within society. The aims of our paper are to present a review of the literature regarding the concepts of sustainable development and social responsibility in a historical perspective, and to highlight the relationship between the two concepts.*

**Key words:** *sustainable development, social responsibility of organizations, corporate social responsibility, society*

**1. INTRODUCTION**

The record of the last decades has shown that significant social, economic, technological, political, and environmental changes have transformed the human society. Since the end of the twentieth century, human activity has already reached “levels at which it could alter the planet’s climate and its biological mix” (Chichilnisky, 1997, p. 467). As a result, sustainable development has become one of the main paradigms of the twenty-first century. Given the global sustainability challenge, today’s governments, businesses, and civil society have expressed their commitment towards sustainable development goals (Drexhage and Murphy, 2010).

Sustainable development and social responsibility represent two of the most debated subjects in the literature (Toma and Marinescu, 2011). In recent years, the number of projects and researches focusing on these subjects has increased continuously. On the one hand, sustainable development seeks “to balance the economic, environmental, and social dimensions of development in a long-term and global perspective” (Organisation for Economic Co-operation and Development- OECD, 2011b, p. 3). On the other hand, the socially responsible organizations actively contribute to the welfare of society. Many business organizations have become socially responsible by equilibrating the economic, the social and the environmental issues of their activities. In other words, they have succeeded in implementing corporate social responsibility (CSR) in their business philosophy.

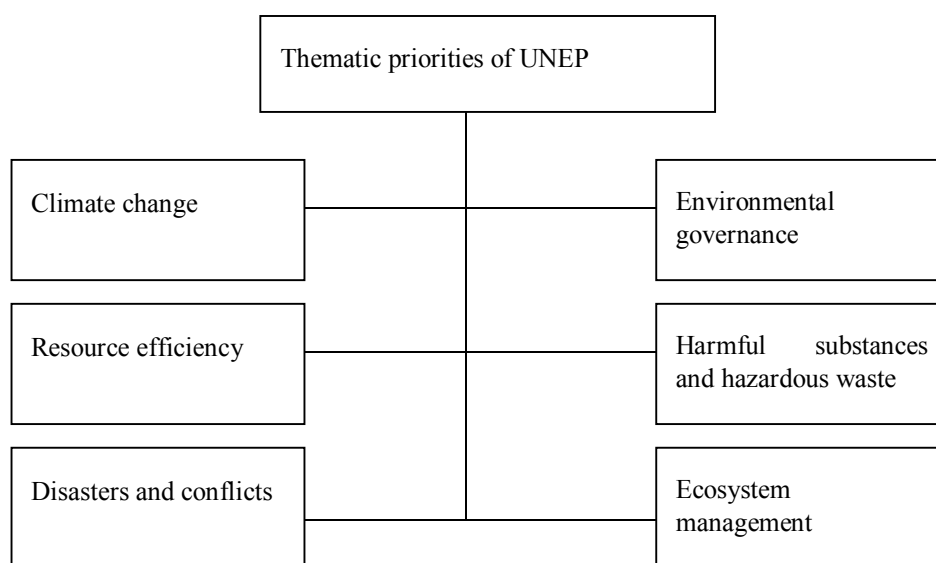
Our paper seeks to provide a better understanding of the strong connection between sustainable development and the social responsibility of organizations within society. The aims of our paper are to present a review of the literature regarding the concepts of sustainable development and social responsibility in a historical perspective, and to highlight the relationship between the two concepts.

The paper is structured as follows. The second chapter of the paper is dealing with the historical evolution of the concepts of sustainable development and social responsibility of organizations, emphasizing some of the main contributions derived from the literature. The relationship between the two concepts is presented in the third chapter. The paper ends with conclusions.

## 2. THE HISTORICAL EVOLUTION OF TWO CONCEPTS: SUSTAINABLE DEVELOPMENT AND SOCIAL RESPONSIBILITY OF ORGANIZATIONS

The term ‘sustainable development’ was used for the first time by the International Union for the Conservation of Nature (IUCN) in 1969. Sustainability at a global scale was discussed at the United Nations (UN) Conference on the Human Environment. Held in Stockholm in 1972, the conference aimed to delineate the rights of human family and to provide a series of recommendations that led to the creation of the UN Environment Programme (UNEP).

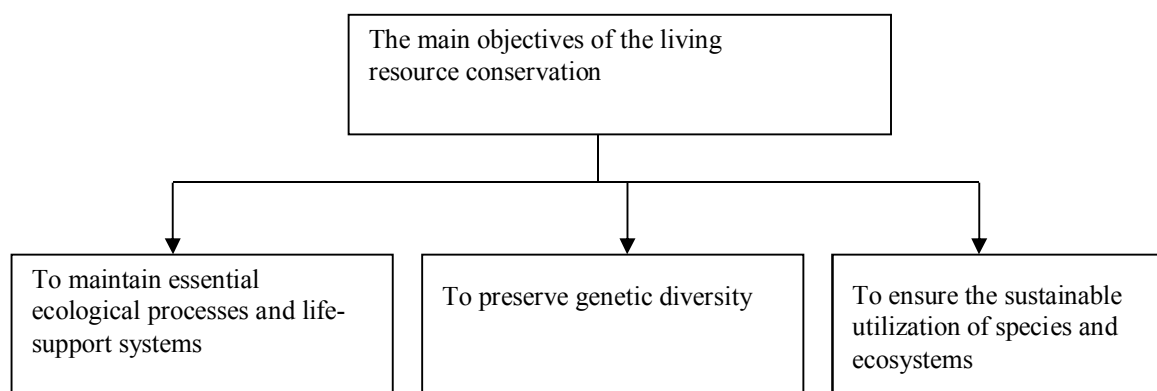
During its forty years of existence, UNEP has provided the needed leadership for promoting the intelligent use of the Earth’s natural assets for sustainable development. Its mission is to support nations and communities around the world to improve their quality of life, without compromising that of the future generations. In order to achieve this mission, UNEP (2010, p. 2) has focused on six thematic priorities over the period 2010-2013 (Fig. 1).



**Fig. 1.** The thematic priorities of UNEP for the 2010-2013 period.

The “World Conservation Strategy: Living Resource Conservation for Sustainable Development” was published in 1980 by the IUCN in collaboration with the UNEP, the Food and Agriculture Organization of the UN (FAO) and the UN Educational, Scientific and Cultural Organization (UNESCO). As the 1980s were characterized by the limitless capacity of people for building and creation, and the global interrelatedness of actions, with its corollary of global responsibility, the World Conservation Strategy aimed “to help advance the achievement of sustainable development through the conservation of living resources” (Fig. 2) and intended “to stimulate a more focused

approach to living resource conservation and to provide policy guidance on how this can be carried out” (IUCN, 1980, p. IV). The strategy considered that in order to be sustainable, development “must take account of social and ecological factors, as well as economic ones; of the living and non-living resource base; and of the long term as well as short term advantages and disadvantages of alternative actions” (IUCN, 1980, p. 2).



**Fig. 2.** Three main objectives of the living resource conservation.

In 1987, the UN published the Report of the World Commission on Environment and Development (WCED) “Our Common Future” or the Brundtland Report. The report stated that the world had to quickly design strategies that would allow nations to move from their often destructive processes of development onto sustainable development paths. Also, it affirmed that the critical objectives for environment and development policies that follow the sustainable development concept were the following:

- reviving growth. Growth had to be revived especially in the developing countries because poverty reduced their capacity to use resources in a sustainable manner.
- changing the quality of growth. In all countries of the world growth had to be less material- and energy- intensive and more equitable.
- meeting essential needs for jobs, food, energy, water, and sanitation. The fundamental challenge was to meet the basic needs of an expanding developing world population.
- ensuring a sustainable level of population. Sustainable development can be pursued “more easily when population size is stabilized at a level consistent with the productive capacity of the ecosystem” (UN, 1987, p. 44).
- conserving and enhancing the resource base. The Earth’s natural resource base had to be conserved and enhanced in order to meet the needs on a sustainable basis.
- reorienting technology and managing risk. The creation and development of environmentally appropriate technologies were closely related to risk management issues (e.g., nuclear reactors).
- merging environment and economics in decision making. The integration of economic

and environmental considerations into the decision making process had to be matched at the international level.

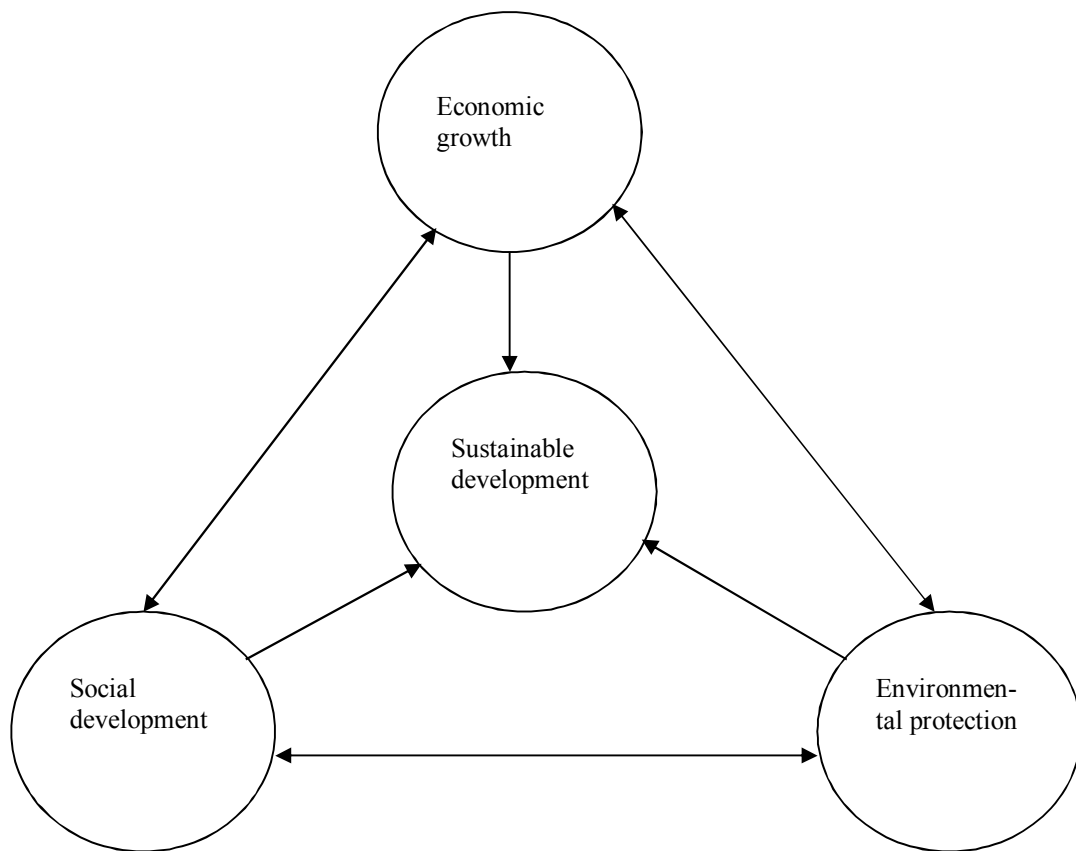
According to the Brundtland Report, the strategy for sustainable development aimed to promote harmony between humanity and nature. That is why the following requirements have been involved in the pursuit of sustainable development:

- “a political system that secures effective citizen participation in decision making,
- an economic system that is able to generate surpluses and technical knowledge on a self-reliant and sustained basis,
- a social system that provides for solutions for the tensions arising from disharmonious development,
- a production system that respects the obligation to preserve the ecological base for development,
- a technological system that can search continuously for new solutions,
- an international system that fosters sustainable patterns of trade and finance, and
- an administrative system that is flexible and has the capacity for self-correction.” (UN, 1987, p. 50)

The Rio Declaration on Environment and Development was adopted by the UN Conference on Environment and Development/the Earth Summit in 1992. The declaration stated that environmental protection constitutes an inseparable part of the development process. Moreover, all states have to fully cooperate in order to conserve, protect and restore the health of the Earth’s ecosystem. Ten years later, the UN organized the World Summit on Sustainable Development in Johannesburg. The Johannesburg Declaration considered sustainable development as a new paradigm of development and reaffirmed the collective responsibility “to advance and strengthen the interdependent and mutually reinforcing pillars of sustainable development- economic development, social development and environmental protection- at the local, national, regional and global levels” (UN, 2002, p. 1). In other words, sustainable development integrates three interdependent and mutually supportive key elements: economic growth, social development and environmental protection (Fig. 3).

The European Council has often stated that sustainable development represents a key principle of the Lisbon Strategy. In 2011, the Council has underscored “the importance of governance for sustainable development at all levels and the need for a reformed IFSD (institutional framework for sustainable development) that is better prepared to respond to current and future challenges, to more efficiently bridge gaps in the implementation of the sustainable development agenda as well as to accelerate global action towards a greener and more sustainable economy and eradication of poverty worldwide” (Council of the European Union, 2011, p. 4).

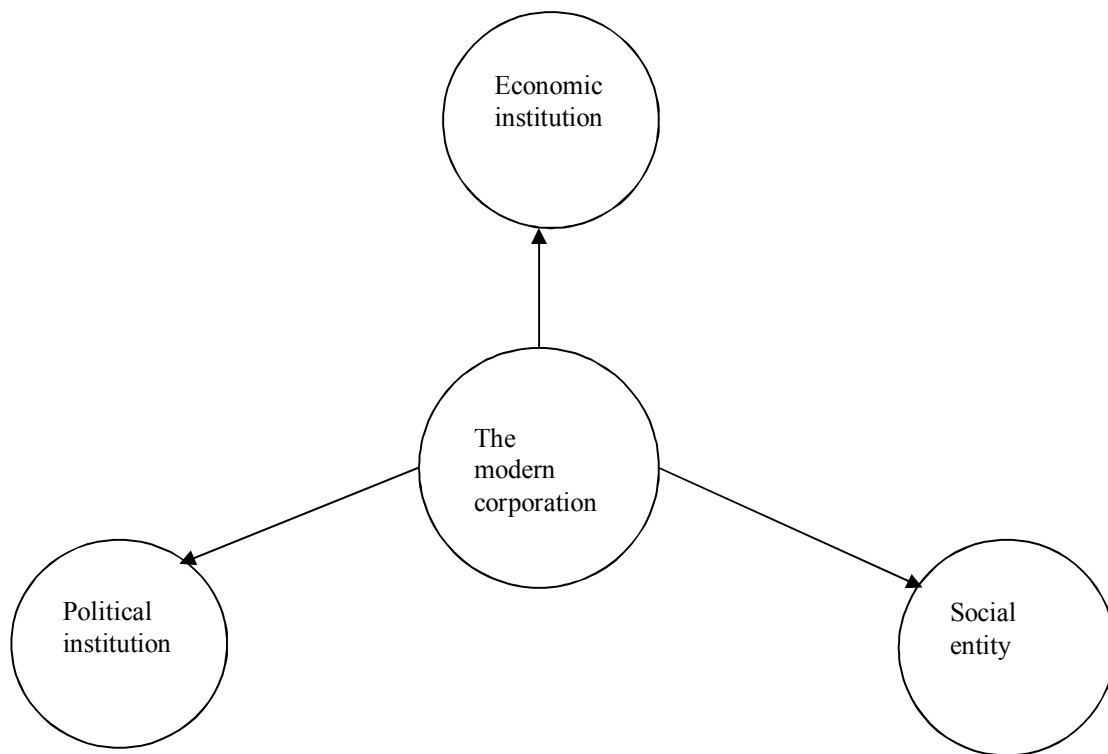




**Fig. 3.** Three interdependent elements of sustainable development.

On the other hand, the concept of ‘social responsibility of organizations’ (especially business organizations) gained prominence in the early 1930s when T. J. Kreps used the term “social audit” for measuring the social involvement of companies which reported on their social responsibility. In the late 1930s, C. Barnard showed that the durable organization depends on the quality of its management which is based on morality. In his opinion, high responsibility is necessary in any type of organization, either big or small.

On his turn, P. F. Drucker considered the modern corporation as being a complex organization (Fig. 4) and the representative social institution of the American society. In his landmark study “The Concept of the Corporation”, he emphasized that any corporation should be a social institution and a community for all employees: “...the essence of the corporation is social, that is human organization” (Drucker, 1946, p. 31).



**Fig. 4.** The modern corporation: a complex organization.

After the Second World War, H. R. Bowen inaugurated the modern era of social responsibility when he published his book entitled “Social Responsibilities of the Businessman” in 1953. In his view, the social responsibility of corporations is a way of integrating the societal values beyond the interests of shareholders.

The distinction between the CSR1 (corporate social responsibility) and CSR2 (corporate social responsiveness) concepts was made by W. C. Frederick in the late 1970s. He argued that the former has ethical or moral threads and the latter is concerned only with the managerial processes.

In the late 1990s, A. B. Carroll identifies the following four components of CSR: ethical, economic, legal, and discretionary (philanthropic). Thus, the social responsibility of business encompasses “the economic, legal, ethical, and discretionary (philanthropic) expectations that society has of organizations at a given point of time” (Carroll and Buchholtz, 2012, p. 34).

In sum, sustainable development and social responsibility of organizations are two concepts that have evolved during the time. Their historical evolution represents one of the elements that lead to the better understanding of their relationship.

### 3. THE SOCIAL RESPONSIBILITY OF ORGANIZATIONS, A FUNDAMENTAL DRIVER OF SUSTAINABLE DEVELOPMENT

Over the time the concepts of ‘sustainable development’ and ‘social responsibility of organizations’ have continued to grow in importance in society. The theoretical framework for these concepts has changed during the past decades. Despite the on-going debates about their meanings, a few common features can be identified for each of them derived from their numerous definitions.

There are still some difficulties in defining the concept of sustainable development in an analytically rigorous way (Barbier, 1987). The main explanation lies in the fact that sustainable development has multiple dimensions (e.g., ecological, economic, social, legal, cultural, political, psychological, etc.) that require attention (Table 1).

**Table 1.** Definitions of sustainable development.

No.	Author	Definition
1.	International Organization for Standardization (ISO)	Sustainable development is about “integrating the goals of a high quality of life, health and prosperity with social justice and maintaining the earth’s capacity to support life in all its diversity” (ISO 26000- Clause 2.23, 2010).
2.	D. Pearce	Sustainable development is “economic development that lasts” (Pearce, 1993, p. 7)
3.	J. R. Engel	Sustainable development can be defined as “the kind of human activity that nourishes and perpetuates the historical fulfillment of the whole community of life on earth” (Engel and Engel, 1990, pp. 10-11).
4.	World Commission on Environment and Development- the Brundtland Report	Sustainable development is “the development that meets the needs of the present without compromising the ability of future generations to meet their own needs“ (WCED, 1987, p. 8).
5.	R. Repetto	Sustainable development is “a development strategy that manages all assets, natural resources, and human resources, as well as financial and physical assets, for increasing long-term wealth and well-being” (Repetto, 1986, p. 15).

Proponents of sustainable development differ in their opinion regarding what is to be developed or how to link economic development with environment protection. The above mentioned definitions reveal several features of the concept of sustainable development as follows:

- Sustainable development expresses the broader needs (social, economic, environmental) of society as a whole.
- Sustainable development emphasizes that human society heavily depends on the natural environment.
- Sustainable development involves an economic and social development that avoids or minimises those human activities the costs of which are borne by the future generations.
- Sustainable development is a dynamic concept because society, technology, and culture

change. Therefore, it involves a time dimension.

- Despite the uncertainty of its future direction, sustainable development is and will be not only a major concern, but also a multi-faceted objective for humanity.

On its turn, the concept of ‘social responsibility of organizations’ in general, and the concept of CSR in particular, are rather elusive concepts. There are not universally acceptable definitions of these concepts in the literature. This could be explained by their relatively long history and by their multidisciplinary approaches (Table 2).

**Table 2.** Definitions of social responsibility of organizations and CSR.

No.	Author	Definition
1.	International Organization for Standardization	Social responsibility is “the responsibility of an organization for the impacts of its decisions and activities on society and the environment, through transparent and ethical behavior [that] ... contributes to sustainable development, including health and the welfare of society, ... takes into account the expectations of the stakeholders, ... is in compliance with applicable law and consistent with international norms of behavior ... [and] is integrated throughout the organization and practiced in its relationships” (ISO 26000- Clause 2.18, 2010).
2.	Commission of the European Communities	CSR is a concept “whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis” (Commission of the European Communities, 2006, p. 2).
3	P. Kotler, N. Lee	CSR represents “a commitment to improve community well-being through discretionary business practices and contributions of corporate resources” (Kotler and Lee, 2005, p. 3).
4.	International Institute for Sustainable Development (IISD)	Social responsibility is taken to mean “a balanced approach for organizations to address economic, social and environmental issues in a way that aims to benefit people, communities and society” (IISD, 2004, pp. 1-2).
5.	H. Bowen	Social responsibility in business refers to “the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society” (Bowen, 1953, p. 6).

In essence, these definitions show that a socially responsible organization has social and environmental obligations in addition to its economic purposes. However, the social responsibility of organizations is essentially a concept whereby organizations decide voluntarily to contribute to a better society.

The analysis of the concepts of ‘sustainable development’ and ‘social responsibility of organizations’ reveals that these are strongly connected. At a macro level, sustainable development refers to the social, economic and environmental goals common to all people and society. At a micro level, social responsibility of organizations relates to the organizations that address social, economic and environmental issues in a responsible manner. Therefore, the organizations that behave socially responsible contribute to sustainable development. That is why the concept of social responsibility is closely linked to the concept of sustainable development. In the past decades, the social responsibility of organizations has become one of the main drivers of sustainable development.

#### 4. CONCLUSIONS

The concepts of sustainable development and social responsibility are among the most important in the literature. As a result, the sustainable development debate and the social responsibility debate have become the subject of an important number of studies in the past decades.

By achieving the balance among its economic, social and environmental components, a society pursues the sustainable development way. Similarly, a socially responsible organization is an organization that demonstrates a balanced approach regarding the economic, social and environmental issues. Our paper shows that social responsibility of organizations has proved to be a key driver of sustainable development.

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**CONTEMPORARY TRENDS FOR IMPROVING THE HEALTH FINANCING  
IN BULGARIA**

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**Abstract**

*The author examines 8 basic trends, which, according to his opinion, could contribute to a better health financing in Bulgaria in conditions of economic crisis. These trends include: achievement of consensus among political parties in Parliament for stabile development of health system; introduction in the process of financing the complex 3d: democratization, decentralization, demonopolisation; future development of market for health services; role of the State and municipalities; calculation of the expenses for medical treatment in different medical institution; introduction of European standards in medical treatment; introduction of DRG in financing of medical treatment in hospitals; financing of final results.*

*The complex application of the over mentioned trends could ensure more effective financing of health in conditions of economic crisis.*

**Key words:** *democratization, decentralization, demonopolisation, DRG, economic crisis*

**GENERAL**

A number of West European authors of today (Saldman; Lepen; Ferroussier - Davis, Busse) review the systems for healthcare financing as a key part of the wide structure of social security and financial support. This is a living organism inextricably bound up with the overall structure of the society and its relative stability requires the trust and the efforts of all system stakeholders: the state and the civil society.

The system for healthcare financing is reviewed as a component of the national security.

Healthcare costs – general parameters

In the last two years due mainly to the economic crisis and certain errors in the strategic management of healthcare, the system of healthcare financing underwent a number of changes.

- it was reported that 1 900 000 people were not health insured;
- healthcare costs from public sources were reduced to 3.8 - 3.9 % of GDP;
- the relative share of public funds compared to the general healthcare costs came up to 57%;
- health insurance contributions of employees amount to 53 leva per month while the contributions for people insured by the state are 19 leva;
- Republic of Bulgaria has the lowest health insurance contribution among the EU Member States - 8%.



- comparatively low healthcare costs per capita - \$328 USD according to public sources;

**THE ABOVE DATA, ALTHOUGH NOT EXHAUSTIVE, REQUIRE OUTLINING SOME KEY CONSIDERATIONS TO CLARIFY THE VISION FOR FURTHER CAPACITY BUILDING OF BULGARIAN HEALTHCARE**

Guidelines of improvement of the healthcare financing

**1. Achievement of a consensus among the politicians for sustainable development of healthcare.**

- expert-based elaboration of the vision for development
- case analysis
- setting priorities
- formulating main objectives
- defining tasks to ensure the implementation of the objectives
- development of a strategy for capacity building in healthcare;
- approval of the strategy with a consensus
- annual action plans

**2. Implementation of the 3-d complex: democratization, decentralization, demonopolisation**

This process underlies the further liberalization of the philosophy of the modern evidence-based health policy. In the basis of interpreting the applicability of this definition is the new concept of healthcare in Bulgaria, which provides that an individual should take the leading role in protection of their own health. This role increases concurrently with the increase of the general and health culture as well as with the improvement of the standard of living.

Democratization of healthcare means establishment of equal rights both for the citizens who use medical services and for the medical establishments that provide medical services. This process means also a free choice of a medical doctor and a medical establishment and introduction of the principle of contracting between the medical care provider and the financing organization.

Decentralization of healthcare means implementation of a healthcare management system, which transfers a part of the rights and responsibilities to the autonomous health establishments. This process must ensue from the implementation of market methods in the healthcare management and grants rights and imposes obligations to the management teams, which would ensure higher medical and economic efficiency.

Demonopolization of healthcare basically refers to liquidation of the monopoly of the NHIF in respect of the compulsory health insurance and takeover of this activity by 4 – 5 health insurance companies for compulsory and voluntary health insurance. This will enable the health insured to select at his/her own a health insurance fund and will create conditions for competition between individual health insurance funds.

### **3. Development of the market of health services**

The introduction of market methods in the health system management started in 1998 and currently includes: replacement of the budget-based model of financing by an insurance-based model; a free market; a free choice of a medical doctor and a health establishment; contracting the scope and the prices of health services; restructuring of the health establishments in line with the demand;

Although awaited as a panacea, these tools of the strategic management didn't achieve to date the expected result for increasing the system efficiency, satisfying the medical needs of the population and the expectations for a better pay for some medical professionals.

### **4. The role of the government and the municipalities**

The withdrawal of the government from its constitutional obligations to public health and the transferring these functions to the market of medical services is considered a wrong move in the process of the ongoing reform in healthcare.

A modern evidence-based health policy should adhere to the principle "more market and more government in healthcare". This principle requires a creative development of both approaches: development of the market of health services and more active involvement of the government in healthcare.

### **5. Pricing of treatment and diagnosing in the individual health establishments**

Pursuant to the Law on Health Establishments, the Diagnostic and Consulting Centres and the hospitals have the status of trading companies. Therefore their incomes should cover their costs and the staff wages come as a balance value. This rule requires that each and every health manager should have full information about real treatment costs for each diagnosis in the health establishment which he/she manages. This is a must upon development of the indicative annual budget of the health establishment.

Practically there are a number of methods with different level of pricing accuracy. With a view to the evidence-based health policy, it is recommended to apply inpatient information systems, which record for each individual patient both the medical tests and treatment and the costs incurred for that purpose. The operating and administrative expenses are also subject to reporting.

### **6. Implementation of the European Standards in healthcare**

This process is based on the rules of the good medical practices and the good pharmaceutical practices, i.e. the scientifically based standards of work.

Quality of healthcare is ensured by implementation of a general legal and regulatory framework, development and implementation in the practice of national medical standards and accreditation of the medical establishments. The medical standards are defined as a totality of rules for professional conduct, conditions and mode of work, which are mandatory for assurance of the quality of medical service.

They are developed within the National Programme for Medical Standards in Republic of Bulgaria.

The assessment of the quality of medical services is realized through accreditation – a process whereby each health establishment is required to prove the quality of the conditions in which it provides the health services, the quality of the activities through which the health services are provided and the quality of the provided medical aid. Accreditation is compulsory in Bulgaria - it has been introduced abiding by the provisions of the Law on Health Establishments.

#### 7. Introduction of DRG for financing the hospital services

- A new modern method for our healthcare, which is more accurate and fair;
- This method taken alone will not solve the problems;
- An experimental implementation is required;
- Increase of the required financial resources;

#### 8. Outcome financing

Method of financing	Source of financing
1. Financing the structures (money follows the health structures)	the budget
2. Financing the activity (money follows the health activities)	a health insurance fund
3. Outcome financing (money goes basically for the achievement of a health outcome)	a health insurance fund the budget

#### CONCLUSIONS:

1. Presently there is no universal model for healthcare financing. In order to achieve a positive result we need to find several complementary models.
2. It is necessary to develop and to expand the application of the outcome financing to the process of treatment.
3. The development of a vision /and subsequently a strategy/ for development of the capacity in healthcare should start with aggregated macro-indicators: costs per capita; % of GDP; ratio between public finance and citizens' private finance used for healthcare.

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**ECONOMIC AND FINANCIAL ANALYSIS OF A COMPANY – SUPPORT  
FOR USERS OF INFORMATION**

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**Abstract**

*In any economic environment, a financial analysis is required as a top priority for any company due to the benefits provided. The study was conducted on the importance of this analysis, accounting data can be used and the interpretation of results based on these data. To obtain an analysis of ABC company based on the financial statements, which allowed us to obtain further information about the health of it by using indicators of cash flows, the profitability, liquidity, solvency and the indebtedness. This analysis was conducted on five consecutive years and underlining the importance of each item allowed patrimonial effects beyond the efforts that each company wants to produce to increase their own performance.*

**Key words:** *financial information, analysis, financial performance*

## **1. INTRODUCTION**

In any market economy, every company wants to maximize the output and for that the managers depends on access to information, the quality of information and the ability of the system to refresh the information provided. Since the objective of accounting can be defined as being to ensure the provision of information to achieve a fair value of the financial position, the financial performance and changes occurring in a company, I consider important how each company manages its information and transmit some of this information to users.

Since 1975, Anderson in his work stressed the importance of information and interaction of this information with other market information can be extremely valuable for a company and any part of a whole by adding the value obtained from each part will get more than the whole got separated.

The organization of financial and accounting activities meet different forms depending on the size and complexity of the company's financial activity. Whatever the shape or the organization each company is obliged to organize and manage financial and accounting so that it can provide financial information to enable activity analysis, the status quo of the company, its situation, the profit / loss on it is registered. Information can be found both financially and in accounting management accounting.

In 1999, Espinosa-Pike in his book tells us that information to be used must provide warranty (on their quality), and this depends on the honesty of those who prepared the documents. These people are those who choose which of the methods allowed by ethics and rules can be used knowing that the way to centralize the data can sometimes produce errors of interpretation.

Hunton and Beeler (1997) states that we use a computer system can help the user control, which would facilitate management of this information. However, these information systems are not often implemented because of organizational constraints due to limited resources, so the most effective way is to select the right staff and then the accountable (by implication, an attitude that creates performance).

In his work Finlay and Marples (1997) mention the importance of information management, stressing that it is important for managers to know not only which information system, which communication system is used but also the processing system used to deliver results of the analysis. These results are obtained by specialists using techniques and analysis models plus their experience in interpreting the results.

According to the Romanian law, financial accounting information intended for external users can be obtained through the a summary of financial statements whereas specific accounting documents and accounting information is intended for internal use management of the company, due to its specific character.

Any financial situation of companies includes financial information on the health of company at a given time; financial Romanian report has four separate parts: balance document, income statement, informative data, and situation of fixed assets.

Each document provides some information as follows: "Balance Sheet" provides information on assets, equity and debt of the company (those physical and financial resources available to the company), "Profit and loss account" gives us information about expenses, revenues and company profits on course activities (considering its achievements which had been supported to enable the achievements to be obtained), "Informative data" includes a more centralized data on the outcome recorded (outstanding payments, number of employees, interest payments, dividends or royalties, charges for research, innovation, other information); situation of fixed assets includes amounts relating to the types of intangible assets (including increases and decreases), depreciation, and any adjustments for impairment if there were.

Large companies are required to prepare a "Statement of Cash Flows" which includes a breakdown of these flows on activities that generated them: operating, investing and financing (optional for small companies). Although financial statements are regarded as historical documents recorded because they are the records of the situation of the company at a certain moment they can also give specific information useful for different users on: capacity of the company to future expansion or the capacity of the company to support financial activities in the future (for managers), earnings and possible future dividends (for shareholders), the collectability of the debt (creditors) etc. (Figure 1).

Lainez and Callao (2000) in their paper on the need for presentation of financial information made available generally to be interpreted and analyzed in order to ensure comparability of data. They noted that although there is a good accessibility of information acquisition, many countries face international diversity in the formulation and application of accounting principles leading to a significant barrier for international comparability of financial reports.

Based on information provided by accounting can be economic and financial analysis. Any company use financial analysis in various occasions: to see if capital requirements can be covered / supported in equity / borrowed, to check the level of liquidity for the analysis of financial results.

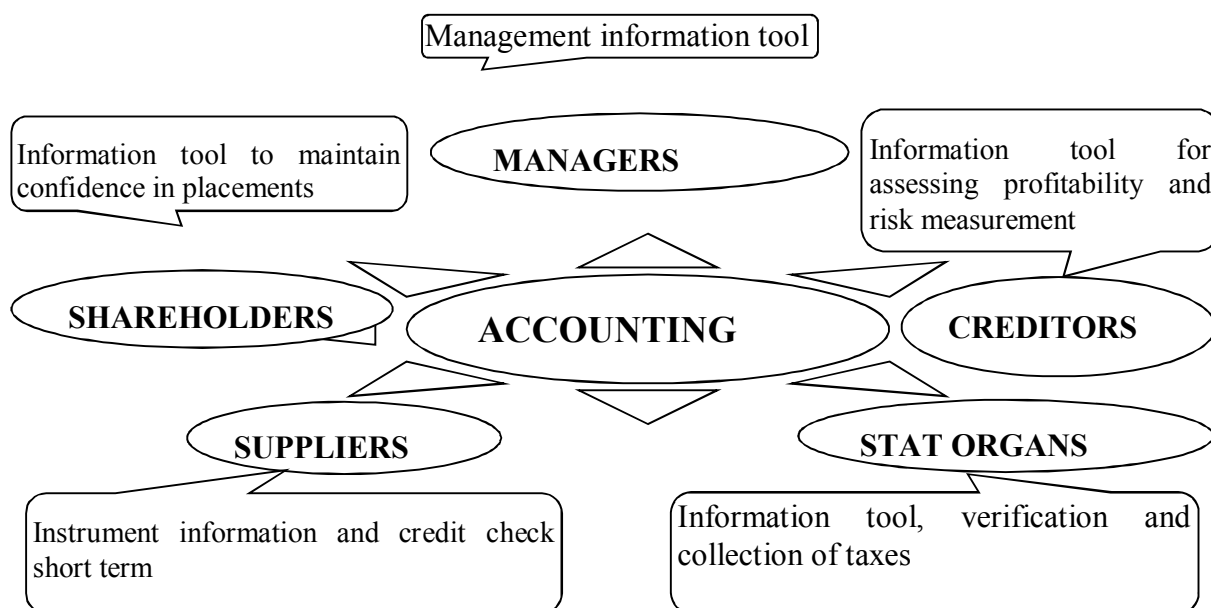


Figure 1. Accounting information on different types of users

On the other hand is considered in the literature that exogenous factors including a company such as the legal system might affect long-term activity of a company (through a legislation incentive for creditors, the rules relating to the execution of contracts and by establishing full and accurate reports), environmental regulations etc., which can cause or influence a firm growth. Levin (Levine, 1999) and other authors believe that corporate social and environmental performance is directly related to corporate financial performance (Orlitzky and all, 2003).

Bittencourt (2012) emphasizes the importance of broader access to finance companies which he says allows growth, demonstrated by his study conducted in four Latin American countries. It emphasizes that Schumpeter's predictions come true about the role of financial development in promoting innovation and economic growth.

In this study Bittencourt (2012) believes that the state can facilitate or support that allows access to finance plant expansion and ultimately this will affect the state through economic growth while other authors consider that the state should take a more restrictive policy because they say the cost of debt includes the risk of bankruptcy (Huynh and all, 2012).

## 2. NEED FOR ECONOMIC AND FINANCIAL ANALYSIS

Because there are many external factors that cannot be controlled, we consider that is very important that managers take into consideration the resources and all information available when they want to make changes in the asset to achieve economic and financial analysis of financial data.

Financial analysis is required because it uses specific tools and means adapted to the aim pursued and leads to: financial diagnosis, part of the diagnosis accounting, financial accounting function targeting, diagnosis profitability and risk diagnosis.

Objectives pursued by the economic and financial analysis are:

- Highlighting malfunctions or bad elements;
- Identify the causes of these difficulties, for correction, removal or counter;
- Presentation of enterprise evolution and propose actions to be taken for improvement or recovery situation.

Financial analysis and the construction involve a judgment on the "financial health" of the company, the strengths and weaknesses of financial management, which can assess the risks of past, present and future. This can be seen as part of a system in which the financial analysis, after which decisions can be financial, it may set financial goals, and if they change the circuit resumes to ensure that objectives can be financially supported (figure 2).

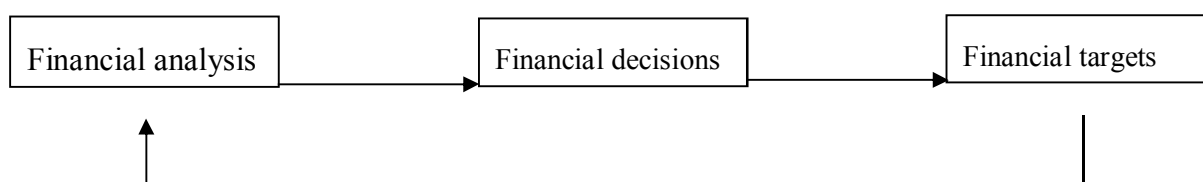


Figure 2. Cycle financial analysis

Financial analysis is to assess the financial policy of the enterprise at a given time in the past and its facilitation of making future decisions. It is achieved through analysis of financial statements because it involves examining the evolution or trend that company records that can be compared with other firms in the same area and analyzed through specific indicators.

The need to achieve financial analysis is underlined by Gaver and Pottier (2005) in their article which made a study using indicators of capitalization, liquidity, asset risk and profitability (on 80 publicly traded property-liability Insurers). Their study that there are differences in regulations and accounting procedures given the sometimes hijacks final information such as: Statutory Accounting Principles (SAP) and the Generally Accepted Accounting Principle (GAAP), and for this reason comparisons are not conclusive. In this sense for the success of an analysis is very important to take into account two limitations: making possible the comparability of data between two or more companies and to be able to look beyond the existing relationship.

First, the need to use the same accounting methods that can be realized for comparability (is inventory records can be achieved by several methods FIFO, LIFO or weighted average cost, and results can be influenced by it, as any valuation of inventory, etc..). Barnes (1987) in his paper considers the use of financial ratios can be performed for many purposes, but mainly they have used to facilitate comparisons by adjusting them according to size.

Second, assume that the results obtained by means of indicators can be used for further investigation of the causes that led to their getting and not as a final aim. To achieve the final analysis others sources of data must be used to complement and support the results obtained through indicators such



as trends in that industry, any technological changes, possible changes in consumer preferences, certain changes in general economic factors, changes occurring inside the company.

Feroz (2003) in his article urges us to use ROE (Return on Equity) using its decomposition as follows:

$$\text{ROE} = (\text{NI}/\text{S}) \times (\text{S}/\text{A}) \times (\text{A}/\text{E})$$

Where:

- First report is profit margin = Net income (NI)/Sales (S);
- Second report is asset utilization = Sales (S)/Total Assets (A);
- Third report is equity multiplier = Total assets (A)/Common equity (E).

This decomposition facilitates the examination he says in terms of profitability (profit margin), level of assets needed to generate sales (asset usage), and the financing of these assets (equity multiplier) and define the important dimensions of technical efficiency of an organization producing income (Feroz et al., 2003).

This mean that one can act to minimize inputs (total assets, equity, etc.) and maximizing output (net), that is to use minimum resources to get maximum results.

Using a studio called Data Envelopment Analysis (DEA) they have tried to discover whether there is a relationship of dependence between the results of the financial ratios (liquidity, solvency side performance) and that is the extent to which this can help us evaluate the effectiveness of companies. Making a statistical descriptive analysis (mean, median, dispersion) of these financial ratios they concluded that the results are similar to those made by Davis and Pele, that there is a correlation between these indicators, on the distribution coefficients (Davis et al ., 1993).

### 3. MATERIALS AND METHODS

Excluding those possible setbacks due to accounting rules and procedures may leave room for interpretation and that may prevent or hinder financial analysis in the present study. That why I have decided that I will use indicators that are used primarily to indicate the past performance of the company, but data can be interpreted and can also be used to extrapolate into the future and to some extent, the trend of evolution or performance or any potential problem areas.

For this analysis we started from the financial data presented in Table 1 and 2, corresponding data for this company ABC and have used data from five consecutive years (data from this study are in RON).

There has been a horizontal analysis of balance because it shows how to realize key financial balances short and long term company through aggregate sizes such as net situation, working capital, working capital needs the treasury. This analysis also highlights the correlations between asset and liability items (debtors, creditors, customers, suppliers, etc.).

Analysis of data elements through the balance property can be achieved using mathematical formulas involving horizontal analysis (analysis of the funding panel - Table 3) and vertical (analysis of economic structure - Table 4) financial data.

Table 1. Financial statement in summarized form of company ABC

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Assets	1100	1200	1,190	1110	1060
2	Current assets, including:	600	730	550	610	630
	- inventories	200	170	150	180	160
	- trade receivables	120	260	180	240	170
	- cash assets	280	300	220	190	300
<b>TOTAL ASSETS (1+2)</b>		<b>1700</b>	<b>1930</b>	<b>1740</b>	<b>1720</b>	<b>1690</b>
3	Capital	1350	1400	1400	1400	1400
4	Reserves	30	40	50	60	70
5	Current result of exercise	20	100	50	60	80
6	Equity capital (3+4+5)	1400	1540	1500	1520	1550
7	Other liabilities (current liabilities)	50	90	80	60	30
8	Long-term loans	250	300	160	140	110
<b>TOTAL LIABILITIES (6+7+8)</b>		<b>1700</b>	<b>1930</b>	<b>1740</b>	<b>1720</b>	<b>1690</b>

ABC Company has recorded the following financial data on the profit or loss (Table 2):

Table 2. Financial data on the outcome recorded

Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
Annual turnover	1200	1400	800	900	1100
Net operating result	19	98	50	55	78
Current result of exercise	20	100	50	60	80

Table 3. The analysis of cash flows

No. Item	Name of financial indicators	Formulas for calculating financial indicators
1	Working Capital Fund (WCF)	WCF = Permanent capital – Fixed assets WCF = Current assets - Liabilities
2	The need for working capital (NWC)	NWC = Current assets, excluding cash availability – Current liabilities, excluding short-term loans NWC = (Inventories + Trade receivables) – Short-term loans
3	Treasury net	TN = Active Treasury – Treasury passive

(TN)	TN= WCF – NWC
WCF = express achieving long-term financial stability and its contribution to achieving balance in the short term; NWC = express part of current assets (inventories and receivables) that is not funded from accounts payable (suppliers, tax liabilities and wage); TN = express a surplus of funding, existing cash and bank accounts.	

Working capital is important, as it expresses the excess resources resulting in permanent financing of investments, which can be "run" to finance current assets.

Expressing net surplus to finance Treasury and when positive is the amount remaining after fully funding the working capital fund working capital needs.

Analysis of the vertical direction of the balance sheet was done because it helps us identify the structure of assets (the ratio between assets and current assets) and liabilities (equity) financing structure (the ratio between equity and debt), and allows calculation of rates rotation of asset and liabilities, calculating rates of return, etc. (Table 4).

Table 4. Patrimonial analysis by combining indicators

No. Item	Name of financial indicators	Formulas for calculating financial indicators
1	Indicators of profitability (IP)	1. Economic rate of return = Net operating profit / Total assets 2. Financial profitability rate = Net profit / Equity capital
2	Liquidity ratios (LR)	1. Current Ratio = (Inventories + Receivables + Cash Assets) / Short-term loans 2. Ratio partial = (Receivables + Cash Assets) / Short-term loans 3. Quick Ratio = Cash Assets / Short-term loans
3	Solvency indicators (SI)	1. The solvency ratio = Total debts / Equity capital 2. Overall solvency ratio = Total assets / Current liabilities
4	Debt indicators (DI)	1. Overall borrowing rate = Total debts / Total liabilities 2. Rate of total financial autonomy = Debts to be paid in a period longer than one year / Equity capital
IP = performance expressed by a company registered efficient use of available resources; LR = expresses the company's ability to generate sufficient cash resources (cash) to deal with debt and ensure business continuity; SI = verify that an undertaking to meet its outstanding obligations owed to its creditors; DI = provides information on the company from its creditors autonomy.		

Analysis of rates by allowing managers and owners to look through calculations relationships between seemingly unrelated elements that the results they provide can identify trends and make decisions.

## 5. RESULTS

A first analysis for ABC Company can be achieved by carrying out calculations according to Table 5, which identify economic development and comparability of data elements recorded in the previous year. Analyzing data, absolute and relative financial balance (Table 5) observed trends in each element and to share its heritage in total. Also notice that the increase or decrease an item produced changes both content and structure.

Table 5. Analysis of the balance data

No. Item	Economic elements	Year N-4		Year N-3		Year N-2		Year N-1		Year N	
		RON	%	RON	%	RON	%	RON	%	RON	%
	0	1	2	3	4	5	6	7	8	9	10
1	Assets	1100	64.71	1200	62.18	1190	68.39	1110	64.53	1060	62.72
2	Current assets, including:	600	35.29	730	37.82	550	31.61	610	35.47	630	37.28
	- inventories	200	11.76	170	8.81	150	8.62	180	10.47	160	9.47
	- trade receivables	120	7.06	260	13.47	180	10.34	240	13.95	170	10.06
	- cash assets	280	16.47	300	15.54	220	12.64	190	11.05	300	17.75
<b>TOTAL ASSETS (1+2)</b>		<b>1700</b>	<b>100</b>	<b>1930</b>	<b>100</b>	<b>1740</b>	<b>100</b>	<b>1720</b>	<b>100</b>	<b>1690</b>	<b>100</b>

3	Capital	1350	79.41	1400	72.54	1400	80.46	1400	81.40	1400	82.84
4	Reserves	30	1.76	40	2.07	50	2.87	60	3.49	70	4.14
5	Current result of exercise	20	1.18	100	5.18	50	2.87	60	3.49	80	4.73
6	Equity capital (3+4+5)	1400	82.35	1540	79.79	1500	86.21	1520	88.37	1550	91.72
7	Other liabilities (current liabilities)	50	2.94	90	4.66	80	4.60	60	3.49	30	1.78
8	Long-term loans	250	14.71	300	15.54	160	9.20	140	8.14	110	6.51
<b>TOTAL LIABILITIES (6+7+8)</b>		<b>1700</b>	<b>100</b>	<b>1930</b>	<b>100</b>	<b>1740</b>	<b>100</b>	<b>1720</b>	<b>100</b>	<b>1690</b>	<b>100</b>

Based on financial balance indicators we then calculated the indicators of analysis of the financing table that expresses the balance between needs and resources: working capital, need for working capital and net treasury for the company ABC (Table 6).

Tabel 6. The analysis of cash flows

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Current assets, including:	600	730	550	610	630
2	- Inventories	200	170	150	180	160
3	- Trade receivables	120	260	180	240	170
4	- Cash assets	280	300	220	190	300
5	Other liabilities (current liabilities)	50	90	80	60	30
6	Total liabilities (Debt)	300	390	240	200	140
7	Working Capital Fund (1-6)	300	340	310	410	490
8	The need for working capital (2+3-5)	270	340	250	360	300
9	Treasury net (7-8)	30	0	60	50	190

There is a fluctuation in working capital from year to year but does not affect the need for working capital funds because there sufficient resources to finance current assets.

There is also a decrease in net cash which is a favourable situation, the company used cash resources.

There is also a decrease in net cash in year N-3 which could create a possible imbalance, but in the following years the company has a positive cash.

Another analysis is required to be made by the patrimonial analysis combined indicators. Many of the measures of profitability involve calculation of the economic and financial profitability.

Analysis by indicators combine asset is necessary because the use of ratios between different elements can assess the overall financial condition of companies. Sometimes also called trend analysis, the ratio analysis was used to compare the company's financial condition during the time, in order to identify any trend, good or bad, in its performance.

Using the formulas from Table 4 a analysis for ABC company was done in Table 7 which consists of elements and decay rates to obtain components that can be analyzed separately and are also subject to analysis.

I should mention here that achieve superior profitability is worth the management company which managed assets effectively, making the face of economic risk (the possibility of registering a result of insufficient or even a loss) and financial risk (can not effectively use capital borrowed and to expose the company to an inability to meet its financial obligations).

Table 7. The analysis of profitability

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Annual turnover	1200	1400	800	900	1100
2	Net operating result	19	98	50	55	78
3	Total assets	1700	1930	1740	1720	1690
4	Gross margin rate (GMR) (2/1)	0.02	0.07	0.06	0.06	0.07
5	Capital rotation (CR) (1/3)	0.71	0.73	0.46	0.52	0.65
6	Economic rate of return* (ERR) (4x5)	0.01	0.05	0.03	0.03	0.05
7	Net profit	20	100	50	60	80
8	Equity capital	1400	1540	1500	1520	1550
9	Rate of capital structure (3/8)	1.21	1.25	1.16	1.13	1.09
10	Rate of remuneration structure (7/2)	1.05	1.02	1.00	1.09	1.03
11	Financial profitability rate ** (4x5x9x10)	0.01	0.06	0.03	0.04	0.05

\*to determine the existence of two factors: one quantity (gross margin or margin rate of accumulation) which is influenced by operating conditions and quality factor (capital rotation) that characterize the effectiveness of capital employed in the activity;

\*\*shows the existence of two factors in addition to those derived from economic profitability. The first express the financing of economic assets in equity while the second expresses the share or contribution to operating result in the total result.

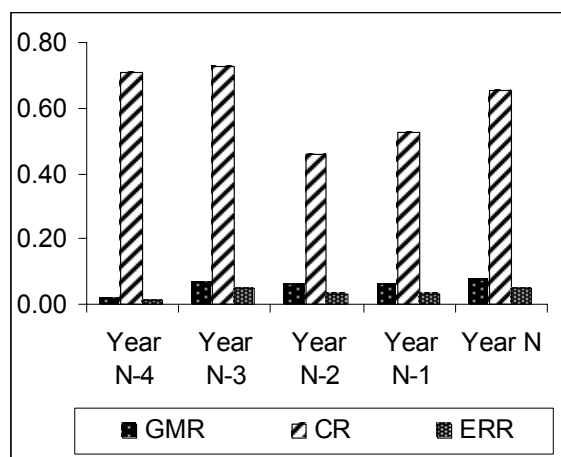


Figure 3. Evolution of the economic profitability afferent

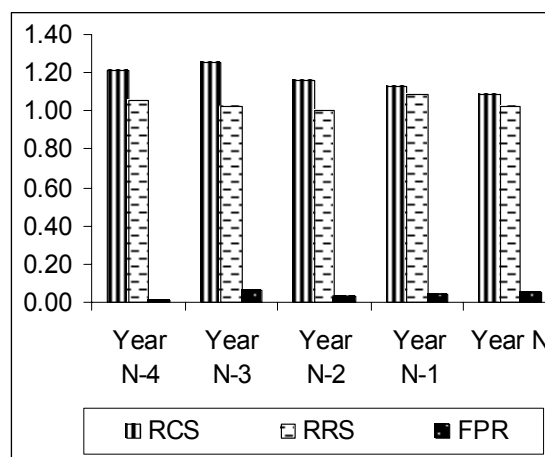


Figure 4. Evolution of the financial profitability afferent

There was a growth rate of economic return which measures the ability to provide both economic asset renewal, as well as pay equity investors.

Return on equity and that expressing yield stronger growth equity, ie pay grade placement made by the owners of the company. Compensation was achieved by paying dividends and increasing reserves.

Analysis heritage can be supported by computing the liquidity rate (Table 8).

Table 8. The analysis of liquidity

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Inventories	200	170	150	180	160
2	Trade receivables	120	260	180	240	170
3	Cash assets	280	300	220	190	300
4	Short-term loans	50	90	80	60.00	30
5	Current Ratio (CR) $((1+2+3)/4)$	12.00	8.11	6.88	10.17	21.00
6	Ratio partial (RP) $((2+3)/4)$	8.00	6.22	5.00	7.17	15.67
7	Quick Ratio (QR) $(3/4)$	5.60	3.33	2.75	3.17	10.00

CR = financial working capital expressed relative size. It is noted that potential liquidity (assets convertible into currency on short-term) can claim chargeability potential (short-term debts repayable).  $CR > 1 \Rightarrow$  It notes that there is capacity to pay debts due in the short term (working capital is positive). There is an improvement in the liquidity of the assets of the maturities of short-term debt this year than last year. RP = the firm's ability to pay short term debts of receivables and availability. Value of this ratio is quite high which means that the company dispose of stagnant resources. QR = company's capacity to repay short term debts instantly existing availability. There was a decrease of its previous year which is a positive situation, the company has optimized the use of cash.

This ability is actually on the entity's ability to cope with the total assets available for payment of any obligations and debt repayment.

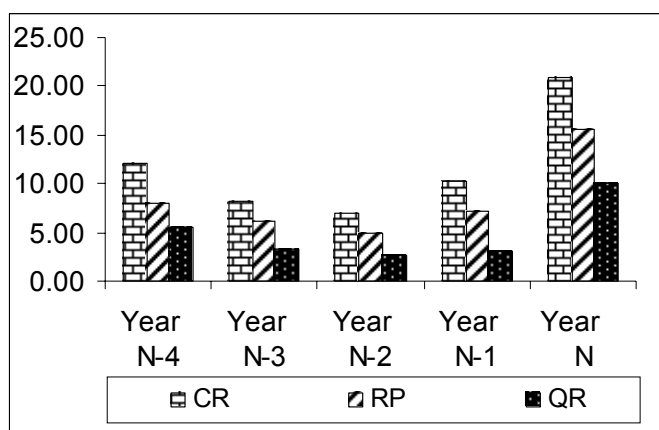


Figure 5. Evolution rates of liquidity

The need for solvency is a must for any company because it allows operating fluently in. Solvency ratios express the degree to which the company meet total debt and have been calculated in Table 9.

Table 9. The analysis of solvency

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Total assets	1,700	1,930	1,740	1,720	1,690
2	Equity capital	1,400	1,540	1,500	1,520	1,550
3	Current short-term debt	50	90	80	60	30
4	Total debts	300	390	240	200	140
5	The solvency ratio (SR) (4/2)	0.21	0.25	0.16	0.13	0.09
6	Overall solvency ratio (OSR) (1/3)	34.00	21.44	21.75	28.67	56.33
SR > 0 that the company can cover the total debt from equity, which is safe for long-term creditors; OSR - results express that short-term company has sufficient resources to meet current liabilities.						

The risk of financial imbalance of the company depends on the size and structure of its Borrowing and leverage knowledge of these indicators is important for both internal and external information by ensuring the creditworthiness of business partners. Calculations on debt indicators were presented in Table 10.

Table 10. The analysis of debt

No. Item	Economic elements	Year N-4	Year N-3	Year N-2	Year N-1	Year N
1	Equity capital	1,400	1,540	1,500	1,520	1,550
2	Permanent capital	1,400	1,540	1,500	1,520	1,550
3	Total debts	300	390	240	200	140
4	Total liabilities	1,700	1,930	1,740	1,720	1,690
5	Overall borrowing rate (OBR) (3/4)	0.18	0.20	0.14	0.12	0.08
6	Financial leverage (FL) (3/1)	0.21	0.25	0.16	0.13	0.09
7	Rate of total financial autonomy (RTFA) (1/3)	4.67	3.95	6.25	7.60	11.07
8	Debt capacity (DC) (1/2)	1.00	1.00	1.00	1.00	1.00
OBR - there is a growing business dependence from various creditors, but it is possible debt repayment (this increase is 18%); FL - although this indicator is less than 1 is an increase from one year to another which leads to diminishing opportunities to access new loans; RTFA - is the inverse of financial leverage and says that the company had a poor outcome that has diminished financial autonomy; DC - says that this year the company has improved its ability to leverage.						

Debt can be used for growth and the company considered observed decrease financial leverage (debt to equity reported). They also see an increase of financial autonomy.



## 5. CONCLUSIONS

All companies are primarily intended to obtain a higher profit. However, mass analysis of profit does not offer enough information on company performance. Therefore, it was necessary to compare it with other measures reflecting the efforts made for obtaining the profit.

In the first part we realize an analysis of balance sheet to determine how they have evolved from year to year. Then we calculated the net positions of heritage and it was found that company ABC is able to cover debts from assets it has. We moved later on the determination of the treasury indicators: although the value decreased from one year to another, they finally recorded as positive values showing that there are sufficient resources to cover working capital needs and ensure a positive treasury.

Company's ability to generate profit was verified by measuring the efficiency and effectiveness of indicators of profitability of the company. Profitability is one of the synthetic indicators of economic and financial efficiency of a company and it is intended to express its results.

At ABC company rates of return have increased this year compared to last year, growth that is justified by:

- increase economic efficiency rate was achieved due to higher gross margin rate that was influenced by increasing turnover and net operating results;
- growth rate of financial return to profitability at the expense of economic growth rate of capital structure (caused by an increase in net profit).

For this activity requires that the company always have the cash resources (cash) that would allow payments due dates, so were calculated liquidity indicators.

Note that rates are too high liquidity which suggests that liquidity stagnates in the company and therefore are not sufficiently used.

Items that can cause favorable effects on liquidity are stocks (which was done) and accelerating debt collection (which was done in a certain extent).

Another prerequisite for financial analysis was to check the solvency knowing that keeping pace is subject to timing of receipts of cash resources (which depends on the possibility of change in currency assets mature) the payment rate (which is given by honouring debt reached at maturity).

There is an increase in solvency date if we take into account current and decreased its total debt when we talk. However, these rates are too high which again tells us that the company faces a cash surplus which is not capitalized.

The analysis of debt identifies the degree of dependence of own resources and those attracted by the company has to identify the steady state. Indebtedness of the company is important to consider because it allows determining the degree of financial independence and possible risks of the company is exposed.

There is a drop in global debt rate can be explained by the increase in debt at a rate less than total liabilities. Leverage refers to the proportion of company capital (which was brought by shareholders) to creditors, ie that the proportion of own and borrowed sources and company under study shows a drop of it. Leverage shows the extent to which the company depends on loans to finance its operations and in our case there is a favorable effect.

Maintaining financial balance showing "health" of the company is conditioned by the correlation of the factors leading to success and those that cause failure. For this consider it necessary to conduct an economic analysis that can provide sufficient financial information stakeholders, analysis can be extended by using other indicators.

Assessment of company performance through rates or composite indicators can help to improve company information system by helping managers in making decisions, which ultimately leads to reduced economic and financial risk.

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**INFORMATION ON CAPITAL RELATIONS IN A UNIT FINANCIAL REPORT ON THE BASIS OF POLISH AND INTERNATIONAL ACCOUNTING STANDARDS**

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**Abstract**

*Information on capital relations in financial reports is important for a wide range of interested parties. A key issue is the proper scope and manner of presenting this information in a unit financial report. The study presents solutions adopted in Polish accounting standards. They have been evaluated and referred to solutions contained in international accounting standards. Changes to the standards of drawing up financial statements have been proposed.*

**Key words:** *financial statements, capital relations, Polish Accounting Law*

**1. INTRODUCTION**

As a result of the capital market development, economic subjects can become owners or co-owners of other units by acquiring their shares. Such transactions lead to the formation of economic entities groups which are closely tied to each other by capital and equity relations. Depending on the number and terms of purchasing the shares of one entity by another subject, there are various degrees of this entity's dependence on the purchasing unit. These units, having met particular requirements, are deemed as capital related.

Each of capital related units retains its legal, and in consequence, reporting separateness. This means that each of the capital related entities is obliged to draw up a separate (unit) financial statement. A financial statement presents information which most frequently does not allow evaluating the degree of this relation and its effects. From the point of views of a user of information contained in financial statements of these units, such a situation may lead to fallacious conclusions and evaluations. An analysis of the situation of a related unit solely on the basis of its financial statement drawn up according to the law in force, in isolation from other related units may result in wrong conclusions. Most frequently it does not take into consideration the equity relations, the effects of various transactions conducted between these units as well as the resulting overlapping of values in unit reports. It is therefore impossible to properly evaluate the influence of one unit exerted on the other. For this reason, a special role is attributed to a consolidated financial statement. However, not all kinds of capital relation require a consolidated financial statement to be drawn up. Also information on this subject is not always sufficient and properly emphasized in both a unit and consolidated financial statement. Solutions within this scope proposed in Polish and international accounting standards differ considerably.

Therefore, the problem is whether and to what extent information on capital relations and other types of connections should be disclosed already on the level of financial statements prepared by these entities, no matter if they will be consolidated or not.

The aim of the study is to analyse the scope of disclosure of information on affiliated units in unit financial statements drawn up in compliance with Polish accounting standards and to show the necessity of extending this scope.

In the study the substantive and formal requirements of Polish solutions in this area have been taken into consideration and referred to international accounting standards.

The thesis of the study is based on the statement that the manner and scope of presented information on capital relations has a considerable influence on the quality and objectivity of a financial report as a source of data for evaluating the financial situation of an economic unit.

A parallel thesis is the statement that the currently binding Polish accounting standards with reference to international accounting standards are insufficient in this scope.

## 2. TYPES OF CAPITAL RELATIONS

### 2.1 *Legal regulations*

The main legal act regulating the problems of capital relations in Poland is the Accounting Act, which contains definitions regarding the kind of capital relations as well as economic units participating in them (The Accounting Act, 1994, the Journal of Laws No. 152, 2009).

Major International Financial Reporting Standards/International Accounting Standards (IFRS/IAS) in this scope include (International Financial Reporting Standards/International Accounting Standards, 2009):

- IAS 24 Disclosure of information on economic subjects,
- IAS 28 Investments in affiliated units,
- IAS 31 Participation in joint ventures,
- IAS 27 Consolidated and separate financial statements
- IFRS 3 Business combinations.

According to IFRS/IAS and the Accounting Act, there are three types of capital relations:

- control,
- significant influence,
- co-control.

Each of the parties to these relations is considered an affiliated unit. Also participation of these parties in subsequent capital relations causes an extension of the circle of capital related units.

### 2.2 *Control relation*

Control relations occur when one unit – parent – controls another unit, which is dependent on it. According to the Accounting Act and IFRS/IAS, the notion of “control” is defined as a capability of one unit to shape the operational and financial policy in another unit, which in practice translates into an ability to impose its own decisions in this scope.

The most frequent manifestation of control is having the majority of votes in a decision-making or supervising body as well as a capacity to appoint and recall most members of the managing,

supervising or administrating bodies. Contrary to IFRS/IAS, Polish law defines acceptable legal forms for a parent and subsidiary unit.

This relation is a basis of a capital group, which is defined as a parent unit with subsidiary units.

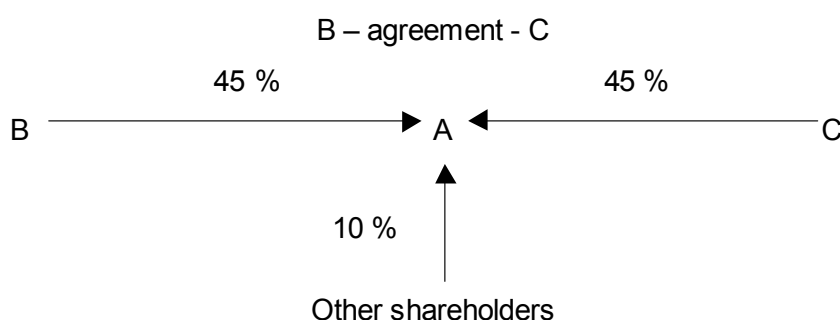
### 2.3 Co-control relation

Another type of capital dependence is co-control.

Co-control means a division of control over economic activity, which is established in an agreement and takes place only when all decisions (both strategic and operational) require a unanimous consent of co-controlling parties. Co-controlling parties are defined as partners.

Co-control results in a joint venture, defined according to IAS 31 as contractual arrangements by virtue of which two or more parties undertake economic activity which is subject to co-control. The above capital relation requires the conclusion of a relevant agreement in which its parties oblige themselves to unanimously take decisions regarding an economic enterprise, even if their equity shares in this enterprise are not identical. In Polish law the formal and legal requirements of such an agreement are specified mainly by the Civil Code. Parties – partners of a venture can be domestic or foreign entrepreneurs, including state-owned enterprises as well as state administration units (local government units). An example of a co-control relation has been shown in Fig. 1.

Figure 1. An example of a co-control relation



Source: own study.

In the above figure, entities A and C, despite a different number of shares, co-control unit A on the basis of a concluded agreement. Examples quoted in IAS and in reference books indicate that joint ventures can take various forms.

Co-control has been defined in IAS 31. It is a division of control over economic activity which is specified in an agreement and takes place when strategic operational and financial decisions require a unanimous consent of partners.

IAS 31 specifies the most common forms:

- jointly controlled activity,

- jointly controlled assets,
- jointly controlled entities.

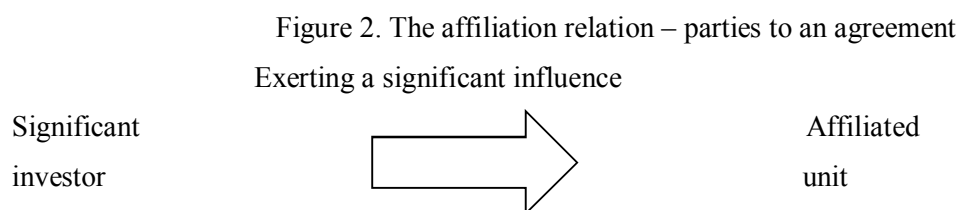
Fig.1 refers to the last of the above mentioned forms.

#### 2.4 Significant influence

The third major capital relation is the exertion of significant influence, which is also referred to as an affiliation relation. Issues connected with this relation identification and settlement are regulated mainly by IAS 27.

The essence of this method is an investor's exerting a significant influence on another unit, which however does not have the hallmarks of its control. This unit is called a unit affiliated with a significant investor. Polish law specifies legal forms permitted for an affiliated unit and a significant investor. International Accounting Standards are more liberal in this respect.

The relation of affiliation is shown in Fig. 2.



Source: own study.

According to IAS, the exertion of significant influence manifests itself in a unit's capability to influence the financial and operational policy of another unit, but without controlling or co-controlling it, which in particular takes the form of:

- a) participating in the taking of decisions on profit division or loss coverage,
- b) having its representatives in the managing, supervising or administrating bodies,
- c) effecting significant transactions with an affiliated unit,
- d) making technical information which is essential for the affiliated unit's activity available to it,
- e) having the capacity to exchange the members of the managing board, supervising or administrating bodies in this unit.

What seems to be a problem is practical identification of this relation on the basis of effected transactions. Single transactions which e.g. determine the level of a unit's turnover are easy to identify and, in this case, to properly interpret. What may raise doubts, however, is a situation when single transactions are not significant, but their number and the value of turnover they generate are. Also the exertion of significant influence by providing vital technical information may in practice be difficult to identify if this information is not of strategic importance to a unit (e.g. a new technology), but makes a significant contribution in the activity, e.g. the organization of goods or products' distribution.

Due to the disputability of significant influence indications, the list in IAS 27 has been extended. An indication of significant influence might be:

- an investor's influence on the formulation and implementation of a development strategy,
- close connections with economic activity,
- support in the obtaining of additional or new sources of capital,
- coordinated marketing campaigns, joint promotions.

In the light of the Accounting Act, significant influence may be determined by a percentage of shares in another unit: no less than 20% and no more than 50%.

If there are no other reasons for exerting a significant influence or exercising control, it may be assumed that acquisition of shares in another unit below the level of 20% does not result in a capital relation effect.

Reference books point to difficulties in proper identification of significant influence (Hussey, Bishop, 1993). Although basic premises may suggest a significant influence, a detailed analysis reveals the existence of control.

#### *2.5 Legal forms of affiliated units according to the Accounting Act*

It has to be emphasised that Polish law defines a permitted legal form for every capital relation, which constitutes a significant difference in relation to solutions contained in IAS/IFRS.

IAS/IFRS do not specify permitted legal forms of a parent unit and a subsidiary unit as well as other units in a capital relation.

Therefore, a situation when there are grounds for a particular capital relation, but the legal form of a unit participating in this relation makes it impossible to properly classify it may raise doubts.

Table 1 presents permitted legal forms.

Table 1. Legal forms of affiliated units according to the Accounting Act

<b>Capital relation participant</b>	<b>Statutory definitions specifying a permitted legal form</b>
Parent unit	<p>Is a commercial company or a state-owned enterprise exercising control over another unit, which in particular:</p> <p>a) has the majority of the total number of votes in the decision-making body of another unit (subsidiary), either directly or indirectly through shares, also on the basis of agreements with other persons having votes who exercise their right to vote in accordance with the will of a parent unit, or</p> <p>b) has a right to manage the financial and operational policy of another (subsidiary) unit in an independent way or through authorised persons or units on the basis of an agreement concluded with other eligible voters who by virtue of the company's statutes or articles of association, jointly with the parent unit have the majority of the total number of votes in the decision-making body, or</p> <p>c) being a shareholder, has a right to appoint or dismiss the majority of members of the managing or supervisory bodies of another (subsidiary) unit, or</p>



	d) being a shareholder of a unit whose managing body members in the previous financial year, during the current financial year and until the time a financial statement for the current financial year is drawn up, at the same time accounts for more than half of the composition of the managing board of this unit (subsidiary), or persons who have been appointed to fulfil these functions as a result of exercising the right to vote by the parent unit in the bodies of this unit (subsidiary), or
Subsidiary unit	is a commercial company or an entity established and acting in accordance with the regulations of a foreign commercial law which is controlled by a parent unit.
Joint subsidiary	is a unit co-controlled by partners on the basis of an agreement concluded between them, the company's statutes or articles of association.
Joint subsidiary partner	is a commercial company or a state-owned enterprise which jointly with other shareholders exercises control over a subsidiary unit.
Significant investor	is a commercial company or a state-owned enterprise having no less than 20% of votes in the decision-making body of another unit – which is not a subsidiary or a joint subsidiary unit – and exerting a significant influence on this unit. The participation in the total number of votes may be lower than 20% if other circumstances point to the exertion of significant influence.
Affiliated unit	is a commercial company or an entity established and acting in accordance with the regulations of a foreign commercial law which is significantly influenced by an investor.

Source: own study on the basis of the Accounting Act

### 2.6. Scope of affiliated units

Subsidiary, joint subsidiary and affiliated units are commonly referred to as subordinate units. Table 2 presents parties to capital relations according to the Accounting Act and IFRS/IAS.

Table 2. Types of relations between units

Types of capital relation	AFFILIATED UNITS	
	Superordinate unit	Subordinate units
Exertion of control	Parent unit	Subsidiary units
Exertion of co-control	Joint subsidiary unit partner	Joint subsidiary units
Significant influence	Significant investor	Affiliated units

Source: own study based on the Accounting Act.

A dependence between affiliated units and subordinate units has been shown in the figure below.

Figure 3. Affiliated versus subordinate units

**Subsidiary unit, significant investor, partner**

+

**Subordinate units**

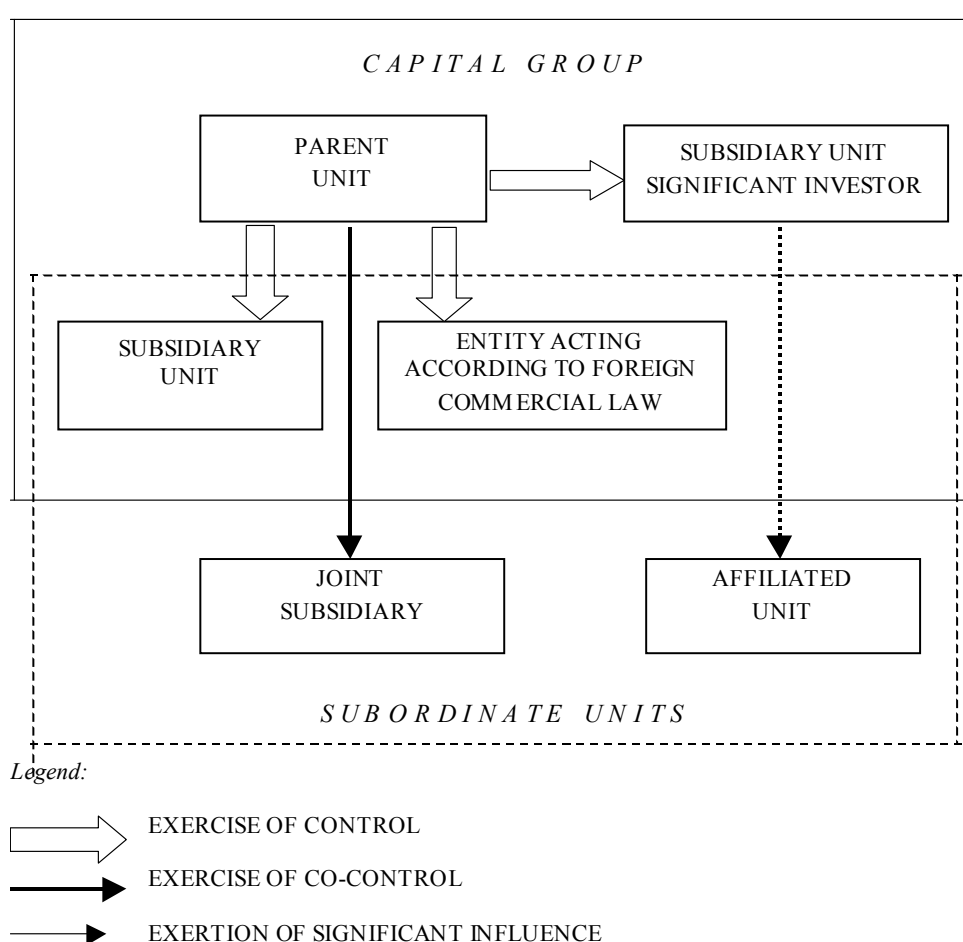
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**Affiliated units**

Source: own study based on the Accounting Act

A considerable difference between IAS regulations and the Accounting Act is observed in the specification of minority interests. According to IAS, all interests that do not belong directly or indirectly to a parent unit are non-controlling interests. According to the definition contained in the standard, a non-controlling interest is a subsidiary unit's equity which cannot be assigned, either directly or indirectly, to a parent unit.

Figure 4. An example of capital relation containing a capital group



Source: ed, Buk H., *Konsolidacja sprawozdań finansowych*, Wydawnictwo UE w Katowicach, Katowice 2010, pp.23.

### *2.7 Affiliated parties*

In the Accounting Act also a category of affiliated parties has been introduced. Polish solutions in this scope have taken into account the requirements of IAS 24, but in a much more general scope. The Accounting Act does not define affiliated parties, while the scope of a financial statement indicates that it is understood as:

- a person who is a member of the managing or supervising body
- a person who is a spouse, a cohabiting person or a relative up to the second degree of kinship
- a person affiliated due to care or custody to any person being a member of the managing or supervisory body,
- a controlled, co-controlled unit, which is directly or indirectly influenced by this person,
- a unit implementing an employee benefit scheme after a period of employment, geared towards employees of the affiliated unit.
- 

## **3. CAPITAL RELATION IN A FINANCIAL STATEMENT ACCORDING TO THE ACCOUNTING ACT**

### *3.1 Principles of presenting information*

The Accounting Act imposes on units the scope, the structure as well as the level of detail required from financial statement elements by providing statement templates, which are attachments to the act. The presentation of information according to the provided templates is aimed at ensuring their proper quality, in particular their comparability. Units preparing a financial statement according to the same template maintain the same form of presented data, which in view of a limited choice of assets and liabilities evaluation methods, facilitates a comparative analysis in relation to the data of other economic units. It also makes it easier to compare data of a particular economic unit versus time, that is, in relation to data for previous years. Such a solution also forces the managing boards of units to maintain an adequate level of significance of the presented information and to make it transparent. The structure of financial statements introduced in attachments to the Accounting Act makes it easier to identify certain relations and dependencies between detailed and synthetic values contained in financial statements. These principles also apply to the preparation of a consolidated financial statement.

The full scope of a financial statement includes its following elements:

- Balance Sheet,
- Profit and Loss account,
- Additional Information including an Introduction to Financial Statement as well as Additional Information and Explanations,
- Statement of Cash Flows,
- Statement of Changes in Equity.

In the basic obligatory scope for smaller units the last two of the above mentioned elements of a financial statement are not drawn up (art. 45 of the Accounting Act).

The capital relation criterion was introduced through an amendment to the Accounting Act in 2002 into four elements of a financial statement, taking into consideration the main reporting items which might be a potential effect of this relation. This criterion was not taken into account only in a statement of changes in equity.

### 3.2 Balance Sheet

In a balance sheet the capital relation has been introduced in the following items:

- Long-term receivables,
- Long-term investments,
- Short-term receivables,
- Short-term investments.

Table 3 contains fragments of a balance system presenting a capital relation

Table 3. Information on a capital relation in balance sheet assets according to the Accounting Act

.....
<b>III. Long-term receivables</b>
1. From affiliated units
2. From other units
<b>IV. Long-term investments</b>
.....
3. Long-term financial assets
a) in affiliated units:
- stocks or shares
- other securities
- granted loans
- other long-term financial assets
b) in other units:
.....
.....
<b>II. Short-term receivables</b>
1. Receivables from affiliated units
a) for deliveries and services, with the maturity date falling:
- up to 12 months
- over 12 months

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b) other
2. Receivables from other units
.....
<b>III. Short-term investments</b>
1. Short-term financial assets
a) in affiliated units
- stocks or shares
- other securities
- granted loans
- other short-term financial assets
b) in other units
- stocks or shares
- other securities
- granted loans
- other short-term financial assets
.....

Source: attachment 1 to the Accounting Act

The capital relation criterion in balance sheet equity and liabilities applies to long- and short-term liabilities presented in a system given in Table 4.

Table 4. Liabilities in balance sheet equity and liabilities according to attachment 1 to the Accounting Act.

.....
II. Long-term liabilities
1. Towards affiliated units
2. Towards other units
a) credits and loans
b) related to the emission of debt securities
c) other financial liabilities
d) other
III. Short-term liabilities
1. Towards affiliated units

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a) for deliveries and services, with the maturity date falling:
- up to 12 months
- over 12 months
b) other
2. Towards other units
a) credits and loans
b) related to the emission of debt securities
c) other financial liabilities
d) For deliveries and services, with the maturity data falling:
- up to 12 months
- over 12 months
e) received prepayments for deliveries
f) bill of exchange liabilities
g) for taxes, customs duties, insurance and other benefits
h) for remunerations
i) other
3. Special funds
.....

Source: attachment 1 of the Accounting Act

### 3.3 Profit and Loss Account

In a profit and loss account (in both a multi-step and comparative variant) this criterion has been taken into consideration in the following items:

- Net revenues from sales,
- Financial revenues,
- Financial costs.

A standard unfolding of the revenues and financial costs items has been presented in Table 5.

It has to be emphasised that in a profit and loss account the profit and loss on interests accounted for using the equity method are not shown separately. Using the equity method in a unit report of a parent unit does not entail separating its effects as separate reporting items.

### 3.4 Cash Flow Statement

In a cash flow statement the capital relation criterion has been taken into account in both methods (direct and indirect) in item B. *Cash flows from investing activities*.

Table 6 presents a system adopted for presented information

Table 5. A fragment of a profit and loss account in a comparative variant

.....
<b>G. FINANCIAL REVENUES</b>
I. Dividends and shares in profits, including:
- <i>from affiliated units</i>
II. Interests, including:
- <i>from affiliated units</i>
III. Profit on disposal of investments
IV. Revaluation of investments
V. Other
<b>H. FINANCIAL COSTS</b>
I. Interests, including:
- <i>from affiliated units</i>
II. Loss on disposal of investments
III. Revaluation of investments
IV. Other
.....

Source: attachment 1 to the Accounting Act

Table 6. A capital relation in cash flows from investing activities in a cash flow statement.

.....
I. Income
.....
3. from financial assets, including
a) in affiliated units
b) in other units
.....
II. Expenditures
.....
3. For financial assets, including
a) in affiliated units
b) in other units

Source: attachment 1 to the Accounting Act

The above presented reporting items of a balance sheet, a profit and loss account as well as a cash flow statement indicate that the user of these statements is informed of values which are an effect of the capital relation, but is not able to specify the type of this relation. Also, he/she is not able to evaluate the scale of the influence exerted by one entity on the other one within the framework of transactions effected between them as well as final effects of the capital relation. Reference books quote among others its negative effects. For instance parent unit A having a controlling interest in unit B is at the same time the main recipient of products manufactured by unit B. Unit A is going to sell the shares to unit B at a maximum profit. To this end, it creates a good financial report of unit B, accepting a high margin on these transactions. After the sale of shares it radically changes the purchase conditions in unit B, thus deteriorating the financial situation of this unit (Buk, 2011). Such situations are not identified on the basis of the above mentioned statements analysis. This problem is frequently related to a broadly understood balance policy in the shaping of total profits by a parent unit. By changing the structure of capital relations one can get rid of unwanted shares on favourable terms. In reference books this is referred to as “throw out a problem child” (Mekce T., 2005).

### *3.5. Additional Information*

Information on transactions effected between affiliated units is included in additional information – in additional information and explanations. It must be emphasized that this statement is obligatory for all units subject to the Accounting Act. In this part of report a statement of significant transactions has to be shown, including the sums which result from them, effected in a given financial year between affiliated units on other than market terms.

Also the nature of these transactions has to be specified. Information on transactions can be grouped according to the kind unless its separation is necessary for proper understanding and evaluation of the financial standing as well as the financial result of this unit. Therefore, in the above quoted case, transactions carried out between units A and B before the sale of shares by unit B to unit A should be reported, including the sums, in additional information of both units.

The relation in this case also takes into account the so-called affiliation of parties, that is, not a capital relation (a spouse or an actually cohabiting person, a relative up to the second degree of kinship etc. as well as a person who is a member of the managing, supervisory body of the unit or the affiliated unit, a unit implementing an employee benefit scheme).

This report should also include a list of companies (name, seat) in which the unit has minimum 20% interest in equity or in the total number of votes in the managing body. Another important requirement is to report the net profit or loss of these companies for the last financial year.

Additional information and explanations should also contain data on joint ventures which are not subject to financial statements consolidation.

An analysis of data contained in this statement for subsequent financial years may give the user a basic picture of the effects of the capital relation and other forms of relations. However, this part of a financial statement, containing most information on the relation, the nature of this relation and the effects in a form of effected transactions is not subject to publication. Therefore, apart from the shareholders, other users do not have access to this information.

### *3.5 Relation in a financial statement drawn up on the basis of IAS/IFRS*

According to IAS 1, a fair presentation of financial statements requires:

- selecting a particular accounting policy by the unit management,



- presenting information in financial statements about adequate quality which is ensured by maintaining the features of a financial statement
- providing additional disclosures required in particular IAS

IAS 1 does not contain a template of financial statements; it merely requires the disclosure of certain items in particular financial statements or in notes for these statements. Most information on the relation is presented in notes for financial statement items.

It has to be emphasised that the relation criterion does not directly apply to a unit financial statement. The majority of requirements specified in great detail in IAS 24 apply to a consolidated financial statement, within the framework of which all information concerning the relation within a capital group as well as units affiliated with the capital group units should be disclosed. Also in this case, relations other than capital ones should be taken into account.

Other requirements to be met by a unit financial statement refer chiefly to notes for particular financial statement items.

A report on the financial condition should among others contain:

- investments accounted for by the equity method,
- non-controlling interest in equity,
- issued basic capital attributable to shareholders of the parent unit,
- other capitals attributable to the parent unit.

In a total income statement it is necessary to report among others the following:

#### **Profit on shares accounted for by the equity method**

##### **Total profit for a year**

Net profit attributable to:

- parent company's owners,
- minority shareholders.

Total profit attributable to:

- parent company's owners,
- minority shareholders.

The above information clearly refers to the control relations, whereas the co-control relation and significant influence are passed over.

#### **4. DISCUSSION**

An overriding principle of drawing up financial statements is the true and fair view principle. The obligation to present reliable data while maintaining the features of significance and comparability results from this rule.

In an analysis of the scope and manner of presenting the information on a relation in a unit financial statement drawn up in accordance with the Accounting Act, its character should be highlighted. To a

large extent it should be treated like a “signal warning” the user of the relation effects which have not been shown or of the necessity to analyse the consolidated financial statement, if the relation exists in units belonging to a capital group. Such an analysis might be necessary for the shareholders of these units or potential investors, who may have an impression of “blocking” the information on the profitability of financial investments in a unit financial statement (Ignatowski, 2003).

Solutions regarding the presentation of information on affiliated units in a unit financial statement drawn up according to the Accounting Act are formalized. A financial statement arrangement provides for separate items in which the relation effects are shown. So presented information is easy to read for a user, adds transparency to sets of this information and facilitates comparison with other units' statements drawn up on the basis of the same act. It should be emphasized that the concentration of data on the relation and transactions based on this relation in additional information and explanations is favourable also for the user. It takes into account the majority of solutions accepted in this area in IAS/IFRS. From the point of view of interested parties other than investors, it seems to be a favourable and sufficient solution. For tax, insurance and credit institutions or for contractors, the introduction of capital (and other) relations into the whole statement as an additional criterion to group and present information undoubtedly facilitates the identification of holding structures and mutual dependencies between units. At the same time it does not provide a possibility to evaluate the scale of this dependence.

However, solutions adopted in the Accounting Act also have a number of drawbacks. The major ones include:

- no possibility to identify the type of relations,
- no possibility to evaluate the effectiveness of such investments,
- no separation of profit and loss on shares accounted for using the equity method in a unit profit and loss account.

The scope of information on the relation in the context of the whole financial statement is narrower and despite its transparency, it does not facilitate interpretation to an investor interested in the profitability of an investment.

An evident weakness of such solutions is also the lack of data comparability in relation to IAS/IFRS.

It should be emphasised that the lack of a formalised financial statement template in accordance with IRSS/IAS makes it difficult to compare the reporting data of various economic units. Taking into consideration the quality features of financial statements specified in IAS 1, including particularly emphasized comparability, such a solution is a considerable limitation. Another danger might be a different understanding of the level of significance in various member states of the European Union and other countries. This may result from previous practices, traditions, habits etc. prevailing in these countries. The lack of a binding template may invite excessive latitude for interpretation of the level of detail of information about a relation.

A drawback of IFRS/IAS solutions regarding the presentation of information about affiliated units is very high dissipation of this information in particular notes for financial statement items. This criterion does not apply to major items in unit financial statements. Highly dissipated detailed information on this subject in different notes undoubtedly makes it difficult for a user to properly read the contents. It lacks transparency and does not facilitate the drawing of conclusions on particular relations and dependencies. Only a very detailed analysis of data allows such conclusions to be reached. A more favourable solution might be to show general information on the relation in the main parts of a

statement and its detailed development in notes. In order to achieve such an effect, additional items concerning the relation effects would have to be included on the list of obligatory disclosures in unit reports.

#### 4. CONCLUSIONS

The scope of information disclosed in a unit financial statement drawn up in accordance with the Accounting Act is insufficient. It does not ensure proper evaluation of the investment's effectiveness for an investor. Neither does it provide a possibility to properly identify the type of capital relation and its effects, especially if different relations co-exist in a unit. However, the manner of presenting this data is logical, organized and transparent, which in turn facilitates its reading and interpretation. It is also a good preparation for reading a consolidated financial statement.

It is necessary to extend the scope of disclosed information on affiliated units while taking into consideration, though not copying the requirements of IFRS/IAS. Given the drawbacks of the solutions adopted in IAS/IFRS, it is worth modifying Polish standards regarding the presentation of information on affiliated units by trying to find different solutions in the future.

Summing up, there is a necessity to continue works in the future in a form of legislative and theoretical analyses of this problem in Polish accounting standards so as to develop more favourable solutions. This study is a contribution to such works.

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**THE EFFECT OF CAPITAL MARKET ON ECONOMIC GROWTH IN PALESTINE**

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**Abstract**

*This paper examines the correlation between capital market development and economic growth in Palestine using a linear regression model. The results show that the capital market development measured by market capitalization and trade value has a positive effect on economic growth measured by rate of growth of GDP. Three equations were estimated. The first linked the effect of market capitalization on economic growth rate, and the second measure the effect of trade value on growth rate. Both variables were found significant at the 5% level. The correlation was also fit in terms the correlation coefficient. Due to the existence of multi-collinearity between the independent variables the regression of the third equation resulted in only one variable found (market capitalization) has a significant effect while the other (trade volume) is not significant at the 5% level. But this does not reduce the significance of the findings, that capital market plays a positive and significant role in inducing economic growth.*

**Key words:** Capital Market, economic Growth, Market Capitalization, Trade Volume.

**1. INTRODUCTION**

Economic growth in a modern economy hinges on an efficient and effective financial sector that pools domestic savings and mobilizes capital for productive projects. Absence of effective capital market could leave most productive projects which carry development agenda unexploited. The money markets are critical to financial stability and development. Well-functioning money markets enable other financial institutions to cover their short-term liquidity needs. Capital market increases the proportion of long-term savings that is channeled to long-term investment. It fulfills the transfer function of current purchasing power, in monetary form, from surplus sectors to deficit sectors, in exchange for reimbursing a greater purchasing power in future. In this way, capital market enables corporations to raise capital funds to finance their investment in real assets. The implication will be an increase in productivity within the economy leading to more employment and income, Central bank of Lesotho (2009) .

Capital markets are vital in the contemporary economy; in order to achieve an efficient transfer of monetary resources from those who save money toward those who need capital and who succeed to use it efficiently .The capital market can significantly affect the quality and quantity of investment decisions. The gathering of temporary capitals that are available in the economy, and the reallocation of those into the needed sectors efficiently and even the favoring of some sectors, outline the capital market's place in the economy of many countries , Central bank of Lesotho (2009) .

On the other hand economic growth in a modern economy hinges on efficient financial sector that pool domestic saving and mobilizes foreign capital for productivity investment, absent of an effective set of

financial institutions, productive projects will remain unexploited, the effect will be cutting substantially the economic growth rate from what would have been possible given appropriate policies and market structures. Bekeart et.al (1995).

In addition to the above functions capital market plays a vital role in the economy which helps economic growth indirectly such as (Rose 2007):

1. encourage savings through providing financial instruments ,such as stocks ,bonds, savings deposits ,commercial papers....etc.
2. improve liquidity as it help investors to liquidate their investment ,when they need liquidity without loss.
3. decrease risk through diversification and through selling hedging instruments.
4. helps the government to implement its monetary policy .
5. decrease the outflows of local capital outside the country through providing investment opportunities to investors.

For capital market to be able to achieve the above functions with high degree of efficiency there has to be available a large base of organization, strict laws and regulations and high level of disclosure and transparency ,sound corporate governance ,brokerage firms, centre for deposit, transfer and cleaning as well as a high degree of organization and efficiency (Arjoon 2005).

McKinnon(1973) and Shaw(1973) were the pioneers who studied the relationship between financial markets and economic growth. They found a positive correlation between financial development and economic growth. There was a large debate about the causality. Does financial development leads to higher economic growth or, growth leads to more financial development, or both. Recent research has not resolve the issue but suggest that financial development is an important determinant of future economic growth.

The purpose of this research is to explore the link between financial markets and economic growth with a special emphasize on the Palestinian Securities Exchange (PSE ). The research comes at an opportune time after 15 years have passed on the establishment of the PSE, no previous study about this subject has been made on Palestine . So this is the first one to tackle this problem.

### *1.1 Economic development in Palestine*

Palestine experienced rapid economic growth between 1994 - 1999, with GDP growth rate averaging over 10% per year. While GDP growth sharply declined during the peak years of the 2nd Intifada, 2000-2002, by more than 13% per year during those difficult years, but it resumed growth in 2003 and by the end of 2005 regained its pre-2nd Intifada level. This suggests a real growth opportunity in Palestine during relatively normal economic conditions, in 2006 due to internal political problem, the economy declined by 5.3% before it started growing the year after, it continue its growth during the next 4 years at a rate averaged more than 7%. In 2010 and 2011, Palestine had a remarkable economic growth rates of 9.7 and 10.3 during the last two years respectively, accompanied by the large growth and improvement of the financial system (PMA 2010) .

Palestine Securities exchange was established in 1997 ,with only 18 firms were listed with total capital of \$81.6 mm, increased to 46 firms by the end of 2011 with total capital of more than \$ 2 bn. The trade value grew at an average annual rate of about (24.8% )as it increased from \$ 25.2 mm in 1998 to \$451.2 mm in 2011. The stock index ( Alquds) has increased to 285 by 2000 before started declining

during the next 3 year because of the Israeli invasion to most cities of the West Bank, and the destruction of the infrastructure of the economy. The index started recovery in 2004 reaching 277 but jumped by over 300% to above 1000 by 2005 due to economic stability and financial restructuring. The index declined in 2006 by more than 45% because of the internal problems and the decline in western financial support to the government after the election, but the index stabilized during the past four years at around 500. Market Capitalization has grown rapidly during the past 15 years due to both increase in number of listed companies and increase in the market value of shares companies. Market Value grow at an average annual rate of about (12.5% ) from \$600 mm in 1998 to \$2782mm 2011(PSE 2011) . The market used to work by instructions made by the market authorities but has been substituted by laws and regulations issued by the government, Capital Market Authority was established which overviews the trading and the financial market as well as the member firms.

The Palestine securities of exchange as we saw above has moved in the same direction as growth rates in both trade value and the size of the market, which suggest the existence of a positive relationship between the two variables. The Palestinian capital market is considered as a complementary to the banking system in saving the necessary funds for enterprises, too. This is more evident in the case of the big companies so that the prudential banking limitations – which bind the bank exposure to one debtor on its own capital – become an inconvenient. One must not forget that the capital market was created for this fundamental scope: to allow companies to raise money, by using the public savings. It is true that during the past years the Palestinian companies have begun to use the capital market for financing their activities, this fact being seen by the increase in market capitalization.

#### *1.2 Importance of study:*

The importance of the capital market in the economy is given by the significant role it plays in the firms' and state's financing, by the weight of the direct financing among the financing modalities. Beside the apparent important thing – the large transaction volume on the stock market – what it really matters is the place which is taken by the capital market in the development of the joint-stock companies Bekeart(1995).

This study is important because it investigate the effect of capital market on economic growth in Palestine and it's the first study on this subject .This study is important to investors , stock market officials and capital market authority, researchers and students of economics and finance .

#### *1.3 limitation of the study:*

In addition to the negative growth rates over the Intifada years Palestinian economy is very sensitive to external shocks, as GDP is being increasingly driven by government and private consumption from remittances and donor aid, while investment has fallen to exceedingly low levels, leaving little productive base for a self sustaining economy. The international monetary fund estimates that already-low private investment declined by over 15% between 2005 and 2006 due to internal problems after the election (IMF 2007).

Adding to the above, unpredictability of the border crossings and check points has prevented Palestinian businesses from importing inputs and exporting products in a timely and planned manner. In response, enterprises have closed and large amounts of financial and human capital have fled. The pace of capital flight has reached an all-time high in the last two years with almost no foreign direct investment and most local capital being kept abroad or invested in real estate or short term trading activities. These problems has caused some limitations of the research can be summarized as follows:

1. It does not cover the period before 1997 because there was no capital market.
2. There was political problem (Al\_Aqsaintifada2000) in which there was an Israeli occupation for some cities, destruction of factories, infrastructure and institutions that were resulted in negative economic growth during the period 2001-2004.
3. There are only 46 companies listed on the Palestine securities exchange and many companies are not listed. This makes the size of the financial market about half of what it should be.
4. no quarterly data about the growth rate of the economy during all the period under study which make the study depending on only annual data with small sample(14 years).

## 2. DATA AND SPECIFICATION OF THE MODEL

In this study, we will use the regression analysis using Ordinary Least Square method to estimate the relationship among economic growth, stock market development. We assume that a simple regression model can be estimated, using one dependent variable representing economic growth and two independent variables representing market development.

We will analyze the link between capital market and the economic growth in Palestine from 1997 to 2011, using annual data, meaning 14 observations. we will present the variables used to characterize the Palestine capital market and economic growth in the next section.

### 2.1 The variables of the Model:

#### (A) Capital market variables:

**We will use two variables representing financial market development;**

1- **size variables:** we will use market capitalization.

2- **volume variable:** we will use annual trading volume or trade value.

(B) **Economic growth variables:** the best variable representing economic growth is the real GDP growth rate.

We selected for our study the following indicators of capital market:

- (i) the real market capitalization, computed in order to eliminate the inflation effect;
- (ii) the real trade value, to eliminate the effect of inflation on trade value.
- (iii) the real GDP is used to eliminate the effect of inflation

In order to analyze the correlations between economic growth and capital market

development we used linear regression model. Using simple and multiple Ordinary Least Square method of estimation. Using the following equations which will be estimated:

$$\text{(EQ.1): } (RGDP) = a + b \cdot (MC) + \epsilon t$$

$$\text{(EQ.2) : } (RGDP) = a + b \cdot (TV) + \epsilon t$$

$$(EQ.3) : (RGDP) = a + b \cdot (MC) + c \cdot (TV) + \epsilon t$$

Where:

RGDP is the real GDP growth rate.

MC is real market capitalization growth rate

TV is real trade value growth rate.

## 2.2 Hypothesis

The economic growth is a complex process that is influenced by more factors, other than the capital market development. Moreover, capital market development is the results of many influence factors. There are several interdependencies between these factors, which makes it difficult to establish and isolate the causal relation between the economic growth and the capital market development.

The research will test the following hypothesis

1. H0 there is no relationship between market capitalization and economic growth

H1 there is a relationship between capitalization and economic growth.

2. H0 there is no relationship between trading value and economic growth

H1 there is a relationship between trading volume and economic growth

We will reject the null hypothesis if estimated ( T ) statistics is higher than 1.96, and thus accept H1. Which means that financial markets have a significant relationship with economic development.

## 3. LITERATURE REVIEW

Researchers in economics and finance started paying attention to the relationship between financial and economic development in early 1970's started by Mackinnon and Shaw in (Mckinon1973) and (Shaw 1973). They found that all financial indicators they used ( 6 indicators) has significant correlation with economic growth. They also found that countries with higher financial development had better opportunity for real economic growth. After that several studies about the relationship between the developments of the financial system and the economic growth has been published. The literature focuses on the financial System's components, the banking sector and the capital market, that has an influence on economic growth.

King and Levine(1993) studied the capital markets development and economic growth, they stated that the level of financial intermediation is a good predictor for economic growth rate, capital accumulation and productivity. In the same context, Carlin and Mayer( 2003) concluded that there is a strong relationship between the structure of countries' financial system and economic growth.

Bekeart et.al (1995) argued that integration in world capital markets will accelerate growth process through decreasing the cost of funds and increase foreign direct investment. They found that Brazil cost of equity capital could be lowered if an aggressive program is undertaken to increase the degree of integration in world capital markets.



Demiurgic-kunt (1996) used data from 44 countries for period of 1986 to 1993 found the different measures of stock exchange size are strongly correlated with other indicators of activity levels of financial ,banking, non-banking institutions as well as to insurance companies and pension funds. He concluded that countries with well-developed stock markets tend to also have well-developed financial intermediaries.

Nyong (1997) developed an aggregate index of capital market development and used it to determine its relationship with long-run economic growth in Nigeria. The study employed a time series data from 1970 to 1994. Four measures of capital market development-ratio were used: market capitalization to GDP (in %), ratio of total value of transactions on the main stock exchange to GDP (in %), the value of equities transactions relative to GDP and listing were used. The four measures were combined into one overall composite index of capital market development using principal component analysis. The financial market depth was included as control. It was found that the capital market development is negatively and significantly correlated with the long-run growth in Nigeria

Brasoveanuet (2006) analyzed the dependence between economic growth and capital market development for Romanian. found that there is a feed-back effect between capital market trade volume and economic growth; these results are similar to the findings of Hondroyiannis (2005) for Greece. The regressions and vector autoregressive suggest that the capital market development is positively correlated with economic growth, with feed-back effect, but the strongest link is from economic growth to capital market, suggesting that financial development follows economic growth, economic growth determining financial institutions to change and develop. This result is consistent with the second possibility of a causal relationship between financial development and economic growth stated by Graff( 1999).

Liu and Hsu( 2006) studied the effect of different components of financial systems on economic growth in Taiwan, Korea and Japan , they emphasized the positive effect of stock market development (measured by market capitalization as percentage of GDP, turnover as percentage in GDP and stock return on economic growth.

Central Bank of Lesotho( 2009) showed that development of capital market in Lesotho will play a significant role in promoting growth and development within the country. It will increase the level of financial intermediation, leading to increased volume and quality of investments, and therefore economic growth. Effective bond market will free up capital for investment in private sector; allow the Government access to finance and therefore pursue development objectives and fuel economic growth. It will also increase investments and flow of money within the country; and support the development of other financial markets like stock exchange. In short, it will increase sources of investment funds for the domestic economy.

Antonios a. (2010 ) studied the effect of stock market on economic development of Germany he used Granger causality tests and found that there is a unidirectional causality between stock market development and economic growth with direction from stock market development to economic growth.

Another study on Nigeria by Donwa and Odia(2010) The objective of this study was to empirically analyze the impact of the Nigerian capital market on Nigerian socio-economic development from 1981 to 2008. The socio-economic development was proxy by the gross domestic product (GDP) while the capital market variables considered included market capitalization, total new issues, volume of transaction and total listed equities and Government stock. Using the ordinary least square it was found that the capital market indices does not have significant impact on the GDP.

#### 4. EMPIRICAL RESULTS:

We used the ordinary least square method to estimate the parameters of the model as explained in section (2). The results of regression are shown in the appendix in detail. They can be summarized as following:

- 1) The effect of trade value on economic growth is shown in the table below:

**Coefficients<sup>a</sup>**

Sig.	t	Standardized Coefficients	Unstandardized Coefficients		Model
		Beta	Std. Error	B	
.726	.359		2.666	.956	(Constant) 1
.068	2.001	.500	.032	.063	TV

a. Dependent Variable :RGDP

$$RGDP = 0.956 + 0.063TV$$

(.359)      (2.001)

The values in parenthesis are the T statistics.

The results shows that the rate of growth of the trade value has a positive effect on the rate of economic growth . each 1% increase in trade value causes 0.06% increases in growth rate .The T statistics is about 2 which means that the variables is significant at 5% level.

So we reject the null-hypothesis H0 and accept H1

**Model Summary**

Std. Error of the Estimate	Adjusted R Square	R Square	R	Model
9.44499	.188	.250	.500 <sup>a</sup>	1

a. Predictors: (Constant), TV

The correlation between the two variables is 0.5 which means there is a correlation but not very strong. This is due to the effect of the changes in stock prices on the trade value and the external effect on the trade value.

2. the effect of market capitalization on economic growth is shown in the table below:

**Coefficients<sup>a</sup>**

Sig.	t	Standardized Coefficients	Unstandardized Coefficients		Model
		Beta	Std. Error	B	
.934	.084		2.174	.183	(Constant) 1
.004	3.490	.710	.089	.311	MC

a. Dependent Variable: RGDP

So the equation will be:

$$RGDP = 0.183 + 0.311MC$$

(0.084) (3.49)

The effect of market capitalization is significant at the 5% level as the T value is 3.5. the results show that there is positive effect on the rate of economic growth. Each 1% increase in market capitalization causes a rise in the rate of growth of GDP by 0.3%. since the T estimate value of 3.5 is more than 1.96 (T from the table) , so we reject the null –hypothesis H0 and accept H1.

**Model Summary**

Std. Error of the Estimate	Adjusted R Square	R Square	R	Model
7.68444	.462	.504	.710 <sup>a</sup>	1

a. Predictors: (Constant), MC

The correlation between the two variables is very good equal to 0.71 which means a good relationship between the two variables.

3. The table below shows the results of the regression of the two variables together on the rate of growth

**Coefficients<sup>a</sup>**

Sig.	t	Standardized Coefficients	Unstandardized Coefficients		Model
		Beta	Std. Error	B	

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.821	-.231		2.134	-.494	(Constant)	1
.176	1.446	.298	.026	.038	TV	
.013	2.962	.611	.091	.268	MC	

a. Dependent Variable: RGDP

When the two variables are put together to see their total effect on the economic rate of growth, we found that:

$$\text{RGDP} = -0.494 + 0.038\text{TV} + 0.268\text{MC}$$

(-0.231) (1.45) (2.96)

The correlations between the variables are estimated in the table below:

**Model Summary**

Std. Error of the Estimate	Adjusted R Square	R Square	R	Model
7.35770	.507	.583	.764 <sup>a</sup>	1

a. Predictors: (Constant), MC, TV

The correlation between the independent variables (TV and MC) and the dependent variables RGDP is very good estimate at 0.764 which is very good. But the t test shows that one of the variables (TV) is not significant at the 5% level while the other one (MC) is still significant. So we accept the null-hypothesis H0 for TV and reject it for MC. in other words, when the two variables put together, TV has no effect on rate of economic growth of GDP and market capitalization has a positive effect.

This result is due to the presence of Multicollinearity between the two independent variables which can be solved only by increasing the size of the sample. But since we cannot increase the size of our sample because the Palestine stock exchange is recently established (1997) and we have no data before that date. In addition we cannot convert into a quarterly data because GDP date is not available on a quarterly basis during the whole period.

The table below estimates the correlation between the independent variables .

**Correlations**

TV	MC		
.631*	1	Pearson Correlation	MC
.016		Sig. (2-tailed)	
14	14	N	
1	.631*	Pearson Correlation	TV
	.016	Sig. (2-tailed)	
14	14	N	

\*. Correlation is significant at the 0.05 level (2-tailed).

As the table shows there is a significant correlation between market capitalization and trade value. This indicates the existence of Multicollinearity between the independent variables

## 5. CONCLUSION AND RECOMMENDATIONS:

The research used the linear regression model to measure the correlations between the rate of growth of the economy measured by the growth rate of GDP and financial markets development measured by market capitalization and trade value measured in real term. We used the data published by the Palestine department of Statistics and the Palestine Securities Exchange during the period 1997-2011 on annual bases. The results of the regression showed a significant effect at the 5% level of both independent variables on the economic growth, when regressed separately. But when both variables used together one of them (trade value) become not significant at the 5% level while the other (market capitalization) becomes more significant. It took part of the other variable due to multicollinearity between the two variables. As it was shown from the correlation test between market capitalization and market value.

These results support the important role played by capital market in economic growth and development. Capital market enhances efficient financial intermediation. It increases mobilization of savings and therefore improves efficiency and volume of investments, economic growth and development.

These findings are consistent with several studies on the subject specially the study of Nyong(1997) on Nigeria, Lui and Hsu (2006) on Korea, Japan and Taiwan and Antonios a. (2010 ) who studied the effect of stock market on economic development of Germany .

Based on these findings we recommend the following to enhance the role the Palestine securities exchange plays in the economy:

1. issuing formal laws to oblige non listed firms to be listed on the PSE.
2. Encourage government and firms to issue bonds to be traded on PSE.

3. Encourage some investors and may be some of the listed companies such as Padico to be a market maker. To increase the market liquidity.
4. Spreading the financial and investment culture and knowledge among young investors and the public.
5. Though the laws and regulations allow trading financial derivatives, we recommend activating the use and trade of these instruments.
6. Encourage foreign investors and investment funds to invest in PSE.

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## ROLE AND PLACE OF CONTINUOUS TRAINING IN CONTEMPORARY EDUCATION

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### Abstract

*The trends in today's economy in recent years show that the information and knowledge became a key factor. As a result, immaterial resources ahead of importance material. Nowadays a transition from an economy of natural resources to an economy of knowledge is seen. Knowledge economy plays an important role in the development of systems for continuous education, of the fact that creation and dissemination of new knowledge is the basis for the formation of economic values. The relatively short life cycle of new knowledge forces a lot organizations to develop knowledge, based on continuous training with the introduction of systems for continuous education to improve individual skills and abilities of staff.*

**Key words:** *knowledge economy, continuous education, distance learning*

### 1. KNOWLEDGE ECONOMY

The changes in the world economy confirmed the impact and significance of the information as a major factor for development. There is a transition and orientation of the business towards the knowledge economy. This necessitates the need for development of training systems to ensure conditions for production and dissemination of new knowledge to improve the individual skills and abilities of staff.

The great importance of the knowledge economy is defined by the fact that:

- determine the type of economy in which knowledge play an important role in ensuring continuous development and competitiveness of organizations;
- a real conditions for establishing sustainable knowledge which are the basis of economic growth.

Thus the Knowledge Economy (KE) ensures conditions for the continuous creation of new knowledge self training and development of organization to realize sustained economic growth.

As a fundamental difference between knowledge economy and material economy can indicate that:

- In the material economy there is a difference between the consumer's and the producer's actions. Also there is a intermediate between them. In the new knowledge-based economy the costumers actively participates in creation of the knowledge.

You can point to five distinctive features

- Productivity is directly dependent on the achievements of science and technology;



- In developed economies there is a transition and focus from material production to information services;
- Organizational changes in production processes / development of horizontal network relationships /;
- Global perspective of Economy;
- Technological and informative explosion

#### *1.1 Four Pillars of Knowledge Economy*

The following pillars are four critical requisites for a country to be able to fully participate in the knowledge economy and create new knowledge:[5]

- Education & Training - An educated and skilled population is needed to create, share and use knowledge.\
- Information Infrastructure - A dynamic information infrastructure-ranging from radio to the internet-is required to facilitate the effective communication, dissemination and processing of information.
- Economic Incentive & Institutional Regime - A regulatory and economic environment that enables the free flow of knowledge, supports investment in Information and Communications Technology (ICT), and encourages entrepreneurship is central to the knowledge economy.
- Innovation Systems - A network of research centers, universities, think tanks, private enterprises and community groups is necessary to tap into the growing stock of global knowledge, assimilate and adapt it to local needs,

The main element is the production, distribution and exploitation of knowledge. The development of the new economy determines an objective necessity of the development of a new scientific direction - management of knowledge.

This direction is based on:

- Management approaches, methods and techniques for creating new knowledge, with the creation of new knowledge are committed scientists and specialists, and with management - managers;
- Providing an opportunity for organizations to maximize the value of knowledge;
- Increasing the capacity of the organization to training and staff development to adapt to changes in market conditions.

According to experts, the main problem and limitation is the lack of training time and adapt to changes in environment.

The factor for success for the economy appears to be the continuity of the knowledge, i.e. concept of the continuous growth of the new knowledge. It should be noted that the relatively short "life cycle" of the knowledge forces companies to use the continuing education as a form of accumulation new knowledge, to use systems and forms for continuing education to improve the staff qualifications.

In practice, this rate of development of science and technology, the graduates periodically return to the education system to update their knowledge and skills needed in professional activities. Continuing

education implies the increasing of education and renewal of knowledge necessary for further training of staff so as to keep up with the implementation of new technologies, products and services.

Continuous training ensures the principle of continuity and consistency in learning. In this context, discovery, transformation and transmission of knowledge can be considered as a process of continuous or lifelong learning [4]. Thus all knowledge appears:

- a logical sequence of previous knowledge and skills;
- necessary and sufficient condition for generating the intellect of the organization

## 2. CONTINUING AND DISTANCE EDUCATION IN BUSINESS DEVELOPMENT

The idea of continuous learning becomes increasingly important. Using forms of continuous training is determined by the following assumptions:

Need to address issues not included in the learning process;

Anticipating pace in the scientific and technical developments introduced in companies compared to the rate of renewal of educational content in the education system;

Development of continuing education not only as a form of staff development, but also as a form of development of the organization.

Main directions in the development of the idea of continuing education appear:

- Staff training throughout professional activity;
- Creating a flexible and open system of education;
- A vertical organization - the continuity between various stages of staff training
- Using of information technologies and resources in training;
- Developing of a complex of ideas, suggesting a link between management, personal developing and goals, to ensure individual and organizational development;
- Permanent self perfection and alteration of the environment.
- Training organization in which we have not only staff training but also a dynamic and continuous transformation of the organization.

### 2.1 Distance learning

Distance learning is a complex of educational services provided to the majority of the population with special educational information environment based on exchange of information from a distance.

Upgrading skills is a major problem in recent years caused by an increase of information and access to it. This requires a search and use of new alternative forms for training. As such, distance learning decides some actual problems of continuing education:

- Unlimited number of staff who have access to a service training;
- Fast and quality training of staff;
- In-service training of working environment and ability to use the new knowledge directly in

the activity;

- Implementation of the principle of individual approach and the principle of differentiation of training;
- Reduction of training costs.

Distance learning can not fully replace the traditional form of education because of lack of direct contact between teacher and student. It is especially suitable in cases where there is already accumulated knowledge and upgrade of personnel qualification is needed.

It should be noted that there are problems and difficulties for the implementation of distance learning in the system of qualification:

- Distance learning is characterized by the use of specific methods, techniques and forms of education. As a general may be stated information and communication technologies. Therefore basic requirement for implementation of distance learning is the ability to work with technical equipment and new technologies;
- Unlike traditional forms of training in distance form have additional preparation and attitude of the teacher and students. The former as well as others must develop habits to work in other environments / virtual / using new information technologies;
- Different form and different environment of training activity require careful preparation of the new learning content. Choice of technology and materials for training and measuring. Since the creation of remote training is complex and difficult process of interaction between teachers and program specialists, the clear and precise planning of the activities of each of the actors is needed;
- When organizing distance form for improving the qualifications of personnel is necessary to take into account the very specific subject area. Specifics of the subject area and learning objectives determine not only the content and structure, but the model of learning [1];

## *2.2 Advantages and disadvantages of distance learning*

Distance learning is convenient because it allows:

- Training take place at your own pace, determined by personal characteristics and educational needs;
- There is not limited selection of educational institution and educational. At this stage the opening of a specialty and the teaching of certain subjects and obtaining the relevant degree is related to the accreditation of the university This accreditation is associated with a number of requirements, the impact of which can be reduced with the introduction of distance learning;
- Use of new equipment in training, which can later be applied when working in the specialty;
- Self-planning time for classes and organizing curricula. This allows:
  - ability to control and management by the teacher for each individual learner;
  - implement asynchronous in the learning process;
- Ability to provide appropriate conditions for the realization of education for each student.

Disadvantages of distance learning:

- Limit the personal contact, as between teachers and students and between students to exchange experiences and information. Somewhat the impact of this deficiency reduced with the use of social networks;
- Need strong personal motivation for students, ability for individual work and self organization;
- In some cases it is impossible to put into practice the scientific knowledge and be discussed emerging issues with the teacher. When distance learning is used as a form of continuing training without leaving work, this flaw is not so strong manifestation.

Other forms to provide continuing education may include: internships, trips to training centers, courses organized in the company, courses organized outside the company's training centers. As it should be noted that the purpose of continuing education must not only generate new knowledge but also provide new contacts, new skills and approaches to work.

### *2.3 Self training organizations*

You can cite the following criteria to distinguish self-learning organizations from traditional [2]:

- Status of workers - in a learning organization is determined by the knowledge skills and attitudes of workers. In the traditional organization is determined by the position and authority which it has;
- Decisions taken in the organization - For the first type is determined by the management staff in the analysis of the situation or workers depending on their credentials. The second type of organization decisions based on rules and precedents, and unlike the previous type here the worker does not take decisions;
- Relations in the organization - the first type have no formal relations and allow comments and discussions, managers consider workers more like partners, there are given more attention to relationships within the group. On later type of relationships bear formal character, not allowed dissent, treated as a destructive process, managers treat workers as contractors, and not tolerate informal relationships between staff at different levels in the hierarchy;
- Aims and objectives - are discussed at all levels within the organization. The second type the tasks we drop from a higher level which not allows workers to form a general idea of the problem to be solved;
- Communication - The first type, different forms of information and the system is characterized by awareness at all levels. In the second part, we have different levels of information, some information remains hidden from staff.

### **3. CONTINUING EDUCATION IN A KNOWLEDGE ECONOMY**

The following conclusions regarding the deployment and use of the system of continuing education can be drawn:

- Increased awareness of society, access to information technologies and their rapid dissemination and accessibility;
- Increasing importance of multi-disciplinary approach to the training;

- Abandoning the traditional teaching of the rapid rate of development of science and technology;
- Short "life cycle" of knowledge which are obtained in the higher education system;

Therefore, introduction of forms of implementation of continuing education in a modern economy should ensure that:

- Correlation between level of education in society to the technological development;
- Creation of technologies and provide intellectual support for major management decisions;
- Development of new technologies and innovative provision of economic operators;
- Storage of information and intellectual base of society;
- Practical implementation of continuous training as a condition for realizing the concepts of lifelong education;
- Provide both basic and further education through the use of forms of continuing education.

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**SYNERGIES BETWEEN THE CAPACITY FOR INNOVATION AND THE EFFICIENCY  
OF ACTIVITIES CARRIED OUT BY AN ORGANIZATION**

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**Abstract**

*The Article considers the concept of an organization's capacity for innovation from the perspective of different aspects of the synergies between this capacity and technology, resources, intellectual assets; as well as the possibility to assess this capacity for evaluating the efficiency of the organization's activities and its use of reserves as points of growth. Consideration is also given to approaches and existing guidelines developed to assess an organization's capacity, as well as to criteria used to define and to assess a company's capacity for innovation.*

**Key words:** *innovations, capacity for innovation, efficiency of the innovation activities, point of growth, criteria of efficiency of the innovation activities.*

**1. INTRODUCTION**

One of the competitive advantages that an organization may have is a certain stepping stone - capacity, i.e. the point which enables growth, provided that there are certain parameters. Quite a big number of works is devoted especially to the assessment of an organization's capacity. At the same time economic literature is somewhat lopsided and authors consider, for example, only the fact of having a capacity for innovation and try to determine possible methods to assess such a capacity.

How can the concept of capacity be described? I believe, that capacity may be deemed to be certain stepping stones which an organization has and which, if necessary, may be developed, invested or may give points of growth. Thus we think that resource capacity, financial capacity, organizational capacity, technology capacity, intellectual capacity, capacity for innovation, and etc. should be distinguished.

**2. THE CONCEPT OF INNOVATIVE CAPACITY**

According to my opinion, the resource capacity should be deemed as an availability of certain resources that an organization has, for example, human or material resources which may be used for a break through. This type includes availability of staff reserve created by the organization.

The financial capacity can be well understood – that is availability of financial resources which allow investing in new areas of business and expanding an organization's activities, and etc.

The organizational capacity is first of all associated with the organizational structure, the specific nature of interaction between the organization's divisions and with the existence of subsidiaries and regional and dealer networks.

The technology capacity enables to have a competitive advantage in the area of production, to streamline its costs and to introduce new technologies of production.

The intellectual capacity includes available intangible assets of an organization, innovators acting as generators of ideas, schools of thought, and directions, as well as cooperation with scientific research institutes and agencies. [1]

The capacity for innovation is closely connected with the intellectual capacity and means a possibility of an organization to generate innovations, to introduce current developments in its practice and existing business processes. An organization has various capacities serving as “points of growth” which can be more or less expressed depending on the specific nature of this organization.

Current methods to assess capacity are quite detailed, but there are difficulties arising from a comprehensive assessment of an organization’s capacities and from an assessment of their contribution to the cost of business.

Some time before the concept of capacity for innovation was suggested by scientist Chris Freeman [2], who believed that innovation is a system of established activities carried out to develop, to master, to use in the industry and to exhaust the industrial/economic and social/organizational capacity that serves as a ground for developments.

Thus an organization’s capacity for innovation includes available (or expected) resources, provided that there is an innovation infrastructure. This allows achieving desired goals in implementing business processes and in ensuring new products and services, which will enable to assess the organization’s overall capacity that will include the assessment of the above said specific capacities. Therefore, the organization’s capacity gives competitive advantages which enable this organization to position itself as a successful, competitive company focused on the innovation-based development.

In the environment of tough competition and given the need to make big investments in maintaining the achieved results of activities, there are different instruments to be mentioned which enable organizations to move forward. First of all, the Kaizen concept should be mentioned together with the principles of the total quality management (therefore a certified system of the quality management is a significant competitive advantage). The concept of reengineering is also quite famous, and outsourcing and outstaffing may be highlighted. Of course, practice shows some mixture resulting from the specific nature of the activities carried out by an organization and its requirements. Nevertheless, it should be mentioned that critical goals of innovation in the area of services and intangible products are the following:

- Customer focus with the view of ensuring a corresponding quality of products (services) and business processes in general
- Highly effective use of such available resources as buildings, equipment, technical means, software, and etc.
- Use of a more advanced equipment and technologies of rendering services, manufacturing products and ensuring business processes
- Improvement of an organization’s basic business processes and enhancement of the management thereof
- Creation of conditions for making an organization’s basic business processes cost effective.

### 3. POSSIBILITY OF ASSESSING THE INNOVATIVE POTENTIAL

Assessing the capacity for innovation requires a detailed analysis or diagnostics of an organization's internal environment which consists of elements shaping its manufacturing and commercial system. Feasibility studies of research and development projects, pilot technological works and certain buildings, as well as of research-and-technology programs in general serve as an instrument of analysis and are considered to be a document, on the basis of which not only the reasonability of financing activities carried out by scientific or production teams in the area of manufacturing research-and-technology products is determined, but also direct activities undertaken in the area of innovation are assessed.

More than once current studies allow considering that understanding of the essence of innovation varies in the society. Thus the All-Russian Public Opinion Research Center [3] conducted an opinion poll around Russia to find out the public opinion concerning the essence of the concept "innovation". 1600 people in 153 residential areas in 46 regions, territories and republics of Russia were interviewed in the course of the survey that showed the following results (Table 1):

Table 1. Respondents' views concerning the essence of the concept "innovation"

Terms	Total number of respondents, %	Including those who have
		incomplete higher education (3 years at least) and higher education
Developments (abstract)	27	38
Introduction of modern technology	15	24
Use of the research and development advances (scientific and technological progress)	3	5
Investments (investment and attraction of funds)	1	3
Social changes (in the current order, changes in life)	1	1
Developments (specific)	1	1
Other	1	0
Difficult to answer	53	30

As the table shows, the most part of respondents – 53% and 30% - can not give an answer about the meaning of this term, and another quite significant part consider that this means developments and introduction of modern technologies, which is quite close to the interpretation of this definition. In spite of all difficulties arising from the assessment of expected results of the development and introduction of technical improvements, especially at early stages of the life cycle, there is a need for management decisions which would allow avoiding mistakes, when making a decision, and minimizing the difference between actual and expected results.



For these purposes, the scientific staff, industrial experts should have complete information and a methodological framework for scientific and economic reasoning of decisions taken in the area of innovation. Methodological Guidelines to Determine the Economic Efficiency of New Equipment, Inventions and Innovations, [4,5] formally adopted in 1977 which have a few provisions that are still relevant nowadays, also include such provisions, the implementation of which does not already meet the modern requirements of the economic management due to the changes which took place.

First of all this concerns the unreasonable use of the annual economic impact as incorporated in the main index. Profitability analysis covering the whole operation period of a research and development project is required as far as there are changes in key indexes not only at the time of mastering a product, but also at the time of its series manufacturing. In addition, the modern management of innovation activities at all levels requires a more differentiating approach to the calculation of prices at all stages of the life cycle of a product and to the risk assessment in determining the social and economic efficiency, as well as an appraisal of results of the state financial support and harmonization of the output information, and etc..

This methodology includes methodological and organizational recommendations related to determining the social and economic effectiveness of innovations being under development or being introduced; in addition, common requirements to a system of indexes and to the methods of determining thereof are outlined; guidance on determining a quality level, calculating competitive prices and taking into account risk and uncertainty is also presented. Methods to determine basic indexes are described in detail by the examples of calculations. The distinguishing characteristic of these provisions as compared to the formal methodological guidelines as of 1977 is that effects and expenses are estimated not for a year, but for a certain period of time. Its basic provisions correspond to the economic feasibility methods for decision making which are applied abroad, and can be used for feasibility studies of developments.

Thus, these approaches may be used as guidelines which allow further improvement of the process of determining an organization's capacity.

On the whole, this methodology is of interest because it establishes a universal system of indexes, methods and rules for making a decision on advisability of a development process and further introduction of its outputs. It is also correct for choosing the best one among all possible options to be included in state programs and in an assessment of expected and actual results of the project implementation; and for carrying out an expertise when making a decision on the state financial support of a project; as well as for developing a price policy with a view to the sales of products (works, services), generalizing results of scientific and technical advances at all management levels and appraising actual results of efforts applied by members engaged in the development and the implementation of projects.

This methodology may be also used at the stage of making a decision on commencement of work or state financial support. Then every project requires an analysis of internal target markets, an evaluation of opportunities for sales of outputs abroad, information on the time for new scientific and technical solutions to appear, cost and quality indexes related to similar products produced by main competitors.

Another aspect of applying this methodology is the so-called "equal impact" to be ensured, when evaluating the social and economic efficiency of a project, for the purpose of which the following parameters are evaluated: meeting social and environmental standards, taking into account all associated positive (and negative) quality, social, environmental and external economic conditions in related areas of production and exploitation; taking into account the disparities between expenses and

effects at different periods of time and therefore making them arise together at one time, measuring global and internal prices for materials and taking into account differences in the cost of labour, when evaluating foreign trade activities.

#### 4. THE USE OF MATHEMATICAL TOOLS FOR INDICATORS OF PROFITABILITY

Projects being under development may result in equal volumes of revenues, while their implementation may require different volumes of investment. Therefore a relative index of effectiveness (profitability) is calculated, which shows saving per one ruble of investment. The profitability index (PI) is calculated by the following formula [4,6]:

$$Ii = \frac{1}{\sum_{i=1}^t K_i} \sum_{i=1}^t (P_i - 3'_i) \frac{1}{(1+E)^{t-tp}}$$

where:

Ii – profitability index, effect per one unit of investment;

Pti – expected cash inflow for the i-step of calculation, RUR;

3ti – expenses arising from the implementation of a project, excluding one-time costs and capital investments for the 1<sup>st</sup> step of calculation, RUR;

ti and tp – sequential numbers of the 1<sup>st</sup> step of calculation and the accounting year correspondingly.

When  $PI > E$ , it means that the profitability (efficiency) of the project concerned exceeds the preselected amount, and this project is sustainable, when it exceeds 1.2. The profitability index, which is close to E, shows the project's low sustainability in the possible situation of changing profits and expenses, and thus manufacturing of such products is dubious. With the view of evaluating the sustainability level of a project, the internal rate of return (IRR) is calculated. It is such a discount rate which ensures that the expected cash outflows are equal to the expected cash inflows for each year of the accounting period. If  $IRR > E$  then the net present value will take place and thus the project concerned is effective; if  $IRR < E$ , then the project concerned is ineffective.

In case that the comparison of alternative projects carried with the use of NPV and IRR has opposite results, the project with a higher index of the net present value is preferred. The constant discount rate index is a subjective value and that's why, when analyzing and selecting projects, it is reasonable to define NPV, given a few discount rates. [4]

#### 5. THE POSSIBILITY OF USING TECHNIQUES

The given description of the specific features of the methodology should be followed by the notice that it is focused particularly on the assessment of an organization's activities reviewed from the perspective of state interests, social and economic factors to be taken into account, budgetary efficiency, and etc. Nevertheless, in the context of the competitive environment it can be used as a methodology to assess activities carried out by an organization.

Hence, certain provisions of this methodology may be used with the view of assessing effectiveness of projects being under development, products and services and evaluating the capacity of an organization. However, consideration should be given to the possibility to assess an organization's capacity for innovation with a view to its further use as a competitive advantage secured by this organization.

The economic practice shows a great number of different systems and criteria for the assessment of the capacity for innovation.

Let's study one of the methodologies which concerns the assessment of the capacity for innovation and which is based on the following four groups of criteria (parameters): research and technology, economic, environmental and social.

The research and technology impact of innovation means the development of different scientific, technical and technology areas (when developing tangible innovations). Scientific knowledge and the knowledge-based economy serve as a basis for innovation processes being run.

The economic impact of innovation is expressed in accelerated business processes, lower costs of manufacturing and service rendering. The big economic impact of innovation promotes further development of innovation activities and strengthens an organization's competitive positions in the market.

The environmental impact is defined by the possibility of no negative environmental impact caused by innovation in the course of production, exploitation and disposal.

The social impact of innovation means that innovation contributes to an increase in social welfare and in the wealth of disadvantaged social groups, as well as to the improvement of the quality of life and labour conditions. Development may significantly change the life environment and facilitate labour.

## **6. CRITERION METHODS OF EVALUATION OF INNOVATIVE CAPACITY**

There is quite a big demand for the methodology of assessment of an organization's capacity for innovation, which suggests specifying criteria in the following groups:

- aspects characterizing a factory (micro);
- aspects characterizing an industry (macro);
- aspects characterizing goods (services) (goods, services) ;
- aspects characterizing marketing (promotion);
- industrial aspects (technology);
- financial aspects(finance);
- social and economic aspects (social and economics);
- business (financial aspects) (business) ;
- risks (risk).

Each group consists of a few criteria which are calculated with weight coefficients taken into account.

Mention should be made of one more approach to the assessment of an organization's capacity for innovation which suggests the following:

- assessing controlling actions;
- assessing the external environment;
- maintaining a catalogue of test parameters characterizing external aspects (political, economic, social, technology);
- maintaining a catalogue of structural parameters characterizing the internal status of an organization;
- developing synergies between structural and test parameters of the system;
- monitoring test parameters and processing statistical data;
- assessing structural parameters;
- Making an integrated assessment of an organization's capacity.

Summary of the existing methods served as a basis in developing a methodology for assessment of the innovation capacity of an organization which produces an educational product in the service area basing on the criteria of the enterprise's capacity for innovation.

With a view to an assessment of the capacity for innovation of an organization rendering services, the following system of parameters divided into five groups can be used:

1. Parameters characterizing the internal resources of an organization:

- rate of upgrading the product line (services);
- system of promoting products (services);
- methods to stimulate sales
- rate of upgrading technologies of main business processes of an organization;
- level of organizational structure;
- characteristics of the use of labour resources;
- competence level of the management and staff members of an organization;
- market strategy of an organization;
- image of an organization;
- level of corporate culture;
- an organization's communication with clients;
- investment attractiveness;
- Financial and economic status of an organization.

2. Parameters characterizing the external environment:

- prospects of the customer market development;
- level of competition;
- assessment of the growth stability;
- trends of changes in the demand;

- expenses arising from the promotion of products (services) in the market.
3. Parameters characterizing the research and development capacity of an organization:
- staff members who have relevant skills and competences and a creative way of thinking;
  - staff reserve created by an organization;
  - a system of continuous upgrade of knowledge, development of staff members' skills and management of knowledge;
  - possibility to improve the main business processes;
  - use of new educational technologies and communication and information technologies;
  - applied methods of planning, account and management;
  - level of the improvement of the technology used to run main business processes and of the technical means.
4. Parameters characterizing products (services):
- performance and usability of products (services);
  - corresponding quality and unique offers;
  - price;
  - net cost of products (services);
  - cost-effectiveness of certain products (services, programs);
  - compliance with standards and regulations, licenses;
  - Additional quality assurance of products (services) provided, for example: the quality management system certificates, membership in industrial, national or international associations.
5. Parameters characterizing the effectiveness of innovation carried out by an organization:
- an increase in the number of users of a product (service) due to innovation (for example due to the use of information and communication technologies);
  - revenues resulting from the promotion of innovative products and services;
  - percentage of the gross revenue from innovative products and services in the total volume of the gross revenue gained for a certain period;
  - cost optimization of a product as a result of innovation;
  - revenue gained from the sales of products (services) due to innovation;
  - cost-effectiveness of products (services) ensured due to innovation;
  - payback period for capital investments in innovation.

Parameters of the first four groups are calculated basing on the expert analysis of an organization and using a five-grade scale for each parameter ranging from "poor" to "excellent" or from "very low" to "very high".

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- poor (very low condition) – 1 point;
- satisfactory (low condition) – 2 points;
- good (average condition) – 3 points
- very good (high level) – 4 points;
- Excellent (very high level) – 5 points.

As far as parameters influencing on the performance index are not equal in terms of their characteristics, their weight should be measured and it is also defined through an expert analysis. In order to ensure higher reliability of the information obtained a group of experts should consist of at least 7 people.

The weight of parameters [4] may be defined by the following formula:

$$v_i = \sum R_{ij} / \sum \sum R_{ij},$$

Where:

$V_i$  – weight coefficient of the  $i$  parameter;

$R_{ij}$  – mark (points) given to the  $i$  parameter by the  $j$  expert.

After having calculated the weight, generalized parameters of the capacity for innovation of a trade enterprise can be defined for each group.

The final stage is a calculation of parameters characterizing the effectiveness of innovations introduced in an organization:

1. Changes in the turnover of funds received as a result of innovation;
2. Gross revenue gained as a result of innovations;
3. Percentage of the gross revenue from innovation in the total volume of the gross revenue gained for a certain period;
4. Product cost optimization as a result of innovation;
5. Profit gained from sales due to innovation;
6. Cost-effectiveness of an organization's educational products which is ensured due to innovation;
7. Payback period for capital investments in innovation;
8. Creation of a repository base of intellectual resources of an organization;
9. Intangible assets which have an impact on the cost of an organization's business (good will, brand)

## 7. CONCLUSIONS

Hence, the Article has showed different aspects of the activities carried out by an organization producing a specialized educational product. It should be mentioned that innovation is a corporate goal, in spite that there may be individual businessmen, separate divisions specializing in research and development; on the whole, the status of innovation activities is maintained by all staff members. A successful innovation is usually associated with the involved horizontal style of management characterized by a constructive process of exchanging opinions.

The key conceptual idea is that introduction and application of innovations is impossible without a team (group) of people who have a mind-set of an innovator and have the following features:

- creativity – ability to see things in a different way, to doubt assumptions and to change traditional approaches to work;
- commitment to the corporate goal;
- commitment to the introduction of tools for the business process management;
- intellectual flexibility and a sense of humour;
- being independent when making a decision;
- Ability to reach a compromise in tough situations and ability to work in a team to reach a shared goal.

The experts of the University of Zagreb [7] believe that there are a few factors which make some groups more creative and more effective than others.

First, effective teams work in the environment of total freedom, being independent and authorized.

Second, the core essence of an effective team is a free flow of information. Members of a team enrich each other by exchanging their knowledge and promoting creativity.

Third, the efficiency of a group depends on synergism. Instead of wasting their energy on rivalry, doublespeak and nonproductive quarrels, members of one team are totally involved in tackling the challenge facing them.

Fourth, the end does not justify the means in good teams. Creative groups are distinguished by their moral principles and professionalism; their members equally appreciate a good work and applied methods of work.

Fifth, communication, decision making and conflict resolution are based on consensus. Consensus encourages open discussions, exchange of opinions and consideration of acceptable options.

And finally, members of good groups share everything: good and bad things, ups and downs, success and failure, fame and punishment. Such atmosphere helps to get rid of any fear to risk and to fail.

Another important conceptual remark is that introduction and application of innovations are impossible without synergies between all economic levers and incentives and without methods to use them and economic methods of management. Only in the case of synergism and organizational, resource and human efforts being concerted, there may be an effect characterizing an organization as innovation-based and able to take advantage of its capacity with a view to continuous development.

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**EXAMINING THE BANK FINANCING OF HUNGARIAN LOCAL-GOVERNMENTS  
DURING THE CRISIS**

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**Abstract**

*The financial crisis of 2008 had a significant impact on the bank relations of the local subsystems of the national budget. The international practice shows differences in the self-governments' access to financial sources provided by banks, their indebtedness. In the study I aim at presenting the international regulation of the bank funding of self-governments and the impact of the crisis on the bank financing of Hungarian self-governments.*

**Key words:** *financial crisis, local governments, loan, bond, bank financing*

**1. INTRODUCTION**

The subprime crisis in 2008 hit not only the sectors of national economy in Hungary, but the state budget and its municipality subsystem, too. Municipalities were considered reliable clients of credit institutions because – in addition to keeping the accounts – they have also had significant part in providing external sources for local governments. The problems of municipality system, however, came into the limelight before the crisis therefore they significantly affected the relations of local governments and credit banks. The objective of the study is to introduce the changes of lending practices of banks in regards to the crisis and the factors which have affected these practices. I have examined the long- and short-term debts of municipalities between 2008 and 2011, as well as the municipal bonds underwritten by credit institutions and evaluated the most important tendencies.

**2. OVERVIEW**

Table 1 intends to describe the municipalities in which countries should request permission for borrowing and what authorities should they report to. As it can be seen, there are significant differences concerning regulations in OECD countries. Borrowing should mostly be realized with central permission and regular reports, while in the regionalized countries the superior municipal level controls borrowing. It is interesting, that municipalities should report to the citizens about the loan accommodations only in Germany and Poland. In Hungary, the municipal borrowing was not bound to permission during the examined period, the regulations limited borrowing at 70% of the corrected own revenues. (Halmosi, 2007)(Dafflon, 2002)

The main reason for regulating the credit accommodation is primarily to prevent the excess local indebtedness. One of the examples is Italy, where the legal regulations enabled to use current credit as well as credit for investment purposes but later these regulations were tightened due to the considerable indebtedness of the sector. (Halmosi, 2007)

**Table 1:** Centralized regulation of local borrowing and direction of reporting

Source: Sutherland, 2005

Countries	Centralized regulation			Reporting Direction			
	Local governmental	Central	Other	Civilian	Local governmental	Central	Other
Canada		X				X	X
Czech Republic		X			X	X	
Denmark	X		X				X
France		X					
Germany	X			X			
Netherlands		X			X	X	
Portugal		X				X	
Spain		X				X	
Poland	X	X	X	X	X	X	X
Hungary (before 2012)							
Hungary Actual		X				X	
Norway		X				X	
Turkey		X			X	X	

The regulations can be:

- according to the aim of borrowing
- bankruptcy control
- limiting of borrowing
- linking borrowing to permission
- limitation according to solvency
- limitation according to borrower organizations.

The regulation practice according to the aim of borrowing is different in international terms, some countries put leasing arrangements into this category, too (e.g. United Kingdom). The international practice uniformly prohibits current credit or ties it to rigorous control. (Halmosi, 2007)

Another case of regulation, where the municipal bankruptcy is allowed (Hungary, Poland, Czech Republic and Estonia). This alternative can be found in the regulation of the newly integrated countries of the European Union. The municipal control of the Western European countries try to handle situations of bankruptcy with the help of stronger control. In case of permission procedures, the permit should be requested primarily from state finance or regional authorities (Spain, Poland, Austria, France and Germany). As regards regulations according to solvency, mostly the future financing ability is the basic condition, and whether excess taxes are levied in order to finance debts, in other words, how much the municipality counts on citizens. (Halmosi, 2007)

### 3. THE HUNGARIAN MUNICIPALITY SYSTEM

The legal basis of the Hungarian municipality system is guaranteed by the Constitution Law and the fundamental acts. The right of local governance is rendered to the settlements (villages, towns, district rank towns, county towns) and counties (regions). There were 3168 municipalities in Hungary until

2011, thus the number of citizens per one local government was above 3000. In the sense of the valid regulation, there is not any superior or subordinate relation between municipalities, but their competencies and tasks can be different. The public tasks will be financed with the help of project financing from 2013. The task-providing minimum level has not been determined before, the settlements and counties could undertake voluntary jobs in addition to their compulsory tasks. It will be changed considerably from 2013.

The income sources of municipalities: income from asset utilization, local taxes in case of which there is a regulatory framework, central taxes (personal income tax in the amount fixed in the act about state budget and the vehicle tax), state budget subsidies, received financial assets (from within and out of state budget) and loans.

**Table 2:** Income of a Hungarian local government system

Source: Kovács-Sipos, 2011

Examined years	1991		1999		2009	
Desingation of Incomes	Bn Huf	%	Bn Huf	%	Bn Huf	%
Own current income	61,16	15,90	614,36	36,80	1 058,06	33,90
including: local taxes	9,48	2,50	198,36	11,90	566,25	18,10
Income passed over	47,02	12,20	204,84	12,30	703,39	22,50
State budget subsidies	190,67	49,50	448,99	26,90	668,95	21,40
Financial assets received	71,02	18,50	273,27	16,40	418,23	13,40
GFS incomes	<b>384,96</b>	<b>100,00</b>	<b>1 669,62</b>	<b>100,00</b>	<b>3 125,44</b>	<b>100,00</b>
Loan and bond incomes	1,56	0,40	43,35	2,60	159,00	5,10
<b>Total revenues</b>	<b>386,52</b>	<b>100,40</b>	<b>1 712,97</b>	<b>102,60</b>	<b>3 284,45</b>	<b>105,10</b>

During the last 20 years of municipality system, we have witnessed considerable changes in the financing structure, as it is introduced with the data of Table 2, too. The greatest change was resulted by the growing share of own current income, including the local taxes – especially the increasing proportion of local business tax. In contrary to this, the reduction of state subsidies and contribution at sectoral level is obvious because it fell to less than half of its previous level. It can be concluded that the ratio of debt financing increased by 2009, primarily due to the income from bond issue and borrowing. In 2009, the sources from the European Union gave the fourth of the income in the group of assets received.

**Table 3:** Expenses of a Hungarian local government system

Source: Kovács-Sipos, 2011

Examined years	1991	1996	2001	2006	2009
GFS expenses, Bn HUF	315	913	1902	3210	3208
including:operational expenses, Bn HUF	252	713	1230	2274	2327
GFS expenses in GDP %	13,9	13,2	12,5	13,5	12,3
operational expenses in GDP %	11,1	10,3	9,3	9,6	8,9

By examining the structure of outgoings (Table 3), it can be stated that the expenditures in GFS system has been permanently increasing in the sector and the ratio of operational expenditures has had a decreasing tendency within the total outgoings. It is therefore obvious that the municipalities could spend more and more funds on capitalization purposes. Examining it in terms of GDP, however, we can see a decreasing tendency, with the exception of 2006, because it was election year and the growth was due to this. In total the municipalities could fulfill more and more expenditures within their operation, and the share of outgoings on investment was increasing, too.

Borrowing funds is an important source of income for the municipality sector. Municipalities can choose their own account managing bank, thus they can build close relations in the course of years because the local subsystem of Hungarian state budget is an important source of deposit collection for the bank sector, too.

It can be declared that the sector has become from its net savings position in 2006 to net debtor due to the considerable bond issues. Most of the bond issues concerned the town municipalities, as well as county towns and county municipalities in great numbers, too. (Gál, 2009). There are 300-400 local governments on the demand side, examining the supply side, it can be seen that six large banks owned 94% of the municipality market thus the heavy concentration is obvious on both the supply and demand sides.

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Figure 1 describes the revenues of municipalities from loans. These revenues of municipality sector from loans shows an increasing tendency in the examined time interval. During the examined period, the course of almost twenty years following the social transition in 1990, there was a cyclicity in the

credit revenues of municipalities which can be related to the four-year municipality election cycles (years 1994, 1998, 2002 and 2006 in the figure). The income from loan rose in the election years due primarily to the fact that the municipalities implement significant investments for which they had to ensure sources or own source in case of awarded projects. The figure of 2006 was extremely high, the highest municipality income from borrowing was in that year out of the examined nearly 20 years, while there was a decline regarding this income source in the last two examined years.

#### 4. RESULTS

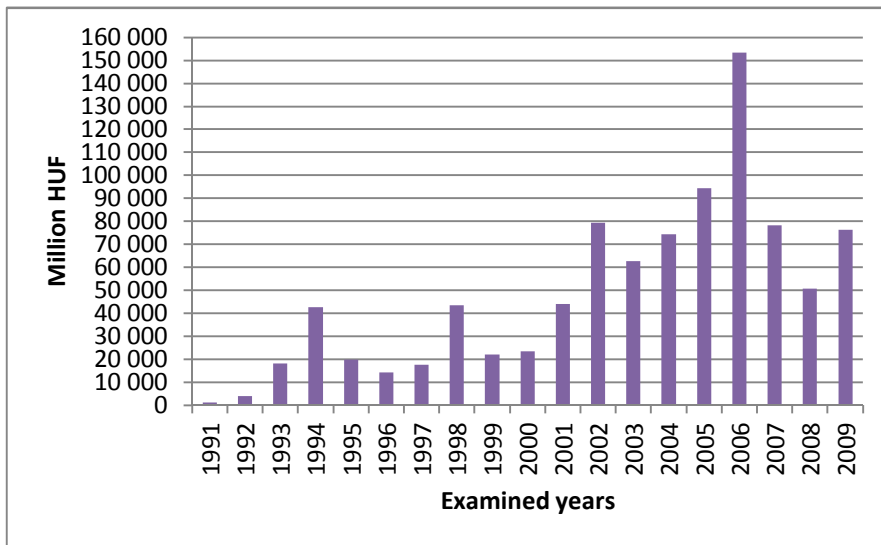


Figure 1: Loan revenues of municipality sector between 1991 and 2009.

Source: Ministry of Internal Affairs, 2011

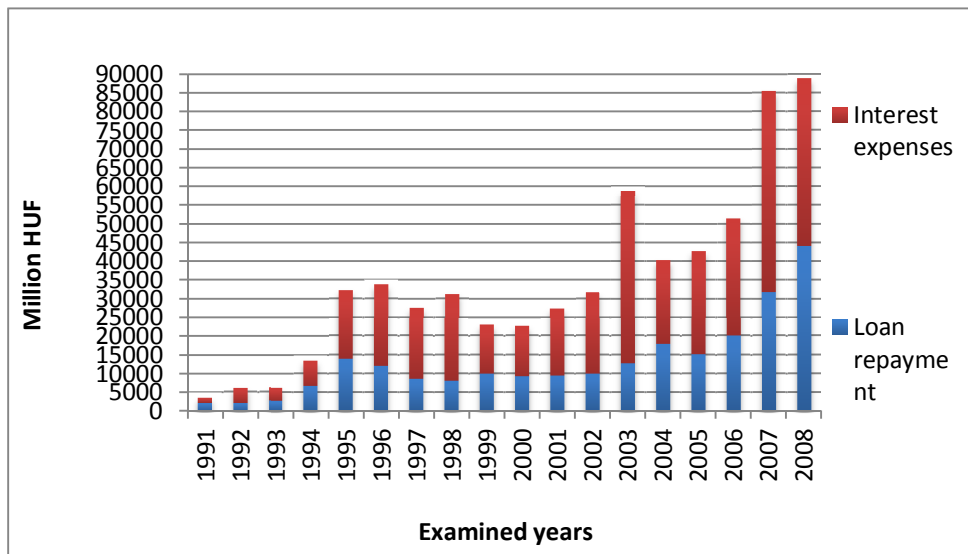


Figure 2: Loan and interest repayment of municipality sector between 1991 and 2008

Source: Ministry of Internal Affairs, 2011

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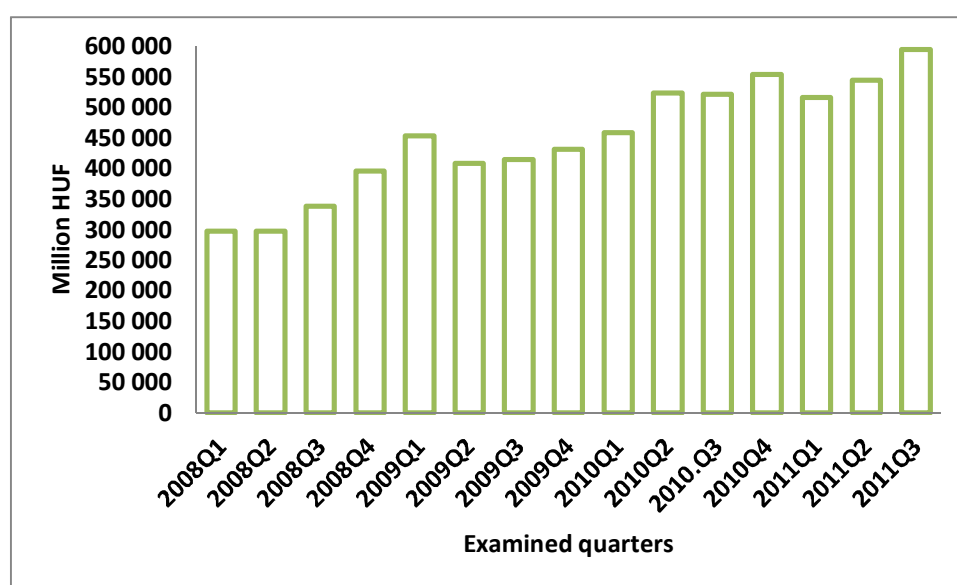


Figure 3: Municipal bond portfolio of banks.

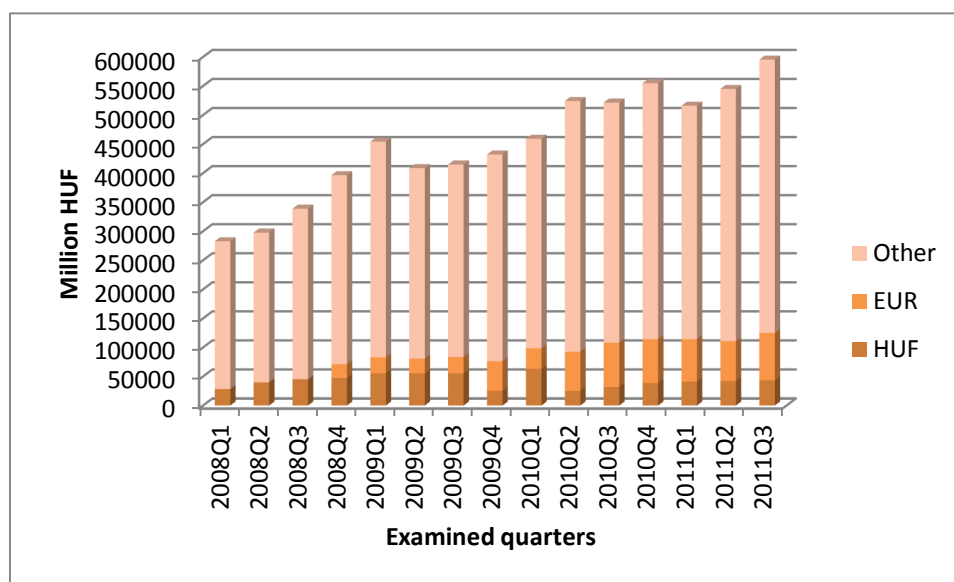
Source: Hungarian Financial Supervisory Authority, 2012

Reviewing the interest payments of municipality sector it can be concluded that the payments of interests drastically increased after the election years, as it is confirmed by the data, too. In 2003 and 2007, owing to the considerable degree of loans and analysing the long-term time series, it can also be concluded that the local governments realize increasingly higher payments of interest and the degree of repayment of principal has considerably grown from 2007, too.

The debt of Hungarian municipalities significantly increased from 2008. One of its elements was the issue of debt security, in other words municipal bonds. The figures in the balance sheets of banks indicate that the long-term bond portfolio increased by 84,28% (238 billion HUF) from 2008 to 2011. It refers to the fact that the bond portfolio of municipalities held in banks has not decreased in spite of the crisis.

It was typical for the municipal bonds that no secondary market had been formed, so the banks were the underwriters of bonds in Hungary, therefore the balance sheets of bank sector give reliable basis

for measurements. The bond issues started before the crisis, their amount was the highest between 2006 and 2008 and primarily the larger towns and county seats issued them. Its typical feature was the 3-4 year grace period and the long maturity. (Kovács, 2010) The bond issue was preferred because in this case – in contrary to borrowing - it was not necessary to go through public procurement procedure thus the municipalities have more possibilities to form the conditions. (Vigvári, 2009a)(Vigvári, 2009b)



**Figure 4:** Distribution of municipal bond portfolio by currencies at the credit institutions

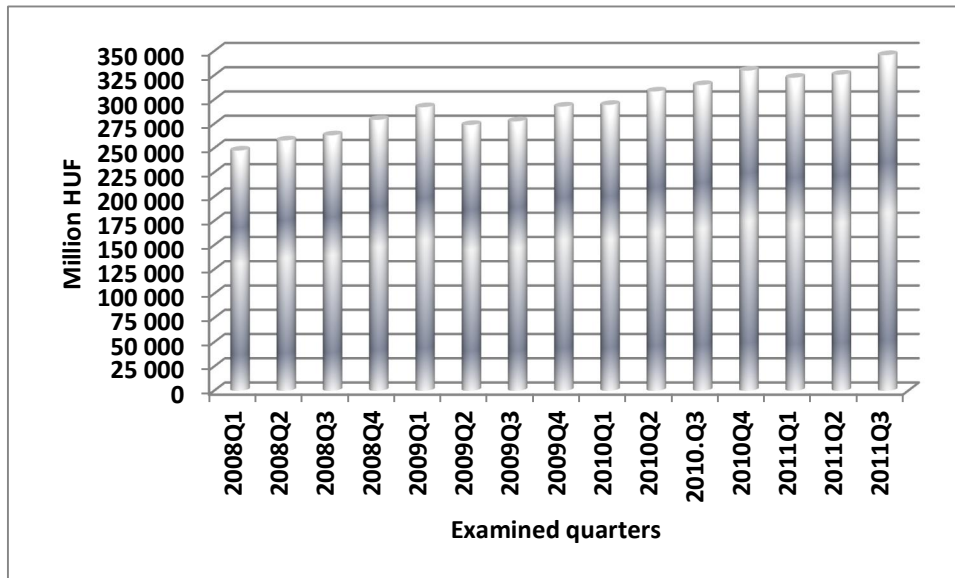
Source: Hungarian Financial Supervisory Authority, 2012

As regards the municipal bond portfolio, it can be stated that most of the bonds is denominated in other currency, in CHF, and the ratio of bond portfolio denominated in EUR increased significantly during the examined period.(Figure 4). These effects can be led back basically to two reasons: the preference to HUF in case of the latest – after 2010 – bond issue, and the permanent exchange rate growth of CHF and EUR to HUF which started in 2008. Thus the drastically rising CHF rate greatly affected the municipal bond portfolio of banks because they are obliged to correct it quarterly in their books according to the official exchange rate of the Hungarian National Bank. That’s the reason why the municipalities suffered significant exchange losses compared to the issue.

In the research of Homolya and Szigel performed in 2008, only half of the issued bond stock served capitalization purposes according to the „golden rule”. Part of the bond was used for bailing out the existing loans and forming reserves, as well as for performing arbitrage actions. It should be noted, that the indebtedness went together with decreasing outgoings for accumulation and investment before and in the early phase of the European Union programming period which started in 2007. (Vigvári, 2009).

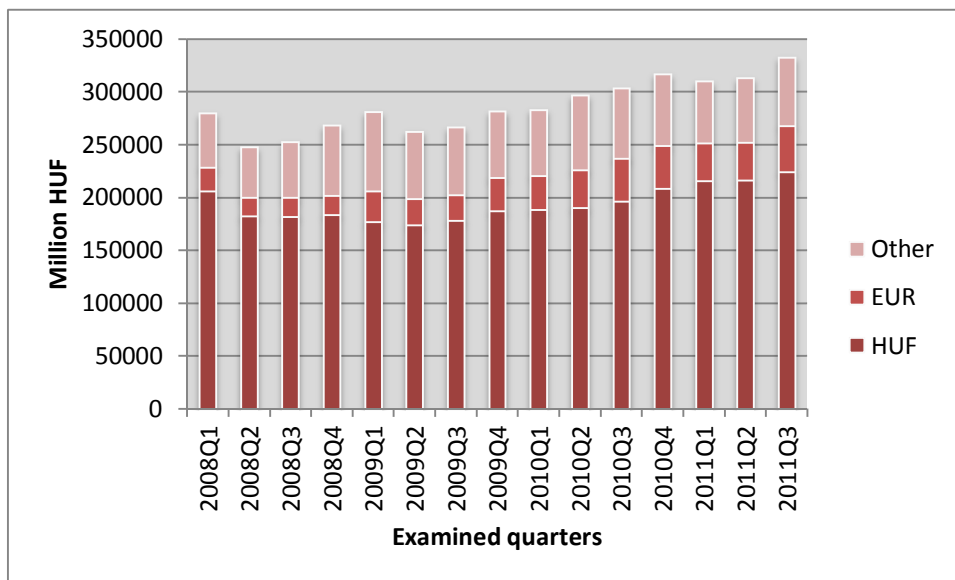
The bond issue was favoured by municipalities because bond sources could be used freely, the control was smaller than in case of bank loans and their bargaining position was better than in case of a bank loan application.

It can be concluded that the municipal bond issue had key role in the indebtedness of Hungarian municipalities. In the long run it will considerably affect the financial management and operation of municipalities because the shortly expiring principal repayment holiday and the starting principal repayment will result deteriorating financial positions in most of the municipal bonds if the CHF and HUF rates remain steadily high.



**Figure 5:** Long-term loan stock of municipalities in the balance sheets of credit institutions

Source: Hungarian Financial Supervisory Authority, 2012



**Figure 6:** Distribution of long-term loan stock by currencies

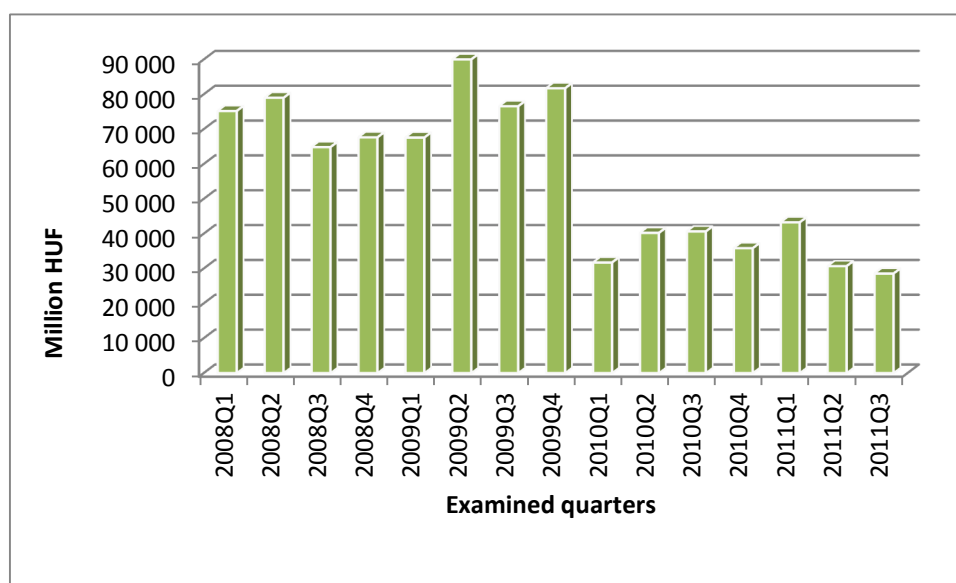
Source: Hungarian Financial Supervisory Authority, 2012



The long term bank loans of municipalities also show an increasing tendency during the examined period, but the dynamics of its growth did not reach that of bond issue. The degree of changes from 2008 to 2011 was 27,29%, so it can be stated that the local governments received additional sources from the banks primarily for development purposes 401nt he amount of 73,35 billion HUF. (Figure5)

It also proves that the Hungarian municipalities preferred debt security to borrowing as regards external fund raising. 401nt he basis of State Audit Office reports the income from loans – similarly to bond issue – served primarily development purposes which were justified by the municipality project proposals of the European Union programming period beginning in 2007.

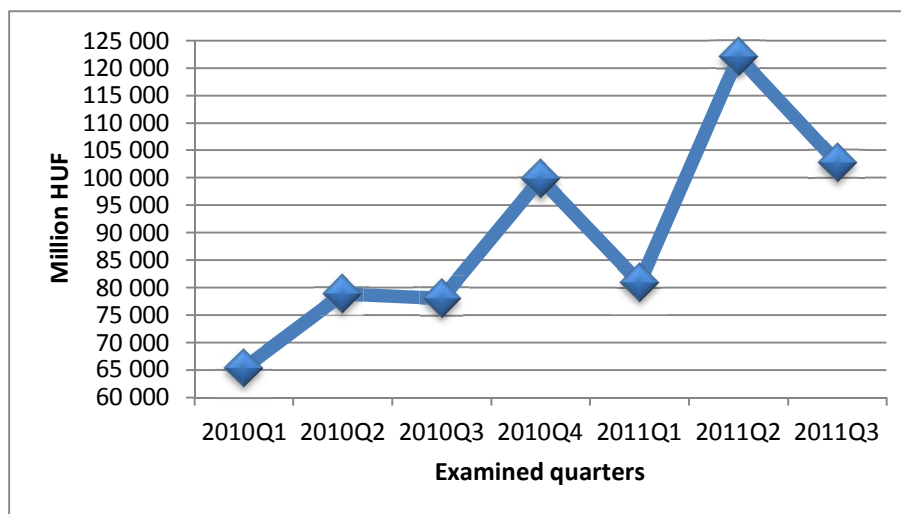
As regards the distribution of bank loan portfolio, it is clear that the settlements ran into debt primarily in HUF, in contrary to bond issue. (Figure 6) In total, the ratio of currency-based loans (CHF, EUR) increased after the crisis due mainly to the rate changes. As a result of this, the risk of municipal loans has grown because the devaluation calculated for municipal loans has risen twentyfold compared to the early 2008. It well describes the growing proportion of problematic loans and the necessity of risk management measures. In my opinion, these risks can grow in the future because the narrowing municipal sources and the exchange rate risks can further expand the losses of credit banks.



**Figure 7:** Short-term loan stock of municipalities in the balance sheets of credit institutions

Source: Hungarian Financial Supervisory Authority, 2012

Examining the short term loans it can be declared that the short-term loan portfolio of municipalities has significantly diminished from 2010. (Figure 7) As regards the currency, the short-term loans were taken in HUF in the majority of cases thus this credit product does not mean any further risks for local governments. Regulation also affects the ratio of short-term loans because public procurement procedure is required for borrowing therefore this form of financing is cracked down. The local governments mostly finance the wages from this source.



**Figure 8:** Overdraft of municipalities in the balance sheets of credit institutions

Source: Hungarian Financial Supervisory Authority, 2012

The current account overdraft indicates considerable growth of overdraft stock, thus by and large the ratio of short-term loans – summing up the overdraft and short-term loan portfolio – has not decreased but shows an increasing tendency, only the forms of financing are shifted. (Figure 8) The current account overdrafts were used mostly for preventing different liquidity problems not only owing to the central budget contributions but also to the post-financing practice of European Union subsidies. It can also be stated on the basis of these facts that the liquidity of municipal sector has been deteriorating from 2010, it is the most important explanation for the rising loan stock.

## 5. CONCLUSION

In conclusion, it is obvious that the rate changes and the crisis affected the Hungarian municipal sector because the significantly increasing exchange rates considerably increased the debt to be repaid, thus worsening indebtedness. Concerning the bond portfolio of municipalities, it can be declared that the local governments got into debt at the bad moment because the registered value of currency bonds grew very high due to the crisis of 2008.

The relation of municipalities and banks has changed very much because of the impacts of the crisis in Hungary. The indebtedness of the sector towards the credit institution sector started much earlier, primarily owing to the bond issue. The impact of the crisis hits and will continue to hit badly the municipal sector due to high proportion of bonds denominated primarily in currency, because the considerable exchange rate losses increase the repayment loads and the related risks. All these and the expiry of principal repayment moratorium will require more sources from local governments and the future financing structure is rather unclear.

In addition to indebtedness, there is another critical area which indicates liquidity problems in the sector by expansion of current account overdraft. It is resulted by the government restrictions and diminishing state budget contributions.

In my opinion, the banking sector can count on the credit demand of municipalities to a decreasing extent in the future because the bond issue repayment begins and the state budget contributions decline, therefore the local governments should build upon their own fund raising capacity. They can also obtain higher amounts of development sources from the next European Union programming period, although the future of Regional Policy between 2014 and 2020 is still very much discussed. The growing debt repayment can affect it badly, so there will not be any long-term credit demand anymore on behalf of local governments. In the future, the loan demand of municipalities will target primarily the short-term loans and the payment services, which can help to handle temporary liquidity problems. It depends, however, very much on the future financing structures because 2013 will be the first year of the newly reformed municipality regulation and the current year is the transitional year.

The long-term impact of these factors include the decline in municipal investment because they will not be able to provide appropriate own resources for their project proposals due to the repayment of loans and bonds. The new legal regulations in the field of crediting can bring significant changes. Another narrowing condition that principal repayment will start in 2013 in case of almost 90% of bonds issued by local governments, so higher and higher sources should be spent on this by the municipalities concerned, especially the county towns and towns. The risk is very obvious because most of the bond debt is denominated in CHF, so the rate changes induced by changing circumstances of world economy can make repayment and obtaining funds more difficult in the future. As regards development possibilities, the grants co-financed by the European Union which can be called until 2013 support municipality sector to a decreasing extent, therefore this factor will not stimulate the cash demand of local governments.

The restructuring of municipality system can bring significant changes because the scope of functions will be reformed, a lot of major tasks will be returned from local authorities to the state. It is an important change concerning municipalities that borrowing by local governments in certain cases and bond issues will be drawn under legal control as well as the debt limit that was valid so far will also be tightened. Therefore the external, credit-like fund raising of local governments will be shifted towards long-term credits.

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**INSTITUTIONAL PRESSURES AFFECTING THE DEVELOPMENT OF FINANCIAL  
ACCOUNTING FRAMEWORK: THE CASE OF ESTONIA**

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**Abstract**

*In the context of Estonia the research based on accounting legislation and other studies shows that the coercive institutional pressure influencing the IFRSs developed by IASB and the European Union. Normative institutional pressures, affecting the development the accounting system, are the Big4 auditing companies. Mimetic institutional pressures are international corporations and the trading partners of companies. Mimetic institutional pressure also takes place, when Estonian Accounting Standards Board follows the same working principles and processes as IASB. Still, more research in the area of normative and mimetic institutional pressures is deemed necessary. Overall, the example of Estonia shows that the harmonization process of IFRSs is unstoppable (and inevitable) and countries, who want to be successful in the international capital market have to be compatible with different institutional pressures.*

**Key words:** *institutional theory, coercive, normative and mimetic institutional pressures, Estonian accounting system*

**1. INTRODUCTION**

Financial accounting framework is like a constitution: It is “a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements” (Booth 2003, 310). Financial statements represent accounting practises used in companies. The formats of financial statements developed during last century have to provide information for decision making purposes (decision usefulness). To provide information to decision makers, companies prepare general-purpose financial statements. These statements provide the most useful information possible at the least cost. Information included must have qualitative characteristics of accounting information for decision-making purposes. Globalization and transnational business expansion have resulted in a greater need for common rules so that the financial statements of organizations in different countries would be prepared on a similar basis and there would be no possibilities for interpretation.

In 2001, International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) started separate discussions about the preparation and presentation of financial statements (IASB homepage). One year later the two organizations decided to work on financial statement presentation as a joint project to further the goal of promoting convergence of accounting standards used internationally. In September 2002 IASB and FASB signed the Norwalk Agreement and pledged to use their best efforts to make their existing financial reporting standards fully compatible and to coordinate their future work programs to ensure that once achieved, compatibility is maintained

(*Memorandum of Understanding* 2002). Differences between GAAP and IFRS will be eliminated by taking into consideration IFRS principles as a base and also by the acceptance, approval, and application of the new standards both locally and internationally (Al-Omari 2010, 34).

In result of the growing internationalization of economic trade and due to the globalization of financial markets the use of international financial reporting standards developed by IASB has increased internationally. 117 countries around the world require or permit the use of “full IFRSs” for listed companies, at least 52 countries require or permit the use of IFRSs for all other companies and in 38 countries the possibility to use IFRSs exist (Heinsaar 2010, 18). Since 2005 all listed companies in European Union are required to prepare their financial statements according to IFRSs (Yalkin *et al.*, 2008, 57). After the implementation of IFRSs in the European Union, many countries including Canada, United States and Mexico have now announced that they will adopt IFRSs for all listed entities from 2011, 2014 and 2012 respectively (Barbu *et al.*, 2010, 218). Thus, the process of international convergence of accounting standards appears to be entering a culminating stage.

Nations all around the world are following the fast pace convergence of national generally accepted accounting principles with that of the IFRSs. This convergence is mostly influenced by globalization as countries world-wide have been pursuing the same purposes to increase their economic growth and to improve the welfare of their residents. These aims are mainly pursued by developing countries, including Estonia. To achieve these aims, Estonia has opened its market to multinational corporations, has joined the international economic associations and developed a more transparent approach in its accounting principles to adapt to the demands of international financial markets. To achieve this Estonia has adjusted its generally accepted accounting principles to IFRSs. Authors in prior studies, for example Fontes *et al* (2005) in Portugal, Al-Omari (2010) in Jordan and Irvine (2007) in United Arab Emirates, have also noted that countries around the world are converging their national standards with that of the IFRS. Thus, globalization is one of the lead factors affecting countries world-wide to adopt IFRSs, especially developing countries.

In prior studies, globalization was defined as “a worldwide pressure to change” (Granell 2000, 89), as the “closer integration of the countries and peoples of the world” (Stiglitz 2001, 9) and is also interpreted “as a universal process of institutionalization that both relies on and results in greater interdependence between economies, political systems, culture and societies” (Irvine, 2007, 126). As globalization has been considered one of the many factors that have had a considerable influence on many countries worldwide to adopt IFRS, then according to prior studies (Barbu *et al.*, 2010; Al-Omari 2010), some can perceive the convergence of international financial reporting standards as the development of new world-wide institution, which has achieved great legitimacy among developing countries and also in international level.

This paper attempts to address how globalization and international financial reporting standards have affected the development of generally accepted accounting principles of Estonia. This is interpreted through institutional theory as according to authors’s knowledge, it has not been done in Estonia from that point of view. The analysis is important to understand pressures affecting the development of financial reporting system in Estonia and take the possible influences into account when developing new accounting legislation in the future. Therefore, the possible future directions regarding accounting in Estonia are discussed briefly using also institutional theory. Finally, the paper outlines opportunities for further institutionally informed studies at a global and societal level.

## 2. METHODOLOGY

As a methodological technique, comparative analysis of literature is used to compose the literature review in this article. This section essentially reflects the views published in scientific articles, monographs and reports of the conference collections.

In the chapter of institutional pressures affecting the development the Estonian accounting system the authors analyze the legislation of Estonia and European Union. This part of the article is supported by the monographs and articles written by the Estonian authors about the Estonian accounting history and the development of the Estonian accounting system.

## 3. LITERATURE REVIEW

The integrity and usefulness of an institutional approach to explain and interpret accounting activity in an International level has been acknowledged by many authors (Al-Omari, 2010; Barbu *et al.*, 2010; Irvine, 2007; Kury, 2007; Baker *et al.*, 2006; Mezas *et al.*, 1994). For instance, American neo-institutional theorist Richard Scott defined institutionalization as “the process by which actions are repeated and given similar meaning by self and others”. Sometimes actions are repeated because explicit rules or laws exist to ensure their repetition (*legal and political influences*). Sometimes activity patterns are supported by norms, values and expectations (*cultural influences*), sometimes by desire and to be or look like another institution (*social influences*) (Hatch 1997, 84).

American sociologists Powell and Dimaggio (1983) distinguish between these three different institutional pressures and give them distinctive labels. They argue that when the pressure to conform comes from governmental regulations or laws, then coercive institutional pressures are at work. Coercive institutional pressures in this concept involve the capacity to establish rules, inspect others to conformity to them, and, as necessary, manipulate sanctions – rewards or punishments – in attempt to influence future behaviour (Scott 2001, 52–53).

According to Al-Omari (2010, 37) and Irvine (2007, 129), World Bank and International Monetary Fund (IMF) represent a coercive pressure in a global perspective. The World Bank is an international financial institution and a vital source of financial and technical assistance to developing countries around the world. The World Bank offers two basic types of loans and credits: investment operations and development policy operations. Countries use investment operations for goods, works and services in support of economic and social development projects in a broad range of economic and social sectors. Development policy operations (formerly known as adjustment loans) provide quick-disbursing financing to support a country’s policy and institutional reforms (World Bank 2011). As force, fear and expedience are central ingredients of the regulatory pillar, few if any rulers are content to base their regime on force alone and all are attempting to cultivate a belief in its legitimacy (Scott 2001, 52–53). There has been no doubt that the World Bank has “pushed countries to adopt IFRS or develop national standards based on IFRS”, which in some cases have made the adoption of IFRS a requirement of their loans (Alfredson *et al.*, 2005, 9). Therefore, some authors see World Bank as one of the advocates of the adoption of IFRSs and harmonization of accounting principles world-wide.

Irvine (2007, 129) and Barbu *et al.* (2010, 221) observe IASB as one of the coercive pressures encouraging the countries around the world to adopt IFRSs. Since implementation of the Securities and Exchange Act of 1934 in the United States, every firm that sells such securities must file financial statements with the U.S. Securities and Exchange Commission (SEC). All such financial statements must comply with a set of rules for the preparation of financial statements. These rules are commonly

known as generally accepted accounting principles (GAAP). The SEC has traditionally delegated the task of determining these institutional rules to a non-governmental organization, which, since 1973, has been the FASB (Mezias *et al.* 1994, 655). FASB operates on the same principles as IASB and therefore, could be seen as a coercive pressure in the United States.

Powell and Dimaggio (1983, 151) take a narrower approach to coercive institutional pressure and observe that as conglomerate corporations increase in size and scope, it is common for subsidiaries to be subject to standardized reporting mechanisms. Subsidiaries most adopt accounting practices, performance evaluations, and budgetary plans that are compatible with the policies of the parent corporation. For example, what accounts receivable should be discounted for in the balance sheet or what accounting principles should be used when accounting for inventories. This leads to a pressure on companies in two ways – firstly, the prepared financial statements have to meet the demands of the parent company, who perhaps prepares the financial statements according to IFRS, and secondly, the subsidiary has to prepare the financial statements according to local GAAP.

When the pressure comes from cultural expectations, for instance via the professional training of organizational members, then according to Powell and Dimaggio (1983, 152) normative institutional pressures are at work. Normative systems are typically viewed as imposing constraints (Scott 2001, 55). For example, the World Bank requirement that projects financed by the bank be “certified by internationally reputable firms of accountants” has aided in the proliferation of the international operations of the Big4<sup>45</sup> international accounting firms (Irvine, 2007, 133). So the Big4 accounting firms play a profound role in the globalization of accounting and represent the normative pressures that effect organizations and the choices they make in accordance to their reporting and practices implemented (Al-Omari 2010, 38). In Estonia, where the Big4 auditing companies make up to 88% of the total revenue produced by ten largest auditing companies (Vetevoog 2009), one can certainly apprehend the pressure from Big4 auditing companies to prepare the annual reports according to their standards. In other words the Big4 companies are endowed with an effective presence in the world capital market, and are considered to be one of the many international forces behind the process and advancement of harmonization of accounting standards (Chand, 2005, 233).

Mezias *et al.* (1994, 658) and Barbu *et al.* (2010, 221) think that in the United States of America, professional accountants constitute examples of normative isomorphism “with a common culture, in the sense of shared definitions of problems and common repertoires for managing those problems”. Therefore, participants in accounting policymaking might exhibit high levels of shared knowledge and beliefs, and this professionalization may contribute to a more orderly, consensual process when making decisions. To conclude, theorists embracing a normative conception of institutions emphasize the stabilizing influence of social beliefs and norms, which are internalized and imposed by others (Scott 2001, 56).

Powell and Dimaggio (1983, 151) call desires to look like other organizations mimetic institutional pressure and explain them as responses to uncertainty that involve copying others organizational structures, practices and outputs. More generally, the wider the population of personnel employed by, or customers served by, an organization, the stronger the pressure felt by the organization to provide the programs and services offered by other organizations. Thus, either a skilled labour force or a broad customer base may encourage mimetic isomorphism (Powell and Dimaggio 1983, 151).

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<sup>45</sup> PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young



Mimetic institutional pressure is viewed differently by many authors. Powell and Dimaggio (1983, 152) see not-for-profit organizations as an example of mimetic institutional pressure. These organizations may change their organizational structure to be more similar to the for-profit firms and carry a powerful message to potential partners in joint ventures that “the sleepy non-profit organization is becoming more business minded”.

Barbu *et al.* (2010, 221) considers different local accounting standards-setting bodies in various countries to be an evidence of mimetic isomorphism as they have adopted structures and procedures similar to those of the IASB and FASB.

In the opinion of Al-Omari (2010, 39), mimetic institutional pressures refers to the copying and duplicating of successful organizational behaviour by other organizations. Successful multinational corporations have contributed to increasing the desirability of expanding and accepting the global harmonization of financial reporting. Therefore, the sophisticated and developed systems within those corporations portray desirable practices and behaviours which are seen essential and imperative to organizations within the developing economies (Al-Omari 2010, 39). Irvine (2007, 135) argues that the UAE’s openness to its globalized environment and its increasing reliance on international trade having been established, it is inevitable that these relationships bring a pressure on the UAE to adopt westernized forms of accountability and financial reporting, particularly those of its “influential trading partner(s)”.

Further, organizations require more than material resources and technical information if they are to survive and thrive in their social environment. They also need social acceptability and credibility (Scott 2001, 58). Zucker (1987, 447) believes that the difference between institutionalized and non-institutionalized environments often appears to be simply a matter of rationality. In this view, the economic success factor is viewed as the product of rational decision making. Conforming to the institutional demands wins social support and ensures survival to an organization, not because it makes more money or better products, but because it goes along with accepted conventions. Therefore, it is understandable how under different institutional pressures not only organizations and firms, but also countries adapt to the demands of the World Bank, IASB, Big4 companies and trade partners to achieve social legitimacy. This kind of behaviour further supports the harmonization of international a counting standards and the rise of a new international institution. As coercive, normative and mimetic pressures are viewed differently by many authors it is vital to determine which pressures are influencing the development of the Estonian accounting system taking into consideration the accounting history of Estonia, the openness to global processes and participation in the international capital market.

#### **4. INSTITUTIONAL PRESSURES AFFECTING THE DEVELOPMENT OF FINANCIAL ACCOUNTING FRAMEWORK OF ESTONIA**

##### *4.1. Coercive institutional pressure*

The collapse of centrally planned economies in the late 1980s and early 1990s changed the accounting environment in the former socialist countries, including Estonia, dramatically (Haldma 2006, 460). Estonia’s economic system was transformed from a centrally planned to a market-based economy, which involved significant legal and institutional changes in regulations and especially accounting regulations and gave rise to the development of a new accounting environment (Hirvoja-Tamm 2010, 32).

Haldma (2003, 504–508) has divided the integration of Estonian financial accounting system into the international framework into three stages: 1) introductory stage that (1990–1994), 2) system building stage (1995–2002) and 3) system improving stage (since 2003).

In 1990 the first steps towards the regulation of accounting and auditing in Estonia were made. This event marked the beginning of the spread of accounting disharmony within the territories comprising the Soviet Union (Haldma 2003, 504–508). In 1990, the Regulation of Accounting was adopted by the National Government and came into force on January 1, 1991 (Alver *et al.* 2009, 103). In 1991, Estonian Accounting Standards Board (EASB) was established. During the following years, 1992–1995, all the “big six” auditing companies started to operate in Estonia and in 1994 the first set of auditing guidelines was enacted in Estonia (Haldma 2003, 504–508).

In 1994 the Estonian Accounting Act (EAA) was enacted and came into effect on January 1, 1995. Estonia was the first nation in Europe to align national GAAP with international accounting standards by law. The Accounting Act of 1995 stated that the Estonian GAAP was based on the standards interpretations and guidelines promulgated by the IASC<sup>46</sup> (Alver *et al.* 2009, 107). Still, the Accounting Act did not contain a detailed set of rules and can best be characterized as constituting legal framework. The legal framework was general and applied to all legal entities and physical persons registered as businesses in Estonia (Alver *et al.* 2009, 104). From 1995 till 2000 the EASB issued 16 Estonian Accounting Standards (EAS) to improve particular aspects of accounting in Estonia including accounting principles, preparation of financial statements, revenue recognition etc. The only problem was that the standards were not for obligatory use. They were only recommendations and in the case of contradictions with the Accounting Act, requirements of the Accounting Act had to be followed. The first Accounting Act was in force for 8 years (from 1995 to 2002) and was changed several times, unfortunately, these changes were mostly cosmetic (Alver *et al.* 2009, 104). In 1995 the Company’s Act was enacted. In 1995 the Government of Estonia submitted an official application to join the European Union (Haldma 2003, 504–508).

In the accounting reform in Estonia was arranged through the new version of EAA and a new set of EAS’s. Both of them came into effect on January 1, 2003 (Haldma 2003, 504–508). Instead of the former two basic statements (the balance sheet and the income statement) the annual report now included four statements the balance sheet, the income statement, the cash flow statement and the statement of changes in owner’s equity (Alver *et al.* 2009, 105). The main characteristics of the new EAA and EAS were clear orientation to the IFRS and the possibility to base the accounting methods and presentation of the information in financial statements on one of the following accounting principles – Estonian GAAP or IFRSs (Haldma 2003, 504–508). The Estonian GAAP is basically a simplified summary of IFRS, primarily meant for small and medium-size entities. The recognition and measurement rules are based on IFRS, but the disclosure requirements are less demanding (EASB homepage).

To further understand the coercive pressures, including organizations and events that affected the development of Estonian accounting system, the authors have concentrated to the system improving stage starting from 2003, although the preparations for the issuance of the new version of EAA and EAS already started in 1990’s.

New Accounting Act that came into effect on January 1, 2003, brought the Estonian accounting legislation closer to the International standards and also contributed to a better organization of the

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<sup>46</sup> International Accounting Standards Committee that is the predecessor of International Accounting Standards Board.

economic environment. The financial reports by business entities became more informative and enabled different interest groups to have a better overview about the reporting company's financial position, assets and liabilities (Tikk 2010, 8).

In May 2004 the Republic of Estonia joined the European Union (EU). From this day forward, Estonia has the obligation to follow in its activities the legislation of EU. The main sources of primary law are the Treaties establishing the EU. Secondary sources include regulations and directives which are based on the Treaties. Regulations, directives and decisions are mandatory to follow for member states (European Union Information Centre). Although directives set sometimes quite specific objectives, they leave the implementation to the EU's member states. Regulations are directly applicable to member states and take effect without the need for implementing measures (European Union Information Centre).

In 2004, the accounting in EU was regulated with Fourth Council Directive 78/660/EEC (in force since 25.07.1978), which treated the preparation of annual accounts of certain types of companies, and Seventh Directive of the European Union 83/349/EEC (in force since 13.06.1983), which defined the preparation of consolidated accounts (Sumberg 2004). The Fourth Directive requires that all public limited companies shall present assets, liabilities, financial position and profit and loss in a way to give a true and fair view of the company's annual accounts (Hirvoja-Tamm 2010, 12). The Seventh Directive obliges the parent company to draw up consolidated accounts and consolidated annual reports besides its separate accounts (Hirvoja-Tamm 2010, 12). The above-mentioned directives applied to private limited companies and limited companies in Estonia and were incorporated to the Estonian Accounting Law when joining the EU. Because the Fourth and Seventh Directive were not based on IFRSs, differences between EAS's and EU legislation existed in 2004.

However, there was no need to improve the Estonian GAAP, because according to the regulation accepted by the European Parliament and European Council in 2002 (1606/2002), all EU companies listed on a regulated market, to prepare their consolidated accounts in accordance with IFRSs (previously IASs) (Sumberg 2004). This requirement entered into effect from 2005 and represented a preliminary peak in the internationalization process of financial accounting in Europe (Haldma 2003, 501).

For other companies the implementation of the IFRS is recommended (Tikk 2010, 9). Although the Estonian GAAP was already oriented to the IFRSs, all the 17 Guidelines of the Accounting Standards Board were amended again (Tikk 2010, 9), because differences between the international accounting standards adopted by EU and accepted by IASB existed. The reason behind the differences is that the IFRSs adopted by IASB does not take effect in European Union automatically. Therefore, differences between the IFRSs in EU and the IFRSs adopted in other countries, not part as the EU, exist. There are two kinds of differences – permanent and temporary. Permanent differences exist do to the fact that EU has decided not to adopt some IFRSs or interpretations of these IFRSs in EU's legislation. At the moment, one of the permanent differences are some sections of IAS 39 "Financial Instruments: Recognition and Measurements" that treat the use of hedging instruments. Temporary differences are due to the fact that the enforcement process of new standards or interpretation released by IASB takes at least 6 months or more in EU.

On December 1, 2005 several changes were introduced in the Accounting Act. With the updated Accounting Act the necessity of providing the users of financial statements with adequate information was emphasized. The amendment was mainly (but not entirely) enforced do to the implementation of e-verification by Estonian Tax and Customs Board – electronically received or generated data is required to be retained in order for the successful conduct of electronic control (Bill 723). The

requirements for the format of registers have been defined because the mechanical procedure of bookkeeping has changed due to computerization (Tikk 2010, 9). Besides that, the amended Accounting Act required more information in the management report, such as the description of the main fields of activity as well as products and services and also the main financial ratios (Estonian Accounting Act). EAS's, which were oriented to IFRSs already required this kind of information to be disclosed in the notes of the annual report. With the updated version of Accounting Act, this requirement was also introduced to the law. Thus, the demand for change in the law was determined by IFRSs.

In 2007 the Accounting Act was amended because of the changes in the Securities Act (Estonian Accounting Act). The idea of the amendments is to follow the disclosure principle in all economic transactions or events, where a business entity issuing securities is one of the parties (Tikk 2010, 10). The change was intended to harmonize the European Parliament and Council Directive 2004/39/EC (the Markets in Financial Instruments Directive) and its implementing Directive 2006/73/EC and 2004/109/EC (the Transparency Directive) (Loot 2007, 1). Thus, the demand for change in the accounting law was determined by EU legislation.

The amendments in the Accounting Act in force from 2008 required that the annual report state the entity's field of activity according to the classification used for the Estonian economic activities based on 10 most significant fields of activities (Estonian Accounting Act). According to the explanatory memorandum, it provides for quick identification and processing of registers maintained by the court. Although EASB and the Estonian Board of Auditors (EBA) saw the change in the context of the annual report inappropriate and suggested that such information should be collected outside the annual report. As a result, such information shall be published after the notes and annexes of the annual report (Loot 2008, 2). Thus, the change in the law was rather administrative in nature, which was designed to help users (registration departments of courts) to better process the data.

In 2009, several changes were introduced to the Accounting Act. The main change worth noting was the development of uniform financial reporting taxonomy (Estonian Accounting Act), which was directly related to the action plan for e-filing of the annual reports. Firstly, the taxonomy of the annual report that meets generally accepted accounting principles in Estonia was developed (except the taxonomy on consolidation or liquidation and final report). This taxonomy was already introduced in 2010 (Loot 2009, 3). As the electronic submission of annual reports is not widespread throughout the world, the authors think that it can be seen as an independent project of Estonia, which can be qualified as exceptional in the world. Therefore, in this case, compelling institutional pressure is the Republic of Estonia, who has been able to set rules and has the ability to see that others follow these rules.

In 2010 the Accounting Act was amended due to the changes in the Authorised Public Accountants Act (Estonian Accounting Act). The Authorised Public Accountants Act was updated because of the requirements of International Standards on Auditing. To draw a parallel here, to merge with the demands of international legislation other Estonian laws besides the Estonian Accounting Act has been influenced by international standards and organizations.

In 2011 the changes in the Accounting Act were the result of Estonia's accession to the euro area and the substitution of national currency from Estonian kroon to euro (Estonian Accounting Act). The functional currency changed to euro instead of kroon as well.

In conclusion, it may be noted that due to the membership in EU, the coercive institutional pressure affecting the development of the Estonian accounting environment is the previously mentioned union.

The legislation of EU (regulations and directives) directly influences the Estonian Accounting Act. As EU has based its accounting laws mainly on international financial reporting standards then in the international perspective one can rather see the IASB as the main coercive institutional pressure affecting the development of the Estonian Accounting Act and the Estonian Accounting Standards.

Other authors have examined the World Bank and the International Monetary Fund as the coercive institutional pressures in a global perspective (Al-Omari 2010, 37; Irvine 2007, 129). Next, the authors briefly focus on the activities of these associations to identify or eliminate their impact on the development of Estonia's accounting record.

Estonia is the member of the World Bank and the International Monetary Fund since 1992. Estonia joined with the International Development Association, which is a part of the World Bank Group, in October, 2008. The last loan Estonia borrowed from the World Bank was in 2000. In 2006, Estonia changed its status in the World Bank from the borrowing-country to the lending-country. Since 2008, Estonia contributes with 185 other countries to the International Development Association (Estonian Development Newsletter 2009, 1). Therefore, it can be argued that in the last decade, the influence of World Bank to the development of Estonian accounting environment is rather minimal as Estonia's status in the World Bank has changed from the influenced to the influencer. However, the impact and the participation of World Bank and International Monetary Fund in the formation of the Republic of Estonia in 1990's must not be forgotten.

At societal level there has been many discussions, how the Estonian GAAP should look like in the future. The chairman of EASB Ago Vilu sees EAS's remaining closely tied with IFRSs. This view is supported by the adoption of IFRS for SME's by IASB in 2009 (Oja 2011). In EU, the use of IFRS for SME's has not been approved, because according to the European Commission, IFRS for SME's is not suitable to use for micro-enterprises (Hirvoja-Tamm 2010, 54) and it is not in accordance with the Fourth and Seventh Directive of European Union (Hirvoja-Tamm 2010, 56). Therefore, in October 2011, the European Commission decided not to adopt the IFRS for SME's into the European legislation. Furthermore, the Commission proposed to simplify accounting rules for SMEs by amending the Accounting Directives (78/660/EEC and 83/349/EEC). With that the Commission aims to reduce the administrative burden for small companies. Simplifying the preparation of financial statements would also make these more comparable, clearer and easier to understand. It would also allow users of financial statements such as shareholders, banks and suppliers to gain a better understanding of a company's performance and financial position. Furthermore, under the proposed revision of the Transparency Directive (2004/109/EC), listed companies, including small and medium-sized issuers, would no longer be obliged to publish quarterly financial information. This would contribute to further cost savings and should help to discourage short-termism on financial markets (European Commission Press Release on October 25, 2011). In December, 2011 the proposals to revise the accounting Directives and the Transparency Directive were approved by European Parliament. After formal approval by the Council, the Directive will enter into force following publication in the Official Journal, which is expected in early 2012. As the simplifications under the new Directive are only optional, no transposition period for Member States to implement it in their national legislation is required (European Commission Press Release on December 14, 2011).

According to the Fourth Directive, a micro-entity is a company which does not exceed at least two of the following three criteria: total assets of up to € 350,000; net turnover of up to € 700,000; and a maximum of 10 employees and typically have limited liability towards third parties. Approximately 75% of EU companies meet these criteria. (European Commission Press Release on December 14, 2011). According to the Estonian Statistical Office 58,347 companies were operating in Estonia in

2010. From these companies 51,854 entities had less than 10 employees, which is 89% of all the companies.

The simplifications proposed by the new Directive are only optional. It will be up to each Member State to decide the extent to which they make use of the new possibilities offered. It means that the Member States can decide to keep in full the current requirements of the Accounting Directives, or exempt micro-entities where that possibility now exists. The Commission hopes that most Member States will see this as an opportunity to reduce the burden on the smallest companies within their jurisdiction. By aligning the micro entities' financial reporting requirements with other reporting requirements (such as tax reporting, for example) they can create a one-stop-shop and substantially reduce the reporting burden. (European Commission Press Release on December 14, 2011)

So far, the majority of the Estonian enterprises draft their annual reports according to the Estonian GAAP, which copies the accounting principles of “big” IFRS. In 2011, several changes were introduced to the EAS's that will be effective from January 1, 2013 (earlier adoption is allowed). The new EAS's follow mainly the guidelines of IFRS for SME's, although some differences exist between to two set of accounting rules (for example, the EAS's will allow the capitalization of development costs and net-method for accounting for government grants). (Estonian Accounting Standards Board homepage)

Estonia is one of the first countries in Europe aligning its local accounting standards with IFRS for SME's. The same process has been started by many other countries in Europe, for example, Great Britain, Netherlands and Denmark (Estonian Accounting Standards Board homepage).

In the light of the recent events – from one side Estonian aligning its accounting standards with IFRS for SME's – and from the other side – European Union banning the IFRS for SME's and creating simplified rules for micro-enterprises – it is hard to predict, what will happen in the accounting future of Estonia and whether we will follow the guidelines set by EU or IASB or both. Still, the recent and the future developments further support the fact that EU and the IASB are the main two coercive institutional pressures affecting the development of financial accounting framework in Estonia.

#### *4.2. Normative institutional pressure*

Al-Omari (2010, 38) views the Big4 accounting firms under normative institutional pressure as these companies play a profound role in the globalization of accounting and represent the normative pressures that effect organizations and the choices they make in accordance to their reporting and practices implemented. Other authors have also researched the influences of the Big4 accounting firms on the preparation of the financial statements. Although this analysis has not been made in the context of institutional theory, they can still be used to assess the influences of Big4 accounting companies to the development of accounting practices.

Most analysis conducted compare the audit quality of Big4 auditing companies and other auditing companies. For example, in the United States, the investigation showed that the quality of audits conducted by Big4 auditing companies depends on the size of the operations of client. Because the bigger client gets more public attention, the risk of getting sued increases for the auditing company. When Big4 and non-Big4 companies audit a client with similar size, the differences in audit quality disappear (Lawrence *et al.* 2007, 28).

Consistent with prior research is also the analysis of Reynolds and Francis (2001) which outlays the fact that the Big4 companies report more conservatively when it comes to bigger clients. They explain

this phenomenon with the fact that with this kind of behaviour, the Big4 companies try to protect their reputation.

Simunic (1980) argues that the accounting services provided by different accounting firms are perceived by investors to be different in quality, with brand name auditors (currently Big 4 auditors) perceived as being more credible than others. In line with this argument, Becker *et al* (1998) and Francis *et al* (1999) posit that owing to their superior knowledge and reputation capital, brand name auditors conduct higher-quality audits. This is supported by a study issued by the General Accounting Office (GAO) of the United States that corroborates the essential aspects in terms of Big 4 audit outcome. The Big 4 audit opinion serves as an effective quality label, whereas most of the second-tier firms are not able to bid successfully for large accounts because of a lack of industry knowledge, geographic pressure and reputation. The GAO argues that a Big 4 audit report is characterized by a distinctive quality label, and therefore contains credible and high quality information (Gray *et al.* 2010, 347).

Gray and Ratzinger (2010, 356) further researched whether there are differences between the Big4 firms in particularly, how their national offices might interpret some specific accounting (GAAP) or auditing (GAAS) question. In a later focus group, an auditor pointed out that there are frequent conversations between representatives of the different Big 4 firms that results in a convergence of their interpretations. For example, when some new accounting or auditing issue arises, that will prompt discussions between the firms. She went on to say that the firms are fairly open in discussing their audit methodologies, so that the methodologies used by the firms are constantly evolving over time. However, the auditors agreed that the differences in interpretations become wider when Big 4 and non-Big 4 firms are compared (Gray and Ratzinger 2010, 360). The authors are in the opinion of that the cooperation of Big4 companies indicates that the financial statements audited by them may therefore be drafted even more according to their regulations.

British Financial Reporting Council has actively reacted against the dominance of Big4 auditing companies and has orientated itself in the international level towards increasing the likelihood of major “public interest entities” selecting non-Big4 auditors (Sawers 2007, 1).

Following, the authors have concentrated to the analysis of normative institutional pressure by Big4 companies in the Estonian context. As a methodical technique document analysis is mainly use. The authors also rely on the studies performed by other Estonian authors.

According to §158<sup>47</sup> of the Authorised Public Accountants Act, the auditing company, who is in a contractual relationship with a public interest entity, must compose and report to the Estonian Board of Auditors the transparency report. Therefore, the transparency reports of the Big4 and other Estonian companies are analysed to determine the normative pressure of Big4 auditing companies in Estonia.

Public interest entity is according to the Authorised Public Accountants Act, a public limited companies, state accounting entities, local governments, legal persons governed by public law, foundations and political parties receiving state budget funds.

Furthermore, public interest entity is a legal entity which accounts or consolidated annual accounts in the financial year exceed two of the following conditions (*Ibid.*):

1) Sales revenue or other income EUR 66 000 000;

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<sup>47</sup> In accordance with the European Union Directive 2006/43/EÜ which treats the audit of consolidated and non-consolidated annual reports.

2) Assets as of the balance sheet date EUR 33 000 000;

3) Average number of employees 1000.

Furthermore, public interest entity is an entity majority-owned by public sector entity or under the control of public sector entity, foundation or non-profit organization or other organization which accounts or consolidated annual accounts in the financial year exceed at least three of the following conditions (*Ibid.*):

1) Sales revenue or other income EUR 14 000 000;

2) Assets as of the balance sheet date EUR 7 000 000;

3) Average number of employees 200;

4) Average number of board members 8.

Besides the number of public interest entities audited during the financial year, the auditing company is also obliged to present in the transparency report the amount of revenues gained from the assurance services. This includes revenues gained from performing audits, reviews and other assurance services (*Ibid.*).

Therefore, the authors have analysed more thoroughly, how many public interest entities in Estonia are audited by Big4 companies and how the revenues from the assurance services are divided between Big4 and non-Big4 companies. Based on this analysis it is possible to draw some initial conclusions, how Big4 companies exercise their normative pressure to Estonian companies, to the development of Estonian accounting framework and audit quality.

According to the homepage of the Estonian Board of Auditors, 16 auditing companies have presented the transparency report for the period 01.07.2010-30.06.2011. Based on the data reported by the auditing companies, 143 public interest entities have been audited (in 2009 128 entities) during that period from which the Big4 companies have audited 68% (in 2009 69%)<sup>48</sup>. Based on these results it can be argued that as most of the “important” annual reports are being audited by Big4 companies then due to reputation risk they perform the audits more conservatively than other auditors and therefore influence the preparation and presentation of the annual reports they audit.

When we look how the sales revenue is distributed during the same period between Big4 and non-Big4 companies, we can see that in together the auditing companies earned revenues of 13.2 million Euros, which is the same as result as in 2009. The revenues of Big4 companies made up to 10.4 million Euros, which is 79%<sup>49</sup> of the total revenues earned during that period (the same as in 2009). When we look public limited companies, who are also public interest entities, in more detail, we can see that the annual reports of 13 public limited companies out of 14 listed in the Tallinn Stock Exchange in 2010, have been audited by Big4 companies (Tallinn Stock Exchange homepage).

To conclude, we can say that based on the sales revenue analysis the impact of Big4 companies on preparation and presentation of annual reports extends beyond public interest entities as the revenues earned also include auditing of non-public interest entities. Although no law requires that the audit or the review of the annual reports have to be conducted by Big4 auditing companies most of the public interest entities have chosen the Big4 companies to do the job.

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<sup>48</sup> The analysis is conducted by the authors on the transparency reports.

<sup>49</sup> The analysis is conducted by the authors on the transparency reports.



If we look at the substance of the annual reports then the research conducted in Estonia show that there are considerable differences between the audit quality of Big4 and non-Big4 companies. Kannistu (2008, 15) studied the annual reports of 15 Estonian companies from which 8 annual reports were audited by Big4 companies and 7 from non-Big4 companies. Important substantive errors, which include recognition of business transactions, appeared according to Kannistu (2008, 45) only in those annual reports, which were audited by non-Big4 companies.

Errors in disclosure, which means that the information required by the law to be disclosed was not disclosed or was disclosed partially, appeared in the annual reports audited both by Big4 and non-Big4 companies. Furthermore, there were more errors in the annual reports audited by non-Big4 companies (Kannistu 2008, 45). The most common mistake was the insufficient description of the accounting principles in the notes of the financial statements and the non-disclosure of the information for individually significant financial objects and transactions (Kannistu 2008, 42–43).

Raigla (2007) studied the information disclosed in the notes of the financial statements. Her sample consisted of 20 non-audited financial statements. With her research Raigla (2007, 49) wanted to show that the non-audited financial statements contain more errors and deficiencies than audited financial statements. The investigation revealed that the sampled annual reports did not use cross-references, the numerical values of notes and financial statements differed, the terminology used was insufficient, disclosed information on sales, taxes and other statement of financial position and income statement were often inadequate or even wrong (Raigla 2007, 49). Detected errors on non-audited annual reports were therefore even more extensive than those identified by Kannistu on audited annual reports.

The work performed by Raigla (2007) is supported by a study conducted by authorised public accountant Villems (2008), who also investigated the most common errors on the annual reports. According to Villems (2008, 182–184) the annual reports commonly do not include detailed notes for statement of income and cash flow. The review of accounting principles used is superficial and there are problems in how to reflect capital and operating leases.

According to the research conducted by the World Bank in 2004, the differences in technical proficiency of Estonian auditors result in significant differences in audit quality. High-quality audit delivery can be expected from select audit firms representing approximately 25 percent of profession (*Report on the...* 2004, 6). Furthermore, the research points out that although there is a significant improvement in the quality of public interest entities audit, the audit quality in SMEs lags behind. The reason behind it is that most sole practitioners and auditors employed in small audit firms do not have access to an audit practice manual. Lacking knowledge about how to apply ISAs many Estonian auditors only use Estonian auditing guidelines, albeit not properly (*Report on the...* 2004, 15). The authors are in the opinion of that in 2011, the situation has improved compared to the situation in 2004, as in 2010 the new Authorised Public Accountants Act was adopted. The new Authorised Public Accountants Act was developed based on the International Standards on Auditing (ISA). To retain their status as authorised public accountant all authorised public accountants have to retake the auditor's exam, which is based on the new auditing law and ISA's.

According to the investigation conducted by the World Bank and other researchers, one can expect higher quality from annual reports audited by international auditing companies. This suggests that the impact of Big4 companies to the financial statements presentation in Estonia is significant, as they audit the most of the Estonian public interest entities and therefore directly influence the preparation and presentation of the financial statements and the development of the Estonian accounting framework.

#### *4.3. Mimetic institutional pressure*

Mimetic institutional pressures refer to the copying and duplicating of successful organizational behaviour by other organizations (Powell and DiMaggio 1983, 151). This is mostly used in situations and conditions of uncertainty, when "institutional rules" are replaced by "technical rules", in this case the organization will decide to mimic similar, larger, or more successful organizations. Organisations, as humans, want to be seen as socially acceptable, and not as outsiders. So, the more organizations behave in a certain manner and practice certain procedures, the more pressure there will be on other organizations to copy these behaviours and follow in the same path (Al-Omari 2010, 39).

The mimetic view therefore stresses conformity with orthodox structures and identity, particularly in times of uncertainty. As successful multinational corporations have expanded their "global reach", they have instituted sophisticated systems of "financial coordination" of their subsidiaries and have modelled to other organizations the desirability of the global harmonization of financial reporting. Intimately connected with the regulatory regimes of the dominant nation states, they have reinforced the desirability, for developing and emerging economies, of conformity with the practices both of multinational corporations and of nations' trading partners (Irvine 2007, 134).

The collapse of Soviet Union in the early 1990s marked the breakdown of centrally planned economy and the need for a new business model in Central and Eastern Europe, including in Estonia. In the transformation process, Estonia directed its course from centrally planned economy to the market economy. This required significant changes in the legislation (including in the accounting standards) and in the structures and working principles of different organizations and entities. Because the rest of the world already had had "an experience" in the market economy, it was easier to copy the traditions and practices of entities already operating in the market economy environment, then to come up with something new. This was supported by the formation of branches of international corporations in Estonia right after becoming independent. Examples include the formation of international fuel company Statoil in 1991, the opening of the branch of PricewaterhouseCoopers – an international auditing company – in 1992, or, the arrival of international food chain McDonalds in 1995. Because all these international companies had decades of experience in working at the international level their practices and know-how had been proven to be successful. Therefore, the structures and working principles established at the international level were applied in the Estonian branches.

Although Powell and DiMaggio (1983, 151) see subsidiaries adopting accounting practices, performance evaluations and budgetary plans of the parent corporation as a coercive institutional pressure, it may be argued that in Estonia, one can witness both – coercive and mimetic institutional pressure. Mimetic institutional pressure takes place, when entities founded upon the Estonian capital, acknowledge the success of the structures and working principles of the branches of international corporations, want to become socially legitimate as well and therefore copy the activities of these branches. This process takes, according to Powell and DiMaggio (1983, 151), place in the environment of uncertainty, and the collapse of the Soviet Union and the transformation from centrally planned to the market economy, definitely was an uncertain period in the history of Estonia. One example of this kind of behaviour is Alexela Oil, a fuel company founded upon the Estonian capital that in close-up copied the business model of Statoil.

Nowadays, the trend to copy the structures, customs and outputs of the international companies, has not disappeared. This is supported by the tax policy of Estonia. To increase the amount of direct investments made to Estonia, the Estonian government changed the Income Tax Act from January 1, 2000. With the amended law, the entities operating in Estonia only have to pay the income tax on profit when it is distributed not earned (Rohtsalu 2002).

The created tax environment furthermore promoted the establishment of new international branches in Estonia. The “immigration” of organizations increased even more after Estonia joined with the EU. This gave more confidence about the economic environment in Estonia to the international corporations, which was from that moment forward subject to the common practises and regulations of EU. Nowadays, when the key to the financial success and a way out of the economical recession seems to be export, it is inevitable and essential to conform to the requirements of international trading partners.

Barbu *et al.* (2010, 221) considers different local accounting standards-setting bodies in various countries to be an evidence of mimetic isomorphism as they have adopted structures and procedures similar to those of the IASB and FASB. The authors believe that it is possible to draw parallels between the standard setting processes of EASB and IASB. The purpose of EASB is to draft accounting standards that clarify and elaborate the Estonian Accounting Act, introduce the Estonian GAAP and to guide the accounting activities in Estonia (EASB homepage). The IASB operates on a similar basis. Its purpose is to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards, to promote the use and rigorous application of those standards and to bring about convergence of national accounting standards and IFRSs to high quality solutions (IASB homepage). The standard development process is also similar for the two organizations – EASB announces the drafts of the new standards and the standards already accepted at its web-page. The acceptance of the new standards is decided with the majority votes<sup>50</sup>.

To conclude, the development of the Estonian GAAP is from one side influenced by coercive institutional pressure – EASB follows IFRSs when drafting the EAS’s. On the other hand, this kind of behaviour is directly influenced by mimetic institutional pressure, because during the standard setting process, EASB copies the practices of IASB.

## 5. DISCUSSION

As coercive, normative and mimetic institutional pressures are viewed differently by many authors it is vital to determine which pressures are influencing the development of the Estonian accounting system taking into consideration the accounting history of Estonia, the openness to the global processes and participation in the international capital market.

The results of the authors’s research showed that in the context of coercive institutional pressure, the development of the accounting legislation in Estonia has been the most influenced by the **IFRSs** developed by IASB. These standards have been incorporated to the legislation of EU although, some differences between the IFRSs issued by IASB and the IFRSs adopted by EU, exist. As Estonia is the member country of EU, the effect of the EU legislation to the Estonian standards setting process and Estonian Accounting Act seems to be quite clear. However, in the light of the recent events, it seems that Estonia has the opportunity to follow its own way when deciding which accounting principles to apply to micro-enterprises and small- and medium-size entities. Therefore, it will be interesting to follow, whether the coercive pressures from IASB or EU (or both) will determine the future accounting legislation for most of the Estonian entities.

Normative institutional pressures, affecting the development of the Estonian accounting system, are the Big4 auditing companies. They audit most of the public interest entities in Estonia and can

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<sup>50</sup> To pass an EAS, 4 out of 7 votes are needed (57%). To pass an IFRS, 4 out of 7 votes are needed (60%).

therefore influence the preparation and presentation of their financial statements. The authors are in the opinion of that further research in this area is needed to confirm or exclude the normative institutional pressure. This can be done by comparing the annual reports audited by Big4 and non-Big4 companies. The analysis should be conducted in a way that does not only point out the variations from the existing law, but also points out the aspects that are disclosed “voluntarily” and that are common to all Big4 companies.

Firstly, international corporations, which structures and practises were copied by the Estonian entities after the collapse of the centrally planned economy in 1990s, can be viewed in the context of mimetic institutional pressure. Secondly, the trading partners of the Estonian companies, whose requirements have to be met in order to increase the export, can be viewed as a mimetic institutional pressure. Mimetic institutional pressure does not only appear in the context of business, where entities copy the practices of successful multinational corporations. This copying of the structures and practices also happens, when EASB follows the same working principles and processes as IASB.

The example of Estonia shows that the harmonization process of international financial reporting standards is unstoppable (and inevitable) and countries, who want to be successful in the international capital markets, have to be compatible with different institutional pressures.

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**THE DETERMINANTS OF INNOVATION ACTIVITIES: EVIDENCE FROM MACEDONIA**

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**Abstract**

*In today's world, the role of innovation is attracting massive attention. There are several empirical and theoretical literature that have attempted to identify factors that prevent South-East European countries from catching up with more developed ones. The aim of this study is to empirically investigate the determinants of innovation activities undertaken by a sample of firms in Macedonia for the period 2000-2010. To examine its validity we will develop a model relating the determinants of innovation such as the impact of ownership structure, firm performance, competition from other firms, sector, location, age, size and other firm characteristics and apply it to the dataset of 60 surveyed firms in ten years. The main contribution of this empirical work is reflected in the application of advanced econometric techniques such as Instrumental Variable (IV) to the analysis of the determinants of innovation activities. By investigating this relationship we provide sufficient evidence to support the view of significant innovation-performance relationship of firms in Macedonia. Furthermore, the results indicate that in Macedonia the ownership structure (be it diffused or concentrated), ownership nationality, firm performance and other firm characteristics have impact on innovation activities.*

**Key words:** *innovation activities, productivity, ownership, instrumental variable (IV)*

**1. INTRODUCTION**

Based on the statistics where US experienced increasing average annual labour productivity from 1.2 percent in the 1973-1995 period to 2.3 percent from 1995 to 2006, whereas in 15 EU countries (members up to 2004) occurs productivity growth slowdown with annual rate of 2.4 percent in the 1973-1995 period to 1.5 percent from 1995 to 2006 one can say that there is evidence for US experiencing higher labour productivity growth than EU (Ark et al., 2008). Several studies have shown that the US increase in labour productivity is attributable to intensive development of innovation activities (O'Mahony et al., 2010; Crescenzi and Rodriguez-Pose, 2011). In order to increase the innovation activities undertaken by firms in the EU the Lisbon Strategy set a goal for Europe to become "the world's most competitive and dynamic knowledge-based economy in the world, capable of sustaining growth with more and better jobs and greater social cohesion" by 2010. This aspiration also presents the first priority area of the 'Europe 2020' Strategy, which is 'smart growth' through the development of knowledge, innovation, and education (EC, 2010). Accordingly, EU has set itself an ambitious target - the Barcelona objective - of increasing R&D expenditures to 3 per cent of GDP in particular by improving the conditions for R&D investment by the private sector, and developing a new indicator to track innovation (EC, 2010). In order for accomplishing these goals the OECD has prepared an 'innovation strategy', containing the following major themes: i) the



“openness” of innovation; ii) the central role of entrepreneurship; iii) creating and applying knowledge; iv) applying innovation to address global and social challenges; and v) improving the governance of policies for innovation.

The literature on the relationship between innovation activities and firm performance (henceforth innovation-performance relationship) varies on different ways of defining innovation and on the measures employed, with challenges faced related to the problem of finding relevant variables for measuring innovation activities. The most often employed measures in the empirical literature are: R&D expenditure – as a measure of input; patents - as a measure of output; and introducing new product/ new process - as output accepted by the market. Further we investigate the empirical evidence on the relationship between innovation activities and firm performance. The main focus is on the data and methodology used in these studies. This stream of literature mainly applies structural approach for modelling innovation.

For the purpose of the paper we empirically investigate the innovation-performance relationship. A dataset derived from the authors survey on a sample of privatised firms in Macedonia is employed, and we apply instrumental variable technique.

The structure of the paper is as follows. In the next section we review the literature related with the innovation-performance relationship, with main focus on the model and the determinants of innovation activity. Section 3 elaborates the sample and the data. Section 4 considers the methods of investigation and the empirical estimations. The interpretation of the results is provided in section 5. Section 6 concludes the study.

## 2. LITERATURE REVIEW ON INNOVATION AND PERFORMANCE

The empirical literature on investigating innovative behaviour and its effect on firm performance face two major methodological challenges: (i) of how to measure innovation or technological change and (ii) with estimation technique to apply for taking into consideration the endogeneity problem. The first methodological challenge is accompanied with the difficulty of getting appropriate data which correspond to the definition of innovation. Consequently the empirical studies have mainly adjusted their analysis of innovation depending on available measure of innovation, by using proxies which reflect some aspects of the innovation process.

In defining innovation activities undertaken by companies most of the empirical evidence follows Joseph Schumpeter, who defined innovation in a broad sense, as (1934, p.66): “carrying out of new combinations” that include “*the introduction of new goods (...), new methods of production (...), the opening of new markets (...), the conquest of new sources of supply (...) and the carrying out of a new organization of any industry*”. He was the first to develop a three-stage classification: invention, innovation and diffusion, known as Schumpeterian trichotomy (Jaffe et al., 2004; pp. 63). Innovation in the Schumpeterian scheme encompasses one of the three stages, however it is often used broadly to refer to all stages of the technological change process.

Following Schumpeter’s definition of innovation activities, most of the empirical literature defines innovation as the development of new products and/or new processes introduced to the market. OECD (2005) Oslo manual guiding the collection of data on innovation reflects this perspective by defining innovation as: “... the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organisational method in business practices, workplace organisation or external relations (p. 46). An alternative definition of innovation adopted more

recently by policymakers in the UK and also applied in the literature (Stoneman, 2010; Battisti et al., 2011) regards innovation as the 'successful exploitation of new ideas'. If this is scrutinised further (i) new ideas – involve new product/process or service, (ii) exploitation – presents the applicability of the idea, (iii) successful – implies that the innovation is adapted by the market (from firm level viewpoint the target is increased profitability).

Based on these definitions, the most common measures used in the literature for analysing the innovative process are as follows: i) a measure of the inputs into the innovative process, such as R&D expenditure, ii) an intermediate output, such as the number of inventions which have been patented, and iii) a direct measure of innovative output, new product or new process. These proxy measures for the innovation process have their limitations. Not all R&D expenditures end in innovation output since this measure reflects only the resources committed to producing innovative output, but not the innovative process. The number of patents does not indicate whether this output has a positive economic value or whether it has successfully been introduced in the market. Whereas the new product and/or process is acknowledged as a proxy that directly quantifies the effect of innovation and its success in the market.

Considering the other methodological challenge, one can put it into two dimensions: (i) the determinants of innovation and the impact of size and market structure on the process, and (ii) the impact of innovation on productivity, firm performance and economic welfare (Stoneman, 2010).

Schumpeter (1928, 1942) developed the ideas on which most of the theoretical and empirical analyses of the economics of innovation are based. His theoretical framework on the relationship between firm size and dynamic market performance is characterised with two contradicting waves. According to Schumpeter Mark I of *The Theory of economic Development*, it is the new (often small) firm that carry out innovation (1934, p.66). According to the second fundamentally different view, Schumpeter Mark II of *Capitalism, Socialism, and Democracy*, it is the established (large) firm that generates technological progress (1943, p.82).

Another determinant related to the Schumpeterian hypothesis is the market structure, indicating positive relationship between innovation and monopoly power. According to him monopolists, compared to competitive firms, have stronger incentives to innovate because of the gains captured without being imitated by rivals. Schumpeter's theory was supported by Galbraith (1952) saying that inventions are costly and only large firms with monopoly power have the necessary resources for undertaking them.

The first economist who contradicts the Schumpeterian view that monopoly stimulates innovation is Arrow (1962). He indicates that firms operating in a competitive market have stronger profit related incentive to innovate than monopolist. This is so because of what Arrow called the 'replacement effect' i.e. an innovative monopolist replaces one profitable investment with another, therefore has less incentives for undertaking changes. Furthermore, innovation yields greater net profit in a perfectly competitive industry than in monopoly because: the payoff to innovation for the monopolist is the additional monopoly profit from the new product or process compared to the gains with the existing technology; whereas the payoff to innovation for the innovating firm in a competitive industry is the net gain of the all profit that flows from successful innovation.

Guided by the Schumpeterian theories, the literature on innovation activities has mainly focused on empirically investigating the impact of market structure and firm size on innovation activities undertaken by firm. There are numerous surveys summarising the findings of this stream of literature

(Kamien and Schwartz, 1982; Scherer, 1980, Baldwin and Scott, 1987; Cohen and Levin, 1989 and Symeonidis, 1996) but they come to inconclusive results.

The findings of the empirical literature summarising the evidence on the impact of market structure and firm size on innovation point out two main hypotheses regarding innovation: (i) large firms tend to have higher innovation activities, and (ii) highly concentrated markets (characterised by imperfect competition) are more conducive to technical change. Cohen and Levin (1989) outline some arguments for large firms being more innovative: i) they can use internal funds to finance the risky R&D activities; ii) they have advantage in financial markets for getting additional sources to finance their innovation activities; iii) they may better exploit economies of scale and scope in R&D activities; iv) they are able to spread fixed costs of innovation over higher levels of sales, and so on.

Earlier studies found support for the Schumpeterian hypothesis that large size companies tend to have higher R&D intensity (Galbraith, 1952). Scherer (1965a, 1965b) evidenced that the relationship between R&D intensity and sales is an inverted U shape. Some other studies obtained similar results to Scherer (Malecki, 1980 and Link, 1981), or even negative relationship between R&D and size (Kamien and Schwartz, 1982). Cohen and Klepper (1996) put forward somehow different conclusion compared to previous studies that large firms are characterised with higher investment in innovation and are more engaged in innovation activities, however innovation output diminishes with firm size.

Considering the second hypothesis, the literature on the innovation-market structure relationship is broad and inconclusive. Symeonidis (1996) expects that R&D intensity will be higher in companies with higher market power because: (i) they will have higher levels of cash flows thus can use profits to finance their R&D activities; and (ii) they are more advanced in appropriating the returns from innovation since they are in better position to benefit from patents, therefore have higher incentives to innovate. The empirical evidence on the innovation-market structure relationship (Farber, 1981; Geroski, 1990; Scherer and Huh, 1992) has generally concluded that the relationship between innovative output and market structure shows weak positive results. This is also confirmed by Aghion et al.'s (2002) study of innovation in transition economies which concluded that new firms drive innovation and that for these firms competitive pressures raise innovation.

More recent literature on innovation has moved toward identifying appropriate models to empirically investigate the technological change. The innovation-performance relationship has been a matter of significant interest among researchers for some period. The more recent literature has enriched the models used for empirically investigating such relationship. The most common way found in the literature for modelling the relationship between innovation activities and firm performance is the multistage approach.

The growing power of simulation techniques has had its impact on the numerous recent studies (Loof and Heshmati, 2006; Griffith et al., 2006; Damijan et al., 2008) which apply similar model to Crepon et al. (1998) known as the CDM model, named according to the three authors Crépon, Duguet and Mairesse. It is a structural model with four stages following the basic form as whether firms would invest in innovation or not; then they decide how much effort to put into innovation; then knowledge is produced as a result of this investment and output is produced using knowledge. This model is formalized in four equations: i) the firm's decision to engage in sufficient effort to result in observable R&D investment; ii) the intensity with which the firm undertakes R&D; iii) the innovation or knowledge production function; and iv) the output production function, where knowledge is an input. By employing the CDM model the most recent studies tend to control for the endogeneity of innovation.

Hall and Mairesse (2006) summarize papers that have employed similar models to CDM for their analysis of innovation. They conclude that important progress has been done in modelling and employing appropriate econometric estimation methods by using innovation survey data. They emphasize that better results are obtained when researchers combine the survey data with census-type information on the accounting data of the firms, which enables the measurement of final outcomes in the form of profitability and productivity. Most of these studies provide positive impact of innovation on productivity growth.

### 3. STATISTICAL OVERVIEW OF THE OVERALL SAMPLE

For the empirical analysis of this study we employ primary firm-level panel data for 60 privatised firms in Macedonia for the period 2001-2010 (for more details on the Privatised Enterprise Survey in Macedonia (PESM) 2011 data see section 3.2.1). The panel dataset of 60 firms in ten years is consisted of two types of variables, i) time-invariant – the questionnaire variables and ii) time-variant – the financial statements of the firms and their ownership evolution in ten years. This section provides the definition of the variables employed in the model such as labour productivity, net profit margin, total asset, ownership variables, restructuring, innovation, size, etc. Table 4.3 gives the definition of the variables included in the empirical work.

<b>Performance Indicators</b>	
Labour Productivity	Sales to number of employees ratio (in logs)
Net Profit Margin	Profit to sales ratio (in logs)
<b>Ownership variables</b>	
Ownership structure	Shares of the 1st largest owner and share of the three largest owners
Absolute Dominance	= 1 if 1st largest owner owns >50%; 0 otherwise
Monitored Dominance	= 1 if 1st largest owner owns >50% and others >10%; 0 otherwise
Jointly Controlling Minority	= 1 if 1st, 2nd and/or 3rd owners together own >50%; 0 otherwise
Dispersed Ownership	= 1 if none of the shareholders own >10%; 0 otherwise
Domestic Macedonian	=1 if the dominant owner is ethnic Macedonian; 0 otherwise
Domestic Albanian	=1 if the dominant owner is ethnic Albanian; 0 otherwise
Foreign Owner	=1 if the dominant owner is foreign investor; 0 otherwise
Individual	=1 if the dominant owner is individual; 0 otherwise (company)
<b>Firm Characteristics</b>	
Innovation Activities	= 1 if firms have introduced new product/process after privatisation; 0 otherwise
Size	Number of employees
Age	Year of establishment subtracted from the current year
Sector	4digit NACE industry

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Capital Intensity	Fixed asset to number of employees ratio
Depreciation	Balance sheet value in years
Leverage	Debt ratio
Total assets turnover	Sales to average total assets ratio
Volatility of Firms' Environment	Standard deviation of ROA
Year since Privatisation	The year of privatisation is subtracted from the current year

Table 1 Definition of the variables

We now continue with the descriptive statistics of the financial data and the relationship between the firm performance indicators and different firm characteristics. Table 4.4 provides an overview on the development of the financial variables through years. One can notice that labour productivity increases through time with the highest point reached in 2008. The average of net profit margin remains negative through the years of analysis. Considering the average capital intensity one can notice that it has a continuously increased with an increase of about 68% for the period under analysis. The leverage has also increased over time.

Year		Labour Productivity (in millions of denars)	Capital Intensity (in millions of denars)	Net Profit Margin (%)	Leverage	Total Assets Turnover
2001	Average	2.6	1.4	-3.1	2.9	.89
	No of obs	54	54	55	55	54
2002	Average	2.9	1.9	1.0	5.3	.86
	No of obs	55	55	55	55	55
2003	Average	3.0	1.8	-9.4	11.4	.81
	No of obs	55	56	56	56	56
2004	Average	3.0	2.1	-6.6	15.3	.82
	No of obs	57	57	57	57	57
2005	Average	3.6	2.2	-9.6	18.1	1.09
	No of obs	58	58	58	58	58
2006	Average	4.9	2.4	-9.3	12.1	.84
	No of obs	57	57	58	58	57
2007	Average	4.6	3.4	-285.0	13.2	.92
	No of obs	57	57	57	57	56
2008	Average	5.6	3.9	-23.6	34.6	.79
	No of obs	56	56	57	57	56

2009	Average	4.5	4.2	-34.8	16.7	.79
	No of obs	56	57	57	58	56
2010	Average	4.9	4.5	-65.4	83.7	.90
	No of obs	57	57	57	57	57
2001-2010	Average	4.0	2.8	-62.4	21.4	.88
	No of obs	563	564	567	568	506

Table 2 Average values of the financial variables, 2001-10

The following figures present some cross tabulations of firm characteristics and how they are related to firm performance. Figure 1 shows the relationship between the product and/or process innovation and the aggregates created for the manufacturing and service industry, regarding their labour productivity.

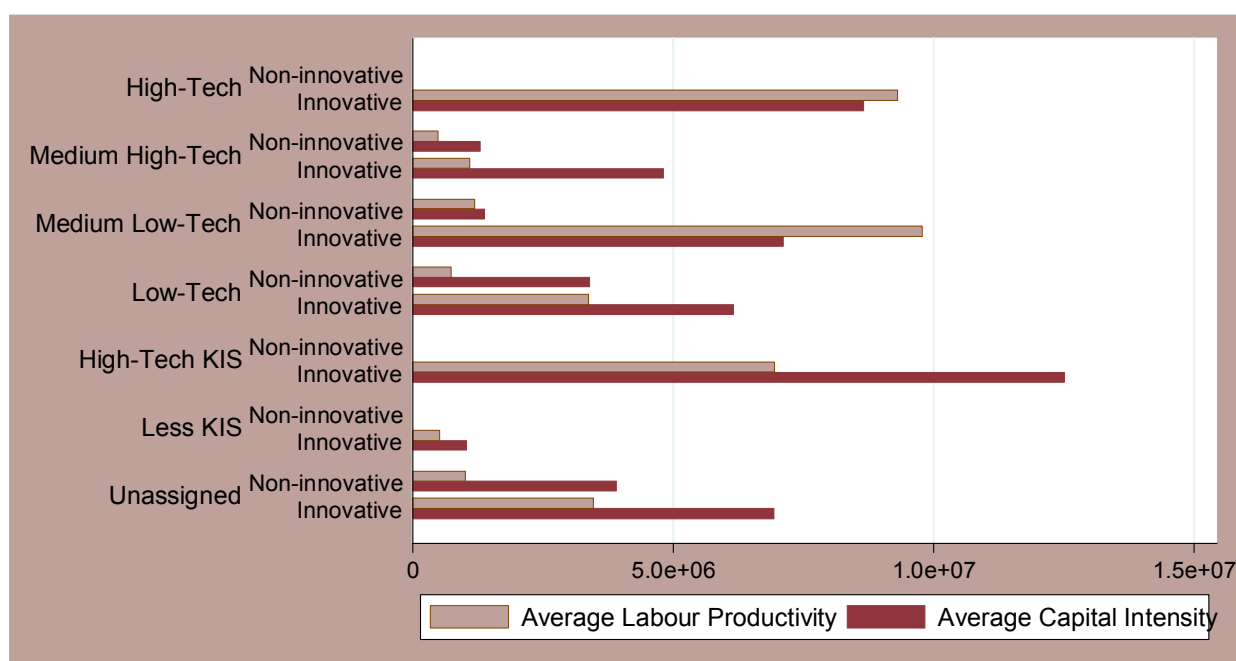


Figure 1 Labour productivity and innovativeness by technological intensity of firms

According to the technological intensity of the industry in which the firms belong, both innovative manufacturing and knowledge intensive service (KIS) firms' in the group of high-technology show to perform better than the other firms. Furthermore, they show to have higher average capital intensity compared to the other firms. Another relevant notice is that there are no non-innovative firms that

belong to the high-technology and high-tech KIS industry. Basically innovative firms are performing better than non-innovative ones.

Figure 2 presents how the firms' size and innovativeness are related to ownership concentration and what is their performance (labour productivity). As it can be noticed, large and innovative firms show to have higher concentration (absolute dominance) and perform better than small and medium firms. Further, all the firms that have indicated to introduce new product and/or process after the period of privatisation show to have more concentrated ownership and perform better than firms that have not.

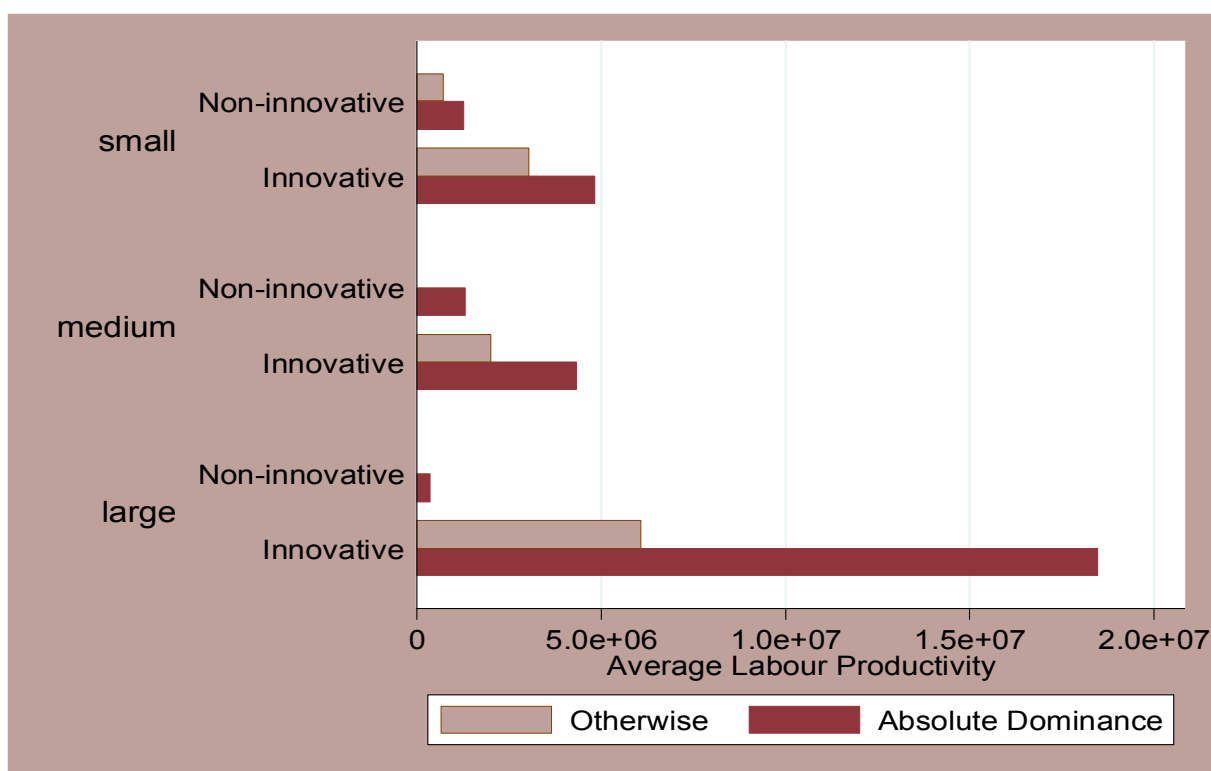


Figure 2 Firms' performance and innovativeness by size and ownership concentration

We considered the statistical overview of the overall sample, with special emphasis on the performance indicators and the firm characteristic variables that are going to be employed in the model. Generally we noticed that better performing are (i) large firms that (ii) have undertaken innovation activities, with (iii) absolute dominance and which (iv) belong to high-technology (for manufacturing sector) and high KIS (for service sector). In the next section we continue with the statistical overview of the evolution of ownership. Two different dimensions of the process of evolution of ownership are analysed: (i) concentration of ownership and (ii) the type of the dominant owners (discussed in the literature review of chapter one).

#### 4. DETERMINANTS OF OWNERSHIP STRUCTURE

The concept presented in this article of implementing the principles of sustainability into strategic management is coherent with the natural evolution of the discipline towards more humanistic management practices. It is founded on many noted management theories such as corporate social responsibility or participation management. Sustainable strategic management as a concept is one proposition companies may find useful when confronted with complexity and instability of their environment. This section examines the relationship between innovation activities and its determinants such as firm performance, ownership structure, type of owners and other firm characteristics. The empirical model of the following form is estimated:

$$Innovation_{it} = \alpha_{it} + \beta_1 Performance_{it} + \beta_2 Ownership Structure_{it} + \sum_{k=1}^2 \delta_k DTypeOwn_{kit} + \sum_{j=1}^m \gamma_j X_{jit} + \varepsilon_{it}$$

The innovation variable reflects the state whether the firm has introduced new or significantly improved product and/or process after the privatisation process. Performance is measured by natural logarithm of (i) labour productivity and (ii) net profit margin. Ownership structure stands for natural logarithm of (i) the share of the largest owner (LogC1). *DTypeOwn* are dummy variables of the dominant owner being (i) Macedonian, (ii) Albanian or (iii) foreign investor. For the surveyed firms we can also distinguish between the type of firm with respect to corporations and individuals. Under X are all other firm characteristics that determine firms' ownership concentration such as size, age, leverage, and so one.

Model	IV/2SLS	2 step-GMM kernel	CUE estimation
<i>Independent Variables</i>	<i>Dependent Variable: INNOV</i>		
<i>LNLP</i>	1.00*** (0.167)	1.01*** (0.296)	1.01*** (0.174)
<i>LC1</i>	-1.32*** (0.247)	-1.33*** (0.407)	-1.33*** (0.259)
<i>Dommac</i>	-1.37*** (0.231)	-1.38*** (0.406)	-1.38*** (0.207)
<i>FRGN</i>	-0.58 (0.362)	-0.58 (0.613)	-0.59* (0.319)
<i>INDIVIDUAL</i>	-0.92*** (0.162)	-0.92*** (0.281)	-0.93*** (0.155)
<i>size</i>	2.89*** (0.635)	2.87*** (1.068)	2.89*** (0.649)
<i>size2</i>	-0.76*** (0.154)	-0.75*** (0.273)	-0.76*** (0.160)
<i>LNAGE</i>	-21.33*** (2.141)	-21.35*** (4.050)	-21.44*** (2.226)
<i>LNAGE2</i>	2.95*** (0.294)	2.96*** (0.572)	2.97*** (0.312)
<i>LNCI</i>	-4.23*** (1.541)	-4.12 (2.848)	-4.18** (1.764)
<i>LNCI2</i>	0.15*** (0.053)	0.15 (0.099)	0.15** (0.062)
<i>LEVERAGE</i>	0.02 (0.123)	0.02 (0.167)	0.01 (0.102)
<i>StROA</i>	-0.01 (0.121)	-0.01 (0.111)	-0.01 (0.118)
<i>YsinceP</i>	0.00 (0.015)	0.00 (0.029)	-0.00 (0.017)



<i>FacRinn</i>	0.52*** (0.086)	0.52*** (0.171)	0.52*** (0.088)
<i>HighTech</i>	-4.01*** (0.456)	-4.01*** (0.754)	-4.00*** (0.390)
<i>MedHTech</i>	-1.01*** (0.359)	-1.00* (0.560)	-1.00*** (0.315)
<i>MedLTech</i>	-0.62*** (0.237)	-0.63 (0.478)	-0.63** (0.256)
<i>HTKIS</i>	-2.09*** (0.601)	-2.08*** (0.773)	-2.09*** (0.434)
<i>Instruments:</i>			
<i>LNdep</i>	√	√	√
<i>ManAGE</i>	√	√	√
<i>Observations</i>	393	393	393
<i>R-squared</i>	0.476	0.475	0.476
<i>Adjusted R-squared</i>	0.449	0.448	0.439
<i>F statistic</i>	20.59	10.36	22.28
<i>Cragg-Donald Wald F statistic</i>	66.28	18.19	45.02

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Table 4.7 Determinants of innovation activities in different models [dependent variable: undertaking innovation activities]

The F-test of the overall significance of all coefficients shows that the coefficients are jointly different from zero. The correlation matrix shows that all the correlation coefficients are small (see Appendix VII). We can now discuss the significance of the coefficients and their impact on the level of ownership concentration.

## 5. CONCLUSIONS

This study critically reviews the empirical literature on innovation-performance relationship. The main focus is on the determinants of innovation and the methodology employed in the innovation literature. Following the applied methodology, this paper continues with the empirical investigation of the determinants of innovation, and their impact on firm performance.

From the review of the empirical evidence on innovation activities, one can come to the conclusion that the measurements of innovation variables that are most commonly employed are related with the Schumpeterian definition of innovation. In other words whether the firms have introduced new product or have changed new production line is an indicator for the firm to be innovative. Based on the definition there are also studies that have employed a measure of input such as R&D intensity of the firm, or measure of output such as patents. However, these measurement are criticized in the literature as they do not indicate whether they enhance firm performance or whether they have been successfully introduced in the market.

Another challenge faced by the literature on innovation is related to the determinants of the innovation activities. Following the Schumpeterian hypothesis on the relationship between the size of the firm

and the market structure, these determinants are most often employed in the innovative behaviour models. The most recent literature extends these models by incorporating other factors such as ownership structure, human capital development, export intensity, availability of financial resources and other firm-level characteristics.

Considering the methodology employed for the empirical estimation of the innovation activities model, the simulation techniques or structural models are the most often used in the literature. However, because of the specific data necessary for estimating the four stage model (the CDM model) some of the studies have applied part of the stages depending on the data availability.

The empirical investigation on the determinants of innovation activities is conducted using the survey on the privatised enterprises in Macedonia. The first model presents the probability of the firms to innovate (probit model) which reveals the determinants of firms' innovation activity.

The general findings for the probit model indicate that size, foreign ownership, foreign competition pressure, the share of employees with university degree and export intensity are significant determinants and positively affect the firms innovative activities.

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**ACCOUNTING EVALUATION PROCEDURES AND COMPANY GROWTH**

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**Abstract**

*In Hungary, the Accounting Law highlights the accounting liability, that is to receive a reliable, genuine and real statement about the activities of a given business entity. That's why it is necessary to apply the principles and rules of assessment determined in legal regulations regarding the compiling of financial report and accounting.*

*In the frames of accounting, the corporation shall permanently keep records about the economic events occurring in the course of business activities and influencing its property, financial and income situation. Therefore it is necessary that the mid-year and year-end tasks are performed according to the principles and applicable evaluation procedures because only these can ensure reliable and comparable information for the business stakeholders, as well as the direction and degree of company growth can be revealed in its reality and complexity.*

**Key words:** *accounting principles, evaluation procedures, reliability,*

**1. INTRODUCTION**

The introduction of market economy has laid the claim that those involved in business provide and receive real data about their activities. It is inevitable to make annual reports which give a lot of information about the situation of the firm in question. Balance sheets, financial reports and added notes help to analyse past events, and tendencies can be set up if there are enough time series for effecting the examination. In addition to this, we are also able to determine the future tasks because we can see the weaknesses and strengths of the company. Moreover, the progress of the firm will also be obvious regarding the growth, as well as the pace of growth. Thus we can have a clear picture about the earning capacity value.

Accounting, as an information system, has been implemented as a tool to measure the business activities. Within bookkeeping activities this system records the events affecting the property and income of the business unit, as well as the assets evaluated at the end of the year. Those involved in market require accessible, reliable and actual information about the property, financial and income situation and changes of firms in order to base their decisions. The internationally applied accounting principles ensure the above requirements in the economic and business sector. In Hungary these principles were laid down in the Accounting Act No. C of 2000, which also contains the rules of evaluating balance sheet items. [HELGERTNÉ-KURCSINKA 2004] These can significantly affect the output of the report therefore they have key role in compiling the annual financial report.

Due to globalization, those concerned urgently needed to harmonize accounting, the common language of business management. In Hungary, the Act No. C of 2000 regulates accounting. This Act

lays down those accounting rules which correspond to the principles of the European Union regarding this field, considers the international accounting principles and on the basis of which, reliable and real picture can be provided about the earning capacity, property, property changes, financial situation and future plans of those subjected to this law. [www.net.jogtar.hu]

That's why the accounting principles set up in the legal regulations and the processes connected with evaluation (depreciation, amortization, etc.) should be enforced and strictly observed within bookkeeping activities, too. Departing from accounting principles is possible but in the way laid down by the law, as it also stresses their importance. The evaluation of balance sheet items should be made carefully which means that all the depreciation and amortization shall be recorded in the books which concern the properties existing on the sheet date and become known until the date of compiling the balance.

In the report among the evaluation rules of balance sheet items there are some generally applied principles fixed by the accounting law which concern all the sub-regulations of evaluation, both in the determination of asset cost (purchase, production), and in their permanent mid-year evaluation as well as in measuring the value of assets or liabilities in the balance sheet. These principles are as follows:

- the evaluation should start from the *principle of continuity*,
- *the principle of consistency* should be considered in the statements applied in consecutive business years,
- the assets and liabilities should be evaluated one by one on the basis of specific valuation principle, considering also the special areas where the *specific valuation principle* is valid,
- when evaluating the balance sheet items, all kinds of depreciation or amortization should be considered which concern the assets existing on the sheet date and become known until the day (date) of preparing the balance sheet. (FRIDRICH et al. 2006)

As regards the application of principal, frame-like rules of accounting, compiling the financial report and bookkeeping, all the companies should develop the rules of methods and processes - on the basis of accounting principles and evaluation instructions -which suit their circumstances and financial processes the best and are required for the practical implementation of accounting. [KOROM et. al. 2005] The accounting system formed and operated this way ensures the real economic content of information and provides real and actual data for decision making by stakeholders mostly in the interest of company growth.

The regulations of accounting law should be observed therefore own accounting policy should be developed to operate the accounting information system, as well as a company accounts system to assist bookkeeping. The accounting policy consists of methods, tools and processes required for the practical implementation of the law, on the basis of principles and instructions for evaluation. This policy ensures the development and operation of an accounting system which meets the conditions of the firm the best. It is compulsory to put it in writing. Its objective is to provide a system for the company, on the basis of which the data and information of annual reports will be reliable and actual. These requirements, however, can be met only if the bookkeeping system of the company correspond to the regulations of the accounting principles and accounting law concerning bookkeeping and accounting vouchers. [KOROM et al 2005]

Accounting should provide information in different structure and depth and different time intervals about the property of the company, the changes regarding the property and the impacts of property changes. Accounting can perform its task – meet the requirements – if completely describes, tracks

and communicates the changes in the property of the company and their impacts, independently from the demands. [BARICZ 2009]

Evaluation is one of the key parts of preparing the report, because „in addition to introduce the property at its value, basically determines the picture about the earning capacity of the company. The profit of the company is the countervalue of output reduced by the value of output according to books.” [KOROM et al 2005] It is obvious that the profit of a company is significantly influenced by the mid-year and year-end evaluations of specific types of property, through which the values are absolutely reliable (and prudent) and reflect real values.

So the point in accounting is that the exact date of the event should be recorded, its subject should be shortly drafted and the relevant feature from the aspect of observation should be noted. The joint feature of economic events is that they can be described not only by quantity criteria, but also in terms of money. [LAÁB 2006] Since they can be expressed in money value, the degree and pace of company growth can be tracked by comparing the different terms. In this regard, it is necessary to prepare the evaluation in case of each balance sheet item according to the reality, that is by enforcing the principle of sincerity.

## 2. EVALUATION OF FIXED ASSETS

The evaluation processes applied in Hungary are strongly affected, determined by the existing principles which influence bookkeeping in its totality. So the evaluation processes have been formed by considering the principles.

In Hungary, the appreciation emerges as a liability in the settlements from January 2001. In the previous time, it was only a possibility. Another novelty that appreciation is extended on inventories, too.

Value adjustment can be applied only in case of fixed assets. The Act No C of 2000 enables reversal in those cases when previously depreciation was accounted for fixed assets (extraordinary depreciation) and inventories, then it came out that the market value of the balance sheet item is higher than the depreciated value shown in books. It is very important to note that in case of intangible assets and tangible assets it is not amortization (depreciation as planned) but extraordinary depreciation.

In case of extraordinary depreciation and loss in value, the profit before tax is decreased because these economic events are recorded among the other expenses. On the basis of this, even the tax liability can be lower. Of course, it cannot be regarded true in all cases because depreciation is an item which increases corporate tax base in Hungary while its reversal decreases the tax base. So the reversal appears in bookkeeping as other revenue, and the reversed depreciation of receivables reduces the tax base.

It is clear that during the evaluation procedures, when an economic event is recorded, either the assets and liabilities side of the balance will change, or a balance sheet item and a factor affecting the profit. This latter have a role in defining the company growth.

The present paper introduces mainly the evaluation of available fixed assets, according to the following table:

IMPACT ON VALUE	DEFINITION OF ECONOMIC EVENT
	<b>COST</b>
-	Depreciation as planned
-	Extraordinary depreciation/Loss in value
+	Reversal of extraordinary depreciation / Reversal of loss in value
+/-	Exchange rate difference from the year-end evaluation of assets in foreign currency value
	<b>BALANCE SHEET VALUE</b>
+	Value adjustment
-	Reversal of value adjustment
	<b>MARKET VALUE</b>

**Figure 1.** Accounting evaluation of fixed assets

Source: own work

There are a lot of assets in the life of companies for shorter and longer terms. Assets are the elements of company property and consist of material and immaterial goods. These goods are recorded at their cost when they are obtained or purchased (apart from some extra cases). So they are activated at this cost. When the balance sheet is prepared, the assets should be evaluated individually on the basis of individual assessment, which means that all kinds of depreciation, amortization should be considered which concern the assets existing on the sheet date and become known until the date of balance sheet. The evaluation should consider the extraordinary depreciation, amortization, reversal which becomes known until the date of balance sheet, including the changes due to market value fluctuation.

Cost can be explained in case of all the assets and liabilities. Its exact definition, however, can be difficult in some cases. Cost is very significant, because it is the value of recording and it has a key role in the determination of planned depreciation or in the course of economic events which affect the profit or the balance sheet value of the assets.

Acquisition can be made as follows:

- purchase,
- manufacturing within own activities,
- apport,
- takeover without payment,
- gift or heritage received,
- takeover in return for receivables,
- surplus found,



- takeover in the frames of exchange deal,
- takeover in return to share.

Further details of procurement and recorded cost of asset elements and the special cases of determining the value are not discussed by the present paper.

### *2.1. Depreciation as planned*

Planned depreciation should be accounted in case of fixed assets and tangible assets from the day of their proper use. The reason for this is that the value of assets in permanent use would decrease under the original cost due to the physical and technical wear and tear. Thus depreciation is the degree of decline expressed in money.

„The principle of prudence in the accounting law means that the planned depreciation in case of these assets should be accounted as an item which decreases profit (cost) even if the profit of the company turns into loss by this or the already existing loss further increases. At the same time, due to the sincerity principle of the law, only that proportion of (gross) cost (procurement or production) can be accounted as planned depreciation, which is not returned in other way when the asset is withdrawn from use.” [FRIEDRICH 2006]

Therefore on the basis of principle of prudence, depreciation should be accounted even in case of loss-making management, so the result of the given year cannot affect the settlement of accounts.

According to the Hungarian accounting law, planned depreciation cannot be accounted in case of the following assets:

- land, building plot, forestry,
- works of art,
- archeological finds,
- non-activated investment,
- assets, the value of which is not depreciated during use, or its value even grows.

The starting point of calculating amortization is the cost of assets, or – in other words – gross value of assets. If the residual value (estimated market value by the end of useful life period) is considerable, the adjusted gross value should be regarded the basis of calculation. The starting date of accounting depreciation in case of tangible assets is activation, while in case of intangible assets, the date of taking them in the inventories.

The Act No. C of 2000 enables the settlement of depreciation of intangible assets and tangible assets of „small value”, that is below 100.000 HUF individual value limit. Amortization in these cases can be settled in lump sum (at the date of taking it into use).

Depreciation reduces the value of profit before tax in the financial statement. The depreciation settled according to the accounting law, however, appears as an increasing item in tax base adjustment. In contrary to this, the depreciation according to tax law is a decreasing item within adjustment when the corporate tax base is determined.

### *2.2. Extraordinary depreciation*

As regards tangible and intangible assets, extraordinary depreciation should be accounted in the following two cases:

- if the accounted value is permanently and significantly higher than the market value of tangible asset (except for investments),
- if the value of tangible asset permanently declines, because it becomes unnecessary, goes wrong, destroyed or cannot be used properly, or unusable.

The extraordinary depreciation should be made to the extent that the tangible asset would be recorded in the balance sheet at the valid (known) market value, in accordance with the usage of investment at the date of balance sheet preparation. If the tangible asset cannot be used properly according to the aim of investment, or it is unusable, destroyed or missing, it should be stricken out from the tangible assets, capital work in progress – following the settlement of extraordinary depreciation.” [SZAKÁCS 2009]

Extraordinary depreciation is recorded among other expenses, thus it reduces the value of assets and increases the expenses. Since the expenses, as decreasing items are listed in the profit statement, they reduce the profit of the company, so they retain company growth.

The reversal of extraordinary depreciation can be made at the end of the financial year, on the basis of data concerning the sheet date of balance.

„If due to the extraordinary depreciation records, the recorded value of tangible assets is lower than the original cost of these assets, and the reasons of extraordinary depreciation do not but partly exist, the extraordinary depreciation records should be eliminated by reducing the already settled extraordinary depreciation.” [SZAKÁCS 2009]

Its accounting is made in opposite to the other revenues, so the reversal of extraordinary depreciation increases the profit.

### *2.3. Loss in value*

Loss in value can be accounted in regard to fixed financial assets within the fixed (invested) assets. This group includes shares and debt securities. „In regard to the investments which mean ownership share in the corporation, loss in value can be accounted in the amount of – loss-like - difference between recorded value of investment and its market value, if this difference seems to be permanent and considerable. The criteria of permanency becomes into foreground, which means that the tendency of relation between market value and recorded value should be scrutinized before preparing the balance sheet.” [KOROM et al. 2005]

If the remaining difference is positive, value adjustment should be accounted.

In case of debt securities with longer maturity than one year, loss in value should be accounted if there is a seemingly permanent and considerable loss-like difference between the recorded value and the market value without accumulated interest.

In case of reversal, the recorded value cannot surpass the value of original purchase. In case of securities, if the original cost was above nominal value, then it can be reversed to the nominal value.

Loss in value increases the expenses of financial transactions, while its reversal decreases them.

### *2.4. Exchange rate difference due to year-end assessment of assets denominated in foreign currency*

The determination of cost of assets denominated in foreign currency is made at the HUF value calculated at the exchange rate of the day of fulfillment. When it is assessed at the end of the year and revealed that its impact on the profit is significant, then the assets are recorded in the balance sheet at

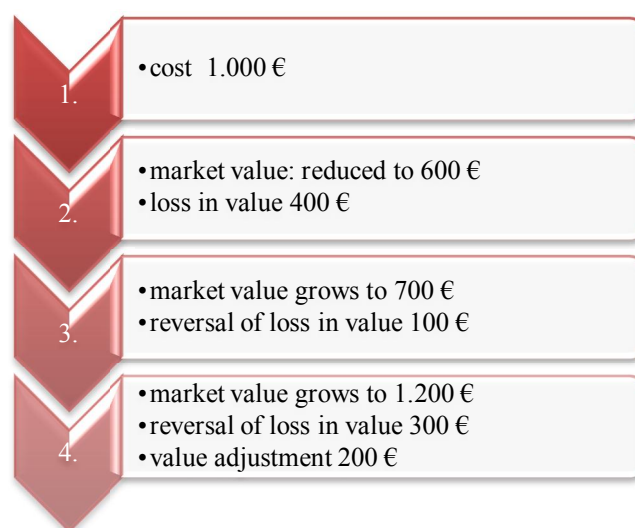
the HUF value calculated at the exchange rate valid on the sheet day. If it is not significant, the item remains at the historical, recorded HUF value.

### 2.5. Value adjustment

The companies have the possibility to demonstrate the positive difference between market value and recorded value in case of some fixed assets, on both sides of the balance.

These are as follows:

- Intangible assets: legal intangibles, intellectual property
- Tangible assets: everywhere besides investments
- Financial investments: long-term shares



**Figure 2.** Recording the changes of real market value in bookkeeping

Source: Korom et al.

Value adjustment can be accounted for intangible assets and tangible assets in the balance sheet if the balance sheet value of the given asset after reversing the extraordinary depreciation is significantly lower than the market value.

In this case the assessment reserve serves as a liability. The value adjustment does not modify the balance sheet value of assets because these are recorded in separated lines in the balance sheet. It is obvious that the value adjustment does not change the company profit because this accounting item has not any impact on profit.

The following figure introduces the assessment of a long-term share.

### 3. CONCLUSIONS

Applying evaluation procedures is the regulation of the accounting law. These procedures considerably affect the profit of the company, thus the degree of growth. Their importance is pretty much obvious. The present paper discusses the assessment procedures of fixed assets. It is clear that most of the assessment methods affect the profit produced by the business entities. (These are listed in the table below.) Out of the detailed procedures, only the value adjustment has no impact on the profit of the company, but it is included in the balance sheet, thus it influences the value of assets and liabilities.

**Table 1.** Impact on profit statement (Source: own construction)

	PRE-TAX PROFIT		TAX BASE ADJUSTING ITEM		EFFECT ON PROFIT IN BALANCE SHEET
	INCREASING	DECREASING	INCREASING	DECREASING	
<b>PLANNED DEPRECIATION</b>		X	accounting depreciation	tax law depreciation	decreasing
<b>EXTRAORDINARY DEPRECIATION</b>		X	X		decreasing
<b>REVERSAL OF EXTRAORDINARY DEPRECIATION</b>	X			X	increasing
<b>LOSS IN VALUE</b>		X	X		decreasing
<b>REVERSAL OF LOSS IN VALUE</b>	X			X	increasing

The above table demonstrates how the discussed evaluation procedures affect the lines of profit statement. Amortization decreases the pre-tax profit, but the same amount increases the corporate tax base, thus the tax liability will be higher, as a result of which, the after-tax profit and the profit in balance sheet will be recorded with a lower value in the profit statement. Consequently, there is a relation between the profit produced by the company and the assessment procedures.

Summing up, it can be stated that the procedures applied in the evaluation strongly affect the profit of the company, thus the degree and direction of growth. It is apart from the fact that the evaluation does not go together with actual cash flow, and still it considerably influences the profit and the earning capacity of the enterprise.

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**THE FUTURE LEASE REPORTING SYSTEM: DECISION-USEFUL TRANSMISSION  
OF INFORMATION**

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**Abstract**

*The currently valid financial reporting for lease agreement is based on the so-called risk-and-reward approach. The financial reporting obligation of the leased item depends on the type of lease contract. The reporting systems follow the all-or-nothing approach, according to which in cases of a finance lease or capital lease the leased item and the resulting obligations must be reported by the lessee, while in the case of operating lease the lessee does not have to recognize it in the balance sheet. The further development of accounting for leases is under consideration. Research of the concepts for the future lease reporting system will be analyzed in the perspective of better decision-useful transmission of information.*

**Key words:** *Leasing, leasing reporting system, decision usefulness.*

**1. INTRODUCTION**

With the publication of the joint standard draft “Leases” on August 17, 2010 (ED/2010/9) the IASB and the FASB intended to create a common basis and common regulations for lease capitalization. While the discussion paper that was published in March 2009 by the IASB (IASB 2009b) only intended to regulate the capitalization by the lessee, the current standard draft includes regulations for both the lessor and the lessee. The right of use concept that will be used in the future provides a completely new basis for the currently valid regulations of the IAS 17. The objective of the new concept is to provide useful information for the users of financial statements about the amount, the timing and the uncertainties of cash flows from lease contracts. The new regulations are not only intended for newly established lease contracts, but also for already existing lease contracts.

The proposed changes are presented and critically evaluated hereafter. Special attention is paid to the analysis of the effects from a balance sheet point of view and the comparability of the regulations with the future IASB framework concept.

**2. THE STANDARD DRAFT “LEASES”**

*2.1. Changes of basic capitalization principles of leases*

According to the currently valid IAS 17, leased items always have to be capitalized by the beneficial (economic) owner. While the legal ownership of a specific leased item is usually attributed to the lessor, the beneficial owner in accordance with IAS 17.7 has to be established under the application of the risk and reward approach. Commonly applied evaluation instruments are, in particular, the existence of a bargain purchase option test (IAS 17.10b), the economic life time test (IAS 17.10c) and

the recovery of investment test (IAS 17.10d). If one of these three evaluation instruments shows a positive result, we talk about a finance lease, in which case the leased item has to be fully capitalized by the lessee. If this is not the case, the leased item remains completely in the balance sheet of the lessor (operating lease).

This basic concept, which does not permit allocate the leased item between the lessee and the lessor, is relinquished in the presented standard draft. In future, the lessee fundamentally will have a right-of-use asset for the leased item and an obligation to capitalize the rental payments. In the future, for the lessor the capitalization will depend on whether significant rewards and risks in connection with the leased item remain with him. If this is the case, the lessor cannot write off the leased asset. If all relevant rewards and risks are transferred to the lessee, only a residual value in the amount of the remaining rights to the leased asset remains on the balance sheet of the lessor. The standard draft only assumes a complete transfer of the beneficial ownership to the lessee if the legal ownership of the leased asset is also automatically transferred to the lessee at the end of the agreed lease term, or if a bargain purchase option exists. In this case, the lease contract is considered a sales transaction.

## 2.2. Application field

Fundamentally, the regulations of the standard draft should be applied to all lease contracts, including the lease of right-of-use assets in sub-lease contracts. The only exceptions where the standard draft is not applied are the following (ED/2010/9 5, 7, 8):

- intangible assets (see also IAS 38 Intangible Assets),
- exploration of minerals and fossil energy sources (see also IAS 6 Exploration for and Evaluation of Mineral Resources),
- regarding biological assets (see also IAS 41 Agriculture),
- suspended situations from which a loss is expected (see also IAS 37 Provisions, Contingent Liabilities and Contingent Assets),
- investments in real estate, which according to IAS 40 Investment Property have to be valued at their fair value,
- in cases of an almost complete transfer of the opportunities and risks to the lessee and
- after the purchasing option is exercised by the lessee.

The nearly complete transfer of rewards and risks to the lessee is given in cases when, for example, the legal ownership is automatically transferred to the lessee at the end of the contract period, or if a bargain purchases option in the form of a very bargain price is offered to the lessee (ED/2010/9 B10). In such cases, the lease contract is considered as a sales transaction of the leased item, which then has to be evaluated by applying the general regulations for the purchase and/or sale of property assets. For contracts, which contain both a leasing and a service component, these two components have to be separated if they are distinguishable. The service component then has to be capitalized in accordance with the ED/2010/9 Revenue from Contracts with Customers.

## 3. CAPITALIZATION BY THE LESSEE

At the beginning of the lease term, the lessee, in accordance with the ED/2010/9 10, has to capitalize a right-of-use asset as the leased asset and a liability for the rental payments. In the statement of comprehensive income, the following positions have to be recorded (ED/2010/9 11):

- a) interest expenses for the lease liabilities,
- b) amortization on the right-of-use asset,
- c) revaluation gains and losses,
- d) changes that result from the new valuation of the lease liability
- e) impairment losses on a right-of-use asset.

The lease obligation has to be capitalized at the beginning of the lease term in accordance with the ED/2010/9 12a in the amount of the discounted lease payments. The discounting method has to be carried out by applying the incremental borrowing rate of interest of the lessee, or, if it can be established, with the interest rate used by the lessor for calculating the rental installments. Only rental installments that will occur with a higher probability than 50% have to be taken into consideration. If the contract has a flexible duration period with an extension option, the probability of it being exercised has to be evaluated for each option. An exercise price for a purchasing option must not be included in the installments. The right-of-use asset has to be capitalized in the amount of the lease liability plus any other initial direct costs incurred by the lessee (ED/2010/9 12b).

During the lease term, the lease liability has to be measured at the amortized cost and at the effective interest rate method, unless a new valuation becomes necessary on the basis of a new assessment of the lease term and the contingent rentals (ED/2010/9 16a in connection with 17). The amortization of the right-of-use asset takes place during the lease term or over the life of the leased item by using IAS 38 (ED/2010/9 20).

According to the ED/2010/9 25, the lease liability has to be separated from other financial liabilities on the balance sheet. In the same way, the right-of-use asset as if they were tangible assets within tangible assets but separately from other tangible assets. The amortization and interest expenses from lease contracts have to be declared in one of the two – either a statement in the comprehensive income statement or in the notes (ED/2010/9 26). In accordance with the ED/2010/9 27 the lease payments have to be declared separately under the cash flow from financing activities in the cash flow statement.

### **Example**

An enterprise signs a lease contract as a lessee for the use of a machine (average useful life: 8 years) for 6 years with an annual rental installment of €30,000, which has to be paid at the beginning of each year. The lease contract does not include options for extension or purchase. Maintenance and repair costs are covered by the lessee. The internal interest rate that is applied by the lessor is not known to the lessee. The incremental borrowing rate of interest of the lessor is 6%.

The lease liability is €156,371 and is based on the rental installments that are discounted by the incremental borrowing rate of interest. The value calculated on the basis of the effective interest method is €133,953 as of December 31, 2011. The right to use the leased item also has to be evaluated with €156,371 at the time of the start. If a straight-line depreciation of €25,659 is applied to the lease term of six years, a book value of €128,294 as of December 31, 2011 results.

*The balance sheet of the lessee therefore contains the following items on December 31, 2011:*

<i>Right to use the leased item</i>	<i>128,294</i>
<i>Lease liabilities</i>	<i>133,953</i>

In the comprehensive income statement of the lessee for the year 2011 the following items from the lease contract have to be included:



<i>Depreciation regarding the right to use the leased item</i>	25,659
<u><i>Interest expenses resulting from the lease contract</i></u>	<u>7,582</u>
<i>Loss from the leased contract</i>	33,241

#### 4. CAPITALIZATION BY THE LESSOR

##### 4.1. Choosing a method

The standard draft provides two different capitalization methods of lease contracts for the lessor: namely the performance-obligation-approach and the de-recognition-approach. The decisive element for the use of these methods is the level of rewards and risks that remain with the lessor with regard to the leased item and subsequent to the termination of the lease term. If significant rewards and risks remain with the lessor, the performance-obligation-approach has to be applied; otherwise the de-recognition-approach has to be applied (ED/2010/9 28).

##### 4.2. Performance obligation approach

At the beginning of the lease term, the lessor, in accordance with the ED/2010/9. 30, has a right to receive rental payments (lease receivables) and to recognize lease liability. The leased item must not be de-recognized. During the contract term, the following items have to be declared in the comprehensive income statement (ED/2010/9.31):

- a) interest income from lease payments.
- b) lease income in the amount of fulfilling the lease liabilities.
- c) changes resulting from a new valuation of the lease receivables according to ED/2010/9. 39.
- d) impairment losses on the right to receive of lease receivables.

Lease income has to be declared as sales revenues if lease is part of the usual business activity of an entity. The lease receivables and the lease liabilities have to be capitalized at the beginning in the amount of the discounted rental payments, plus any initial direct costs of the lessor; the interest rate that is used by the lessor to charge the lessee has to be applied as the discounting rate (ED/2010/9 33).

The valuation of the lease receivables during the lease term is based on the amortized cost and on the effective interest method. According to the ED/2010/9 37b, the remaining lease liability has to be set at the amortized cost. If it cannot be determined clearly, the lease liability has to be amortized in straight line. The leased items, the lease receivables, the lease liabilities and the resulting net leased asset value or net lease liability have to be recognized on the balance sheet of the lessor (ED/2010/9 42). The interest income from lease receivables, the lease income from the fulfillment of lease obligations and the depreciation on the leased item in accordance with the ED/2010/9 44 have to be declared separately from other positions in the comprehensive income statement.

##### *Example*

An enterprise in the role of the lessor acquires a machine on January 2, 2011 with an average useful life of 8 years. The acquisition cost is €200,000 (plus VAT). At the same time, the lessor concludes a lease contract with a lessee for the use of this machine for a period of 6 years, with an annual rental payment of €30,000. The payments have to be paid at the beginning of each year. This lease contract does not include options for extension or purchase. Maintenance and repair costs are covered by the lessee. The lessor expects proceeds of €60,000 through the sale of the machine at the end of the lease term.

The lessor has to set the leased item at the beginning at the acquisition cost of €200,000. As of December 31, 2011, the book value has to be reduced by the scheduled depreciation of €25,000.

For the evaluation of the lease receivables and the lease liabilities, the internal interest rate of the lease agreement has to be determined. For this, the expected series of payments has to be set up:

	January 2, 2011	January 2, 2012	January 2, 2013	January 2, 2014	January 2, 2015	January 2, 2016	January 2, 2017
<i>Acquisition cost</i>	-200,000						
<i>Rental payments</i>	+30,000	+30,000	+30,000	+30,000	+30,000	+30,000	
<i>Proceeds from sale</i>							+60,000
<i>Total amount</i>	170,000	+30,000	+30,000	+30,000	+30,000	+30,000	+60,000

The internal interest rate for this payment series is 5.77%. To determine the lease receivables and the lease liability, the six rental payments of €30,000 each have to be discounted with the internal interest rate, and thus the initial figure of €157,155 results. On 31.12.2011, the balance sheet amount of the lease receivables is reduced to €134,496 by applying the effective interest rate because only five rental payments are still open. Due to the absence of information about the utility structure of the lessee, the lease liability has to be amortized over a period of six years by €26,192 to €130,963. Therefore, in the balance sheet of the lessor the following items are included on December 31, 2011:

<i>Leased asset</i>	175,000
<i>Lease receivables</i>	134,496
<i>Lease liability</i>	<u>(130,963)</u>
<i>Net-leased-asset-value</i>	178,533

The comprehensive income statement of the lessor for the year 2011 includes the following items from the lease contract:

<i>Interest income from the lease receivables</i>	7,341
<i>Lease income from fulfilling the lease liabilities</i>	26,192
<i>Depreciation on the leased asset</i>	<u>(25,000)</u>
<i>Profit from the lease agreement</i>	8,533

#### 4.3. De-recognition approach

If only insignificant rewards and risks from the leased asset remain with the lessor, the de-recognition-approach is applied. When this approach is used, the rights to receive rental payments have to be capitalized at the beginning of the lease agreement. In return, the balance sheet amount with regard to the leased assets has to be reduced by the value of the right of use by the lessee. The residual asset value, which represents the rights to the leased asset that remain with the lessor, remains part of the assets of the lessor.

Lease income has to be reported as sales revenue if leasing is the usual business activity of an enterprise. The lease receivables have to be recognized in the balance sheet in the amount of the discounted rental payments plus any initial costs of the lessor; the discount rate of the interest rate, which the lessor charges to the lessee, has to be applied to this (ED/2010/9 49a). In addition, the residual asset in the amount of the remaining rights to the leased item has to be capitalized. To determine this value, the fair value of the rights (to the leased item) that were transferred to the lessee, have to be put into relation to the fair value of the rights that remain with the lessor. Based on this ratio, the book value of the leased item has to be divided between the lessor and the lessee. The value that has to be written off by the lessor at the beginning of the lease term is determined by applying the following formula (ED/2010/9 50):

$$\text{Value of the residual asset} = \frac{\text{Fair value of rental payments}}{\text{Fair value of leased item}} \times \text{Book value of leased item}$$

During the lease term, the lease receivables have to be valued at the amortized cost and by applying the effective interest method. This applies as long as no new valuation on the basis of new assessments regarding the lease term or contingent rental payments or impairment is necessary (ED/2010/9.54 in connection with 56 (a) and 58). A new valuation of the residual asset during the lease term does not have to be carried out, unless indications about the change of the lease term exist, or impairment is necessary (ED/2010/9 55 in connection with 56a and 59).

The following positions have to be declared on the balance sheet of the lessor:

- a) lease receivables, separate from other financial assets
- b) the residual asset, separate from other tangible assets (ED/2010/9 60).

The presentation in the comprehensive financial statement in line with the ED/2010/9 61 depends on the business model of the lessor. If the lessor offers leasing only as an alternative to the sale of goods, then the income and expenses from leases have to be reported analogously with sales revenue and cost of sales separately. However, if the lease is only a financing service, then the lease income and lease expenses have to be reported in a net position. Interest income from lease contracts has to be reported separately from other interest income in the comprehensive income statement. In the cash flow statement if the direct method is applied the cash receipts from rental payments are shown separately from operating activities. For indirect method the changes in the right to receive lease payments are shown separately from changes in other operating receivables.

## 5. EXPLANATORY DISCLOSURE NOTES

With the help of numerous qualitative and quantitative explanatory disclosure notes detailed information should be conveyed to the recipients (ED/2010/9.70) of the annual financial statement, such as

- the amounts reported the financial statements and
- the effect from amount, timing and uncertainty to the future cash flow from the lease agreement.

According to the ED/2010/9 73, it is necessary to explain the nature of the lease agreement in detail.

## 6. EFFECTS ON SELECTED SUBJECT AREAS

### 6.1. Sale-and-leaseback-transactions

Within the framework of a sale-and-leaseback-transaction the legal ownership of a property asset is transferred from the seller to the buyer through a sales transaction. Subsequently, the buyer grants a right to the seller to use the same item of property.

The lease contract between the buyer in the role of the lessor and the seller in the role of the lessee has to be quantified as a finance or operating lease in accordance with the currently valid regulations of the IAS 17. If it is a finance lease, the beneficial ownership is transferred back to the seller. In this case, IAS 17.59 stipulates that any excess of sales proceeds over the carrying amount shall not be immediately recognized as income by the seller-lessee. Instead, it shall be deferred and amortized over the lease term.

In the case of an operating lease, the legal ownership is transferred with the beneficial ownership to the buyer and thus, the seller has to realize the profit from the sale (IAS 17.61).

According to the ED/2010/9 66-69 the evaluation of a sale-and-leaseback-transaction depends on, whether the sales contract meets the criteria of a purchase or a sale of the asset. If, through the contract almost all rewards and risks are transferred to the buyer, the seller has to capitalize the sale in accordance with the relevant IFRS and evaluate the lease contract in accordance with the ED/2010/9. The buyer also has to capitalize the asset in accordance with the relevant IFRS and has to disclose the lease agreement according to the performance obligation approach within the meaning of the ED/2010/9 30-45.

If the criteria for a sale are not fulfilled, for example, if the legal ownership is automatically transferred back to the seller at the end of the lease contract on the basis of a bargain purchase option, the seller cannot write off the asset and has to capitalize the sales price as a financial liability. At the same time, the buyer cannot recognize the item in his/her balance sheet and instead has to capitalize the purchasing price as a receivable.

If the sale price or the rental payments do not correspond to the fair value, the buyer has to adapt

- the evaluation of the right of use on his balance sheet for the leased item to the usual market conditions for rental payments and
- the profit or loss from the disposal of the leased item by the difference between the agreed rental payments and the usual rental payments in the market.

The buyer has to adapt the book value of the leased item and the lease liability to the usual market conditions for rental payments (ED/2010/9 69). In the framework of a sale-and-leaseback-transaction the lessee has an obligation to provide explanations in the notes. The most important conditions in connection with the transaction and the profits and losses resulting from the transaction have to be declared (ED/2010/9 76).

### 6.2. Multi-level lease agreements

Since IAS 17 does not include concrete regulations concerning multi-level lease agreements, within the meaning of IAS 8.12 and the regulation in ACS 840 has to be applied for the time being. According to the applied top-down-approach, first the main lease agreement and then the sub-lease

agreement have to be evaluated. If, in the main lease agreement, the rewards and risks are transferred to the lessee (finance lease), then the lessee can in turn transfer the beneficial ownership to his lessee. However, if the main lease contract is already an operating lease, then the sub-lease agreements must also be qualified as operating leases.

According to the ED/2010/9 5 the general regulations for lease agreements are also applied to sub-lease agreements. Thus, at every level a new examination takes place on which rights to the leased asset have been transferred to the lessee. Then, based on the ratio of the remaining rights to the transferred rights, a division of the capitalization obligations between the lessor and the lessee is determined.

A lessee, who at the same time is lessor of the same leased item, has to recognize into the balance sheet the lease liability from the main lease agreement and the assets and liabilities from the sub-lease agreement individually. In addition, the balance of these three positions must be either capitalized as a net leased asset, or as a net lease liability from the sub-lease agreement (ED/2010/9.43 in connection with B29). Significant sub-lease agreements have to be disclosed additionally in the notes and separately from the main lease agreement (ED/2010/9 74).

## 7. EVALUATION OF THE STANDARD DRAFT

### *7.1. Abolition of balance sheet-related leeway concerning the approach*

The current classification of lease contracts required by the accounting standards for lease agreements, namely the classification into finance leases and operating lease, has caused considerable problems of demarcation. The following balance sheet-related instruments developed from that situation:

- in the case of lease agreements that are located in the peripheral area of these two categories, a certain scope of discretion with regard to the classification exists.
- through an arrangement of the facts, lease contracts can be prepared in such a way that the desired balance sheet consequences will result.

The classification to one of these two categories results in the fact that the leased asset has to be completely capitalized either by the lessor or by the lessee, a decision that has enormous effects on the balance sheet. Therefore, the accounting standards have considerable influence on the setup of the lease contract, and the original fiscal objectives of leases are sometimes moved into the background.

According to the new concept of the standard draft, the either/or decision concerning the classification of leased items will no longer exist. Instead, it will be analyzed as to which rights and obligations the contract partners have agreed on in the lease agreement. These rights and obligations will have to be evaluated and be capitalized in the respective balance sheets of the lessor and lessee as assets or as liabilities. Therefore, the economic consequences of the lease agreement can be portrayed much more precisely on the balance sheets. The current scope of discretion for companies with balance sheets will be abolished, and the depiction on the balance sheet will have much less influence on the contract setup in future.

### *7.2. Creation of new balance sheet-related leeway within the framework of the evaluation*

The advantages of the “right-of-use-concept” in the framework of the balance sheet approach are brought through new balance sheet-related leeway in the evaluation. The evaluation of individual balance sheet positions on the side of the lessee or lessor depends on the assessment of the probability

that options are exercised or on the occurrence of certain conditions.

The more flexible the lease agreements are set up, the larger the scope of discretion in the evaluation will be. It should be noted as positive that the right of the lessee to use the leased asset does not have to be evaluated independently at the time of initiation, but will be set in the amount of the lease liability plus any direct initial costs. The lease liability results from the discounting of the expected rental payments and by applying the interest rate, which the lessor will charge to the lessee or, if this rate is not known, the incremental borrowing rate of interest of the lessee is applied. Thus, the lessee has little influence on the applied interest rates. An independent evaluation of the right of use would lead to high complexity in cases of termination or extension options, purchasing options, right to tender, residual value guarantees or contingent rental payments. By the lessor the lease receivables and lease liabilities are also determined through the discounting of the rental payments plus any initial costs.

### *7.3. Relationship to the future IASB framework concept*

According to the ED/2010/9, the financial reporting of lease agreements should be compatible with the new IASB framework concept, which is now under discussion. One question is whether optional or contingent rental payments can fulfill the definition of criteria for receivables/liabilities at all. According to the current state of the discussion on the future IASB framework concept, an asset should be defined as a current economic resource, to which the enterprise has either a right or access that is not available to third parties. However, it is not necessary that this right to the asset or the access to it is legally enforceable. Therefore it is likely that a lease receivable that the lessor will receive with a higher than 50% probability will be capitalized as an asset because according to the current economic circumstances it is more favorable for the lessee.

In future, a liability is to be defined as a current economic obligation where the entity is the debtor. An entity is to be a debtor only in the sense of this definition, if the economic obligation is legally enforceable. Thus, a lessee should not capitalize an obligation for contingent or optional rental payments as long as the condition does not occur, or as long as the option has not been exercised. Therefore, the approach of lease liabilities to contingent or optional rental payments according to the ED/2010/9 contradicts the intended liability definition in the future IASB framework concept. However, the application of the planned asset and liability definition of the future IASB framework concept does not allow for a reasonable characterization of the economic reality. The lessor would have to capitalize lease receivables and a lease liability if the performance obligation-approach were applied. The lessee, however, could only capitalize a right of use and could not capitalize lease liability. Here, it becomes a problem that legal enforceability is demanded for capitalization of a liability but not for the capitalization of an asset. A possible solution could be that legally not enforceable liabilities are capitalized as liabilities if the enterprise is likely to make this commitment in order to maintain or recognize an asset.

## **8. CONCLUSIONS**

In the case of the ED/2010/9 “Leases”, the lease capitalization in the IFRS-capitalization is placed on a new basis. While until the present time the leased asset was completely allocated to the beneficial owner on the balance sheet with the “right-of-use-concept”, from now on, as a rule, it will be necessary to divide it between the lessor and the lessee. The new concept reduces the balance-related leeway regarding the balance approach because an either/or decision regarding the allocation of the leased item can no longer be made. The division of the right to use the leased item between the lessor

and lessee, required by the “right-of-use-concept” – does increase the scope of discretion regarding the evaluation. However, more substantial and useful information on the economic consequences of lease agreements will be transmitted to the final recipients; therefore the reform has to be welcomed. Existing inconsistencies between the ED/2010/9 and the intended definitions of assets and liabilities will have to be corrected during the development of a new IASB framework concept.

The IASB did not only move away from its original proposals with regards to the lease capitalization. During the commenting period, more than 760 letters were received by the IASB. Although the endeavor to reform the lease capitalization was welcomed in principle, both the complexity of the new approach and the expected higher costs of the implementation met with criticism. The IASB has taken these points of criticism into consideration and in 2011, besides the development of the receivable and residual models, various changes were adopted. Some of these are the following:

- simplification of short-term lease agreements (contract duration period < 12 months)
- definition of the duration of the lease agreement
- inclusion of variable rental payments when determining the lease liabilities only if they are index-based or, from an economic perspective, are considered minimum rental payments

At this point in time the revision of the original standard draft by IASB and FASB has not yet been concluded. The IASB plans to publish a revised draft after the final discussions in the first half of 2012. This draft can then be commented again within a period of 120 days. The adoption of a final standard is expected during the second half of 2012.

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