

megatrend

review

**The international
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Tel: +381 11 220 30 61
Fax: +381 11 220 30 47

E-mail: imilutinovic@megatrend.edu.rs

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EDITORIAL

On the Occasion of Publishing “Megatrend Review”, Vol. 7, No. 1, 2010

This issue of “Megatrend Review” is a result of long term strategy of its Editorial Board aiming to open pages of our scientific journal for applied economics to boarder states, region of South East Europe, Europe and the world. In that way, “Megatrend Review” becomes a place for intensive gathering and interaction of opinions and views on current events in national, regional and international economics with all challenges emerging in the field of global economy, economic policy and development, financial markets and business in present crisis period.

We would particularly like to stress that this issue of “Megatrend Review” is the third one in the series that will be devoted to certain states – in this case to Hungary and complex aspects of its present economic situation. The authors of contributions are distinguished scientists and professors mainly on *University of Pécs*, from Pécs, Hungary. Previous two issues of “Megatrend Review” had been dedicated to the economy of Italy and Romania.

Our guest editor, Professor Norbert Pap, whom we have the honour to introduce to our readers, has appointed the authors of contributions from Hungary. Professor Pap is higher education researcher and lecturer - associate professor at University of Pécs, Faculty of Sciences, Institute of Geography. His main professional activities and responsibilities are: holding lectures, organizing education, administration, research (theoretical and practical), publication, project management, elaborating studies. He has been president of Hungarian Geographical Society, Tolna County Section, since 2004, Balkan working team chairman of the Pécs Academic Committee of HAS, since 2004 too, and he received three important awards: Pro Geographia Award (2008), Young Researcher Award HAS PAB (2002), and Szádeczky Kárdos Elemér Award (1998). Professor Pap published large number of scientific articles in prestigious international journals. He is the author of books: *L'Ungheria ed il Mediterraneo. Il carattere geografico dei rapporti fra l'Ungheria e gli stati dell' Europa meridionale* (2008), and *A Balkán “kis” politikai földrajza (The “small” political Geography of Balkans*, Balkán Füzetek No. 5, 2007); he is co-author of books: *Bevezetés a terület - és településfejlesztésbe* (2007), *Kistérségfejlesztés (Small region Development*, 2007), *A területi tervezés gyakorlati kérdései* (2004), *Törésvonalak Dél-Európában (Fracture lines in Souther-Europe*, 2001), *Európa politikai földrajza (Political geography of Europe*, 1997).

We are very grateful to professor Pap for his professional effort he made as guest editor and an author of an excellent contribution for our journal. We also

thank to all authors from Hungary, Italy, Bosnia and Herzegovina, and Serbia for their excellent contributions.

PROFESSOR MIĆA JOVANANOVIĆ, PHD
President of Editorial Board
Rector of Megatrend University

GUEST EDITOR'S WORD

Following the aims of the editorial board of *Megatrend Review*, I chose a group of recent essays (hopefully raising the interest of Serbian and international scholars) and proposed them to be published about Hungary, about the various dimensions of its society and economics, also suitable to represent the scientists of our institution, the oldest and one of the biggest Hungarian university (University of Pécs).

The papers had been prepared last year. The subjects of the essays range (as a consequence of the scientific background of their authors) from applied economics through geo-economics to local economic development of regional policy. Presenting the newest results of their researches was a main expectation towards the authors. A typical example, proving the above, is that between the request and the publication three of the authors had defended their PhD thesis and published an interesting and concentrated part of their work in this issue. Among the authors, besides some elder colleagues, mainly younger scholars are represented. The importance of our university in the Hungarian higher educational system is indicated by the relatively large number of scientists working in various Hungarian or international universities acquiring their PhD in Pécs. One can find them even among the authors of this volume. (Békési László, Hardi Tamás) I do think that the published papers truly represent the fresh approach, innovative and problem-focusing efforts of this new generation.

Living in one of the Central European states which went through the transition process, this experience is fundamental in defining research topics. The past twenty years had brought tremendous changes in the every days of the Hungarian society as well as in our private life. Our society is being tired, disappointed and frustrated. The high hopes of the transition had been only partially fulfilled. We cannot really overcome the heritage of Hungarian economy and culture; the structures of the communist Hungary still live in peoples' minds in several aspects. Corresponding to the needs of modernization is rather bitter and lacks the feel of relief. That is why the achieved results are often followed by decline. Not only the general public but even the actors of the economy are full with pessimism. Therefore in Hungary you have to work a lot for a success.

The single papers represent one segment of this process and situation. I considered exceptionally important to publish also some in-depth analyses giving the results of empirical investigations besides the essays of strategic relevance (dimensions of trans-border relations, establishment of the institutional system of the micro regions, economical questions of the local self-governments, human resource development, and employment policy). This explains the selection of the papers about the Serbian-Hungarian trans-border cooperation, about the

mentality of the businessmen of rural areas, or about the innovation capacity of UP. I also considered important to bring the reader as close as possible to the reality of Hungarian people, institutions and enterprises.

What else is connecting the essays of this volume is the strong influence of geoeconomical approach. Each and every paper examines the territoriality of economy and society. A peculiar contradiction of the late 20th century modernization and European Union integration is that despite the huge attention, the size of which had never been paid to regional development in Hungary before, the territorial differences regarding level of development have grown in the last 20 years from slopes to canyons. Therefore understanding Hungarian economy is not possible without examining the territorial dimensions.

ASSOCIATE PROFESSOR NORBERT PAP, PHD
University of Pécs

LECTURER LÁSZLÓ BÉKÉSI, PHD*

*International Studies Institute and International Business School,
International Relations Department, Budapest Corvinus University*

CYCLES OF HUNGARIAN NATIONAL IDENTITY AND ECONOMY ON RAIL

Abstract: *Orientation of an economy or a society could be measured by several ways. Number of joint ventures, marriages between people with various citizenships, foreign trade figures, investments, preferred tourist destinations, number of played foreign movies, translated books, foreign workers, etc.*

I would like to emphasize the importance of railway network as an indicator of economic orientation and also identity. The issue could be examined in various dimensions as development of railway network, volumes of transported goods and people, modernization plans, timetable issues. This paper would like to point out than when Western orientation had priority, the Budapest-Western border/Vienna railway line had priority and when the entire country was turned towards Moscow, then the Budapest Eastern border/Záhony line was the most important traffic line or backbone of the country's economy. This Western-Eastern-Western orientation could be understood as an A-B-A' cycle.

Key words: *Regional differences, Political Geography, Railway passenger transport, time mapping, innovations and development, politico-economic cycles*

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1. Introduction

In November 2008, there was a little news made it to the TV news and covers of various magazines: 5 wagons of apple had been sold to Russia after some 20 years break.

In the 1980s, from the Soviet neighboring Hungarian Szabolcs-Szatmár county every year more than half million tons of apple had been exported to the USSR on refrigerated trains (Gerhes without year).

Can we see similar breakdowns in the passenger figures of the railway? And where else all the people travel by trains recently from Hungary to?

* E-mail: bekesi@uni-corvinus.hu

Hungary as the entire Central European region was undergoing significant previously unimaginable changes in the last twenty years. By Geopolitical thinkers as Sir Halford Mackinder the control of Central Europe is equal the control of the World.

As the recent situation shows Russia totally lost the politico-military control and we all joined with fireworks and smiles to the western systems. Did Russia lost Central Europe or did we simply lost Russia at the same time?

2. Turning of a region's economic orientation

In various historical periods a country or regions could have different orientation.

Ancient Rome was focusing on the Mediterranean area. Therefore the southern area was the developed core area facing with urban systems, security, and civilisation. The south faced towards Egypt, the Greek culture, having interactions in trade, religions, economy, architecture, sciences, agriculture etc. The north (northern that the Apennine peninsula) was the barbarian, empty, cold, risky periphery and chaotic area. Today the entire orientation is upside down partly because of the changed preference between the neighbors. The southern neighbors are not preferred partners, the EU partners in trade, political relations, the core of tourism and core of industrial production, welfare and urban landscapes of the so called 'Blue Banana' are all on the north. The south became feudalistic, risky, crime infected, bad neighbor faced zone. Similar changes took hundreds or thousands of years in most of the cases. So it is unique to have a chance to describe 180 grade changes within a short period of 1 or 2 decades. Or ever we can find the exact dates changes. See the conclusions for dates.

3. Railway connections as indication of politico-economic relations

Political and economic interest could be clearly seen in the domestic and cross border railway system plans of a country/empire.

Friedrich Ratzel wrote one of the first Political Geography book in Germany in 1897. In that time he realized already that the geography of transport is one of the most important segment of controlling the space. His book's subtitle was the Geography of the States, Transport and Wars.¹ Maybe this was the first relevant book on the issue of rail transport and spatial aspects of political powers.

Later on Sir Halford Mackinder (1904) pointed out that from the second part of the 19th century land powers could be equal with sea powers by strength if

¹ F. Ratzel: *Politische Geographie oder die Geographie der Staaten, des Verkehrs und des Krieges*, Oldenbourg, München, 1897

they build proper railway networks. In this case steam fueled locomotives can compete steam fueled merchant navies and battleships in speed, effectiveness, transport and military logistics of troops, supply and weapons.²

In the competition of land and sea powers land powers will emerge by railways and land communication systems. He also pointed out that the Pivot area, the center of history is more or less the territory of Russia (he wrote his ideas in 1904) and the key area to reach the center, and the land power is Central Europe. So railway is a key to mobility. He also mentions the border between Hungary and Vienna as a symbolic border or all nomad and Turkish invasions, so both Hungary's eastern and western border have key roles in the history.

Therefore we can mention that the railway connection between Russia (today's Commonwealth of Independent States) and Central Europe have significant symbolic, political and economic importance.

British Empire is a general example of the railway as a political tool. But the history of the USA expansions towards the western frontiers or the Russian Imperial territorial integration of Siberia and the Caucasus could be seen as a history/struggle of railway building. The Cairo-Cape Town British Empire's railway was a symbol of colonial power. The North American East Coast-West Coast lines are the symbols of the integrity of the US States, the Trans Siberian line is there to demonstrate the power of Russia, the Berlin-Baghdad line was built to show the German-Ottoman alliance system.³

Military aspects of the railway could be learned from every military-geographic study both for civilian scientist and for military personnel. While the Hungarian Peoples' Army officers Military Geography textbook (A Magyar Népköztársaság Honvédelmi Minisztériuma, 1954) deals with the issues of fuel (in that time mostly coal, today diesel or electric power), carrying capacity, number of rails (one or two pairs), gauge, quality of stations, density of lines and their directions, capacity of loading. Electric lines are faster, but the electric system is vulnerable and a potential risk in time of conflict. The book argues that in Hungary there are only lines from and to the capital. It is explained not with the Trianon Treaty, but the lack of need of other lines since all the economic transactions could be described as center-periphery or Budapest and the rest of the country. However it is important to mention that the lines between other cities were given to neighboring countries in the end of WWI peace treaties.

Soviet military books rather deal with the issues how to blow up railway lines, electric systems and railway bridges instead of how to use them.⁴

² H. De Blij: *Systematic Political Geography*, Wiley, New York, 1973, p. 486; H. Mackinder: "The Geography of Pivot of History", in: *Geographic Journal*, 23/4, April 1904, pp. 421-444.

³ L. Békési: *A politika földrajza*, AULA Kiadó, Budapest, 2004, p. 206.

⁴ Beber: *Sputnik partizana*, KOMSOMOL, Moskva, 1941, p. 272.

Woodward⁵ mentions the impacts, control, employment, military industry, evacuation, energy needs, environmental issues and other dimensions relating the railways.

Kozma-Héjja-Stefancsik in *Military Geography Handbook*⁶ mention that both the railway towards Austria and Ukraine have key importance, but modernization needed both the rail system and the outdated rolling stock. They mention that there are 9 railway lines toward Austria - including the short cross border routes so called 'corridor trains'⁷ and only one towards Ukraine however only one line towards Austria is important and have double rail road.

Rechnitzer⁸ explains that the spatial structure or inequality of Hungary could be clearly described by innovations. We shall mention that railway or its modernization is one of the most important innovations since the appearance of railway in the territory of Hungary.

For us the most important issue will be speed but several other dimensions will be discussed.

4. Brief related history of the Hungarian Railways: The post 1918 and the post 1945 situation

Territorial decisions and new border drawing processes of the Trianon Treaty were always motivated by railway lines and railway nodal points of the former Austro-Hungarian Empire.

The former integrity of the Austro-Hungarian Empire's railway network can be seen still today. Railway lines of today Salonta (Nagyszalonta) in Romania railway station contains rail from Bochum 1886 (today's Bochumín of the Czech Republic). Slovenian city of Koper have some old locomotive and railway coaches exhibited in front of the station made in 1907 by Weitzer János 'Waggon LTD' rolling stock from Arad (today's Resita in Romania). My hometown Dunakeszi's Railway Carriage Factory still has 'Resicza' (today Romania) rails from the 1880's. High Tatras small gauge forest railways still used rolling stock/technical support carriage from Budapest 1912. Krakow and Venice have same system brick build railway bridges. All the former empire's countries have similar warehouses and railway station buildings all around. There were around 50 special pattern building used by the railways of the Empire in classical, eclectic or even romantic architectural style and not only railway stations, bridges, ware-

⁵ R. Woodward: *Military Geographies*, Blackwell Publishing, Oxford, 2004, p. 196.

⁶ E. Kozma, I. Héjja, F. Stefancsik: *Katonaföldrajzi kézikönyv*, Zrinyi, Budapest, 1993, p. 180.

⁷ I. Előhegyi: *Korszerű villamosmozdonyok: Taurus*, MÁV ZRT, Budapest, 2009, p. 280.

⁸ J. Rechnitzer: *Szétszakadás vagy felzárkózás, A térszerkezetet alakító innovációk*, MTA RKK, Győr, 1993

houses, but for example hidroglobuses, guard houses, telephone centers, service flats etc. as well.⁹ Railway tunnels have the same patterns also till recent days.¹⁰

In the 1900 timetable there were no international trains towards Russia at all, just within the Austro-Hungarian Empire's neighboring areas towards Russia as Lemberg/Lvov/Lviv and Przemysl. But there were even sleeping car connections towards Venice, Constantinople/Istanbul, Berlin, and Paris.

One of the post 1918 changes was the loss of huge part of the railway system. Before, trains between Budapest and Vienna traveled via Bratislava/Pozsony and the trains arrived to the Nyugati (Western) Railway station built by Eiffel.

From 1945 western connections were minimized, and at the same time USSR received the Trans Carpathian area from Czechoslovakia (who inherited it from Hungary after the World War I). In those territories standard Russian wide gauge rails were built and European rails were removed totally.

5. Distance as time

Distance is mostly understood as geometric length in two-dimensional surface between two points or locations. This category is used in maps as well.

But we can understand and measure time in various dimensions referring to our principal aim. Difference in culture, aims, economy etc. and cost are principal between the major distance categories.

In our case we will examine the distance in two ways:

- as frequency of cross border contacts between locations/countries
- and the time to reach the borders from Budapest.

The examined mean of transport will be train and especially passenger trains, however similar conclusions could be drawn after analyzing the volume of transport goods in train as well.

5.1. Mapping the Time as Distance

Transport systems are always signs of politico-economic orientation. The real map of a given territory as for example a country can drastically differ from the time map, where the unit of the distance is the time unit. There are always preferred orientations and neighboring countries for transport system modernizations, capacity enlargement and quality improvements. Dicken and Loyd¹¹

⁹ T. Edelényi: *Vasúti épületek*, Műszaki Könyvkiadó, Budapest, 1983, p. 372.

¹⁰ J. Nagy Ed.: *A vasúti pálya építési és fenntartási módszerei*, Műszaki Könyvkiadó, Budapest, 1982, p. 614.

¹¹ P. Dicken, P. Lloyd: *Modern Western Society: Geographical Perspective on Work, Home and Wellbeing*. Longman, London, 1981, p. 408.

gave an example of the United Kingdom. The time map of the UK shows that Paris, Amsterdam, Northern Italy or even New York is closer by time than the northernmost areas of Scotland. It could be clearly explained by political, military, economic and value orientations.

5.2. *Dimensions to Compare Railway Service in the Budapest-Hegyeshalom and Budapest-Záhony Lines*

5.2.1. Waiting time at the border and technological comparability

Hungarian Railways have different gauged rail systems from other European countries. The Ukrainian Railways inherited the Russian/Soviet rail sizes, however in the pioneer age of railway building in the second part of the nineteenth century on the Austro-Hungarian controlled Western Ukrainian/Polish territories standard European sized railways were laid down. The Soviet State Standard (GOST) sized rails right after Soviet state penetrated the area has replaced these lines. To cross the Hungarian-Ukrainian border with the same sleeping cars it is necessary to change the undercarriage system and the locomotive. It is a time-consuming process took some 2 hours. Actually it was a shorter process in the socialist period. In the time of the COMECON it was always brought up as a possibility that Soviet standard railway route could be built deep in the territory of Hungary but it was considered as an offensive move against Hungarian national identity and the plan was cancelled several times.

On the western side between Budapest and Vienna all technological issues had been solved. The electric systems had been brought together so high speed locomotives are able to carry the train without any changes. Austrian and sometimes German locomotives pass the Austrian-Hungarian border and draw the rolling stock on the entire length of the journey. No time needed to change the engines or wheels. No time needed anymore for passport control and customs procedures either.

5.2.2 Personal mobility towards the east and the west in train, motivation, marketing

Before 1989, big organized masses traveled between Hungary and the Soviet Union by trains. So called Friendship Trains brought thousands of Hungarian workers and youth to Moscow and other big cities. Students, workers, delegations traveled both direction. János Kádár personally preferred rail transport as well. A special part of the personal travel was the soldiers from the USSR to the Southern Army Group of the Soviet Army to Hungary. This military use of the railway (both the personal crew and equipment of the Soviet Army was managed by a special detached unit of the MAV. It included not only the 60 000 armed personnel, but technical crew, civilians, shop workers, family members or even Soviet State Bank officials being presented in every army base.¹²

¹² K. Vándor: *Légiőrő társbérletben*, VPP Kiadó, Dunakeszi, 2009, p. 288.

Today there are no special fares to Russia or Ukraine. On the other hand there are always special fares for western travelers, as reduced price tickets or combined railway ticket plus Vienna public transport ticket. This attracts big masses.

Media always suggest the people that it is dangerous to travel to Russia or Ukraine. While I write this paper, the news reports that Ukraine is highly infected with deadly flue viruses.

5.2.3 Security

There are no major crime issues on the Budapest-Vienna route however the Budapest-Lviv-Kiev-Moscow route or the extreme nonsense Budapest-Bratislava-Czech Republic-Poland-Belarus-Moscow (or Sankt Petersburg) super long time wasting first-west-then-east routes are considered as risk of crime in all parts of the journey especially on the nights. Pickpockets, smugglers, gangs and drunken „passengers” (they are both could be victims or crime committing fellows) make colorful the journey and long stops at poor stations especially in Ukraine where the conductors fight with local vendors and deadbeat beggars. Sleeping car conductors can tell everyday nightmares of robberies, fights, tricks of opening locked doors, using sleeping sprays to neutralize and „deactivate” sleeping passengers etc. As mentioned already health issues could be risk factors as well.

5.2.4 Quality of rolling stock of the passenger trains

The rolling stock, the cars had significant difference on the eastern and western relation.

Since the difference of the gauge between Hungary and the Post Soviet states, only 'Soviet' sleeping cars are able to enter Hungary with changed undercarriages/wheels. These cars however in some cases modernized ones (for example the ones of the Ukrainian Railway operated ones), most of them are still coal heated old timers from the nineteen seventies. It is interesting to mention that smugglers usually hide cigarettes or other valuable 'duty free' items under the coal. Most of the sleeping cars of the Soviet (and Chinese) Railways built in East Germany, for example in Bautzen and however they represented the highest quality in that time, today they seems to be uncomfortable. Once the most elite Hungarian rolling stock, the Government Train or so called Silver Arrow was also used mostly for journeys between Budapest and Moscow my high ranked party and government members. Today this 1969 built luxury train is in the Railway Museum in Budapest.

Today in the Hungarian-Austrian line we can find only modernized, fast speed (160 kilometers per hour or even faster), clean, trendy, environment friendly carriages. The toilets for example are all collecting the things into containers therefore it keeps clean the rails from human waste, smell, diseases etc.

Within the European Union all international trains should be equipped with containers collecting the liquids instead of pouring it to the rails. Russian and Ukrainian sleeping cars have traditional toilet systems.

From December 2008, new service is available from the direction of Vienna. The Austrian Railway-made Rail Jet trains offer Premium, First and Economy classes, disabled facilities and they extremely focus on information distribution in 3 languages and with info screens. The trains go with the same engines from Munich to Budapest.

Figure 1: Rail Jet Engine



Figure 2: Info-screens inside outside between Budapest and Munich

5.2.5 Locomotives

Both of the Hungarian railway companies MÁV and GYSEV decided to purchase high speed (230 kilometers per hour) electric locomotives in 2000 to replace Hungarian designed engines on the western border area. The German Siemens and Krauss-Maffei companies built the so-called TAURUS locomotives. They were made to use all Hungarian, Austrian, Slovakian, Slovenian and Italian electric systems as they are regularly transporting both personal trains and goods to Passau, Germany; Bratislava, Slovakia; Trviso, Italy.¹³ These locomotives could be used in Czech Republic as well.

¹³ I. Előhegyi: *Korszerű villamosmozdonyok: Taurus*, MÁV ZRT, Budapest, 2009, p. 280.

Figure 3: *Competition of generations: Old Czech(hoslovakian) and Austrian Siemens locomotives (could be used in several countries systems) in Praha Holesovice Station*



5.2.6 Information languages

Civilization similarities or gap, Chebishev distance¹⁴ could be understood by observing communication channels, languages.

In the socialist period Esperanto language was also preferred among Hungarian Railways leaders, language courses have been organized between rail workers and in some cases railway station information signs had been written in Esperanto as well. The general railway information on trains was written in Hungarian, Russian, Italian, French and German. Today the Russian texts could be found only in old outdated coaches and only with negative forbidding messages on emergency break/toilet usage restrictions/window leaning restrictions.¹⁵ Not any general information, advertisement etc. could be found in the coaches

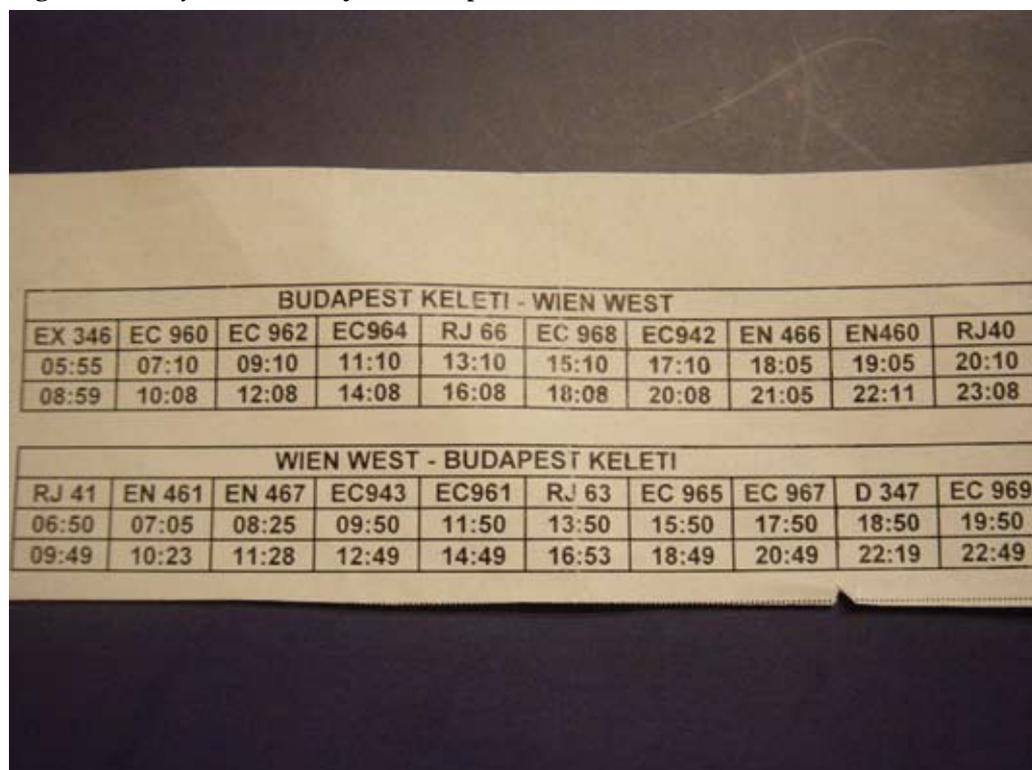
¹⁴ See: J. Nemes Nagy: *Tér a társadalomkutatásban. Hilscher Rezső Szociálpolitikai Egyesület, Budapest, 1998, p. 262*

¹⁵ L. Békési: "Cirill betűk Magyarországon 2008-ban. Avagy a szó elszáll, az írás megmarad?", in: *Balkán Füzetek Különszám, Vol. 2, PTE. FI. KMBTK, Pécs., 2009, pp. 302-308.*

or in Railway station. Russian languages rarely used in marketing as well, however for example in Czech Republic Russian messages are almost as common as English due to the Russian tourism.

On the other side of the country, the Austrian Railways ÖBB introduced the high speed Rail Jet Trains. This Austrian trains used between for example Munich and Budapest have full Hungarian language written information and even display screens on speed, map of the journey, following stations, timetable etc. operating in Hungarian language. Loudspeakers have shared information in German, English and Hungarian on the entire journey. Vienna Westbahnhof (Western railway Station) even have Hungarian loudspeaker messages for all Budapest related trains and connections. In Hungary there is no chance to hear any Russian loudspeaker messages in any station. Leaflets with all Budapest-Vienna timetables are available even in stations not served by trains to Vienna as in Nyugati Palyaudvar (Western Station of Budapest).

Figure 4: Leaflets with daily 10 Budapest-Vienna connections



BUDAPEST KELETI - WIEN WEST									
EX 346	EC 960	EC 962	EC964	RJ 66	EC 968	EC942	EN 466	EN460	RJ40
05:55	07:10	09:10	11:10	13:10	15:10	17:10	18:05	19:05	20:10
08:59	10:08	12:08	14:08	16:08	18:08	20:08	21:05	22:11	23:08

WIEN WEST - BUDAPEST KELETI									
RJ 41	EN 461	EN 467	EC943	EC961	RJ 63	EC 965	EC 967	D 347	EC 969
06:50	07:05	08:25	09:50	11:50	13:50	15:50	17:50	18:50	19:50
09:49	10:23	11:28	12:49	14:49	16:53	18:49	20:49	22:19	22:49

5.2.7 Variety of routes

The networks are changing in both directions. Towards Vienna there are several routes further. There was only one international route cancelled from Budapest. The Paris Budapest route but it has technical reasons. French Railways introduced the TGV super trains and they do not prefer other foreign rolling stock in their rail system as competitors of the supplement needs TGV trains. So the one hundred year old historical Orient Express loved by Agatha Christie and Mata Hari between Budapest and Paris silently passed away and remained only as a nostalgia train for organized groups. The orient ran only between Paris and Vienna till 2001 and between Strasbourg (from where the TGV is available) and Vienna since 2007. Last time it was mentioned in the 2000/2001 Hungarian Timetable (Simon ed., 2000).

Towards Moscow there is one train daily (Tisza Express) and towards Moscow and Sankt Petersburg via Czech Republic. They are both only one trains basically composed from carriages to various destinations and contain only a few carriages. On the Budapest Moscow route there are only one dining car and one sleeping car. There are added sleeping cars but only in the summer from Thessaloniki, Belgrade (daily) and Zagreb (once a week) and even Venice to Moscow (once a week). So one train contains the entire variety of routes. Same train contains sleeping cars for shorter journeys between Budapest and Kiev or Lviv (Timetable 2008/2009). So same train, same platform from Budapest Keleti (Eastern Railway Station) to Moscow and Berlin. But where can we find the Budapest-Czech Republic-Moscow or Sankt Petersburg carriages??? It is extremely listed on the train Budapest-Berlin so called Metropol. This train contains daily one sleeping car from Budapest to Moscow via the Czech Republic, one sleeping car twice a week to Minsk and once a week a sleeping car towards Sankt Petersburg. Air route as competitor of train have similar situations, so we cannot blame air companies to attract passengers more. There are no daily flights to Sankt Petersburg from Budapest. So there are simply no daily connections on air or on the rail from Budapest. Tricky disappointed people try to sneak to Sankt Petersburg from Budapest on the Budapest-Helsinki flights instead and then took a disaster bus journey rather than use the non-existing train or direct flights. So the entire Budapest-CIS rail route systems contain daily only 2 or 3 sleeping cars on the winter and maybe one or two more in the summer high season. The Pushkin Express going through the eastern part of Hungary between the Balkans and Moscow was cancelled in 1998 (Simon ed., 1998, Timetable, 1998-1999) due to maybe the Balkan conflicts.

6. Similarity to Russian pipelines strategies

Fixed railway lines have some similarities to pipelines and electric wire systems. In our case we shall mention a well-known issue of the Russian Ukrainian pipeline disputes relating to gas and oil transport to the European Union. The Russian strategy's priority at the moment is to use and build or enlarge existing capacities of gas and oil pipelines avoiding the territory and therefore the control and risks of the Ukraine.

It is also known that in some cases in transport systems the longer route is cheaper, more risk free or shorter by the meaning of time. It is widely accepted for example in the air route systems that to go to the Far East from Budapest, first we have to fly to the west for example to Vienna, Frankfurt, Munich, Amsterdam, Kopenhagen, Paris or London and change the flight thereto one heading really towards the Far East. So to go east, we shall hit the road to the west. It is similar at the moment between Budapest and Sankt Petersburg in the railway system. In the period of the USSR all Budapest Moscow and Budapest Leningrad railway lined went directly ont he Budapest Záhony Chop Lvov line and split there. Today there is a traditional line to Moscow via Ukraine. But both towards Moscow and Sankt Petersburg there was a line across Slovakia, Poland and Belarus and finally Russia. From 2008 the line went even more to the west: Slovakia, then Czech Republic and then Poland Belarus and Russia. So to reach Moscow or Sankt Petersburg we shall travel as far to the opposite direction as the western line or longitude of Vienna. The only reason for this is to avoid Ukraine. Somehow the Slovakian-Czech-Polish 'Bermuda Triangle' is one of the most crimes affected in the European railway systems.

7. Conclusions

We can confirm that international goods and also passenger railway transports are good indicators of political and economic international relations. Railroads have important role also in military relations and in value similarities. As we examined passenger transport between eastern and western neighboring countries we could follow the dynamics of political 'climate change' in the entire period of the last two decades. As I mentioned in the Globalized Europe Political Geography Conference in Koper 2004,¹⁶ Hungary's orientation went through an A-B-A' cycle, once facing towards Austria as an integrated internal part of the Austro-Hungarian Empire. We can agree that the 1918-1945 period with the short revolutionary period of 1919 was also a west oriented era (and therefore

¹⁶ L. Békési: "Back to the Future. A Cycle of Symbolic Places in Budapest as a Part of the K. u. K. Soviet and Western Era", in: Anton Gosar Ed.: *Globalized Europe*, Univerzita Primorskem, Koper, 2005, pp. 295-306.

part of the A phase of the cycle). The one state stage of Austria and Hungary stimulated the railway connections. It was somehow similar in the early twentieth century period in Norway/Sweden. Swedish steel exported through Norwegian Narvik by railways built between Sweden and Norway. The two countries had the same king as a personal union till 1905. The 1945-1989 period brought eastern orientation by all means. Iron Curtain made impossible any serious cooperation between Hungary and western countries. This period (B) had been followed a restoration of western values and relations and the judging of the past. Today as an A' part of the cycle the Austro-Hungarian period is a golden age and the communist era considered as a nightmare experience. To see the changes of preferences of today, we can say that the western Vienna Budapest line is the most developing by frequency of trains, modernization of rolling stock, waiting time at the borders, quality of service, security. At the same time Budapest Moscow or Budapest Leingrad/Sankt Petersburg line is slower and worse than ever in the history with irrational timetable route changes crossing three extra countries, which have no common border with Russia.

To summarize the changes and situations today we can clearly find the dates of the changes: 1989-1991. To translate all to the languages of railways today: Would you go to Sankt Petersburg from Budapest by train? One sleeping car once a week via Czech Republic in a nonsense westward route in a coal heated samovar served 1970 GDR built rusty carriage. Do not forget home your insurance! Would you go to Vienna? Three high speed 2008 built Rail Jet trains in Premium/First/Economy Classes, Disabled facilities, TV Screens, Hungarian loudspeakers, bistro or choose any other train from the daily ten connections is shorter time than ever.

There is only one Russian word mentioned on the two destinations but with totally different meanings: BISTRO car.

The Iron Curtain disappeared twenty years ago and the process had been topped with the Soviet Army withdrawal from Hungary in 1991 (also with trains). While the last train left for the USSR on the eastern border in the summer of 1991 with the symbolic Soviet tanks and soldiers, Franc Joseph's ghost train silently arrived to His Majesty's private waiting room on the Western Railway Station and the A' part of the cycle started.

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PROFESSOR DRAGANA GNJATOVIĆ, PHD*
Megatrend University, Belgrade
ANA JOVANCAI, M.A.

Faculty of International Economy, Megatrend University, Belgrade

INSTABILITY OF FINANCIAL MARKETS AS A CAUSE OF THE GLOBAL FINANCIAL CRISIS - THE MINSKY MOMENT -

Abstract: *Until the emergence of the mortgage loans repayments crisis in the US in the summer of 2007, the lessons of Professor Hyman P. Minsky on the devastating effects of private debt accumulation in times of economic boom were almost unnoticed among economic theorists. Only when it was clear that mainstream economic theories could not be implemented in the situation in which the American economy found itself in 2007, followed by the economies of many other countries in 2008, professor Minsky's theory on the inbuilt instability of financial markets became accepted as a basis for an explanation of the causes of the current global financial crisis.*

Key words: *Hyman P. Minsky, global financial crisis, private debt*

JEL classification: G 18, E 31

1. Introduction

The key characteristic of the capitalist economic system is that the financial market is by definition unstable, and this instability is an integral part of the processes that move the mechanism of the crisis of the economic cycle.

Hyman P. Minsky, 1992

The global financial crisis, which is transforming into a second Great Global Economic Crisis,¹ has caught the world's leading theorists by surprise.² The cur-

* E-mail: dgnjatovic@megatrend.edu.rs

¹ P. Krugman: "How Did Economists Get It So Wrong?", *The Times Magazine*, September 9th, 2009

² I. Stojanović: "Da li je ekonomija kao nauka bez ideje za izlazak iz začaranog kruga ekonom-ske krize?", *Megatrend revija*, Vol. 6, No. 2, 2009, pp. 175-176.

rent crisis has its institutional roots in the highly liberalized US financial market, which is, in turn, a result of a wave of deregulation of the economy that swept over the US during the 1980s, primarily under the influence of the monopoly power of big capital. Deregulation in the American economy was manifested through the reprivatization of certain sectors that had previously been state-owned, through a general reduction in tax rates and through an extreme liberalization of financial markets.³ The spokesmen for big capital were theorists whose analytical tools were founded in a critique of Keynesianism: monetarists headed by Milton Friedman, supply-side theorists led by Arthur Laffer, and representatives of new classical economics, headed by Robert Lucas.⁴ Deregulation was especially manifested on the financial market, on which, besides conventional banking institutions and stock brokers, began to appear various financial intermediaries that introduced new, original financial instruments. What followed was a sudden expansion of the interbank market, a boom in stock trading and a specific, previously unknown, symbiosis of banking and stock market operations.⁵

While Keynes' critics, especially those of the new classical orientation, were thrilled with the virtues of the innovations of financial instruments and the general liberalization of financial markets, Professor Hyman P. Minsky (1919-1996) expressed a negative view of the financial innovations that had flooded the banks and Wall Street during the 1980s. Professor Minsky, of Belarus origin, was born in Chicago and graduated in mathematics from the University of Chicago in 1941. He then earned a master's degree in public administration and a doctorate in economics from Harvard University, where he studied under Joseph Schumpeter and Wasily Leontief. He taught economics at the following American universities: Brown University in Rhode Island (1949-1958), University of California at Berkeley (1957-1965), and Washington University in St. Louis (1965-1990). As a mathematics graduate, he was no stranger to the possibilities of mathematical modeling in economics, but thought that economics should remain a social science, since it deals with phenomena that are too complex to be explained by highly abstract, exact equations. Also, he had nothing against financial institutions, which is testified by the fact that, along with his university career, he was a long-time director of the Mark Twain Bank in St. Louis. As a result, he was certainly much better acquainted with banking operations than ivory tower economists.

³ D. Gnjatović: *Osnovi makroekonomije*, Megatrend univerzitet, Beograd, 2002, pp. 152-157.

⁴ D. Gnjatović, Vladimir Grbić: *Ekonomska politika – teorija, analiza i primena*, Megatrend univerzitet, Beograd, 2009

⁵ M. Kulić: *Finansijska tržišta*, Megatrend univerzitet, Beograd, 2007, pp. 29, 30.

2. Minsky's reply to Keynes' critics

Professor Minsky developed a theory according to which financial markets are by definition unstable because they generate abnormally high private debt during times of economic expansion; this instability of financial markets, which is built into the capitalist system, is the cause of cyclical swings in the economy; this instability can be removed only by regulatory measures on the part of the state and the central bank.

Professor Hyman Minsky is a post-Keynesian theorist. Post-Keynesianism is a school of macroeconomics that bases its teaching on Keynes' economic demand theory.⁶ In addition to Minsky, adherents of this macroeconomic school are Keynes' successors: Michal Kalecki, Joan Robinson, Nicholas Kaldor, Paul Davidson, and Paul Krugman.⁷ Professor Minsky is placed among the post-Keynesians for two reasons. First, he based his theory on the inbuilt instability of financial markets on Keynes' theory of money, in which the key role is played by the explanation about the speculative demand for money.⁸ Second, following Keynes' teaching, he was an advocate of state intervention on financial markets, sharply opposing the deregulatory measures that were applied to these markets during the 1980s in the US.

Minsky offered an explanation for the events in the American economy during the 1970s and 1980s, at a time when the ties and interdependence of the functioning of financial markets and the economy were hardly being mentioned in macroeconomics.⁹ Minsky showed how financial markets become overheated and underlined the regulative role of the central bank as the banks' bank. Disagreeing with most economists that belonged to the new classical school, Minsky found that such volatile behavior on the part of the financial system, as well as the booms and busts that accompany it, are unavoidable in an economy with a totally liberalized financial market. He warned that such volatility can be stopped only through regulatory measures on the part of the state and the central bank.

Minsky's theory on the inbuilt instability of financial markets remained almost unnoticed among economists during the last two decades of the 20th century, since at that time the field of macroeconomics was ruled by doctrines that saw the financial market as a successful example of the application of eco-

⁶ B. Snowdown, H. R. Vane: *Modern Macroeconomics, Its Origins, Development and Current State*, Edward Elgar, 2005, pp. 451-473.

⁷ Professor Paul Krugman used to say that, in the field of macroeconomics, he leans toward the views of neoclassical synthesis theorists, such as Paul Samuelson; however, in recent works, he has essentially accepted the basic postulates of post-Keynesianism. On favoring the neoclassical synthesis, see: Paul Krugman: "Return of Depression Economics", *Foreign Affairs*, January-February 1999, Vol. 78, No. 1, pp. 56-75. On the evolution of his views, see: Paul Krugman: "How Did Economists Get It So Wrong?", *ibid.*

⁸ H. P. Minsky: *John Maynard Keynes*, Columbia University Press, 1975

⁹ H. P. Minsky: *Stabilizing an Unstable Economy*, McGraw-Hill, 1986

nomical liberalism, i.e. of the sovereignty of the price mechanism, which resolves all relations of supply and demand. The basic postulate of representatives of the then incontestable new classical economy, Finn E. Kydland, Robert Lucas and Edward C. Prescott, was the thesis on the ability of the market to, by way of the price mechanism, secure the full employment of the factors of production at all times, that state intervention in the economy through fiscal policy is not necessary, that fluctuations in the economy may appear only sporadically, as a consequence of sudden jumps in production, i.e. exclusively on the supply side, as a result of big technological advances in production.¹⁰

The new classicists were joined at the end of the 20th century by representatives of new Keynesianism, headed by John B. Taylor, Gregory Mankiw and David Romer. They accepted all the new classicists' postulates, except the one according to which fiscal policy is totally unnecessary. Their teaching warns that prices are flexible, i.e. adjustable to market conditions of supply and demand only in the long term; in the short term, there is inflexibility in prices on the market of goods and services due to the monopolistic behavior of large corporations, as well as inflexibility of wages, due to the activity of labor unions and company wage policies; as a result, state intervention through fiscal policy measures is necessary in the short term. Thus, the new Keynesian doctrine reduced the role of fiscal policy to the removal of the imperfections of the market mechanism.¹¹

Hence, none of the leading macroeconomic theories allowed for the possibility that anything at all could happen on the financial market that might shake the entire capitalist economy, necessitating state intervention. Both these ruling theories rejected Keynes' teaching about aggregate demand as the cause of cyclical swings in the economy, opting for the view that the impulse of economic activity is always on the side of production, i.e. supply.

Presented verbally rather than through mathematical equations, Minsky's theory was not acceptable for incorporation into the teachings of the economists of the new classical and new Keynesian schools, among other things because they sought to present complex macroeconomic problems through relatively simple microeconomic models,¹² in which, additionally, private debt did not figure at all as a variable.

During the 1980s and 1990s, Minsky's teaching did not have an influence on the leading macroeconomic schools of thought, or on the policies of developed countries' central banks. His teaching was not accepted among central banks because they were then relying exclusively on instruments and measures that

¹⁰ F. E. Kydland, E. C. Prescott: "Time to Build and Aggregate Fluctuations," *Economica*, Vol. 50, No. 6, 1982

¹¹ G. N. Mankiw: *Principles of Macroeconomics*, The Dryden Press, Toronto, 1998

¹² I. Stojanović: "Apstraktni matmatički modeli i deduktivne metode u mikroekonomskoj analizi realnih privrednih pojava", *Megatrend revija*, Vol. 4, No. 2, 2007, pp. 85-104.

indirectly influenced interest rate movements on the financial market. Their function of direct regulation of the banking system was reduced to a minimum.

Minsky's theory on the destructive effects of accumulating private debt during times of economic prosperity attracted attention only at the end of the 2000s, with the appearance of the crisis of mortgage loan repayments in the US. His theory on the inbuilt instability of financial markets is now becoming increasingly accepted in macroeconomics.¹³ This theory may serve as a basis for explaining the causes and characteristics of the global financial crisis that broke out in the US in the summer of 2007.

3. The Minsky credit cycle

Professor Minsky said that, under conditions of a totally liberalized financial market, banks and stock traders periodically play the role of arsonists, setting the entire economy ablaze. He thought that the deregulation of financial markets in the US at the beginning of the 1980s gave investors an open door for unrestrained, speculative behavior, for taking on excessive risk, which amplified the booms and busts in the economic cycle. According to Minsky, the only way to stop this occurrence was for the state to restrain financiers through regulatory measures.

Professor Minsky developed a theory that showed the interdependence of the real and financial sectors of the economy, and the fragility of financial markets during times of prosperity. He warned that, once corporate cash flow during such times rose beyond what was needed to pay off corporate debt, excessive new borrowing takes place for the purposes of buying stocks, and debts grow beyond the borrowers' ability to pay them off, leading to financial crisis. Namely, due to such, essentially speculative, growth in borrowing, the banks, which grant easy credits to increase their own profits, eventually reach a moment when they are faced with uncollectable loans. The banks are then forced to tighten credit conditions, even for companies that are still creditworthy, leading the entire economy into economic contraction.

The theory of the instability of financial markets thus starts from the hypothesis that it is possible to identify a credit cycle that appears during a boom, and which leads to a crisis disruption in the economy.¹⁴ According to Minsky, the credit cycle has five phases. These are: displacement, boom, euphoria, profit-taking and panic.

Displacement occurs during a boom, when investors are carried away by the possibility of high profits and buy securities whose prices are jumping on the

¹³ Since 2008, the McGraw Hill publishing house has been rapidly issuing reprints of all the most important works of Hyman Minsky.

¹⁴ H. P. Minsky, *The Financial Instability Hypothesis*, Working Paper No 74, Levy Economics Institute, May 1992

market. Investors borrow money from banks in order to buy securities, and plan to pay them off from surplus cash flow.

Boom is the phase of the credit cycle in which investors borrow more and more in order to buy more and more securities. Thus, new bank loans allow the buying of securities on the market. Rapidly growing demand for securities drives their prices higher, which in turn motivates investors to borrow even more from banks. The situation that develops on the stock market at that time is known in economics as a “stock market bubble”.

The financial boom transforms into *euphoria*, when banks, in search of quick profits and in order to secure funds for crediting their clients, begin to borrow more and more on the interbank market. Credits are now approved to less and less creditworthy clients, even those with suspect credit histories. Bank and market operations enter the phase of speculative activity.

Profit taking is a phase of the credit cycle in which banks claim high banking profits and brokers claim high capital gains. This is the phase of the highest financial risk, since a large part of the profit is speculative. This phase lasts as long as borrowers of lower creditworthiness succeed in paying off their financial obligations to banks from their capital gains.

The beginning of *stock market panic* is usually portended by dramatic events. Most often, it is the bankruptcy of a respectable financial institution that drowns in uncollectable claims against clients to whom it had previously granted easy credit. Banks become cautious in granting new loans, thus putting a stop to new speculative buying of securities on the market. Traders are now trying to get rid of their securities at all cost, selling them at ever lower prices. While securities prices are plummeting, banks' interest rates are growing. Events that happen during times of market panic are known in economics as the “bursting of the market bubble.”

The credit cycle ends as the impulse of interest rate growth carries over into the real sector of the economy, in accordance with the standard Keynesian scheme. Namely, interest rate growth leads to a fall in investment demand. Households are buying fewer durable consumer goods and real estate, producers of consumer durables are accumulating inventory, lowering production, laying off workers. The construction industry slows. Companies are investing less in the purchase of machines and equipment. Worker layoffs increase the unemployment rate in the national economy and lower buying power on the market. The recessionary spiral threatens to cause deflation.

4. The categorization of borrowers according to Minsky

Warning that the accumulation of the debt of insolvent borrowers in banks is the key factor that pushes the capitalist economy into crisis, Minsky identified three categories of debtors: hedge borrowers, speculative borrowers and Ponzi borrowers.

The *hedge borrower* can pay back both principal and interest from his current revenues. Trading in securities on the stock market is not his basic profession but a product of the fact that, in a boom environment, he had acquired surplus cash flows that were not intended for financing previously assumed financial obligations.

The *speculative borrower* can meet interest payments from his current revenues but constantly has to refinance the servicing of the principal. This type of borrower expects that growing earnings from his basic business will cover the ever-increasing costs of servicing interest, which are increasing because of his rolling over of the principal, and that the speculative growth of earnings from capital gains will be greater than or at least equal to the costs of servicing the principal.

The *Ponzi borrower* has no cash flow from any stable business activity that would service his debt but exclusively counts on the appreciation of the value (price rise) of his financial assets.¹⁵ Because of the unlikelihood of most investments' capital gains being sufficient to pay off the debt in the long term, much of this type of finance is fraudulent.

When the inevitable moment comes and the "bubble bursts," i.e. securities prices no longer grow, the first to be hit are Ponzi borrowers, who go bankrupt. They are followed by speculative borrowers, who can no longer refinance the principal since the banks, which have restricted crediting terms, are no longer willing to grant credit. According to the domino effect principle, the speculative borrowers can then bring down many hedge borrowers, who are hard pressed to find new investment opportunities. If most of the borrowers in an economy belong to the category of hedge borrowers, then it is harder for the financial system to fall into crisis, which contributes to macroeconomic stability in the long run. However, if in times of prosperity the structure of borrowers changes in favor of speculative and Ponzi borrowers, then the financial system is generating macroeconomic instability and exacerbates the crisis disruption.

¹⁵ Minsky named the category of Ponzi borrowers after Charles Ponzi (1882 – 1949), considered to be the greatest swindler in American history. After World War I, Ponzi took advantage of the situation in which the inflation rate in Italy was much higher than in the US. Between the fall of 1918 and the summer of 1920, through arbitrage operations with international postal coupons, he earned millions. Ponzi paid 50% interest to coupon sellers every 45 days, or 100% quarterly, since he bought them at a discount and exchanged them for postal stamps at nominal value, which he would then sell. Of course, he paid the interest to investors from the funds of new investors. When business boomed, seeking even bigger profits, investors did not cash in their profits immediately. R. Sobel: *The Great Bull Market: Wall Street in the 1920s*, Norton, New York, 1968

5. Explaining the causes of the global financial and economic crisis of 2008-2010 with Minsky's theory

By applying Minsky's logic, it is possible to explain the causes of the onset and the development of the credit boom cycle in the US from 2003 to 2007, which was to lead many capitalist economies into a global financial and economic crisis in 2008-2010.

When in 2003 the president of the Federal Reserve, Alan Greenspan, decided to reduce the interest rates on short-term state-issued securities to 1%, this was followed by an unexpected inflow of liquidity from abroad, primarily China, which found economic interest in buying US state securities. That was the way in which conditions were formed in the US for the acceleration of the first phase of the credit boom cycle that would lead to the global financial crisis in 2008.

Federal Reserve policy brought the price of bank lending capital, before all mortgage loans, to a historic minimum. This was the impulse for the second phase of the credit cycle – the financial boom in crediting real estate. This financial boom considerably eclipsed in value the previous boom at the end of the 1980s, which came about as a result of the price growth of securities invested in new technologies.

In this phase of the credit cycle, Ponzi mortgage borrowers appeared alongside hedge mortgage borrowers. Namely, analogously to Minsky's types of borrowers who invest in financial assets on the market, it is possible to categorize the mortgage borrowers that invested in real estate during the 2003-2007 period. The hedge mortgage borrower was anyone who used a mortgage loan to buy real estate and regularly serviced the principal and the interest from his own cash flow. The speculative mortgage borrower initially paid only the interest on his mortgage loan, and would refinance later to pay back the principal. The Ponzi borrower took on a negative amortization loan, which meant that the monthly payments did not cover the entire interest, and that the principal, thus, continued to increase.

Speculative and Ponzi mortgage borrowers were able to appear and their numbers suddenly jump in the observed period in the US exclusively thanks to the appearance and rapid development of the shadow banking system. The shadow banking system is made up of institutions that function legally, but outside the range of banking regulation.¹⁶ Differently from conventional, regulated banks, shadow banks are financed by uninsured short-term sources, which may but do not have to be covered by conventional bank credit lines. Since they operate below the radar of traditional bank regulation, these high-risk financial intermediaries in the US operated in the shadow, outside the reach of the Federal Reserve and the Federal Credit Insurance Agency. The shadow banking system

¹⁶ P. McCulley: "The Shadow Banking System and Hyman Minsky Economic Journey", *Global Central Bank Focus*, PIMCO, May 2009

brought the credit cycle to the phase of euphoria at the beginning of 2006. Then, in mid 2006, when stock prices reached their peak, the smart traders began to cash in their profits.

In search of quick profits, lenders gave out more and more exceptionally favorable loans to insolvent mortgage borrowers, in the hope that real estate prices would endlessly rise. The phases of financial boom and euphoria were accompanied by the appearance of new, innovative credit instruments on the liberalized US financial market. In the 1980s, as it turned out, these were junk bonds, while in the 2003-2007 period, were securitized mortgages, which allowed banks to provide housing loans without worrying about whether they would ever be repaid. Investors who bought the new mortgage-backed financial instruments accepted the risk of the eventual default of mortgage borrowers, regardless of the fact that the loans were being approved not only by regular banking institutions but also by those who operated on the shadow credit market.

Until August 2007, both the real estate market and the mortgage loan markets in the US steadily grew. Growth of demand on the real estate market was both the cause and the effect of the growth of the mortgage loan market within the shadow banking system, which made it possible for the financing of mortgage borrowers to increasingly turn to speculative and Ponzi borrowers, through ever riskier mortgage loans. The riskiness of these loans stemmed from the fact that they were being taken by less and less solvent borrowers, as well as the fact that the ratio between their own and borrowed funds among lenders continued to grow in favor of borrowed funds. The growing supply of mortgage loans brought rapid growth in the supply of real estate, as easy crediting caused a sudden growth of demand on the real estate market.

When the bubble burst on the real estate market, a reverse process began. Panic overtook the financial market when two Bear Stearns hedge funds that had invested heavily in mortgage securities collapsed in summer of 2007. During the following six months, the Federal Reserve struggled fruitlessly to prevent a general financial collapse. According to Dean Baker, the coordinator of the Center for Economic and Policy Research in Washington, until the beginning of February 2008, real estate prices in the US were falling at an annual rate of more than 10%, something not seen since before the Great Depression of 1929-1933. This means that, in the first wave of the crisis, American households were getting poorer at a rate of two trillion dollars a year.¹⁷ The banking institutions that did not fall victim to the wave of bankruptcies reacted by restricting conditions for credit approval.

¹⁷ J. Cassidy: "The Minski Moment", *New Yorker*, February 4, 2008

6. The Minsky Moment

Human nature is inherently pro-cyclical. According to Minsky, “from time to time, capitalist economies exhibit inflations and accumulating debts which have the potential to spin out of control. In such situations, people’s reactions amplify such movement in the economy – inflation feeds upon inflation and debt accumulation stimulates further debt accumulation.”¹⁸ In other words, when it comes to investment, it is human nature to make snap decisions. When they decide to invest, people estimate the moment in which they judge the investment to be profitable today, rather than its future value. People, thus, naturally undertake activities that amplify upward and downward cycle amplitudes. The lesson for the makers of economic policy and regulatory bodies is to apply counter-cyclical instruments and measures, such as demanding that the size of bank capital be contingent, that bank capital must increase in periods of inflation and debt accumulation and decrease in times of falling economic and credit activity.

Minsky disciple Paul McCulley referred to the moment in which investment decisions are made on the securities market as a Minsky moment.¹⁹ The Minsky moment that leads the capitalist financial system and the entire capitalist economy into collapse, appears in an overheated credit cycle, when investors are faced with cash flow problems due to spiraling debts they have incurred in order to finance speculative investments. At that moment, a major securities sell-off begins on the market, as it is impossible to find a buyer who will bid at the high asking prices previously quoted, leading to a sudden and precipitous collapse in securities prices and a sharp drop in market liquidity.

7. Conclusion

Post-Keynesians are unanimous in their assessment that, during the 2003-2007 period, the Federal Reserve held the benchmark interest rate too low for too long, ignoring their warnings about what was happening on the US mortgage market. However, the Federal Reserve was not alone in its ignorant stance. In the period between 2003 and 2007, most Americans did not want to hear anything about the shortcomings of funds that invested in mortgage-backed securities, or about mortgages that allowed borrowers to make monthly payments so low that their outstanding debt in fact continued to grow. In search of quick enrichment, they were busy buying and selling houses and mortgage-backed securities, which is in the nature of a speculative mania.

¹⁸ H. P. Minsky, *The Financial Instability Hypothesis*, *ibid.*

¹⁹ The term Minsky moment was first used by Minsky’s disciple Paul McCulley in 1998, when explaining the causes of financial crises in Asia and Russia, which had broken out in 1997 and 1998. Paul McCulley, *ibid.*

Minsky wrote that “in order for market economies to function well, appropriate state intervention measures are needed, along with an appropriate institutional structure of the financial sector.” Taking Minsky’s philosophy to heart, it is possible to conclude that, instead of restarting old debates about whether it is better to reduce taxes or increase public spending in the current economic crisis, economic policy makers should focus on the question of how to reform the financial system so that it serves as the circulatory system of the entire economy, and not as an arsonist. Economic policy makers should merely apply the financial system regulatory measures that Minsky has already proposed: to ban overly risky stock market dealing, restrict irresponsible loan approval, which would protect creditworthy borrowers, help the victims of fraud, exclude irresponsible lenders, and introduce criminal responsibility for bad assessments on the part of rating agencies.

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ASSISTANT PROFESSOR SANJA VUČKOVIĆ, PhD*
Faculty of Business Studies, Megatrend University, Belgrade

FINANCIAL MARKET REGULATION AFTER THE GLOBAL ECONOMIC CRISIS

Abstract: *The paper reviews previous results and future challenges in the field of financial regulation. The global economic crisis has uncovered the numerous weaknesses of the contemporary financial system. Almost certainly, future financial regulation will be more restrictive, more elaborated and broader. That will have major effects on financial flows within and between countries, on the work of financial institutions and on the structure of financial markets.*

Key words: *financial markets, state regulation, global economic crisis*

JEL classification: G 18, E 31

Introduction

The latest financial and economic crisis has led to a reexamination of the role of various participants on the financial market. The conditions that existed in the financial system before the outbreak of the economic crisis are being reconsidered, as part of a search for its causes. Coming under closer scrutiny are the newest generation securities, rating agencies, conglomerate banks, managers, brokers and, finally, the state and its regulatory system. According to some views, the state was too rigid in its regulation of the financial market, becoming one of the main culprits for its collapse, since participants were actually trying all possible ways to find new sources of financing and investment and to satisfy their natural drive for greater profits. On the other side are the views of many economists that the crisis is a consequence of excessive deregulation of the financial market.

* E-mail: svuckovic@megatrend.edu.rs

This work will analyze possible paths of reform of financial regulations. First, we would like to determine whether financial regulation is at all necessary; second – what were the characteristics of regulation up till now; and, third – the direction in which regulation might change. Although at present there is no reliable information regarding future reform measures, it is undoubted that the general disappointment with the financial markets will result in numerous changes within the frameworks that determine their functioning.

2. The theoretical foundations of the free market and state regulation

Regulation is often criticized as unnecessary bureaucratic meddling in economic flows and as a consequence of ambitions on the part of the state administration to run everything, including the economy. What is forgotten is that the need for state regulation also arises from some objective circumstances. Practice has shown that economic theories are often based on unrealistic presumptions and that optimal economic results cannot be achieved if everything is left to the market.

In this part of the work, we will cite the ideas of two proponents of the market mechanism, Smith and Walras, in order to subsequently point out the different factors that bring into question the social usefulness of unrestrained market activity: limited competition, external effects, informational asymmetry and the irrationality of market actors.

The debate regarding the intensity of the state's participation in the process of creating market efficiency and the public interest has continued since Adam Smith's time. According to Smith's idea, competition will drive the individual to work for the public interest while achieving his own interest (profit). He thought that private interest was a much more lasting characteristic of human nature than the concern to do good and that it offers a much more reliable basis for the organization of society. The constant striving for greater profit on the part of the individual represents a search for more efficient ways of production and for products that will satisfy consumer needs. Therefore, any active state role would disrupt and delay that process, while all control and regulation would be superfluous, as it would serve to limit the competition that would otherwise eliminate uncompetitive producers from the process of production. An efficient economy assumes an allocation of resources in which the position of one side cannot improve unless the other side's position worsens (the state known as the Pareto optimum). Economists are always searching for Pareto improvements, i.e. changes that bring benefits to some, without harming others. The endless search for Pareto improvements brings the economy of welfare to the following question: what is that welfare for each individual? Different individuals have different understandings of the concept of welfare and everyone experiences it in their own way. Second, it is not the relative welfare of different individuals that

is being taken into consideration but the welfare of everyone separately, which can cause the economy, in spite of Pareto improvements, to produce pronounced inequalities in society and a greater gap between the rich and the poor. The welfare economy finds the solution in the process of competition and considers an economy to be Pareto efficient if it is marked by pronounced competition. It is possible to achieve a Pareto efficient allocation of resources through the market mechanism, accompanied by an appropriate initial redistribution. Is that how things truly stand? Why don't, under certain conditions, competitive markets achieve efficiency? Before answering the question, we should first analyze the contribution of some other theories to the search for optimal state regulations.

The foundations of general macroeconomic balance were set in the work of Leon Walras. This economist's idea was to simultaneously determine the prices and quantities of goods and services in a given economy by identifying and leveling the supply of certain goods and services and the demand for them.¹ The function of the demand is determined by the prices of products and services, the earnings of individuals and their preferences. On the other hand, supply is determined by production costs, and the prices of production services and technology. Under conditions of perfect competition, consumers will maximize their usefulness and the producers their profit, taking prices as given quantities. Equilibrium is achieved with the aid of prices that balance the market and lead to a situation in which there is no surplus of demand over supply. This theory leads to the same results as the previous one (Pareto efficiency) and it is supposed that they apply under the same conditions – in an economy in which there is perfect competition and in which no individual is big enough to be able to influence the prices of products and services, in which everyone possesses perfect information and in which all other technical conditions have been fulfilled. In short, these are called – perfect conditions. Most often, perfect conditions do not exist in contemporary economies and the reality is totally different. During the last two centuries, it has been realized that, in certain important areas, the market does not act as perfectly as the proponents of the functioning of the free market see it. It often stimulates the dissatisfaction of one side, which is convinced that others enjoy better living conditions, frequently leads to the pollution of the environment, and contributes to the formation of inequalities in society. Economic theory has crystallized several key situations in which markets do not achieve efficiency (Pareto efficiency or the Walrasian equilibrium).² Reviews and analyses of these cases provide answers to the previously posed questions and give argumentation in favor of greater activity on the part of the state.

Some branches of the economy are marked by limited competition, i.e. a situation characterized by the existence of only one company (or several com-

¹ On different theories of the market and regulation, see: C. A. Pelaez and C. M. Pelaez: *Regulation of Banks and Finance*, Palgrave Macmillan, 2009

² J. Stiglitz: *Ekonomija javnog sektora*, Ekonomski fakultet, 2004

panies) that supplies the market (monopoly or oligopoly). Through its activity, the state itself often enables the formation of such situations as, for example, on the one hand, it approves patents as exclusive rights to a certain invention and, thus, stimulates innovation but, on the other hand, makes competition on the market less perfect. Sometimes it is beneficial to have only several companies in a certain field, as that makes production more efficient (entry barriers enable the achievement of economies of scale on the part of protected companies).

Also, there exists a certain number of purely public goods that the individual uses free-of-charge and it is almost impossible to exclude them from the enjoyment of those goods (even if they so desire), but their total costs outstrip the benefits the individual would enjoy by producing such a good. In such situations, state activity and investment is necessary.

In the same way, whenever private markets are unwilling to provide a certain product or service, even in situations where the costs of their provision are lower than what individuals are prepared to pay, market imperfection exists, and such markets are called incomplete, since suppliers do not have an interest in offering a wide array of goods or services. This is a frequent case in the area of providing insurance or the approval of certain credits.

The very existence of positive and negative external effects through which individuals (positively or negatively) affect one another imposes a certain form of state intervention. Whenever external effects exist, the allocation of resources provided by the market will be insufficient.

The basic manifestation of the inefficiency of the financial market is the presence of informational asymmetry, a situation in which market actors do not have complete information on the position, success and business prospects of other subjects. Asymmetry appears as an initial agent of processes that are deemed harmful for the functioning of the financial market and the national economy. We are talking about the problems of adverse selection, moral hazard and “herd behavior,” phenomena that, in the final instance, may lead to financial crises and recessional tendencies in the economy. Adverse selection is a problem of *ex ante* informational asymmetry, i.e. a phenomenon that is present even before agreement between interested sides is reached. On financial markets, investors in securities (or creditors) often possess incomplete knowledge on the creditworthiness (quality) of the issuers. Since creditors cannot precisely evaluate the creditworthiness of each individual borrower, they will tend to lend funds at an interest rate that reflects the average quality of all the borrowers on the market. The consequence will be that firms with above-average creditworthiness will be able to acquire funds only at a higher interest rate (higher cost) than their creditworthiness warrants, while companies with a lower creditworthiness will be treated to a lower interest rate (lower costs) than they actually deserve. Analogously, companies of above-average quality will try to avoid issuing securities at market rates, as the costs of acquiring funds will be unrealistically high (i.e.

the securities will be undervalued), and the issuers will mainly be firms of low creditworthiness and quality. Considering the fact that quality companies will withdraw from the financial market (due to unfavorable conditions for attracting capital), it further comes out that many projects that would otherwise bring profit remain unrealized. Companies that are less successful and prone to high risks will appear as users of funds (with a much greater probability that the funds will not be repaid), which means that the ultimate outcome from the standpoint of the optimal functioning of the financial market and the national economy will be unfavorable.

Moral hazard is a manifestation of *ex post* informational asymmetry. On the financial market, the creditor is exposed to the hazard that the debtor will invest the obtained funds into projects that are, from the creditor's standpoint, undesirable (too risky, immoral). Moral hazard occurs because the debtor is stimulated to invest in high-risk projects from which he will earn high profits, for which, in case of failure, either the creditor or the state will sustain the largest portion of losses (due to the existence of a dispersed scheme of deposit insurance).

Herd behavior is a concept that describes the behavior of investors when information is inaccessible or when their obtainment requires significant costs. Investors on the financial market can follow the behavior of actors whom they believe are better informed about the characteristics of the assets in which they have invested and, thus avoid the costs of researching investment possibilities (overpriced/underpriced securities). However, if a significant number of investors follow the behavior of a leader, thus increasing demand for assets that are valued as underpriced, the price of that instrument will rise. The consequence will be that the investor who invested time and money into finding favorable investments will no longer be able to claim the entire value of the deviation of the price from the realistic value of the instrument. That will result in a reduced interest in making efforts to discover segments in which the financial market is not efficient, which will contribute to an even greater inefficiency of the financial system and to a misallocation of funds.

During the last twenty years, there has been a rise in the significance of economic theories with psychological elements in their foundations. They point to the fact that people (even the biggest professionals and experienced investors on the financial market) are not always rational and that, as a result, the regulation of financial and economic flows cannot be left to the market. People use various mental shortcuts (heuristics) in human decision-making, which, actually, denotes decision-making without the use of professional techniques, statistics and mathematics, and even without the use of a wholly rational consideration of the problems. Some of the phenomena on the financial market that show investor irrationality are: calendar anomalies (predictable price behavior in the course of a year, month and day), excessive price variability (price oscillations unexplainable by rational factors), unexpected effect on prices (an absence

of influence of important information, together with an obvious influence of irrelevant information), excessive trade (quantity of trade that cannot be rationally explained). Behavior is also affected by factors such as weather conditions and people's moods.³ The most important consequence of investor psychology on the macro plan is the possibility of the formation of a herd effect, speculative bubbles and stock market collapse. The financial system may become permanently destabilized.

In an influential book, published upon the outbreak of the current global crisis, Akerlof and Shiller reminded that Keynes had pointed to the significance of non-economic motives and irrational behavior for disruptions in economic cycles.⁴ Keynes thought that this phenomenon was the main cause of market fluctuations and high unemployment, which set the stage for a face-off between two great economic thinkers – Adam Smith and Keynes. In short, the former believed in the free market, the latter in the imperfection of the market and in state intervention. We shall now point to the ways in which this dilemma on the financial market was resolved before the outbreak of the current crisis. In the last part of the work, we shall look at the new challenges in researching the optimal relationship between the market and regulation.

3. Financial market regulations in the pre-crisis period

Over the centuries of financial market development, a number of goals of financial regulation have crystallized:

- Protection of market participants. The state's interest is for investors on the financial market to be protected from illegal activities (fraud and abuse), the establishment of an atmosphere of trust that would, thus, secure preconditions for an efficient functioning of the market.
- Stimulating competition in the provision of financial services. Competition between financial intermediaries brings lower priced services, improved quality and prepares intermediaries for the harsh competition in the international arena.
- Maintaining the stability of financial institutions. Due to the great significance of financial institutions in the collection and allocation of financial resources, their regulation is supposed to secure the stability of the financial system.

³ On psychology in economics, see, for example, R. Shiller, *Irrational Exuberance*, Princeton University Press, 2000

⁴ G. Akerlof, R. Shiller: *Animal Spirits*, Princeton University Press, 2009. The title of this book points to the imperfection of human decision-making. Akerlof and Shiller say that the expression stems from the Latin term for mental energy or life force, which means that people are moved by impalpable stimuli and impulses.

- Protecting the economy from negative influences from abroad. State intervention often limits the access and controls the business activity of foreign actors on the domestic financial market.
- Maintaining macroeconomic stability. The connection between the financial and the real sector of the economy is strong, so the overall economic balance requires the supervision of all its segments.
- Securing efficient payment operations. The efficient functioning of the financial market and the national economy requires a developed system of accounting and execution of payment of financial operations.
- Control of monetary-credit policy. The contemporary state shifts the instruments of economic policy to the financial market.
- Regulation of the ownership structure and relations. Processes of nationalization and denationalization are always current, and the place where they occur should be the financial market.

The success of financial regulation is measured by the degree to which the said goals are fulfilled. The longer the period of the functioning of the financial market and the economy as a whole, the bigger the conviction that financial regulation is well set. Still, no matter how hard regulators try to perfect and standardize regulatory norms, it constantly turns out that it is necessary for them to be further adjusted. The process of cyclical changes on the financial market and changes in the area of regulation, where interaction occurs between the regulators and those that are regulated (institutions), is called the regulatory dialectic. Namely, regulation policy is dynamic and adapts to innovations on the financial market. And vice-versa, changes in the work of financial institutions often represent replies to changes in the field of regulation. In addition, actors on the financial market try to find the most favorable environment for conducting financial operations. The activity of investors directed toward finding a more favorable regulatory environment is called regulatory arbitrage. Arbitrage can be geographically oriented – finding a market somewhere on the globe where the actor will enjoy the most favorable treatment. On the other hand, one may change the structure of business activities with the aim of finding the financial instrument that will be able to circumvent existing regulations or take advantage of treatment that is more favorable relative to other instruments. These activities will place new demands before regulation: which will result in its adaptation but also in still newer financial innovations.

The architecture of financial regulation has so far been based on three pillars: capital requirements, deposit insurance and disclosure requirements. The first two are direct forms of market regulation, since the regulator (the state) himself controls business activity and prescribes measures to which institutions have to adhere. The first two forms of regulation are often referred to by the single name of safety and sound or prudential regulation. On the other hand, dis-

closure requirements represent an indirect way of regulating financial markets, as the financial institution is being required to allow public scrutiny of relevant information about the company, while market actors are left the option of forming their own conclusions about the success of its operations.

When it comes to demands regarding capital requirements, financial institutions can perform their intermediary role only if they justify the trust of their clients (depositors in the case of banks, issuers and investors in the case of transactions with securities). The intermediary's obligation to carry out contracted work will be credible only if he is solvent at the time of execution. That is why it is in the interest of clients, the state and intermediaries themselves for regulations to prevent overly risky dealing that would lead to mounting losses and financial institution insolvency.

For financial institutions it is characteristic that they have a low share of own capital in their total capital (i.e. they have high financial leverage). Such a situation increases the interest of institutions to enter risky deals since, in case of failure, shareholders will lose much less than the creditors (there is, thus, significant moral hazard). That is why regulation – through demands for minimum capital requirements or adequate levels of capital – works toward securing conditions for financial institutions to operate in a responsible manner. By prescribing minimum ratios of own and total capital, the possibility of financial institutions' insolvency is reduced. A big advance in this field was made at the end of the 1980s, when national regulatory bodies accepted the conclusions of the Basle Committee on Banking Regulations and Supervisory Practices, which in July 1988 presented future regulatory directions through capital adequacy indicators, and which banks in developed countries began to carry out in full from the beginning of 1993. In June 2004, the so-called Basle II Standard was established, also with the intention of achieving clearer and more complete regulation of the banking sector and of contributing to financial stability (in addition to credit risk, it includes market and operational risk). The essence of the Basle regulatory guidelines is that riskier placements in institutions' assets require the holding of higher levels of own capital.

In the second regulatory field, deposit insurance, many countries provide added protection to depositors in the form of deposit insurance in case their financial institution is not able to fulfill its obligations. If it turns out that the bank cannot pay out its obligations, then the state institutions (such as the Federal Deposit Insurance Corporation, FDIC, in the US) are obliged to take on the bank's obligations. In return, the state guarantor's rights outweigh the owners' in case of bankruptcy. It should be born in mind that it has been known from earlier times that deposit insurance carries certain negative effects. Namely, banks have an interest in engaging in risky operations (moral hazard) and increase the value of insuring such operations, while depositors' interest in supervising bank operations declines (since the government guarantees the return of their funds).

The third pillar of contemporary financial regulation are disclosure requirements. In order that market actors can supervise financial institutions by themselves, the state prescribes disclosure requirement regulation, which requires that financial institutions make their financial reports public at regular time intervals. Disclosure requirement regulation is justified in the context of the problem of informational asymmetry, i.e. the phenomenon by which financial institution managers possess more information on the financial situation and prospects of a company that operates on the financial market. In order to provide a more equal position to investors on the market, regulation requires public disclosure of information that would otherwise remain inaccessible.

The above-described segments of financial regulation have been applied at national level but it has also been attempted, in some places successfully, to set common regulatory standards at international level. Financial instability is a phenomenon which easily transcends national bounds and the international financial marketplace becomes a powerful source of external effects.

The less developed countries have striven during the past twenty years to adjust their financial regulations to the principles set in developed countries. Two key differences existed: first, their financial institutions were not well developed and the array of offered financial instruments was narrower than in the developed countries; and, second, developing countries have in principle retained greater control over capital flows. Those differences have shown themselves as good in the current crisis: their financial institutions did not suffer losses from sophisticated securities, while the high restrictiveness related to capital flows (especially the high mandatory reserves imposed by central banks) has shown itself to be an instrument of protection from instability.

The types of tendencies that existed in developed countries are best described by the endless practice of financial deregulation in the US. During the term of President Reagan, the liberalization of the real estate market was initiated in 1982, by way of the well-known Garn–St. Germain Depository Institutions Act, in 1999, the Clinton Administration repealed the famous Glass-Steagall Act, which separated commercial from investment banking, while in 2004 the Securities and Exchange Commission (SEC) allowed investment with higher financial leverage (and risk). Derivative financial instruments and non-banking financial institutions were practically never regulated (it was believed they were self-regulating).⁵

At the end of this portion of the work, we conclude that, in the period before the crisis broke out, financial regulation was based on two elements. First, regulation focused primarily on banks and traditional banking operations, while other financial institutions, as well as financial innovations in the banking sector itself, were not considered a danger to the stability of the financial system. Second, trust in free-market mechanisms was great, while capital control and

⁵ J. Stiglitz: "Capitalist Fools", *Vanity Fair*, January 2009

the limiting of financial institution growth was considered anachronous in developed countries.

Just when it was thought that the rules of the game were set optimally, that they allow the unhindered functioning of the financial market and that each segment of the financial system was adequately regulated (or that it was self-regulating), financial collapse occurred, quickly turning into an economic crisis of global proportions. The world suffered its first recession since World War II in 2009, with unemployment even in developed countries reaching two figures, exploding fiscal deficits (as a result of massive state aid to the financial sector), a double-figure fall in global trade, negative capital flows (net outflows) in developing countries, trillion dollar losses on the part of US and European banks from bad placements, and stock market index losses of up to one half of total value.⁶ Financial market regulation had failed, since none of the goals mentioned at the beginning of this portion of the work had been realized.

In the last part, we will examine the connection between various identified weaknesses of the financial system in the current crisis and possible solutions, i.e. changes in the regulation of financial markets.

4. Possible outcomes for future regulation of financial markets

A difficult task is being placed before the creators of the economic and financial system. It is necessary to find a new balance between market discipline, on the one hand, and competition, development of financial innovations and economic growth, on the other. Further, it is necessary to limit and by all means avoid the appearance of crisis situations.

The administrations of developed countries reacted decisively as soon as they realized the scope of the crisis in the second half of 2008, with the US taking the lead and the developed countries of Europe and Asia mostly following. Intervention measures can be divided into several groups. The first consists of measures directed toward increasing central bank liquidity, and finance ministries carried out exceptionally expansionist measures of monetary and fiscal policy, in order to prevent the collapse of credit activity from private sources. Second, measures were taken to prevent bankruptcies of both firms and financial institutions – it was judged that the real and the financial economy would collapse if the big corporations and banks were to fail. Third, measures that focused on the segment of housing credits were brought, primarily by stimulating banks to lessen the credit burden of credit end-users. Fourth, with the passage of time, new financial regulation measures are being proposed.

⁶ Data from the International Monetary Fund publication, *World Economic Outlook*, October 2009.

Since all the above groups of measures transcend the bounds and topic of this work, we will deal below with current proposals for financial system reform. That this process will not be at all easy or brief is shown by opposing views that accompany each proposal. There are mostly agreements in connection with areas where changes are needed, but not about the essence and direction of those changes.

At international level, at the G-20 summits, there has been talk about the guidelines of future financial regulations but, as in the case of other measures, the US administration is the most active. That is a partial consequence of the fact that the US, where the crisis originated, is under the intense scrutiny of both the domestic and the international public, but maybe even more so a result of the desire and promise of the (new) president that he will energetically engage in the solution of the piled-up problems. In two instances, in mid 2009 and at the end of January 2010, President Obama has presented elements of new financial regulations. In the first instance, he referred to the following areas of reform: protection of consumers (bank clients), manager bonuses, capital adequacy of financial institutions, regulation of the so-called shadow banking sector and financial derivatives. Six months later, Obama added proposals for the introduction of special taxes for big financial institutions (in the measure in which the state bailed them out) and for barring banks from simultaneously engaging in commercial and investment banking. A great public debate is currently being waged in expert circles about the said proposals. Some of them are truly revolutionary, especially the last: if the banks were compelled to separate their base operations from their investment operations, that would represent a return to the Glass-Steagall Act, which was considered to represent the distant (and dark) past for the financial industry.

The first question connected with possible solutions to financial problems relates to methods and ways of helping people who have incautiously over-indebted themselves. Should individual mortgages be refinanced, or should help be extended, through certain measures, systematically, to help everyone? In other words, should the measures be general or aimed at individual, problematic cases? The only possible solution is for mortgages to be converted into loans with longer pay-off periods and lower interest rates. It might have been expected for the banks themselves to undertake this operation in order to solve their own problems. Still, in December 2008 the FDIC brought out data showing that as many as one half of the refinanced mortgages from the first half of 2008 have once more become problematic, since their debt burden had not decreased. That means that the market (the banks) had not reacted sufficiently well. An even bigger problem manifested itself in 2009, when banks once more failed to reduce the population's debt burden, despite the generous budgetary help that the state provided to financial institutions. Generally speaking, case-by-case interventions should be avoided because they do not bring long-term improvements; it is better to regulate the large blocks of toxic credit at once. According to other views,

which find their arguments in the fact that financial derivatives are legitimate contractual relations between banks and investors, systematic state intervention should not be allowed, since that will enable financial institutions to re-engage, with moral hazard, in high-risk deals. Investors that earn high interest rates should be aware of the risks they are taking. All state intervention in the form of help or in dissolving such contracts would represent meddling into the mutual relations of two sides, while also raising borrowing costs. In addition, such reliance on the lender of last resort would lead to further moral hazard and new problems. Certain politicians would be lobbied by the big financial institutions to support the passage of certain laws in the domain of financial regulation. That would discriminate against small companies that do not exert great influence on legislators, and bring them into an uncompetitive position. That would also stifle the development of financial innovations and raise the costs of financial services, which would in turn lead to the instability of the financial system. It was proposed that a regulatory body be introduced within the finance ministry,⁷ whose primary task would be to give early warning of increasing systemic risk, as well as that regulatory measures in all financial areas be coordinated.

Numerous proposals relate to the regulation (deregulation) of the banking sector. Earlier in the paper, we presented the contributions of the Basle II agreement, which by various regulations sought to maintain the stability of financial institutions throughout the world. Proposals for strong regulation of this field base their support in the viewpoint of a group of economists, headed by Paul Krugman and FED president Ben Bernanke,⁸ by which the basic reason for the outbreak of the crisis lies in the inadequate regulation of the banking sector. They agree that an overall revision of the system is necessary, which would presume the existence of clear rules and standards that regulate more (than previously) segments of business on the financial market, before all, large financial institutions and their risk management, all towards the goal of establishing financial stability. It looks as though the big financial systems will become the most important subject of prudential control, as it is thought that the crisis in fact began in the “kitchen” of such “financial supermarkets.” Reforms in this field will underscore the significance of managing the risk of companies, their liquidity, capital adequacy, level of debt, and regulation of inducements – manager rewards, all with the goal of protecting all the participants on the market. One of the more concrete proposed measures is that, when issuing (originating) mortgage securities, banks should reserve high levels of capital, which will force them to pay more attention to the quality of securities that they issue. The

⁷ Financial Services Oversight Council – FSOC.

⁸ For more details, see: Krugman, P.: *The Return of Depression Economics and the Crisis of 2008*. W. W. Norton Company Limited, 2009 and B. Bernanke: “Federal Reserve Policies in the Financial Crisis”, <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>.

intention is to secure much greater transparency on the market when it comes to the reporting of both banks and rating agencies. The rating agencies, which have been hit especially hard by public reaction, have to more clearly divide the instruments that have some sort of assets at their base (derivatives) from ordinary corporate debentures.

Great attention in future regulation is also paid to the so-called shadow banking system, made up of non-banking institutions that invest big capital into the financial market and, thus, affect the (in)stability of the entire system. These are financial institutions, typical intermediaries between investors and those seeking capital, which issue their own securities and whose contribution to the latest crisis is quite large. They could be insurance companies or pension funds that transfer money collected through premiums and other deposits through the financial market and conduct operations that are almost identical to those of the banking sector (except for the method of collecting capital). These market participants should be regulated in a similar way as banks in terms of capital adequacy, debt level and appropriate transparency of operations.

A third view about regulatory reform is related to the question of breaking up the “too big to fail” financial institutions.⁹ Stiglitz and many other economists think that such systems should be broken up into smaller regional institutions as, due to their size and potential support from the state, they are prone to taking high risks in their business, without fear of bankruptcy. They have been joined by US president Obama in one of his latest addresses on the subject of new economic reforms.¹⁰ He emphasized that Americans cannot be hostages of a financial system made up of several big institutions. Rather than applying the geographical principle of measuring size, he is presenting the prospect of stopping increases in bank size by field of activity. Also, banks will no longer be allowed to own, sponsor or invest in hedge funds or other private funds for profit-making purposes. It is anticipated that the central bank will receive greater authority to supervise financial institutions and elaborate a mechanism for their bankruptcy in case of poor results. There remains the dilemma of whether to leave financial sector regulation under the auspices of the central bank or to specialize a separate state agency for that purpose.

The regulation of financial derivatives appears as the most important and most sensitive area of new state reform. American investor and businessman Warren Buffet has called financial derivatives “financial weapons of mass destruction,”¹¹ while former US president Bill Clinton and former FED president

⁹ The expression refers to the largest and most important financial institutions that must not be allowed to go bankrupt as that would have long-term effects on the economy as a whole.

¹⁰ For more details, see: President’s Remarks on Regulatory Reform-January 21, 2010. <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>.

¹¹ For more details, see: Warren Buffett , “The Economist-Derivatives-A Nuclear Winter?”, http://www.economist.com/finance/displayStory.cfm?story_id=12274112.

Greenspan now admit that they insufficiently regulated these very important financial instruments during their mandates. It was underscored earlier that there are views that the financial crisis was not caused by unclear regulatory policy but, on the contrary, by overly rigid, inflexible control, without sensitivity for innovative development. In accordance with the latter viewpoint, the latest generation financial derivatives as generators of the crisis came about precisely because the regulation of standard banking operations was overly rigid and strict (since it was only there that it existed), forcing the big financial institutions in search for profits to find new and cheaper ways of securing capital. And then, overestimating their capacities in on-balance and off-balance assets, they created numerous derivatives with exotic names (CDO, CDS, SCDO, CLN) and soon, together with them, experienced financial disaster.¹² Financial derivatives are derived securities that have at their base assets that can come in various forms: mortgages, various loans and other securities, and whose basic characteristic is a very unclear relationship between risk and yield. It has been shown that these financial derivatives contribute much more to the spreading of risk and oscillations in the value of assets at their base than to effecting risk reduction through diversification. Proposals for the regulation of the said instruments vary. The most significant demands are to the effect that the auditing of standardized financial derivatives from the over-the-counter market should be done through regulated central institutions, that high margins and capital values should be set for all market participants, that constant financial reports on the possession of these instruments should be required, that the types of financial intermediaries that may participate in transactions with financial derivatives should be limited. In the US, regulation would be carried out through the Securities and Exchange Commission and the Commodity Futures Trading Commission. In addition, it is certain that the Financial Products Safety Commission (FPSC) will be created, and that its task will be to investigate the quality of securities and services, and to provide all necessary information to the public.

Management inducements in the form of bonuses and other compensation are sharply criticized in the newest reforms and regulatory plans. It is immoral for such bonuses to be paid out in companies and financial institutions that receive state aid. However, even the faltering US giants were paying out bonuses in the midst of the crisis. It is considered that manager bonuses made a negative contribution to the onset and expansion of the financial crisis, and that, for years back, they played a role in sporadic company bankruptcies. Namely, with the aim of earning the biggest possible bonuses, managers are often oriented towards short-term rises in share prices, while disregarding principles of sound, responsible and long-term business operations. They also resort to accounting fraud. Such behavior has a negative effect on other participants on the financial

¹² For more details on these financial instruments see: P. Kapor: "Strukturni finansijski instrumenti: CDO, CDS, SCDO, CLN i ABCP", *Poslovna politika*, mart-april 2008

market, since it provides inaccurate information about certain companies. However, there are opposing views even when it comes to this question. Some think that top managers take on the biggest responsibilities for company results and that, on that basis, they require satisfaction in the form of high salaries, bonuses and other rewards that are most often high in value.

In addition to these most important areas, future directions of interest for state regulation will most often be the creation of micro and macro prudential or *ex ante* control of financial institutions. This is supported by numerous proposals for the creation of various state commissions and agencies that we mentioned earlier. An extensive survey conducted by the OECD points to a high correlation between the prudential control of financial institutions and their competitiveness.¹³ Actually, a thorough and thought-out regulatory policy will not worsen an institution's position on the financial market (relative to the competition), but will provide it with greater stability, which is especially important in unstable business conditions. Canada is an example of a country with good state regulations. This country did not have major financial problems in the midst of the crisis, as was the case with the US, even though it had an even more pronounced concentration of financial institutions. The cause of this advantage lies in stricter limitations when it comes to issuing mortgages and level of institutional debt (low leverage levels). Even before the crisis, Canada had a separate, independent agency charged with the protection of borrowers.

A very important precondition for successful financial regulation is the balancing and harmonization of procedures and activities with other countries. Otherwise, it may happen that, as previously, on the path of blind profit maximization, financial actors turn to markets with the loosest regulation and without great limitations when it comes to business transparency. That does not solve the essence of financial problems and the economy may very well face a future crisis situation as a result. Support for this thesis comes in the form of the interesting statement of the governor of the English central bank, Mervyn King, who says that financial institutions are global in life but national in death.

Reforms in the area of finance must not be applied separately from other economic reforms, as that would be a recipe for failure and would not bring the desired results. Macroeconomic stability will continue to be an important prerequisite for financial stability in the future.

Finally, after reviewing the most important proposals for financial system reform, several interesting dilemmas remain. Will well-conceived, all-encompassing regulations truly succeed in creating an environment for a fair market game? Is the state sufficiently credible and wise to be able to advance the development of the financial market? Will the big financial institutions, in spite of

¹³ Ahred, R, Arnold, J. and Murtin, F.: *Prudential Regulation and Competition*, OECD Economics Department Working Paper No. 735, OECD Publishing, 2009

close state supervision, succeed in finding new ways of, as they would put it, diversifying risk, which may in practice bring increased systemic risk?

5. Conclusion

The current financial and economic crisis has brought large losses to the real and the financial sector, but has also brought into question previous knowledge about the functioning of financial markets. Despite the fact that certain economists claim that the crisis was caused by excessive (rather than insufficient) regulation, they are a minority. There is great dissatisfaction, even fury, with the way in which contemporary financial markets function. All the shortcomings of the free market have shown themselves in the worst possible light: moral hazard, informational asymmetry, psychological influences, negative external effects. That is why great changes in the regulatory framework of financial markets are on the horizon. For now, it is certain that more capital will have to be reserved for financial operations, that all (including derivative-based and not just ordinary) financial operations will be under close scrutiny of supervisors, that risks will be monitored more closely and measured more accurately, that clients (financial services users) will be more protected, that managers will receive lower benefits and that banks will be more restrained in their free growth (by breadth – geographically, and by depth – in taking on new forms of business activities).

It is necessary to restore confidence in the financial market, so that it may successfully carry out its intended functions, before all the stimulation of capital flows towards the most productive uses and discovering the price of market instruments. In the current crisis, the financial markets have never been farther from these goals. Regulation must protect the participants on the financial market, encourage competition, maintain financial system stability and help achieve macroeconomic stability. The crisis has shown that regulation has not been up to task. Standard measures of financial regulation – adequacy of bank capital for traditional banking operations, protection of depositors and transparency, have shown themselves to be insufficient. That is why the areas of regulation are currently expanding, but the impression remains that there is no consensus about the kind and amount of regulation that is needed. There is a danger that over-regulation of certain activities will slow the development of financial markets and lessen the chances of economic recovery, on the one hand, and produce new, untamable financial innovations (financial products) with potentially devastating effects, on the other.

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ASSOCIATE PROFESSOR MÁRIA LÁSZLÓ, PHD*
*Department of Political Geography and Regional Development,
Institute of Geography, University of Pécs*
RESEARCH FELLOW ANITA SZEBÉNYI
*Department of Political Geography and Regional Development,
Institute of Geography, University of Pécs*

THE ECONOMIC INSTRUMENTS OF LOCAL GOVERNMENT IN HUNGARY

Abstract: *The establishment and regulation of local government system was one of the most important issues during the Hungarian regime change. The Law on Local Governments in 1990 gave local settlements wide-ranging powers of self-government, however its economic resources have not been created since then. Cooperation among settlements or its lack – although it has undergone fundamental changes since 1990 – is still problematical regarding both micro-regions and the role of county governments and their economic means.*

The present paper deals with the economic situation of local governments and it focuses on the economic bases, assets and budget of self-government. Through the analysis of income sources we examine the relationship among power, task and resource distribution.

Keywords: *local government, assets and budget of self-government, power, task and resource distribution, finances*

JEL classification: H 72, R 11

1. Introduction

The position of Hungarian local governments and their history of almost twenty years are intertwined with the history of the change of regime, as the legislation of self-governments was among the first to be enacted after the change of regime in August 1990. In the process of democratization and decentralization, where the division of power, tasks and resources of the state, as well as the status of territorial levels influence the vital issues of public administration and territorial organization, the act was inevitably determined by political compro-

* E-mail: lasmaria@gamma.ttk.pte.hu

mises. Its consequences can still be felt today and influence both the economic condition of local governments, and the entire system of public finance. One of the reasons is that the division of labor and financing between the subsystems of public finance is unclear, which influences most the relationship between the state and local governments, but it also affects the relations of other subsystems, particularly social security. A significant portion of problems with the distribution of resources between the subsystems of public finance also impacts the budget of local governments. These problems are rooted in the delayed reform to public finance, which failed to realize until now.

Research into the economic instruments and the economic condition of local government requires an interdisciplinary approach to the subject also because in Hungary, the differences between regions and settlements are substantially greater than the levels of economic development would suggest, despite all intentions and interventions. It is also because the distributive mechanism of state subsidies aimed at the reduction of differences in defining and modifying the financing system of local governments; yet the differences between the regions and settlements have grown.

2. The condition of local governments as reflected by the regulation

In the legislation concerning the Hungarian self-governments, along with the act on local governments, the acts on regional and settlement development, the act on construction, the act on the protection of environment and nature and the related implementation directives actually took into account the European Charter of Local Self-government, and its spirit, concluded in Strasbourg in 1985 and ratified by more than 30 countries. This document was born in the process of decentralization, which took place in the European countries; it considered the peculiarities of countries with a democratic establishment but greatly different traditions, and described the essence of the autonomy of self-government. The condition to the autonomy of self-government is as follows: what can be managed locally, on the level nearest to inhabitants and in a way adapted to the inhabitants' needs, has to be provided there. This was also adopted by the Hungarian legislation, as it provided great freedom to local governments to define their tasks and make decisions, thus ensuring that self-governance shall be the guarantee of democracy and development. It was already problematic on the legislation level to provide appropriate financial and human resources for local governments to administer and implement their tasks.

The act on local governments stipulates that local governments implement their tasks on a level and in a quality permitted by their financial resources and the inhabitants' needs. In Hungary, legislation created the legal framework of self-government providing public services, while there is an option of municipal

enterprises too. The regulation in this area too is more lax than in most Western European countries. It is true that we can see plenty of open issues and regulation problems concerning the tasks and their resources.¹ The public service provider has the secure resources required for task provision, while enterprising self-governments are characterized by profit-orientation and risk-taking to achieve relatively bigger profits. It has to be remarked here that the Hungarian legislation of self-government did not actually select a model, and consequently, legal regulation is dominated by the current act on annual budget as well as the condition of current central budget in terms of financing, which creates significant uncertainty in the financial system of self-government. The act on self-governments declares that self-governments act freely in the local public affairs within their authority. "Local public affairs are connected to the provision of public needs to the inhabitants, the local execution of powers, as well as the establishment of their organizational, human and financial conditions. (1990 Act LXV, Section 1 1. §. (2)). "The law can assign mandatory task and authorities to the local government. By assigning mandatory tasks and authorities to be provided by the local government, the parliament concurrently ensures the necessary financial conditions for their provision, and decides on the amount and means of budgetary contribution" (paragraph 5). Then, later, in paragraph 87 § (2), it states: "In the case of assigning a new task to self-government, the parliament concurrently ensures the necessary financial resources for its provision." This latter sentence was only included in the text after amending the Act in 1994, and since then there has been a constant debate about new tasks for self-governments when it comes to financing.

The Hungarian regulation of self-governments is extremely liberal, especially in terms of legal guarantees for the organizational system of self-government and the autonomy of decision-making.² The logic of regulation clearly shows that lawmakers principally took care that the organization and operation of self-government should be independent of the influence of central, superior bodies; and in practice, it should relieve the central budget of the financing burden. The act on self-governments legally cancelled the hierarchy of settlements, thereby creating equal opportunities for the settlements in the process of resource allocation. It made possible for every settlement to manage their finances based on local features and grass root initiatives, since the normative funds and the framework of tendering system are the same for settlements of different size and type in terms of earning their revenue from the state. Thus centralization survived on the revenue side by preferring the financing function of central budget and tax, and it was coupled with the decentralization of tasks, authority and responsibil-

¹ Cs. László: *Tépett vitorlák... Az államháztartásról közgazdasági és jogi szempontból Aula Kiadó, 1994, pp. 323-341*

² I. Pálné Kovács, M. László M.: "Az önkormányzati önállóság és a közgazdasági feltételrendszer", *Társadalomkutatás*, 4. 1993, pp. 86-102.

ity (László, M., 1997).³ As legislation in the field of financing mandatory tasks of self-governments rather meant the relief, or better to say, withdrawal, of the state, it generated more conflicts on local level and in the relationship of self-governments and the state.

Based on the nature of economic regulation, and the means and extent of financing, it can be stated that the economic instruments of self-government did not, or could not, realize. Although a local government can form its financial management strategy itself, find cost-efficient forms of provision and force its institutions to follow suit, it cannot, however, remove their own resources of revenue, as the law protects the financial autonomy of institutions and budgetary organs. Local governments carry out revenue-oriented financial management and rely on integrated funds, thus the regulation encourages local governments to seek revenue and uncover local resources for their financial management, and does not separate budgetary funds needed for the operation and development of settlements within the local budget. That is why we see that the priority of operating the settlements often limits renovations and maintenance. It is also problematic for settlements that the conditions to increase their own revenue are greatly restricted due to the removal of central resources. Additionally, the priority of operating the settlements is unable to create real local interest for the local players too, although it should be an essential component of self-government. Several of our basic research studies confirmed that in periods when the additional load is not connected to some mobilizing objective, i.e., local developments, the local network of connections play a significantly smaller role in the process of uncovering and expanding resources, and also in stimulating local players of the economy and the inhabitants.

The fact that the central budget and central redistribution strongly determine the operational and development decisions of self-governments greatly harms the autonomy of self-government. It leads to a reduced level of revenue interest and local economic activity. As the freely available resources for own development are scarce, an overwhelming majority of local governments were able to realize only projects, which were financed by external funds or resources, earned via tendering (e.g. targeted or earmarked government subsidies, EU resources). However, the most dependent settlements were those, which were excluded from these resources, as they were simply unable to bid lacking self-contribution and personnel. The objectives and means of settlement financing depend on many factors, of which only a few are highlighted here in connection with the economic condition of Hungarian local governments. The structure of public administration and the number of public administration units, as well as the relationship between the different levels definitely have to be mentioned. Since every settlement has the right to self-government and our settlements did

³ M. László: Az önkormányzatok gazdasági eszközrendszere PhD dolgozat, JPTE KTK Regionális politika és gazdaságtan PhD program, Pécs, 1997, p. 150

use this right, 3,167 local governments have been established, 2,839 in villages and 328 in towns.

Therefore the Hungarian self-governmental system yielded a deeply fragmented and highly differentiated structure, formed by settlements with relatively high autonomy.

As there was a lack of financing for regional task provision for settlements and local governments were unwilling to associate for a long time, it actually made the task provision of self-governments even more expensive, and further increased the differences between settlements in terms of service standard. Although in the past years, local government associations have significantly changed due to the financial incentives received from the state, a vast number of local governments still perceive the establishment of subregional associations as coercion. It was also seen during the international comparisons that there are great similarities among the various countries in the provision of basic services; however, their practice is different in defining mandatory and voluntary functions on local level. In this sense, it can be said that Hungarian local governments were assigned too many mandatory tasks whose provision has pushed voluntary tasks into the background, which should otherwise better reflect the local characteristics. The development of self-government management and the reform to state budget are equally enhanced by the decision, control and management of an autonomous local government which can reveal and mobilize human resources and financial reserves, and can adapt to local conditions that is impossible for the kind of hierarchical and uniform control and management ruled from above (I. Illés, 1996).

Summarizing the vital issues of financial management of local governments in our self-governmental system running for nearly two decades and amending to the aspects already mentioned, the following problems can be highlighted:

- The dependence of local governments on the central budget has remained strong and often changed to the wrong extent and in the wrong direction;
- The high rate of redistribution limits own revenue resources, the size and rate of own revenue, preventing revenue-orientation to improve;
- Local tax policy was influenced by economic emergencies and not by local economic policy and the need to develop local economy; local tax concessions and exemptions often served macroeconomic social policy aims;
- The budget of local governments was exceedingly used for operations, the extent of renovation and maintenance was less than required, while the most dependent settlements were excluded from external development funds;
- Revenue-orientation failed to realize, and it did not mobilize the local network of connections to uncover and concentrate resources;
- The conflicts in the financing of regional relationships did not encourage a cooperative behavior but rather resulted in the settlements becoming

inward-looking, the present cooperation can mostly be due to financial incentives from the state;

- Revenue resources, needed mainly for development, largely depended on external factors and the priorities set by central organs;
- The transformation of ownership structure did not benefit the local governments either, since during privatization the interests of self-government were not represented properly from legislation to implementation, our local governments obtained a large amount of fully depreciated property, but obtaining property was second to actual property management;
- Capacity utilization, economies of scale and cost analysis were not appreciated in financial management, and the earlier attitudes toward budget and baseline continued, practically on every level;
- The distribution and redistribution of revenue are out of proportion with public consumption and the satisfaction of need for public goods both on the level of national economy and of settlements, thereby increasing the dissatisfaction of every participant, while players of the state budget point fingers to each other;
- There is no connection between normative financing and the costs of task provision, and it is also problematic to work out the mechanism and conditions required to maintain the real value of normatives, which emerged not only because of the economic and financial crisis.

In the sphere of local governments and in the satisfaction of needs for public goods in general, it is important to draw on the principles and analyses concerning capacity utilization, scale of economies and efficiency, which demand to categorize the tasks, set up priorities related to the quantity and quality of public goods in both the operation of settlements and in regional and settlement development, as well as in the objectives and instruments of regional policy. It is still valid that the future of settlements lies, along with the independence of local governments in their organization and decision-making, in their relationship with the institutional system of regional policy concerning resource allocation and their willingness to regional integration. Decentralization in a political and economic sense can take root and become irreversible only if local governments themselves are able to demonstrate the political, public administrative and economic advantages of the autonomy of self-government through their day-to-day activity.

3. Financing of self-government and the regional levels

Through market economy, local economy diversified regarding the forms of ownership, organizational forms of financial management and the main types of business organization. The financial management of self-government means, on

the one hand, managing their own property and budget, and, on the other hand, all the relationships and connections in which players and organizations represent the arena of self-government management and are subjects of fundraising.

Our research found that the institutionalized forms of human services are determined, along with their diversity and multisectoral structure, by the economic features of budgetary organs and the issues of budgetary funds. In analyzing Oll as the institutionalized forms of regional relationships. After passing the act on self-government, the autonomy of settlements was interpreted in a way that settlements mostly undertook self-sufficiency, or provision of services and tasks which suppressed regional relationships and thereby the issues of scale of economies and efficiency. A major change in this area was brought about by the system of multipurpose subregional associations, whose territory cover the NUTS subregions but based on the legislation – by earning normative financial subsidies from the state – they provide public services for the settlements of subregions. Since mid-1990s, perhaps the most significant development took place within the system of self-governments about the settlements and their organizations. This development implied a certain degree of organizational proliferation. Multipurpose/complex subregional associations were needed also because, together with the required efficiency of regional provision of tasks, the European Union can only endorse the development of transparent systems, and could/can only include such in its development policy. By principle, the EU offers great autonomy to member states in the field of regional public administration and the cooperation between settlements, i.e., it intends to keep national sovereignty intact. The collaboration of settlements, as well as the mandatory or optional forms of cooperation are determined by the traditions of nation states, the existing settlement structure, the level of development, and last but not least, by the connections to public goals and programs, and the ensuing pragmatism.

A large portion of self-governmental tasks belonging to the subregion is provided for by the complex (multipurpose) subregional association with legal entity. This association can be established by all or a certain number of participating local governments, which belong to the given subregion. This association with legal entity plays an important role in applying for and using state funds. This paper does not aim at analyzing the process, conflicts and contradictions of the legal regulation, but nevertheless, it is important to mention that the issue of legal regulation has come into the crossfire of political arguments. In terms of economy, it is highly significant that previous associations did not have legal entity, i.e., they were established via the free association of self-governments, but the body of representatives of local governments exercised the rights. Such associations were the associations for regional development, investment, tourism, as well as associations which have functioned since the beginning based on the act on self-government to operate institutions, authoritative-administrative associations, common bodies of representatives or offices of notary-district. Certain

local governments were members of various associations, so this regional level became obscure, i.e., the different organizations were not regionally unified, and they did not coincide. The regulation of multipurpose subregional associations tried to resolve this situation by allowing the establishment of multipurpose subregional associations with the participation of all local governments belonging to the given subregion and providing for at least three public services and subregional development tasks. In case the associations do not comply with it but include more than half of relevant local governments, and are set up with the participation of at least two local governments whose size of population reaches 60% of the total population of the subregion, and are formed to provide at least three public services, can also be regarded as multipurpose associations, though they are entitled to a lower amount of subsidy. An association is entitled to subsidy if it was formed by 60% of local governments within the boundaries of subregion, on condition that the size of population reaches 50% of the subregion's total population.

If the multipurpose subregional association is formed not to provide public services but rather regional development tasks, all local governments have to agree to join. Multipurpose subregional associations can earn funds to operate tasks (public services) from within their area on a higher professional level as well as jointly and more efficiently. It is characteristic of the multipurpose subregional associations that self-governments mostly sought to better utilize human capacities based on the resolutions of association councils, and did not really undertake to merge or even cancel institutions. The position of self-government changed in many aspects, since the subregions tried to obtain additional subsidies in order to modernize the subregional public administration, as well as to implement the integrated subregional administration and customer service set up by the regional administrative organs. The establishment and strengthening of multipurpose subregional associations have an impact on numerous problems of the mid-level, primarily the position of municipal governments. Municipal governments, because of the act on self-government, lost some of their previous public administrative functions and positions.

The 1990 Act LXV on self-government regulated the counties too, but they can be described more and more as operators of institutions. Counties were obliged to take up tasks from local governments, which the local governments could not, or did not want to, keep. Mostly there was a financing reason for it, when counties had to take over the institutions and provide for the tasks. By operating the institutions, municipal governments have been able to provide for less and less self-government-type tasks, and their role in the institutional network and tasks of regional development is also diminished due to the formation of NUTS regions. This statement is valid even if we know that the chairman of regional development councils is elected from the chairmen of municipal governments belonging to the region. As the financing of the self-government's

mandatory tasks is based on subsidies and contributions from the state, i.e., not based on cost coverage related to the current budget, local governments did not undertake unfavorably financed tasks or transferred the uneconomic institutions to the municipal governments. The present way of normative financing, where normatives do not cover the costs, limits the decision-making liberty of self-government.

While the normative distribution system is an improvement in terms of economic autonomy of the self-government and equal rights, it has several drawbacks too. It is a step forward because more and more normatives are introduced in financing in order to stimulate subregional associations, while it is also true that overall normative subsidies did not change, moreover, they decreased in real terms what could be seen as a symbolic amount to subsidize villages. True, these subsidies were noticeable and important resources only in small villages. The disadvantage is evident in that subsidies are tied to the mandatory tasks of self-government so that it disregards the actual costs, since it is declared to be state contribution to the provision of mandatory tasks. There is no elaborated mechanism to maintain the real value of normatives, to catch up with the inflation rate. Although the Hungarian regulation of self-government employs the system of material automatism, but without wage automatism or at its low level, it is the local government that has to finance the loss or deficit resulting from the wage-intensive institutional structure. One of the biggest disadvantages of normative state funds is that self-governments receive them directly and without earmark, i.e., this subsidy does not finance the actual tasks carried out by the self-government but mainly relieves the state budget. Another consequence is the rigidity of the existing institutional structure, while this type of financing also prevents new provisional forms and players from offering services to the inhabitants, and does not really encourage cost-effectiveness and association or collaboration.

4. Regional differences

The position of local governments is in many ways connected with the country's regional differences. Hungary's gross domestic product measured at current purchase prices amounted to 25,479 billion HUF in 2007, almost half of which (47%) was produced in Central Hungary. Due to its leading role in economy, 37% of the country's total gross domestic product was produced in Budapest.

Table 1: *Gross domestic product (GDP) by region*

Region	GDP (at purchasers' price)			
	Billion HUF		share, %	
	2006	2007	2006	2007
Central Hungary	11203	12008	47.1	47.1
Central Transdanubia	2372	2607	10.0	10.2
Western Transdanubia	2369	2483	10.0	9.7
Southern Transdanubia	1549	1668	6.5	6.5
Northern Hungary	1899	2024	8.0	7.9
Northern Great Plain	2280	2426	9.6	9.5
Southern Great Plain	2104	2265	8.8	8.9
Country total	23775	25479	100.0	100.0

Source: KSH, 2009

The gross domestic product per capita in Hungary in 2007 was 2,534,000 HUF. Although in the seven regions of the country the specific regional differences were somewhat moderated, the ranking order of regions did not change. Central Hungary including the capital continues to hold first position, followed by Western Transdanubia, and Central Transdanubia in the third place. Out of the first three regions, the GDP per capita in Central Hungary is higher than the national average; in Western Transdanubia it was 1,9% lower, while in Central Transdanubia already 7% lower. The order of these three regions did not change according to the regional GDP calculations dating back to 14 years. The other regions (lagging behind the national average by 32-37%) are positioned on almost the same level. Southern Transdanubia has kept its fourth position for ten years ahead of Southern Great Plain, Northern Hungary came before Northern Great Plain in 2004, and this order has remained unchanged.

Table 2: Gross domestic product per capita by region

Region	GDP per capita, thousand HUF	Difference from the national average, %		
		2007	2006	2007
	2006	2007	2006	2007
Central Hungary	3911	4162	65.7	64.3
Central Transdanubia	2141	2357	-9.3	-7.0
Western Transdanubia	2369	2487	0.4	-1.9
Southern Transdanubia	1598	1730	32.3	-31.7
Northern Hungary	1512	1627	-36.0	-35.8
Northern Great Plain	1491	1596	-36.8	-37.0
Southern Great Plain	1564	1692	-33.7	-33.2
Country total	2361	2534	-	-

Source: KSH, 2009

If counties are also ranked based on GDP per capita, we can say that in addition to the capital, Győr-Moson-Sopron County and Komárom-Esztergom County are above the national average, while Fejér County, Vas and Pest County exceed the county average; the other counties, however, remain below the county average calculated without the capital.

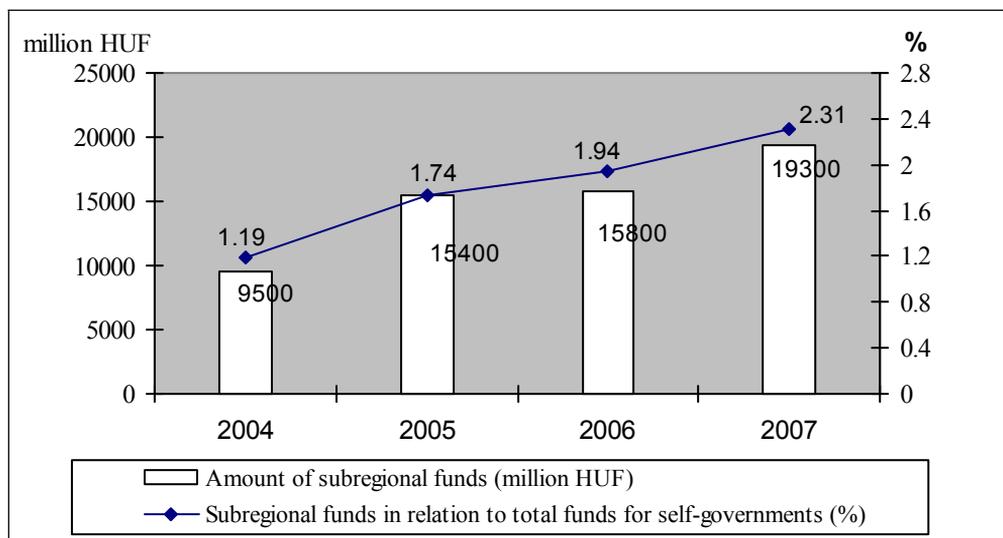
It is possible to make an international comparison of development by using GDP per capita data measured in purchasing power standard (PPS). In this respect, the development of Hungarian regions – with the exception of Central Hungary including the capital – still shows significant lag. In 2007 the GDP per capita of Hungary was 37% less than the EU average. More specifically, the indicator value of the central region is 3.1% higher, while the two most developed Transdanubian regions were already 38-42% below the EU average. The per capita value of the other Hungarian regions did not reach even half of the average; the lag only grew bigger, which was 57% in Southern Transdanubia, 58% in Southern Great Plain, and 60% in Northern Great Plain. The position of the Central Hungarian region measured against the EU average further weakened compared to 2006. The lag of Central Transdanubia behind the average slightly decreased; however, it increased in the other regions compared to the previous year. The difference between the development levels of regions can be observed in other EU member states. According to a “News Release” published in February 2009 by Eurostat, the GDP per capita measured in purchasing power standard exceeded 1.5 times the EU average in 2006, in 18 of the 271 regions of the European Union, while it remained below 75% of the average in 68 regions. Except for Central Hungary, all Hungarian regions lost their previous position among the EU regions, and fell 3-5 positions in the ranking. The central region

showing the best result is only positioned in the second third, the other regions can be found in the last third.

Decentralization was evident in the instruments tackling regional disparities and resource allocation, i.e., the regions obtained a greater role in allocating decentralized funds to reduce territorial differences and stimulate the economy, whether allocating domestic or EU funds. In terms of self-government, it is important that decisions and their preparation got nearer to the regional levels. The results can also be seen in the process of project generation, which specifically determined the planning for the period 2007-2013 and thereby it was able to involve a larger number of local players.

However, regarding the financial management of self-government and the economic basis, we believe it is more important that the established subregional associations undertake to provide public services, for which they receive normative subsidies from the state. *Graph 1.* shows that its size and share in the self-government subsidies have not yet reached a substantial level but for the cooperation of settlements and provision for mid-level tasks, the increasing amount and share of funds are especially significant. It is true that the financial incentives of the government are often perceived as coercive by the local governments, but for the standard, efficiency and economies of scale of public services, the professional public or the political sphere never questions its importance.

Graph 1: Amount of subregional funds (million HUF), and its share in the total funds for self-government (%)

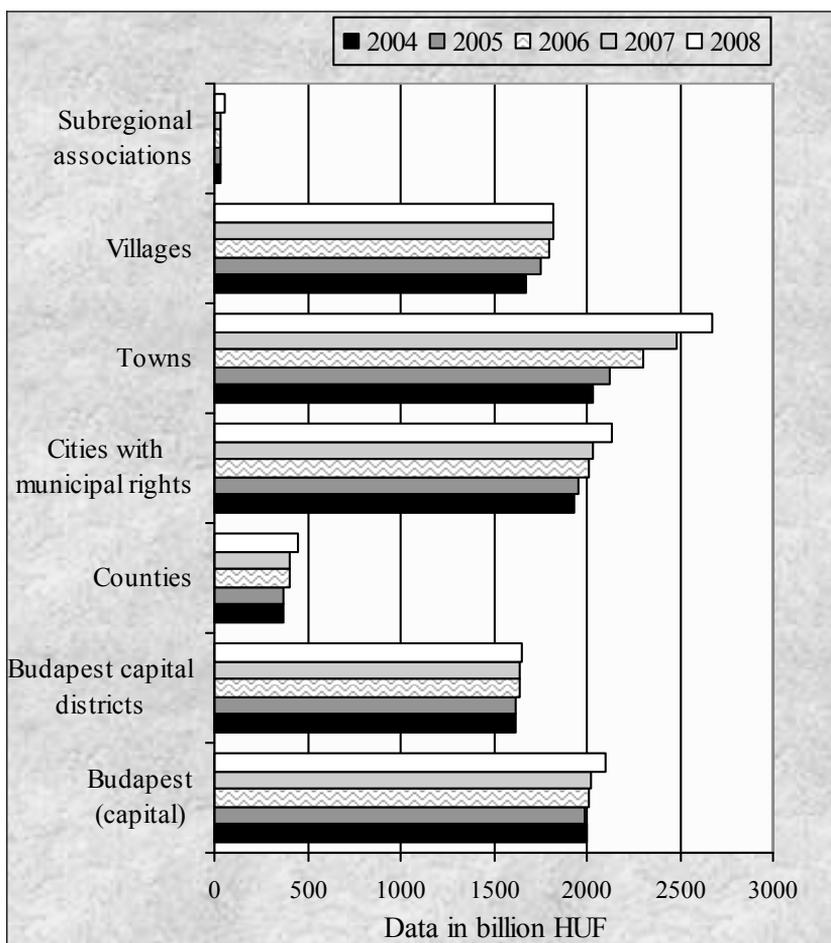


Source: after I. Hoffman (2007) ed. A. Szabényi

The institutionalization of subregions as self-government association and its independent legal entity, as well as its general and direct empowerment to authority represent a substantial change in the economic instruments of self-governments, as the establishment and application of normative financing, as well as the fixing of subregional boundaries created a transparent and manageable level for regional policy. Of course settlements, next to assignment of self-government rights, got the option to finally decide where to belong, and subregions could also decide themselves on belonging to a county and region. In the self-government system, towns, mainly small towns and villages with less than 500 inhabitants, have the biggest budgetary problems, since government funds can ensure the stagnation of operation in the best case. The only possibility to move from stagnation is the improving willingness to cooperation and regional integration, as well as the transformation of institutional structure, which is still left to be done. The practice of actual association agreements and cooperation show that local governments primarily aimed to better utilize personnel in human services and to improve safeguarding of their interests, as well as put a larger emphasis on fund raising. Today it can be still stated that the existing structure can better safeguard its interests in our local governments, often pushing aside the need for changes, but thereby also innovation and the search for new ways.

5. Issues of the economic basis of self-government

The analysis of the economic basis of self-government, its property and budget, is also carried out in terms of self-government autonomy. “The self-governmental subsystem of national finances consisted of 3194 local governments and 173 subregional associations in 2008. The balance sheet property of local governments increased from 9,861 billion HUF to 11,099 billion HUF between 2005-2008. Local governments managed 3,364 billion HUF of net budgetary revenue in 2005, and 21% more in 2008. For task provision in 2008, 40,000 public servants and 361000 full-time public employees were employed” (State Audit Office, 2009).

Graph 2: Property by type of self-government (data in billion HUF)

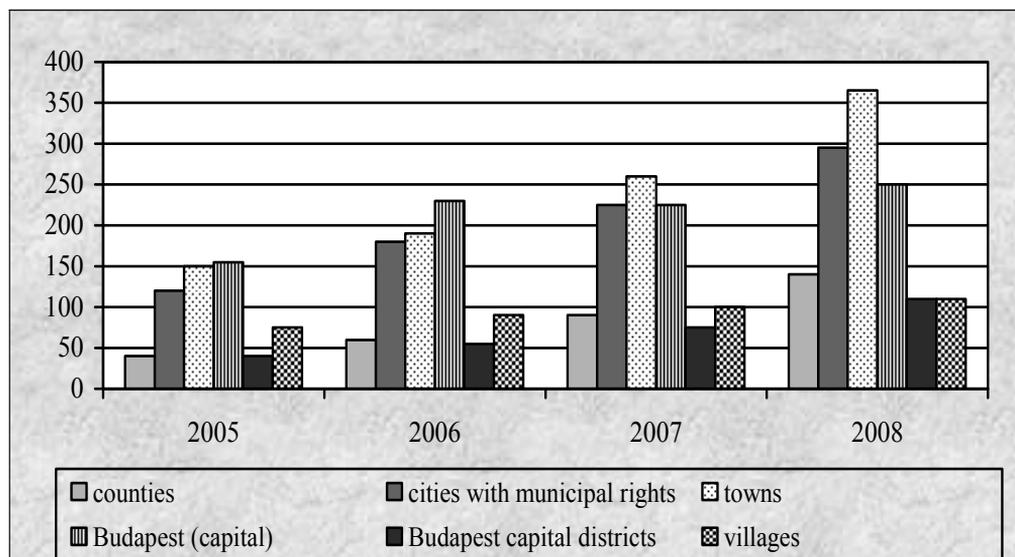
Source: Based on SAO report ed. A. Szabényi

By reviewing a longer period it can be established that the value of self-government property is closely related to regional and settlement differences, the privatization process after 1990 and the budgetary situation of local governments. In the past years, the conditions to provide for self-government tasks were met in terms of property; however, tasks related to property management have grown, while the budgetary function of property declined. After privatization, local governments obtained/took over ownership rights of property management required for task provision, and had to face serious challenges. It was especially difficult to ensure the technical condition of property, and, because of budgetary problems, local governments were forced, mainly in the first decade of self-government, to sell the property in order to gain short-term, annual budget-

ary revenues. Consequently, the share of marketable property, in particular real property, of local governments decreased in the national average, but it was even worse in places with larger shortage of resources, i.e., in underdeveloped regions and settlements. Nevertheless, local governments were compelled to give priority to annual budgetary management at the expense of long-term interests. It was especially perceivable in the cancellation of maintenance and renovation works, which in turn resulted in a more difficult situation of property management in the sphere of self-government.

The act on self-government regulates the economic basis of local governments, essentially stating that local governments have their own property and independently manage their budgetary revenues and expenditures. The property of local governments consists of their possessions and property-tied rights due of the self-government. A separate part of the property of local government is the principal property, which has to be accounted for separately from other property. Principal property functions to provide for mandatory self-governmental tasks and authority or to locally exercise public powers, and can be unmarketable and marketable with restriction. Unmarketable principal property includes local public roads and their structures, squares, parks and any other real or moveable property, which is declared unmarketable by law or the local government. Public utilities, institutions and public buildings, as well as real and moveable properties determined by the local government are marketable with restriction. For the legal regulation of property, it is worthwhile to notice that the business enterprise of the local government cannot endanger the provision of its mandatory tasks, and local governments can get involved in a business enterprise in which their liability does not go above the amount of their contribution in property.

Actually, the Hungarian regulation of self-government reflects the logic of self-government providing public service, also by declaring the conditions related to the priority of mandatory tasks. Looking at the changes in the property of local governments, it is clear that in the past years, the increase in the balance sheet property is the result of 8% increase of real property and related rights, 7% increase of invested financial assets, and 23% increase of assets provided for operation, trust, concession, and management. Although the year-end volume of liquid assets substantially grew (by 126%) between 2005 and 2008, it is a gain from revenue of bond issue in 2007 and 2008. In contrast, the assets and resources of local governments increased by only 12.6% in the same period. The growth of debt size at local governments signals in practically every settlement type that in contrast with investment-induced property value, the year-end size of liabilities has grown and significantly grew year by year, being an unfavorable process (Graph 3). At the end of 2008, the size of debt rose to double the year-end value of 2005.

Graph 3: Debt size by type of self-government (data in billion HUF)

Source: based on SAO report ed. A. Szabényi

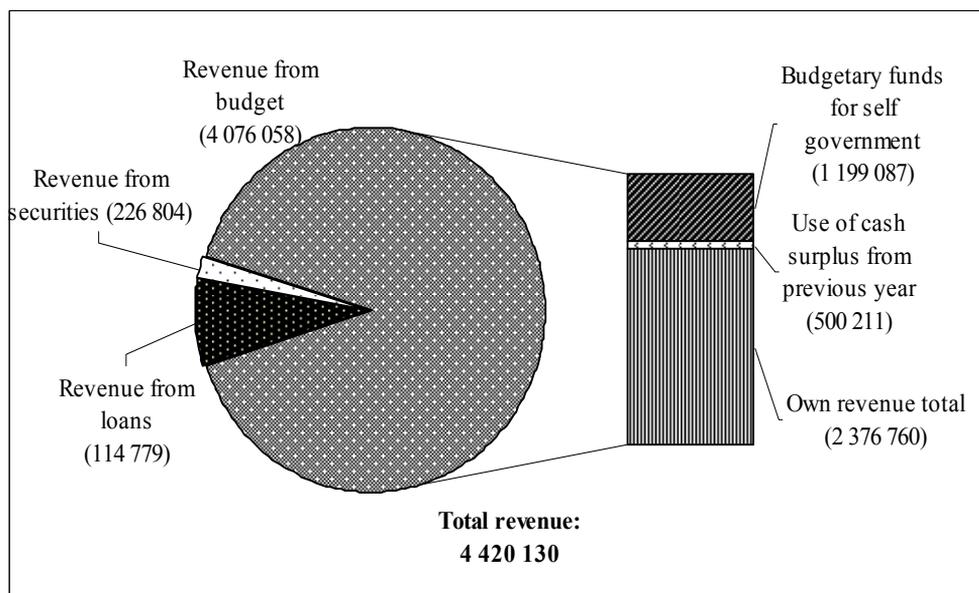
It has to be pointed out that 87% of the increase of debt size was due to long-term liabilities, of which 63% was due to bond issue. The debt size related to bond issue, constituting more than one-third of total debt, increases the annual liabilities of local governments, which will grow due to principal repayment liability deferred to 3-4 years, and will further burden the annual budget. This payment bond is substantial already in 2009 (2.9 billion HUF), which means that local governments got into a difficult financial situation and not only because of the government's austerity measures induced by the crisis. In the past 20 years, the number of local governments with budget deficit continuously rose and their rate accounts for two-thirds of all local governments. The expansion of bond issue caused the number of borrowing local governments to go down within the financial operations in 2007-2008. Among the different settlements, the main borrowers were local governments with municipal rights, as well as districts of the capital and the local governments of towns, which is connected to both the problems of regional financing of self-governmental tasks and the institutional structure, its invariability and rigidity.

Our analyses revealed that in one group of settlements, the problem is rooted in backwardness, i.e., the lack or relatively low level of public services, and development funds are needed to overcome it, while operational resources are also scarce. The other group of settlements, along with the lack of resources, has tried for decades to tackle the bottlenecks, which cause the public services to be more expensive, and the operational costs and investment need to be too

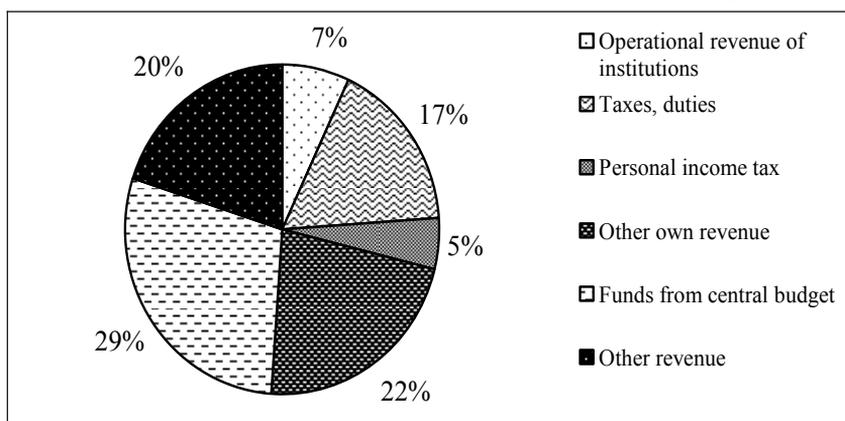
high. In more developed settlements where public services are available, there is a relatively large need for development and reconstruction due to the age of institutional network, buildings, etc. Financing is more focused on the continuity and sustaining of services as preferred by the short-term economic approach.

Relying on resource-oriented regulation, local governments determine their spending on public services, and their possibilities, based on the size of the realized and by law freely available resources, while the limit of their expenditures are their revenues. The financial management of local governments is influenced by their active and passive revenue interest. Revenue interest is active if their disposable income depends on the quantity and quality of revenue activities of local governments, and it has an impact on the volume and standard of public service activity of self-government (e.g. in case of own revenue and funds obtained from tendering). Revenue interest is passive when local governments are unable to influence the size of revenues, but those revenues strongly influence their financial possibilities and thereby the quantity and quality of public services, (e.g. normative central funds and shared taxes). Revenue interest is displayed in Graph 4 and 5.

Graph 4: Incurred gross revenue of local governments in 2008 (data in million HUF)



Source: based on SAO report ed. A. Szabényi

Graph 5: *Distribution of incurred net revenue of local governments, percentage (2008)*

Source: based on SAO report ed. A. Szabényi

The data above reveal that the revenue interest of the Hungarian local governments is fundamentally passive, since their sources of revenue depend to a larger extent on the macroeconomic objectives and the condition of central budget. Among them, revenue from securities and loans reflects more the economic emergency and less the autonomy of self-government. In the case of local taxes (taxes on buildings, plots, communal tax, business tax, tourist tax), the passive interest can be primarily seen in that applying concessions and exemptions does not serve the objectives of local economic policy but essentially macroeconomic, and mainly social policy goals. Additionally, due to the relatively high central tax charge, levying local taxes is met with heavy opposition despite that most local governments issued its own tax regulation, mainly to prove that they did everything to raise funds locally (Table 3).

Table 3: *Number of local governments levying local taxes by tax type (2008)*

Description	Yr. 2008
Building tax - residential	420
- non-residential	758
Plot tax	432
Communal tax of private persons	2261
Communal tax of entrepreneurs	693
Tourist tax - on duration of stay	584
- on accommodation fee	9
- on building	167
Business tax	2698
Number of local governments levying local taxes	3126

Source: based on SAO report ed. A. Szabényi

In the structure of self-governmental spending in the reviewed period of 2005-2008, the personal expenditures rose by 6%, while material and accumulation-type expenditures rose by 12%. As the increased spending involved the rise of debt size of local governments and the earned budgetary funds also rose substantially by 36%, it cannot really be expected that the active revenue interest of local governments would increase in the coming years without major changes taking place.

For local governments, the Parliament determines normative budgetary contribution in proportion with the population size of settlements, age groups, and number of people in care by institutions and based on other indicators. Normative contribution, as expressed in the term, is the state contribution to the provision of mandatory tasks, which does not cover the costs of the given mandatory task; so local governments have to operate local services by relying on their integrated liquid funds. In principle, managing an integrated budget helps and encourages financial management and task provision based on local priorities and local features, but lacking resources, voluntary tasks are put aside in the process of task ranking where mandatory tasks enjoy priority. The priority of operating the settlement, as opposed to development, limits the activity of local society and the development of local connections, although there are significant changes in this field as well. For local governments, the legal guarantee for financing is that in terms of normative financing, the amount of state funds cannot be lowered in the budgetary year and local governments may be assigned a new mandatory task only by being assigned resources. It is true that after the 1994 modification of the act there were a lot of conflicts and debates about the way and volume of financing, and the changes in mandatory tasks (e.g. in the area of financing for public employee's wages, educational, social, employment, aid, healthcare services).

In fact, an overall reform to public finance can resolve the budgetary condition and issues of financial balance of local governments, as well as the active revenue interest, which is still substantially impeded by the connected interests. The financial management of local governments and its instruments specifically reflect the harmony of relationships between power, services and resource allocation, their synchronicity or even shortcomings, between the central and local government, between public administration and self-governmental levels. Through the financial management of local governments, the exposure and analysis of the specific mechanism of resource allocation in the new and changing environment (in a situation determined by the relationship with neighboring countries and the changing cooperation with Europe), it substantially influences the objectives and instruments of regional policy. The harmonization of regional and settlement development, the improvement of the standard and efficiency of public services are greatly dependent on the instruments of local governments and the financing issues of self-government. Generally speaking, the main issue

is making progress in the area of public finance, where also the economic issues are displayed as social policy issues.

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PROFESSOR ANDREA PANZAROLA, PHD*
Associate Professor of Civil Procedure Law
LUM Jean Monnet University of Casamassima, Bari, Italy

NOTORIOUS FACTS IN ITALIAN LAW

Abstract: *The article analyses the concept of notorious facts in Italian law. After explaining the concept itself, its foundations are analysed. Then there is discussion on the issues of allegation and possible verification. There is also attention paid to special hypotheses such as so-called “local notorious fact”, i.e. a fact “limited to a restricted circle of subjects”, which has found its way into legal systems. Finally, contestation before the Supreme Court is studied.*

Key words: *notorious facts, local notorious fact, Italian law*

JEL classification: K10, K40

1. The concept

There is a tendency to believe that art. 115, paragraph 2 of the Italian Code of Civil Procedure describes the concept known as “notorious fact”. This description is found in the part of the paragraph, which refers to “notions of fact that fall within common experience”. A connection to the judge’s power to place them “at the basis of his decision” “without the need for proof” is therein drawn. The existence of the phrase “*common* experience” transpires the essential meaning of “notorious” for Italian law. In other words, in order for an experience to be “common”, it cannot but originate outside trial proceedings. Therefore, the concept of notorious fact comprises only those facts pertaining to social, human or natural life that are acquired – as legislation is wont to state – “by the community with such certainty as to seem undisputable”. Analogously, those notions of fact known only by a few (e.g. by a judge in relation to his trial experience, when one speaks of *Gerichtskundigkeit* “in the strict sense”: *infra* § 5) are excluded from the concept of notorious. Consequently, it becomes necessary to define what is known as a “local notorious fact”¹.

* E-mail: panzarola@lum.it

¹ See § 5.

But attention must initially turn to determining in what way the facts are acquired as, even if the facts in question are shown to be known to a multitude of individuals, this demonstration alone is not sufficient to define a given fact as “notorious”. This definition is valid only on the condition that – as reflected in the wording of art. 115, paragraph 2 and underlined even earlier by Italian writers in fundamental studies completed in the 1920s and 1930s² – said facts are known because they form part of normal “culture” and are not mere pieces of information known at a particular moment in time³.

Just as a judge need not have “current” knowledge of a fact⁴ in order for it to be deemed “notorious”, it is equally true that a fact can be deemed such when it forms part of the “culture” of a community to which the judge does not belong. This holds true as long as the fact in question does not regard specialised or technical knowledge, which most certainly cannot be regarded as falling within the limits of “common experience” (i.e. that of the average citizen) appropriately indicated by the legislator.

The very text of the law (art. 115, paragraph 2) also lends support to a widespread understanding of the aspect of “relativity”, considered typical of the “notorious fact”. Thus the condition of notorious is to be evaluated with reference to the time when and place where the decision is taken. The *experience*, i.e. the substance, is not – to borrow an expression used by Salvatore Satta in another context – “but an experience, and is valid until a contrary experience occurs”.

² Italian doctrine, though drawing upon contributions from German writings (“truly notable on the subject of proof”, F. CARNELUTTI commented, *La prova civile. Parte generale. Il concetto giuridico della prova*, Rome, 1915 – reprint Milan, 1992 –, pp. 9-10, mentioning, amongst other things Stein’s book; said book is mentioned, together with the essay by Schmidt, in the work by G. CHIOVENDA, *Principii di diritto processuale civile*, unedited reprint, Naples, 1980, with a preface by V. Andrioli, p. 733 and note 1), presents the same level of originality: cf. P. CALAMANDREI, *Per la definizione del fatto notorio*; in *Riv. dir. proc. civ.*, 1925, parte I, p. 273 ss. (first republished in ID., *Studi sul processo civile*, Vol. II, Padua, 1930, p. 289 ss.; then in ID., *Opere giuridiche*, edited by M. Cappelletti, Vol. V, with a presentation by T. Carnacini, Naples, 1972, p. 425 ss.); G. CHIARELLI, *La definizione del fatto notorio*, in *Arch. giur.*, 1927, p. 227 ss.; E. ALLORIO, *Osservazioni sul fatto notorio*, in *Riv. dir. proc. civ.*, 1934, part II, p. 3 ss. (as well as in ID., *Problemi di diritto*, Vol. I, *L’ordinamento giuridico nel prisma dell’accertamento giudiziale e altri studi*, Milan, 1957, p. 361 ss.); G. MAZZARELLA, *Appunti sul fatto notorio*, in *Riv. dir. proc. civ.*, 1934, parte II, p. 65 ss.; G. CALOGERO, *La logica del giudice e il suo controllo in Cassazione*, Padua, 1937 (reprint Padua, 1964), spec. pp. 70 ss., 104 ss., 167 ss. (in accordance with the radical criticism that the author makes with reference to the so-called proceduralist logicism); G. PAVANINI, *Massime di esperienza e fatti notori in Corte di cassazione*, in *Riv. dir. proc. civ.*, 1937, parte I, p. 247 ss.

³ For more information on the rationale followed to narrow the definition of notorious see § 2; for more information on what constitutes the criterion of “average culture” for admission to the concept of “local notorious fact” see § 5.

⁴ As to the requisite of “potentiality” see *infra* § 4.

Moreover, an experience defined as “common” must be evaluated with reference to the space, time, social classes, etc, in which it germinates.

The more one compares the wording of this law with the wording of provisions set forth in other codes, the more one is able to appreciate it. Not infrequently, said provisions are either generic⁵ or apparently imprecise⁶. Otherwise, they are seemingly linked to the judge’s discretionary evaluation⁷.

In contrast, the Italian code of 1940 appears to have profited from ample elaboration of the concept on the part of legal scholars (first and foremost Piero Calamandrei⁸) during the period in which the now lapsed code of civil procedure, which itself provided no indications to this regard, was in effect.

Additionally, attempts to determine what requisites are needed to define an “experience” as “common” (art. 115, paragraph 2) also lead to the question of the relationship between “notorious fact” and another institution known as “common sense presumptions”. By developing Richard Schmidt’s studies, Friedrich Stein indicated the way in his well-known work of 1893 on a judge’s private knowledge (*Das private Wissen des Richters*)⁹. The approach taken in the book was not essentially abandoned in subsequent years, despite a context prone to considering contrasts as being somehow relative, at least as regards certain ends. Indeed, the strong contrast between “notorious fact” and “common sense presumptions” persists when teachings continue to state that, even if both are able to reflect the “experiences” of a certain society at a certain moment in time, there is still a basic, underlying difference between “notorious fact” and “common sense presumptions”. Only “common sense presumptions” (*Erfahrungssätze*, to remain with the definition first given by Stein) consist of rules based on logic and

⁵ See the Austrian and German systems *infra* § 5.

⁶ Art. 281.4 of the Spanish *Ley de Enjuiciamiento Civil* for example establishes that *No será necesario probar los hechos que – strangely enough – gocen de notoriedad absoluta y general*. On the dissatisfying definition of notorious fact in Spanish law cf. J. MONTERO AROCA, in AA.VV., *Derecho jurisdiccional, II, Proceso civil*, 11^a ed., Valencia, 2002, p. 252.

⁷ Cf. for example art. 61, no. 1, of the Russian code, according to which “the facts *recognised by the judge as being notorious* have no need of proof”. As to Russian law cf. in *Codice di procedura civile della Federazione Russa 2003* (Italian-English-Russian), edited by N. Picardi and R. Martino, Bari, 2007, p. 123.

⁸ See *retro* sub 1.

⁹ The fundamental work by F. STEIN, *Das private Wissen des Richters. Untersuchungen zum Beweisrecht beider Prozesse*, Leipzig, 1893, reprint Aalen, 1969 (*sub C.*, § 8 ss., spec. p. 138 ss.), is worth consideration (a fact recognised also by Stein, as stated in the introduction to his book) as is the work written shortly before (July 1892) on a “judge’s extrajudicial observations”; by R. SCHMIDT, *Die außergerichtlichen Wahrnehmungen des Prozeßrichters*, in *Sächsisches Archiv für bürgerliches Recht und Prozeß*, 1892, Vol. II, p. 265 ss. (also published in a special edition, Leipzig, 1892). The essay by J. KOHLER, *Ueber notorische Thatsachen*, in *Gesammelte Beiträge zum Civilprocess*, Berlin, 1894 (reprint Aalen, 1980, *Gesammelte Beiträge zum Zivilprozess*), pp. 68-72, is the first amongst those to criticise the distinction drawn by Stein between the concepts of notorious fact and judicial notice.

critical evaluation of proof (with exceptions made for those presumptions which the judge employs to interpret and specify legal regulations). To the contrary, “notorious facts” are specific events or situations of fact, which are expressed in concrete and individual *in facto* judgements.

Another way of expressing the same distinction is to take a syllogistic perspective of the construction of the judicial decision. The former¹⁰, in that they are “rules” (“forms” of reasoning), are in the major premise of a syllogism (“probatory”, those who recognise the autonomy of the category are quick to state). The latter¹¹, in that they are “facts” (“objects” of reasoning), are in the minor premise. This is no different from what ordinarily happens with the judicial rules that are assigned to *Obersatz* and the facts that are assigned to *Untersatz*.

The “notorious fact” falls into the latter category due to its “substantive” nature, as it is established before and outside the courtroom for reasons of “culture”. On the one hand, this very aspect of “notorious fact” leads to the refusal of the concept of “judicial notorious fact” on the part of Italian legislators (*infra* § 5). On the other hand, this same aspect is the premise of an effect typically taking place in proceedings (reflected in the old saying: *notoria non egent probatione*). An exception to the rule that wants the judge to decide *secundum probata partium* is made for the “notorious fact”, in accordance with that expressly declared in art. 115, paragraph 2 of the Italian Code of Civil Procedure¹².

¹⁰ Common sense presumptions.

¹¹ Notorious facts.

¹² G.A. MICHELI, *Sulla nozione di fatto notorio*, in *Giur. compl. Cass. Civ.*, 1945, II quadrimestre, pp. 286-287; L. MONTESANO, *Osservazioni sui fatti notori*, in *Giur. compl. Cass. civ.*, 1947, III quadrimestre, p. 222 ss.; V. DENTI, *Ancora sulla nozione del fatto notorio*, in *Giur. compl. Cass. civ.*, 1947, III quadrimestre, p. 264 ss.; G. DE STEFANO, *Il notorio nel processo civile*, Milan, 1947 (which *adde*, without essential changes, Id., voce *Fatto notorio - dir. priv.* -, in *Enc. dir.*, XVI, Milan, 1967, p. 999 ss.; as well as, for a specific profile, Id., *Osservazioni sulla censurabilità del notorio in Cassazione*, in *Giur. it.*, 1955, I, 1, c. 777 ss.); C. LEONE, *Contributo allo studio delle massime di esperienza e dei fatti notori*, Bari, 1951 (extract from *Annali della Facoltà di Economia e Commercio dell'Università di Bari*, Nuova Serie, Vol. X, 1950); F. CARNELUTTI, *Massime d'esperienza e fatti notori*, in *Riv. dir. proc.*, 1959, p. 639 ss.; G. De STEFANO, *Note minime sulla cosiddetta notorietà locale*, in *Giur. it.*, 1959, I, 1, c. 99 ss.; S. SATTA, *Commentario al codice di procedura civile*, lib. I, *Disposizioni generali*, Milan, 1959, p. 460 ss.; M. CAPPELLETTI, *La testimonianza della parte nel sistema dell'oralità. Contributo alla teoria della utilizzazione probatoria del sapere delle parti nel processo civile*, Milan, 1962, Vol. I, pp. 57-58, 350-351; Vol. II, p. 663; M. TARUFFO, *Studi sulla rilevanza della prova*, Padua, 1970, pp. 48, 53, 197 ss., 246; E. GRASSO, *Dei poteri del giudice*, in *Commentario del cod. di proc. civ.*, directed by E. Allorio, I, Turin, 1973, p. 1308 ss.; V. ANDRIOLI, voce *Prova (diritto processuale civile)*, in *Noviss. Dig. It.*, Vol. XIV, Turin, 1967, p. 279 ss.; S. PATTI, *Prove, disposizioni generali*, in *Commentario del codice civile Scialoja-Branca*, 1987, pp. 10-11 (as well as Id., voce *Prova. I) Diritto processuale civile*, in *Enciclopedia Giuridica Treccani*, Vol. XXV, Rome, 1991); G. VERDE, voce *Prova (dir. proc. civ.)*, in *Enc. dir.*, Vol. XXXVII, Milan, 1988, pp. 618-619; B. CAVALLONE, *Il giudice e la prova nel processo civile*, Padua, 1991 (in some of the collected essays, spec. pp. 137 ss.,

As the law allows for total exoneration from the need for proof (there is no need for the presentation of proof from the parties, from the acting or intervening public prosecutor, as ordered *ex officio* by the judge), it does not seem correct from a legal perspective¹³ to qualify some facts (“secondary” ones) as “notorious” and to not qualify others (“principal facts”) as such. Due to ongoing silence on the part of the legislature, there is still controversy as to whether or not, on the basis of “notorious fact”, it is possible to derogate from the principle that obliges the judge to decide *secundum allegata* (§ 3).

2. The foundation

It is known that the *conditores* (“founders”) wanted to “preserve” those “aphorisms of ancient wisdom” mentioned at the end of the preceding paragraph in the Italian Code of Civil Procedure of 1940 as “statements of principle”¹⁴. These aphorisms must be considered together: the handed down medieval maxim – “*iudex secundum allegata et probata decidere debet*” – must be evaluated by reference to the judge’s “conscience” (not “*secundum conscientiam*”). The two principles continued to co-exist side by side for a very long time. As long as the judge was bound to the “*allegata*” and “*probata*”, he was unable to summon his “conscience”. This constraint prevented him from taking his decision utilising what we might today call his “private knowledge”.

In accordance with the aforementioned art.115, paragraph 2, the concept of “notorious” frees the judge from otherwise mandatory adherence to the first of these principles (more appropriately for the “*probata*” see § 3). However, if one reflects on this fact, it is equally clear that the concept of notorious calls into question the second principle. This is especially true if one takes into consideration the mutual implication that has historically existed between said principles (“*iudex secundum allegata et probata decidere debet, non secundum conscientiam*”). From this perspective, the interpretation given to the notorious fact on the part of whom has seen in it an effect at the judicial level is clearly evident. This effect is two-fold. On the one hand, the notorious fact can be taken into account in the decision making process without the need for proof. On the other hand, it introduces an exception to the principle that prohibits the judge from utilising his private knowledge. Moreover, the above perspective shows connections with centuries-old experience¹⁵. Analogously, such an interpretation of this institution clarifies the *reason* for the exception made for that prohibition.

202 ss., 244 ss., 297 ss.); D. BUONCRISTIANI, *L'allegazione dei fatti nel processo civile, profili sistematici*, Turin, 2001, spec. 125 ss.

¹³ On this topic see *infra* § 3.

¹⁴ See paragraph 13 of Minister Guardasigilli Dino Grandi’s Report to the King.

¹⁵ On the principle *quod non est in actis non est in mundo* see *infra* § 3.

Indeed, it has been said that the judge may here make an exception and draw upon his private knowledge because, in doing so, he does not come up against the psychological incompatibility that exists between the function of witness and that of the individual responsible for evaluating the testimony (when these functions are combined in one subject).

For facts failing to have the requisite characteristics needed to qualify as “notorious”¹⁶, said incompatibility soon becomes apparent, justifying, if not forcing, the general prohibition that prevents the judge from using his “private knowledge” in taking a decision and, at the same time, preserving impartiality. But the situation changes when the facts in question are “common knowledge” for a determined social group, reflecting a shared experience and criticism. The judge who refers to them in his decision without any proof is, in actual fact, considering the facts as pieces of shared knowledge and not taking on two irreconcilable functions. In this way, he reinforces the relationship between civil proceedings and life. In general, the judge’s relationship with the community is strengthening and the judge shows himself to be the expression of the community¹⁷ at the dawn of the third millennium. The judge thereby ensures that the community in whose name he takes the decision is able to see the immediate expression of a concept widely known and accepted by the community.

The consideration given to notorious facts in a trial is not based merely on the desire to adjust the results of judicial activities to match facts that are well known to the community in whose name the judge decides. Another underlying reason is the need to shorten the duration of the juridical process. Although this reason has always been valid, it is even more important nowadays given the constitutional guarantee of a “reasonable duration” of the trial. (art. 111, paragraph 2, of the Italian Constitution).

Finally, the pressing need for free use of the institution of notorious fact is so urgent and widespread that it is not at all surprising that the most disparate codes tend to favour it. Some of these codes comprise specific laws to this effect whilst others do not. Others still broaden the concept to such an extent as to be able to include the so-called “judicial” notorious fact (§ 5). Some codes (e.g. the French one) refrain from explicitly naming and defining the concept as such. Nonetheless, others codes do clearly and accurately describe it elsewhere. No code can refuse and ignore it because, in one way or another, judges are allowed to use it. There is a universal need to recognise it above and beyond a given trial or a specific place. It is not farfetched to think that this phenomenon is truly

¹⁶ Including facts known to a multitude of individuals constituting merely circumstantial information: see § 1.

¹⁷ The link between the judge and the “community” (see N. PICARDI, *La giurisdizione all'alba del terzo millennio*, Milan, 2007, spec. pp. 183 ss., 132 ss., 88 ss.) could offer new elements on which to formulate the question of the foundation of “notorious fact”.

essential and wholly necessary in any and every judicial system, be it based on civil or common law (the latter with the institution of *judicial notice*).

3. Allegation

The literal wording of art. 115, paragraph 2 of the Italian Code of Civil Procedure and its placement in an article headed “availability of *proof*” seem to limit any exemptions applied to notorious facts to that from the need for proof. In a nutshell, the judge can make use of notorious facts in his decision “without the need for proof”. However, the same provision does not state “without the need for allegation of facts”.

But lawmakers’ unbroken silence to this regard has rarely appeared decisive to interpreters of the law¹⁸. Some authors deem the allegation to be superfluous whilst others continue to insist upon it. Regardless, they all want application of the principle of party disposition (art. 99 of the Italian Code of Civil Procedure), according to which the acting agent must specify the terms of application. This naturally leads to the conclusion that, as regards “principal facts”, the specific allegation is indispensable for “constituent facts” (so-called hetero-determinant rights: see *infra* this §).

It does not escape notice that the question becomes much less urgent as soon as the place held *more solito* by notorious fact in Italian law is made clear. Rather than concerning (as certainly possible: see *retro* § 1) frequently specific and precisely defined “principal” facts, the notorious fact – due to its essentially schematic nature, able to be defined as a common experience – more usually pertains to “secondary” facts. Some writers insist that although the parties must explicitly introduce the notorious fact, there is no burden of proof. Others insist that the parties are obliged neither to present proof of notorious facts nor to introduce them.

The above contrasting positions are the result of a reflection that depended on an ever-changing scenario. One need only observe how doctrinal speculation on the general subject of the allegation of facts in a trial has been enriched over the years thanks to an increase in the number of contributions and new results.

Today there is a tendency to believe that – even the parties normally introduce them – secondary facts can, at any rate, emerge from the official records of trial proceedings. It can be inferred that this discussion, created within the context of the concept of notorious fact, has lost much of its importance. Rather than being an exception to a general, opposite rule, the proposal to not require allegation by the parties (for a “secondary” notorious fact) confirms and supports a principle of the judicial system. One can also note that the perspective taken in doctrine on secondary facts has today been extended to primary facts. This is true not only with reference to the objections the judge can raise, but also

¹⁸ See *retro* sub 12.

as regards “constituent facts” (in so called “self-determining” rights). Both the former and latter could, based on general consensus, be taken *ex officio* from the trial records.

The thesis that the allegation pertaining to a notorious fact is superfluous must be revised in the light of the overall problem regarding the allegation relating to facts in a trial. On the one hand, this position allows for the objection *ex officio*. On the other, it highlights the importance of the debate between the parties.

With this, although steps have been taken towards a finding a solution, the problem has yet to be resolved. Clearly, there is a technical difference between “allegation” and “introduction” of facts in a trial. Conceivably, even in accordance with the agreed conditions within which the party need not make allegation for a “notorious” fact, there may be some who deem it equally impossible to cite such a fact *ex officio*, when there is no trace of it in the official court records. In the Middle Ages, in order to oppose those in favour of this solution, i.e. those obeying the principle that *quod non est in actis non est in mundo*, others formulated the concept of notorious¹⁹ in order to limit the excessive burden of proof implicitly included in the above principle (see also *retro* § 2). Nonetheless, the required respect for rule *audi alteram partem* would seem to favour adoption of the other principle which, objectively, better guarantees the parties’ rights. Otherwise, it would be necessary for the parties to prepare their arguments in advance should the judge think to use a notorious fact that does not emerge *ex actis*.

¹⁹ On the historical origins of the institution of “notorious fact” (which, over time, in addition to *notorium facti* (therein *permanentis*, *transeuntis* and *interpolate*) has been known as either *notorium iuris* or *notorium praesumptionis*.) reference should be made to C. LESSONA, *Trattato delle prove in materia civile*, Vol. I, *Parte generale*, 3^a ed., Florence, 1922 (reprint ed. 1914), p. 297 ss.; as well as the work by G.W. WETZEL, *System des ordentlichen Zivilprozesses*, 3^a ed., Leipzig, 1878 (reprint Aalen, 1969), p. 179 ss. (even if the results are refuted in some places). Reference should also be made to L. FERRARA, *Relatività del notorio*, in *Foro it.*, 1940, I, c. 965 ss.; C. GHISALBERTI, *La teoria del notorio nel diritto comune*, in *Annali di storia del dir.*, I, 1957, p. 403 ss. (with special consideration for the two most important works on the concept of notorious fact in common law, one by Antonio da Budrio and one by Benedetto Capra); ID., voce *Fatto notorio (storia)*, in *Enc. dir.*, XVI, Milan, 1967, p. 995 ss. As regards this concept in canon law reference should be made to R. BERTOLINO, *Il notorio nell’ordinamento giuridico della Chiesa*, Turin, 1965, p. 115 ss. (in “Università di Torino. Memorie dell’Istituto Giuridico. Serie II, Memoria CXX”). For reflections on the theory of notorious within the context of objections see A. PANZAROLA, *La ricsuzione del giudice civile. Il problema della impugnabilità della ordinanza*, Bari, 2008, pp. 127, 130, 141, 148, 154.

In general, on the problem (something with which jurists have wrestled for more than six centuries: cf. R. SCHMIDT, *op. cit.*, spec. p. 279 ss.) as to whether the judge must decide *secundum allegata* or *secundum conscientiam*, cf. K.W. NÖRR, *Zur Stellung des Richters im gelehrten Prozess der Frühzeit: Iudex secundum allegata non secundum conscientiam iudicat*, München, 1967 (in “Münchener Universitätschriften. Reihe der Juristischen Fakultät”, Vol. 2). Finally reference should be made to A. PADOA SCHIOPPA, *La coscienza del giudice*, in ID., *Italia ed Europa nella storia del diritto*, Bologna, 2003, p. 251 ss. On the problem of judge-witness also cf. A. PANZAROLA, *op. cit.*, p. 319.

4. Possible verification

Interpreters have always been interested in the question of what means, when necessary, are able to provide a judge with knowledge of notorious facts. One could say that the topic has received attention since the Middle Ages²⁰ when, by *ex officio* initiative, an *inspectio ocularis* was carried out in order to ascertain the condition of notorious facts.

Today, the very position of this topic presumes recognition not only of the element of “relativity” (*retro* § 1) but also of the element of “potentiality” in the concept of notorious fact. This definition of notorious allows for the possibility that such a fact may be acquired or learnt. Thus, a notorious fact need not necessarily be known by the judge to be at the basis of his decision. If one accepts the definition of “notorious fact” in terms of exemption from the principle that prohibits the judge to reach a decision based on his personal knowledge (*retro*, § 2), then it becomes clear and indisputable that a judge can gather information via private investigation. Whenever a judge is not aware of a notorious fact, he may freely make use of private investigation. Discussion must turn not only to *if*, but also to *how* the investigation is to be carried out (with the sole limit being the reasonable reliability of the source of information). If this is the perspective taken, there is no room to draw up a specific set of legal regulations regarding the practical means of verifying a notorious fact. Once acquired, due to its very characteristics (*retro*, §§ 1 and 2) such a fact seems, at the most, exempt from further preliminary verification.

5. Special hypotheses

Despite frequent acceptance of a concept as rigorous as “notorious fact” (*retro* § 1), the so-called “local notorious fact”, i.e. a fact “limited to a restricted circle of subjects”, has found its way into legal systems. The set requisite is that this fact must have become part of the average culture of the individuals forming the restricted circle²¹. The same cannot be said of the so-called “judicial notorious fact”, meaning a fact that is known by a judge *virtute officii* based on his official activity carried out during a trial²².

Elsewhere, especially in legal systems in Germany (§ 291 *Zivilprozessordnung* - ZPO) and Austria (§ 269 ZPO), the concept of “judicial” notorious fact

²⁰ See *retro* sub 19.

²¹ Thereby further demonstrating the essential role the way of knowledge has in determining if a fact can be deemed “notorious” or not (see *sub* § 1).

²² Italian writers who have shown themselves in favour of the concept of “judicial notorious fact” include G.A. MICHELI, *Corso di diritto processuale civile*, I, *Parte generale*, Milano, 1959, p. 231 and, before him, in broader terms, ID., *L'onere della prova*, Padua, 1942 (reprint Padua, 1966), p. 120 ss.

has been recognised thanks to legal provisions that are otherwise more generic than those put forth in the Italian code. In the absence of an explicit legislative definition of “notorious fact”, a general category of “notorious” (*Offenkundigkeit*) has been forged, therein comprising two distinct figures, the *Allgemeinkundigkeit* and the *Gerichtskundigkeit*²³. The latter refers to those facts known by the judge for reasons of office.

Other legal systems, such as the Polish, Hungarian, Bulgarian, Swedish, Finnish, Czech, Norwegian and other systems, contain more or less similar schemes²⁴.

In paragraph 179 of Japan’s Code of Civil Procedure²⁵ mention is made of notorious fact (found in the second part of the provision) without any further specifications. This sets the premise thereby ensuring that the German model is followed, also on this point.

As seen and discussed above (*retro* § 1), in Italy, the aforementioned art. 115, paragraph 2, which evokes only those facts forming part of “common experience”, stands in contrast to the concept of “judicial notorious fact”. In the abstract and going beyond this general precept, one could well hypothesise the existence of specific legal provisions which, from time to time, give the judge faculty to deem a fact true even if it has not been proven (or even affirmed by the parties: *retro* § 3) when said fact has become known to him based on his experience “in office”. On a more concrete level, it does not escape notice that the most relevant hypotheses, which have been adopted over time in order to give further evidence of the existence of the above specified provisions (art.s 273 and 274 of the Italian Code of Civil Procedure), have either appeared to be of dubious interpretation or been repealed²⁶.

²³ On the German experience of *Gerichtskundigkeit* – in addition to the works mentioned by F. STEIN (§ 10. III. of his work: pp. 157-162) and by R. SCHMIDT (*op. cit.*, spec. pp. 273 e 277) – one could well consult R. SCHULTZ, *Die Gerichtskundigkeit von Tatsachen*, in *Festgabe für Richard Schmidt zu seinem siebzigsten Geburtstag 19. Januar 1932 überreicht von Verehrern und Schülern*, Leipzig, 1932 (reprint Aalen, 1979), Vol. I (*Straf- und Prozessrecht*), p. 283 ss.

²⁴ On the treatment of “notorious fact” in European legislations some useful indications can be found in AA.VV., *Beweis – Preuve – Evidence. Grundzüge des zivilprozessualen Beweisrechts in Europa*, Baden-Baden, 2003, edited by H. Nagel and E.-M. Bajons.

²⁵ On Japanese legislation see *Das Japanische Zivilprozessrecht. Zivilprozessgesetz und Zivilprozessverordnung nach der Reform von 1996*, edited by C. Heath and A. Petersen, Tübingen, 2001, p. 79.

²⁶ For example, first art. 688 cod. comm. and then art. 6 the Royal Decree of 16 March 1942, n. 267, in the part referring to the declaration of bankruptcy by the office: according to some this can also be made based on elements coming from other verdicts the judge knew about. Or – based on the context resulting from the ancient law on the injunction of lawyers, notaries, etc. – on the subjective condition of the professional authorised to initiative a “purely” monitory procedure. Said condition, even if it should be proven in principle,

The whole of legal readings reveals a circumspect attitude on the part of legal systems. In other words, given that the notorious fact deviates from the principle regulating proof and, above all, from the principle of debate between the parties (Rule of *audi alteram partem*), it must be understood in the strict sense. Moreover, as a corollary, there can be no room for the types of knowledge that a judge obtains “from previous dealings with analogous controversies”.

More broadly speaking, against the claimed existence of a principle that allows for recourse to a judicial notorious fact in trials inspired by the so-called investigative technique, it should be argued that the rules of debate (*audi alteram partem*) between the parties are compulsory and must, at any rate, be observed as they are in the verification of proof required by the office. In conclusion, there seems to be no other solution than this: if the expression “judicial notorious fact” is meant to mean that which a judge, in his official role, has come to know outside of the trial he is conducting, the prohibition against utilising private knowledge returns to having full effect (*retro* § 2), with which that special notion of (judicial) notorious can be confused.

The problem regarding what we shall call “arbitral notorious fact” must be posed on a different basis. Presuming that the concept of “arbitral notorious fact” were accepted²⁷, it would be noted that this concept could lead to an enlargement of the category of “notorious fact”, as is derived from the formerly cited art. 115, paragraph 2 of the Italian Code of Civil Procedure. Thus one could say that that the arbitrator is in the condition to autonomously dip into the well of those notions of fact forming part of a shared wealth of knowledge “in the environment in which he operates”. Indeed, it is right to imagine that the parties decide to choose one or more arbitrators even, if not only, in the light of the essentially similar notions of fact (he has or they have). So, rather than being surprised, it seems natural that, upon taking a decision, the arbitrators are allowed to see said facts as true “without the need for proof” (and allegation as described in § 3). With this, clearly the activity of arbitrators would not cease to encourage a deviation, however motivated, from the opposite rule that wants them deciding *iuxta (allegata et) probata* (in accordance with that clarified earlier, specifically in §§ 1-3). Thus the importance of the call for control by the parties via an incisive debate (Rule *audi alteram partem*) is clear.

could – according to certain doctrines – be verified by the judge in accordance with the principles forming the cornerstones of the concept of “judicial notorious fact”.

²⁷ In accordance with that auspicated by doctrine. On relations between arbitration and “notoriety” see G. VERDE, *Lineamenti di diritto dell'arbitrato*, 2^a ed., Turin, 2006, pp. 124-125.

6. Contestation before the Supreme Court

In application of art. 115, paragraph 2 of the Italian Code of Civil Procedure the magistrate passes judgement on what are essentially individual facts (*retro*, § 1). Obviously, the question about whether or not such facts can be re-examined arises given that the law limits the contestation solely to juridical aspects of the decision.

To the contrary, the above problem would not be put forward by individuals such as Enrico Allorio²⁸ who emphasise the link between knowledge of notorious fact and knowledge of the law, treating a notorious fact in the same manner as they would the law. But when one refutes Allorio's idea (i.e. notoriety forms part of a judge's official knowledge in that it is a fact of culture) – as the legal system and prevailing legal doctrine do –, then, at that point, contestation of the concept of notorious fact before the Court of Cassation once again becomes relevant. This is because the way in which the concept of notorious fact is seen in the field of *quaestio facti* is the very basis of the restrictive attitude of Italian Supreme Court.

This is linked to the idea that the position of a fact deemed to be notorious in a sentence that is contested and brought before the Court of Cassation can be controlled in that the appellant contests the sense given to the concept²⁹ of notorious fact (on the part of a judge in a lower court in the “original” sentence that is being appealed). The appellant cannot simply contest the notorious aspect of the fact on which the judge based his decision, but must put forward specific reasons why the concept cannot be accepted³⁰. At the most, the unacceptability of the notorious fact being contested can be expressed using the system of revocation within which there is limited room for the so-called revocatory fact. (art. 395 n. 4, Code of Civil Procedure).

On the other hand, the moment in which the Supreme Court declares that the judge is not held to indicate the elements on which he based his acceptance of a given fact as being notorious, it is clear there is no room to verify the reasons for his decision.

At this point the question arises as to whether or not the judge is obliged to base his decision on notorious facts. This Supreme Court tends to assign the judge discretionary power to this regard. In principle this power cannot be contested.

In the end, the relationship between the Court of Cassation and the notorious fact can be seen from a perspective different from that so far presented, i.e. how the Court of Cassation evaluates the decision taken by a lower judge. At this point, one may well ask if the Supreme Court can autonomously recognise a given fact as being a “notorious fact”. Assuming this is so, one also could lay the

²⁸ See *retro* sub 2.

²⁹ See *retro* § 1.

³⁰ See the end of this §.

bases for re-defining the limits within which the Court of Cassation may judge a notorious fact when the facts that the judge deemed notorious “exceed the limits of reasonable credibility”. In this case, control on the part of the Court of Cassation should be complete. Upon occasion, even the Supreme Court has shown itself to be convinced of this. It is almost as if the Court knew that, leaving the usual limits of its judgement unchanged, the reasons for a discipline of the notorious fact (see *retro*, § 2) would be cancelled in one blow.

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PROFESSOR GIORGIO SPANGHER, PHD*
Roma La Sapienza University
LUM Jean Monnet University of Casamassima, Bari, Italy

EVOLUTION AND INVOLUTION OF THE PROVISIONAL SYSTEM

Abstract: *The article studies evolution and involution of the provisional system in the Italian law. After introductory remarks, the evolution of the discipline that deals with precautionary measures is analysed. Then, the project of a new code made by the Commission Dalia and the draft of a new enabling act prepared by the Commission Riccio is studied. Finally, new challenges for the precautionary measures are discussed.*

Key words: *provisional system, precautionary measures, Italian law*

JEL classification: K10, K49

1. Introduction

The matter of the personal precautionary measures, as it is provided for by the IV book of the new criminal procedure code, has been surely one of the most important matters of this reform, even if its contents have been anticipated by the law nr. 330 of 1988. As regards the systematic aspect, the precautionary matter has been strictly re-written, as it comes out from the exact re-organization in Titles and Articles, able to give a precise and consequential arrangement to the envisaged aspects, and from its capability to be a real subsystem of rules, which shall be open to integrate in the several procedural models.

In its primary outline, the precautionary system could be called “in equilibrium”, as it considered the individual needs and those of the legal system, researching and finding the right mediation point.

The basic lines of this matter – which are even fruit of their progressive evolution, oriented towards the adaptation to the changed senses of the social expectations and to the provisions set up in the international Covenants¹ – can be identified as follows:

* E-mail: spangher@lum.it

¹ As regards this item, see in particular the Covenant for the Human rights and fundamental freedom protection, ratified by the Law 4 August 1955, n. 848 and the International agreement on civil and political rights, ratified by the Law 25 October 1977, nr. 881. On

- a clear-cut distinction of the roles between the Public Prosecutor who asks for the measures and the Court which must pronounce on the precautionary claim; with the subsequent overcoming of the “judicial authority” concept, as provided for by art. 13, item 2 of the Italian Constitution and of the powers *ex officio* of the judge²;
- an articulation of a wide range of measures, among which we can choose the most suitable one, in relation to the requirements of the precautionary measures, which are identified in the seriousness of the evidences, in the traditional *pericula libertatis*, in the punishment thresholds which have been re-formulated as regards the crimes causing a social alert³;
- the provisions on this matter of a significant “package” of inhibition measures that support the traditional restrictive ones, among which the prison had the *extrema ratio* role;
- the exclusion of automatic mechanisms to apply most serious measures when there is an ascertained violation of the less heavy ones, as the court – according to what the Constitutional Court has often stated⁴ – must always evaluate case by case the emerging background and the position of every individual;

this matter see AMODIO, *La tutela della libertà personale dell'imputato nella Convenzione europea dei diritti dell'uomo*, in *Rivista italiana di diritto e procedura penale*, 1967, 841; CHIAVARIO, *Le garanzie fondamentali del processo nel Patto internazionale sui diritti civili e politici*, in *Rivista italiana di diritto e procedura penale*, 1978, 481.

² See CORDERO, *Procedura penale*, Milano, 2006, 515, according to which in the new system the precautionary measures is characterized by “two qualifying novelties: the precautionary powers are only to the courts; and the Public Prosecutor has exclusively the power to ask for the precautionary claim if not we will have the nullity”. Moreover, as regards the clear-cut distinction of the roles of the trial see: CHIAVARIO, *Libertà personale (dir. proc. pen.)*, in *Enciclopedia giuridica Treccani*, XIX, Roma, 1990, 5; ID, *La riforma del processo penale. Appunti sul nuovo codice*, Torino, 1990, 144; GREVI, *La garanzia dell'intervento giurisdizionale nel corso delle indagini preliminari*, in *La giustizia penale*, 1988, I, 481.

³ AS DE CARO, in the *Presupposti e criteri applicativi*, in AA. VV. *Prove e misure cautelari. II) Le misure cautelari*, a cura di SCALFATI, in *Trattato di procedura penale*, diretto da SPANGHER, Torino, 2008, 58, states “the first frame of the criminal procedure code of 1998 had a *pure* finalism, which were grounded to this definition: a measure could ... be applied only after having applied the necessary precautionary measure that must be chosen among the ones provided for and after having taken into account the principles of adequacy and proportionality to be applied to the choice that the court will make”.

⁴ Even after the introduction, thanks to art. 16 of the Leg. Decree of 24.11.2000, converted in the Law nr. 4 of the 19.01.2001, of the provision which allows to substitute the house arrests with the preventive detention when there has been a violation of the prohibition to move away from the home (art. 276, paragraph 1 ter c.p.p.), the Constitutional Court has underlined that the presumption of the house arrests inadequacy does not deprive the court of the power to evaluate, as regards its structure and aims, this infringement in order to verify if it has an effective prejudicial feature in order to provoke the substitution of the house arrest with the preventive detention (Constitutional Court, 6 march 2002, nr. 40, in *Giurisprudenza costituzionale* 2002, 550).

- the regulation of the length of the preventive detention – according with the constitutional provisions (art. 13, paragraph 5 of Italian Constitution), even if they only deal with the preventive detention – that has been modulated on the reasonable times of the proceeding and trial length, leaving to some particular instruments – the renovation, the suspension, the postponement, the freeze or the neutralisation – the task to adapt those choices to the trial emergencies; the strong acknowledgment of the defensive guarantees which – after that the immediate contact between the attorney for the defence and the prisoner on remand has become a rule and not an exception⁵ – were mostly based on the control from the review Court that should be done with regularity;
- a regulation which must favour – ex officio and even with an ex parte motion – the control if the conditions which have caused the enforcement of that measures still persist (without excluding Public Prosecutor initiatives which worsen the precautionary measures in case of new elements)⁶;
- a strict division of the precautionary measures from the arrest of suspects and from the apprehension *flagrante delicto*⁷ even as regards the methods;
- an attention towards the weak person, joined to the need to respect the dignity of the person who is subjected to the measures⁸;

⁵ In pursuance of the art. 135 c.p.p. of 1930, the attorney for the defence could confer with prisoner on remand only by authority received from the examining magistrate; moreover, that authorization could be granted only at the end of the interrogations, as it was barred, before that moment, the chance to have a colloquy: as stated by GREVI, *Libertà personale dell'imputato e Costituzione*, Milano, 1976, 293, nota 441, which has found in this rule a strong constitutional unlawfulness. The provisions of the 1988 code are deeply different, as the art. 104 provide that the colloquy with the attorney for the defence is “a real right” to be exercised “only for the interrogation and then it must be done before it”: RAMAJOLI, *I rapporti difensore-imputato nel nuovo codice di rito*, in *La giustizia penale*, 1989, III, 374.

⁶ On this matter see SERVE, *Revoke, modification, extension*, in Aar. Vv. *Prove e misure cautelari. II) Le misure cautelari*, a cura di SCALFATI, in *Trattato di procedura penale*, diretto da SPANGHER, Torino, 2008, 205, according to which art. 229 c.p.p. “has the flexibility and the dynamism which are typical of the precautionary measure, as the status libertatis has a continuous adherence with the changes which arrives during the trial”.

⁷ D'AMBROSIO, sub art. 379 c.p.p., in *Commento al nuovo codice di procedura penale*, coordinato da CHIAVARIO, IV, Torino, 1990, 347 agrees with this point of view when he underlines how “the lawmaker (have) wanted to give a unequivocal sign of the interest to avoid the mixture between precautionary measures and pre-trial measures (...) and, on the contrary to create a clear-cut distinction between the two measures”; likewise we have the opinions of SCOMPARIN, *Arresto e fermo*, in AA. Vv., *Libertà e cautele nel processo penale*, coordinato da CHIAVARIO, in *Giurisprudenza sistematica di diritto processuale penale*, diretta da CHIAVARIO e MARZADURI, Torino, 1996, 234.

⁸ In fact, “as regards the real situation (...) and except from the really coercive situations which justify some restrictions, the way to apply these measures must protect the rights of the peo-

- a new rule that provides the remedy for an unjust detention (even for the illegal one);
- a wide and well-constructed pointing out of situations which can cause the lack of measures effects ⁹.

We have not to exclude even other solutions, which are provided for by art. 272 and 315 c.p.p.: in fact they seem to be important for the following developments of this matter.

2. The evolution of the discipline

The substantial sharing made from the juridical operators of the trial module as regards the precautionary measures, set up in the reform, has not been affected by some first embitterment of the rules with which we think to intervene with reference to specific individual situations (aids ill persons, as regards the emerging inadequacy of the regulation against worrying news stories), as well as, with reference to organized crime episodes¹⁰. They have been specific or reflex actions, which sometimes are aimed, and sometimes are linked to the punishment thresholds with large scale relapses.

The breaking point of the widespread acceptance of this sub-system has been a period in which – because of some interpretative straining of the laws and some no-uniform procedures from the judicial offices – the precautionary measures' function has been distorted, and has become a repressive and inquisitorial instrument – maybe because of the peculiarity of the individuals under precautionary measures.

The Parliament reaction, culminated in the Law nr. 332 of 1995, has re-written the requirements of the coercive measures and the class of guarantees for the prisoners on remand.

ple who have lost his personal freedom”: as stated by SPANGHER, sub art. 277 c.p.p., in *Codice di procedura penale commentato*, I, a cura di GIARDA e SPANGHER, Milano, 2007, 2141.

⁹ This matter has been deeply developed by MARANDOLA, *L'interrogatorio di garanzia*, Padova, 2006, 485 and follows.

¹⁰ This reference deals with the provisions provide for by art. 275, paragraph 275 c.p.p., introduced by Leg. Decree nr. 152 of 13.05.91, converted in the Law nr. 203 of 12.07.1991 and nr. 292 of 09.09.1992, and in the Law nr. 356 of 8.11.1991, which has been successively modified by the Law nr. 332 of 8.08.1995. In particular, they states that in case of serious evidences of guilt, at the mafia-style crimes are applied “the provisional arrest in prison, except when the magistrate has acquired evidences according to which we cannot have the need for a provisional arrest”.

As regards the first aspect, the lawmaker has remodelled the “pericula” and has specified the thresholds and the conditions to apply the preventive detention in prison ¹¹.

As regards the second aspect, we have a reinforcement of the defensive guarantees, which have been subdivided in different ways, but that aim to the anticipation of the defensive tutelage compared with the review that, moreover, maintains its central position. So, the lawmaker has foreseen among the other evidences that the Public Prosecutor must always submit to the single-judge Court or to the Collegiate Court the favourable ones¹² and that the precautionary measure provision has to state all the evidences which are at the basis of it ¹³.

The changed rules have further been inserted with many subsequent interventions of the Constitutional Court and of the joint sitting of the divisions of the Court of Cassation which have reinforced in a meaningful way some trial “passages” where the specific aspects of the right to counsel were not adequately protected.

In this peculiar situation we have, without being exhaustive, the decisions on the limits of the review proceeding ¹⁴; the extent of the efficacy of the prisoner

¹¹ As regards these changes see, among the others, AMODIO, *Premessa*, in AA. Vv., *Nuove norme sulle misure cautelari e sul diritto di difesa*, a cura di AMODIO, Milano, 1996, 3; CHIAVARIO, *Chiaroscuri di una «novella» dagli intenti riequilibratori*, in *Legislazione penale*, 1995, 568-569; GREVI, *Più ombre che luci nella L. 8 agosto 1995 n. 332 tra istanze garantistiche ed esigenze del processo*, in *Misure cautelari e diritto di difesa nella L. 8 agosto 1995, n. 332*, Milano, 1996, 1 e ss.; ILLUMINATI, *sub art. 3 L. 8 agosto 1995, n. 332*, in AA. Vv. *Modifiche al codice di procedura penale*, Padova, 1995, 64 and follows.

¹² MARANDOLA, *L'interrogatorio di garanzia*, cit., 313, considers the change that oblige the Public Prosecutor to submit to the Court “all the evidences in favour of the defendant and the possible inferences and defence briefs which have been already filed” as it is predisposed to “offer a binocular sight of the detective results”.

¹³ As regards the re-definition of the structural elements of the precautionary measure see v. SPANGHER, *sub art. 292 c.p.p.*, in *Codice di procedura penale commentato*, a cura di GIARDA e SPANGHER, I, Milano, 2007, 2241 and follows.

¹⁴ At first, the joint sitting of the divisions of the Court of Criminal Cassation decision of 29.10.1997, Schillaci, in *Cassazione penale* 1998, 792 has cleared up that it is not enough that, within the time limit, that is, the 5 days set up by the judicial authority to send the acts, these acts are sent to the counsel as it is necessary that these acts must reach the ad quem judge. Afterwards, the Constitutional Court decision of 22.06.1998, nr. 232, in *Cassazione penale* 1998, 2850 has pointed out that the 5 days time limit within the judicial authority must send to the office of the court's clerk the acts as provided for by art. 309, paragraph 5 c.p.p., if not the coercive measures is annulled, runs from the day in which the request arrive to the office of the review court's clerk. According to this interpretation we have also the decision of the Council after the joint sitting of the divisions of the Court of Criminal Cassation decision of 16.12.1998, Alagni, in *Cassazione penale* 1999, 1405; after the joint sitting of the divisions of the Court of Criminal Cassation decision of 22.03.2000, Audino, in *Cassazione penale* 2000, 2231; and after the joint sitting of the divisions of the Court of Criminal Cassation decision made by Solfrizzi, in *CED Cass.*, n. 215827

on remand interrogation¹⁵; the clarification of the laws on the multiple charges¹⁶ the laws on the length of the precautionary measures in case of trial regress (in this case, according to the first stand of the Constitutional Court, after the results of a strong conflict which cause a different statement from the joint sittings of the divisions of the Court of Cassation)¹⁷.

¹⁵ We have had this result after a double intervention of the Constitutional Court on art. 294 c.p.p.. First of all, the Council has stated the constitutional illegitimacy of the rule as regards the part in which it does not foresee that, till the sending of the acts to the trial judge, the judge can immediately question the prisoner on remand and however, within the 5 days from the beginning of its precautionary measure: Corte cost., 3.04.1997, n. 77, in *Giurisprudenza costituzionale* 1997, 741. Afterwards, the Constitutional Court has stated again the Constitutional illegality of art. 294 c.p.p. as regards the part in which it does not foresee that till the beginning of the trial the judge can question the prisoner on remand: Corte cost., 17 febbraio 1999, n. 32, in *Giurisprudenza costituzionale* 1999, 240.

¹⁶ On this matter see the joint sitting of the divisions of the Court of Criminal Cassation decision of 25.06.1997, Atene in *CED Cass.*, n. 208167, that has pointed out that the prohibition of the multiple charges can be applied on condition that it can be drawn by the acts, within the time limits as set up in the first and in the second item of art. 297, paragraph 3 c.p.p., as regards the different considered situations, all the elements that were at the basis of the precautionary measures orders whose effects must be backdated, because as regards its efficacy it is not enough the simple new of the crime. After some jurisprudential clashes the joint sittings of the court of Cassation have discussed this subject matter again. In particular, according with joint sittings of the Criminal Cassation court of 22.03.2005, Rahulia, in *Cassazione penale* 2005, 2886, when more than one precautionary measures towards one defendant have been issued for different crimes which are closely linked, we must apply the antedating as provided for by art. 297, paragraph 3 of c.p.p., even as regards facts which belongs to “another” proceeding, if they could be deduced from the deeds we have before the committal for trial for the crime or the crimes for which there is the issue of the first measure. According with this theory the Council has stated the constitutional illegality of art. 297, paragraph 3 of c.p.p. as regards the part in which the measure must not be issued for different crimes when the evidences at the basis of this order could be deduced by the further measure’s deeds: see Corte cost., 3 novembre 2005, n. 408, in *Giurisprudenza costituzionale* 2005, 6.

¹⁷ In particular, the Constitutional Court of 18.07.1998, n. 292, in *Giurisprudenza costituzionale* 1998, 2242 has recognized in the provision of art. 304, paragraph 6 c.p.p. a “closing mechanisms” of the system. Then, the Council has stated that when the preventive detention period within a certain phase of the trial overcomes the top limit, which is equal to the double of the limit we have for the same phase, the measure loses its efficacy, even if this limit has been suspended, postponed or it has begun again after the criminal proceeding regression. Swerving from this way, the Joint sittings of the Court of Cassation has successively think that, in order to the method to identify the final limit, we must calculate only the preventive detention periods that the defendant has had in the same phase or in the same degree, except for the periods for different steps or degrees: see Cass. pen., sez. un., 19.01.2000, Musitano, in *Diritto e giustizia* 2000, n. 9, 60. Nevertheless the Constitutional Court has clashed with this interpretation, stating that in the final limit of a step we have to calculate all the preventive detention periods of the defendant, from the beginning of the phase or of the degree to which the proceeding has regressed (see Corte cost., 19.06.2000, n. 214, in *Cassazione penale* 2000, 2923; Corte cost., 22.11.2000, n. 529, in *Cassazione*

This kind of reconstruction has also seen some important interventions on the supporting rules when there has been the approval of the law on the private inquiries and of that on the fulfilment of the fair trial.

To this “fil rouge” of the evolution of this matter we have another one that has come along side – and sometimes clashes with it – which is generated by the increasing social alert and by the requests of safety and that has tighten up the rules on the precautionary measures in a significant way: in particular, we refer to the laws nr. 4 of 2001, and then to the law nr. 128 of 2001.

As regards this outline, a contribution of reasonable, but important involution has been given, recently, by the Court of Cassation and even by the Joint sittings of this court, after a first activity of guarantee and tutelage, even if in an outline that, considered on the whole, shows lights and shades.

According to this last outline, even if we must consider the important contribution that the Joint sittings of the Court of Cassation has had to set some main points of this matter, in a really articulated and rich outline, that is often controversial and not homogeneous, we cannot deny that some “crisis” aspects of the system remain as we have not find fairly answers.

Even in this case, without being exhaustive, we can point out:

- the difficulty to determine the favourable acts for the defence, that the Public prosecutor must send to the judge at the moment of the precautionary claim¹⁸, and even when he send the acts which are at the basis of the precautionary measure request to the review court;
- the non-provision of a similar obligation in the following phases, mostly if we have a request to annul the measure;
- too much indulgent laws on the reason for the precautionary measure in order to verify the real insertion in the measure core of the structural elements provided for by the law¹⁹;

penale 2000, 832), the joint sittings of the Court of Cassation have maintained their position (see Cass. pen., sez. un., 27.07.2002, D’Agostino, in *CED Cass.*, 222002), pressing further intervention of the Constitutional Court (see Corte cost., 15.07.2003, n. 243, in *Giurisprudenza costituzionale* 2003, 2061; Corte cost., 7.11.2003, n. 335, in *Giurisprudenza costituzionale* 2003, 9; Corte cost., 30.01.2004, n. 59, in *Giurisprudenza costituzionale* 2004, 1). The persisting “resistance” of the Court of Cassation to state the illegitimacy of art. 303, paragraph 2 c.p.p. as regards the part in which, according to the interpretation of the Joint sittings, does not allow to cumulate as regards the calculations of the limits as set up by art. 304, paragraph 6 c.p.p., the precautionary measures periods suffered in different phases of the trial: see, Corte cost., 22.11.2005, n. 299, in *Giurisprudenza costituzionale* 2005, 2917.

¹⁸ See Marandola, *L’interrogatorio di garanzia*, cit., 317, according to which the “vacuity of the information, can (...) create depreciable iniquities as regards its fulfilment”.

¹⁹ In fact, about this subject matter, the predominant trend states the legitimacy of the per relationem opinion when this provision is known or has been known by the interested party (see Cass. pen., sez. V, 14.01.1997, Perrone, in *CED Cass.*, n. 206570; Cass. pen., sez. I, 7.02.1995, Magliocco, in *CED Cass.*, n. 200930; Cass. pen., sez. III, 24.11.1994,

- a restrictive guideline as regards the tutelage of the criminal defendant with two counsels for the defence;
- a suitable coverage of the laws on the invalidity in relation to the bounds to the defensive actions as regards the prisoner on remand interrogation²⁰;
- the inadequacy of the prisoner on remand interrogation laws in case of deputed deed from the judge without having the dossier;
- the non-recognition of the right for the prisoner on remand to be present before the review court²¹;
- the jurisprudential involution as regards the competence to declare the effectiveness loss of the measure because of the non-respect of the time limits for the review proceedings²²;

Giallombrado, in *CED Cass.*, n. 200303; Cass. pen., 20.06.1994, Sella, in *Archivio della nuova procedura penale* 1995, 319). Moving from these preliminary remarks, the criminal Court of Cassation, sez. II in the hearing of 14.10.2003 (Biancofiore, in *CED Cass.*, n. 227080) has considered – as regards the hypothesis in which the measure has been issued when we have had the final decision on the confirmation of the arrest – that the integrations of the precautionary measure fundamental elements can be legally deduced by the hearing record. The joint sittings of the Court of Cassation agree on this interpretation when they state that the order to fulfil the precautionary measure and the one which decide upon the review claim are strictly linked and complementary: the reason of the review court supplements and completes the possible lack of reasons of the measure issued by the first judge and vice versa, the insufficient reasons of the review court could be integrated by the impugned measure one, when in this last order the court has showed the logical and juridical reasons that has caused the issue of the measure, as provided for article 273, 274, 275 c.p.p.: see Cass. pen., sez. un., 3.07.1996, Moni, in *CED Cass.*, n. 205257.

²⁰ See, for example, the matter on the implications as regards the non-transmission of the favourable acts to the court by the Public prosecutor. In fact, because of the silence of the law, someone think that this omission does not produce trial consequences, as it is possible only to identify the disciplinary or criminal aspects, see among the others, GIOSTRA, *Una prima valutazione della riforma, novità, limiti, prospettive*, in *Diritto penale e processo* 1996, 115.

²¹ See, Cass. pen., sez. IV, 13.01.2005, Chakhsi, in *Diritto penale e processo* 2005, 1129, according to which as regards the personal precautionary measures' review, the right for the person in a prison out of the district which have issued the measure to express his reasons to the competent court must meet the particular celerity and quickness of the proceeding, and consequently the court must evaluate the defensive usefulness of the indicted person presence to the hearing.

²² On this matter, firstly the joint sitting of the criminal court of cassation of 15.01.1999 (Caridi, in *Diritto penale e processo* 1999, 1012) has considered that when we have the efficacy loss of a precautionary measure the indicted person can ask the judge of the main proceeding to state the intervening automatic abrogation of the measure, and even to act before the review court. Successively, Cass. pen., sez. un., 15.01.1999, Liddi, in *Diritto penale e processo* 1999, 1012, has specified that the prompt release can be asked by the court of the main proceeding in pursuance of art. 306 c.p.p. when this request has not been rejected by the review court or by the Court of Cassation – or when the court has pointed it out ex officio, as, in this last case, we have the trial preclusion which comes from the so-called precautionary judgment. Finally, Cass. pen., sez. un., 31.05.2000, Piscopo,

- the inadequacy of the time limits for the decision from the Court of Cassation with the following need to put in action the instrument of the revocation, and the following statement – in case of revocation – of the lack of interest (except for the case of efficacy as provided for by art. 314 c.p.p. that must make clear by the counsel of the defence;
- the chance for the Public Prosecutor to produce to the review judge the deeds of the inquiry that exists at the moment of the claim²³;
- the lack of the time limits for the decision from the review judge in case of annulment with the adjournment of the relevant judgment²⁴;
- a scholars' trend, for the moment only from few of them, charges the defence and not the Public prosecutor of the burden to transfer the favourable deeds already know by the defence, or better to allow the p.p. to transfer partially the deeds that can be integrated during the proceedings or, the chance for the review court to decide on the basis of the only deeds it has;
- the subjects on the qualification of the crime and of the length of the preventive detention;

3. The project of a new code made by the Commission Dalia and the draft of a new enabling act prepared by the Commission Riccio

A reflection of the whole precautionary matter has been elaborated through the project of a new code made by the Commission Dalia and even through the draft of a new enabling act prepared by the Commission Riccio.

If we try to make a synthesis of the most important aspects of the two reforms, we can point out, as regards the Dalia project: a strong systematic structure, mostly as regards the impugnments of the precautionary measures, that overcomes the confusion on the real precautionary measures (and even uni-

in *Cassazione penale* 2000, 2977, has stated that the omission of the judgement, even ex officio, from the review court on the intervening efficacy loss of a precautionary measure as set up by art. 309, paragraph 10 of c.p.p., is a vice of the decision and it can be asserted exclusively through the petition to the Court of Cassation and not even through the instance which states the precautionary measure in-effectiveness which must be submitted to the judge of the main proceeding. Moreover, in the judgement before the court of Cassation the omission, as it is a vice in the judgement, can be pointed out ex officio, but it can only be denounced with a specific and unique reason for the impugnment.

²³ According to this statement see Cass. pen., sez. VI, 9.03.2004, Fallace, in *CED Cass.*, n. 228875; Cass. pen., sez. VI, 17.12.2002, Vetrugno, in *CED Cass.*, n. 223436; Cass. pen., sez. VI, 12.11.1998, Sabatini, in *CED Cass.*, n. 212563.

²⁴ On this matter, see Cass. pen., sez. un., 8.05.1996, D'Avino, in *CED Cass.*, n. 204463, according to which, in this case, the provision of art. 309, paragraph 10 c.p.p. cannot be applied as the order that provides for the precautionary measure loses immediately its efficacy if the decision on the claim does not come within 10 days from the receipt of the deeds.

fies the matters of the juvenile trials and that before the justice of the peace); a strengthening of the provisions for the measures, as it can be issued if we have proofs of guilt and no more serious evidences; a general raising of the punishment thresholds to apply the precautionary measures in a general way; the shifting of the probative burden which is in charge of the Public prosecutor, as regards the measures for the organized crimes; the exclusion of the measure in case of probation; a wider articulation of the requirements to apply the prohibition measures; the elimination of the hypothesis to freeze the due date of the precautionary measure and a simplification of the laws on the suspension of the length of these measures, the elimination of the *per saltum* procedure, the possible adjournment of the due date within the review judgement must be taken.

As regards the draft of a new enabling act prepared by the Commission Riccio, we have to point out among the other important aspects: the exclusion of the presumption of law on precautionary matters; the duty for the judge to justify the rebuttal of the precautionary measure claim, in the cases set by the present art. 275, paragraph 3 c.p.p.; the right of the prisoner on remand to attend the hearing before the review court; the chance to have time-limits for the defence during the review proceeding, the preservation of the *per saltum* appeal; the definition of time limits that are closer than those within nowadays the Court of Cassation must give its judgement and within it must file the reasons of its decision; the provisions of guarantees for the remand proceeding, such as the right to have time-limits for the defence and for taking a decision, or to attend the trial personally; the provision of the repayment of the legal costs in favour or upon request of the criminal defendant, in case of final pronouncement of inadmissibility or of dismissal of the impugment by the Public prosecutor; except for the justified reasons (that is, when we have a wider acknowledgement of the repayment of the legal costs for the one who has suffered an unnecessary or groundless trial).

But, both projects highlight the trend to use the precautionary measures as an instrument to speed up the trial (with the consequences that we will point out afterwards). At last, both drafts suggest regulating the so-called advance debate, that is, the preventive interrogation of the person who would be arrested before the judge pronounces his decision as regards the Public prosecutor's claim. Nevertheless, these kinds of solutions seem to be divergent. According to a softer interpretation, the Rocco project provides – without regulating it, the *de quo* interrogation to issue lower precautionary measures, probably according with the model that has been set up by art. 289 c.p.p.. The Dalia Project's articles foresee the possibility that this verification and this confrontation could lead to a detention till 30 days, during which the judge can make the investigations.

We think it's right to avoid, in consideration of the wide involvement of persons made by these two commissions and the widening that they have produced, and even the high level of drawing up, that this knowledge background – real point of evolution of the criminal procedure – is wasted, or better that a further work

of drawing up overlaps to it. It is better to carry out a synthesis that highlights the convergences and solves the possible conflicts in the choice between these two points of view or rather overcome the different positions in a new synthesis.

4. New challenges for the precautionary measures

But we have to point out how, in spite of the strong attention that these two projects have devoted to the matter of the precautionary measures to overcome the most difficult passages and to redraw this subject with method, this matter must face up the new challenges that have arrived owing to the dynamics that these subject matter is suffering and passing through because of the effects of some rules, and of the usual procedures that are modifying the behaviours, especially in the attorney's offices.

In other words, the precautionary measures' matter will face up new verifications.

The first one is the joint nature. It is a subject that recurs in the discussion on the applicatory procedure of these measures, which is partly linked to the theme of the so-called advanced debate²⁵.

As we know, from a long time we discuss on the opportunities that the measures are applied by a collective body which can provide even for the interrogation before applying the measure, with the following sacrifice of the review judgment²⁶.

If the solution of the advanced debate shall be convincing as regards the lower precautionary measures, it has negative implications on the other measures; such as the preventive detention: prolongation of the detention times, elimination of the verification, difficulties for the defence because of the shortness of the times, problems as regards the jurisdiction of the revocation of the orders, are only some problems of this matter.

The lawmaker in the new regulation on the wastes in Campania region has made some steps towards the joint nature. Even if there is a very particular state of emergency as regards the request of personal and real precautionary measures

²⁵ In order to analyse the subject matter of the anticipated debate, according to the french model see CONSO, *La collegialità del g.i.p.: un'ipotesi praticabile?*, in *Diritto penale e processo* 1996, 401; GIOSTRA, *Considerazioni sul progetto di riforma della custodia cautelare*, in *Gazzetta giuridica* 1995, n. 3, 23; TONINI, *L'applicazione della custodia cautelare in carcere: i modelli francese e italiano a confronto*, in AA. Vv., *G.i.p. e libertà personale. Verso un contraddittorio anticipato?* Atti del Convegno (Firenze 7 maggio 1996), Napoli, 1997, 100; ZAPPALÀ, *Le garanzie giurisdizionali in tema di libertà personale e di ricerca della prova*, in *Rivista di diritto processuale*, 1994, 483.

²⁶ On this subject matter, see among the others, SPANGHER, *Relazione*, in AA. Vv., *G.i.p. e libertà personale. Verso un contraddittorio anticipato?* Atti del Convegno (Firenze 7.05.1996), Napoli, 1997, 48 e ss.

(law nr. 123 of 2008) he has provided that the jurisdiction is for the district court in joint sitting²⁷.

The second problem – which is surely a most complicated one – is the consideration according to which the progressive reinforcement of the defensive guarantee runs the risk of having a precautionary measure which is more and more an anticipation of the sentence.

Indeed, the trend to homogenize the requirements according to which the judge issues the precautionary measures, compared with the evaluation criteria of the circumstantial evidences, leads to the homologation of the premises of the precautionary measures and of the final judgment.

Moreover, in the end, the more and more accentuated and incisive development of the defensive activity, as regards the position of the convict, makes or runs the risk of making more stable this measure, beyond the differences that we can have as regards the need to issue these measures.

Further elements strengthen this trend. We speak about what has been set up by art. 405, paragraph 1 bis c.p.p.. If, from the one side, this rule protect the person for which the Court of Cassation has excluded the evidences' seriousness even with all the problems and the doubts that we can have as regards the fulfilment of this measure²⁸, from the other side, the possible rebuttal of the petition could cause, *rebus sic stantibus*, a restraint in the merits.

This kind of approach has been confirmed – even if with a different outline – by the changes caused by art. 275 paragraphs 1 bis and 2 ter of the c.p.p., according to which the trial court and the appellate one can apply the precautionary measures together with the final judgment.

This rule seems to identify a strict link between the (presumable) penalty and the precautionary measure, according to the anticipation of the punishment idea, which is justified by the danger of flight or of repetition of the crimes, and even by the impossibility to enforce the judgment that states the penal liability of a person, because it is not yet irrevocable, and because it is influenced by some specific precautionary needs.

²⁷ See DIDDI, *Ritocchi ad attribuzioni e competenze distrettuali*, in *Il decreto sicurezza*, a cura di SCALFATI, Torino, 2008, 150; MAGGIO, *La «competenza partenopea» per i reati riferiti alla gestione dei rifiuti in materia ambientale*, in AA. VV., *Le nuove norme sulla sicurezza pubblica*, a cura di LORUSSO, Padova, 2008, 50.

²⁸ According to GARUTI, *Dall'inappellabilità delle sentenze di proscioglimento ai nuovi «vincoli» in punto di archiviazione e di condanna dell'imputato*, in *Diritto penale e processo* 2006, 811, nevertheless the legal institute provided for by art. 405, paragraph 1 bis c.p.p. must be organized “according to a viewpoint of a wider responsibility of the Public prosecutor task”, we still have “the doubts which are linked to the lawmaker attempt to overcome the monopoly of the Public prosecutor office as regards the penal action, but even to give to the Court of Cassation the control of the selection of the crime information”; likewise, BRICCHETTI-PISTORELLI, *Suprema Corte: vincolo inedito per il p.m.*, in *Guida al diritto*, 2006, n. 10, 62.

A further element which strengthens this theory can be surely inferred from the recent rule – set up by art. 2, paragraph 1, item f,g and h of the Law nr. 125 of 2008 – which provides that in case of the application of a non annulled or revoked precautionary measure the Public prosecutor can ask to carry out a special procedure such as the “giudizio immediato” within 180 days²⁹. Even if in this case, the precautionary measure stability seems to construct that requirement of penal liability which could start up the trial, without having the pre-trial hearing.

The third problematic outline is the shifting of the Public Prosecutor venture from the preventive phase to the precautionary one. Several elements can confirm this trend. First of all, we can point out the jurisprudence trend which allows the arrest of the suspect when there is the lack of efficacy of the measures owing to a mis-interrogation³⁰. Even if this kind of positions could be justified, they seem to harm what has been provided for by art. 320 c.p.p..

Secondly, we can point out an accentuated recourse to the arrest of the suspect even apart from the following recognition of the requirements when we have the confirmation. This datum is strengthened by the enlargement of the requirement for the arrest as provided for art. 384 c.p.p.³¹, and even by the possible developments of the identification arrest (that, besides, allows the Criminal Investigation Department to overcome the limits provide for by art. 350 c.p.p.).

²⁹ On this subject matter see, BARAZZETTA-CORBETTA, *Modifiche a disposizioni del c.p.p.*, in AA. Vv., «Decreto sicurezza»: tutte le novità, Milano, 2008, 121; LORUSSO, *Il giudizio immediato (apparentemente) obbligatorio e la nuova ipotesi riservata all'imputato in vinculis*, in AA. Vv., *Le nuove norme sulla sicurezza pubblica*, a cura di LORUSSO, Padova, 2008, 141; VALENTINI, *La poliedrica identità del nuovo giudizio immediato*, in AA. Vv., *Misure urgenti in materia di sicurezza pubblica*, a cura di MAZZA e VIGANÒ, Torino, 2008, 281; VARRASO, *Il «doppio binario» del giudizio immediato richiesto dal pubblico ministero*, in *Il decreto sicurezza*, a cura di SCALFATI, Torino, 2008, 175.

³⁰ On this subject matter see Cass. pen., sez. IV, 23 luglio 2004, Ejili, in *CED Cass.*, n. 228966, according to which when we have the release of a precautionary measure because of the omette interrogation, in order to restore it, the art. 302 c.p.p. does not require that the interrogation must be done released on bail (that is, after the real release of the prisoner on remand), but only that this measure is no more in force at the moment of the interrogation and that the judge, before deciding to issue a new precautionary measure, can evaluate the possible preventive defence of the interested person; in accordance to this outline, see Cass. pen., sez. VI, 26 novembre 2008, Mamone, in *CED Cass.*, n. 241609; Cass. pen., sez. VI, 14 ottobre 2008, Makunia, in *CED Cass.*, n. 241404; Cass. pen., sez. IV, 8 ottobre 2007, Shehu, in *CED Cass.*, n. 237234; Cass. pen., sez. IV, 16 luglio 2007, Zunino, in *CED Cass.*, n. 237052.

³¹ Because of the interpolation of art. 384, paragraph 1, c.p.p. thanks to art. 11 of the Law nr. 128 of 26.03.2001, the danger of flight can be evaluated “even as regards the impossibility to identify the suspect”. Art. 13, paragraph 3, item a) of the D.L. nr. 144 of 27.07.2005 converted with some changes in the Law nr. 155 of 31.07.2005, has enlarged the range of the hypotheses according to which the judge can issue the measure, including even the crimes with terrorism purposes, even the international ones, or those to subvert the democracy. at last, according to this last law the “false papers possession” becomes a typical elements from which we can draw the flight danger (see art. 384, paragraph 3, c.p.p.)

The use of the precautionary instrument is even encouraged in relation to the enlargement of the hypothesis of arrest of the suspect and of apprehension *flagrante delicto* regulated by the Code rules and even by special laws.

The Public prosecutor has a lot of benefits from this kind of measures.

Briefly: it is not necessary to file the deeds before the interrogations; in this way the times to have the court judgment speed up; to the time limit within the review court has to issue its decision of verification, we have to add the 96 hours of the precautionary measure; the interrogation must be appointed at the moment of the precautionary measure issue, and this causes some difficulties for the defence; the Public prosecutor can interrogate the prisoner on demand before the judge³².

In this way, especially if the precautionary measure has not yet been confirmed, the decision to restrict the personal freedom goes back to the Public Prosecutor avoiding what is provided by art. 291 of c.p.p.. This issue is further strengthened when we apply the art. 275, paragraph 3 of c.p.p., according to which the requirements to issue a precautionary measure are presumed from the criminal action, though supported by serious evidences, and when we have a measure issued by the judge who is in charge of the confirmation but not for the precautionary measure.

We can have a further strengthen of the power of the Public prosecutor action even when he, after a rebuttal of the precautionary measure claim and awaiting for the appeal, instead of presenting new probative material to the review court, that causes the suspensory effect, against the granting of the appeal, opts for a new request which must take into account the new material (that could already exist). We are inclined to acknowledge legitimacy to this initiative that would be a way for the waiver to the appeal or to break the interest to do it³³, and this is an

³² Considering that when the interested person has been directly reached by a precautionary measure, the art. 294 paragraph 6 c.p.p. excludes that the Public prosecutor can interrogate him before the judge, it is obvious that we have a lack of the system consistency. On this subject matter see CHIAVARIO, *Chiaroscuri di una «novella» dagli intenti riequilibratori*, cit., 576; DAVIGO, *Gli effetti della l. 8 agosto 1995, n. 332 sui procedimenti relativi a reati contro la pubblica amministrazione*, in AA. Vv., *Misure cautelari e diritto di difesa*, a cura di GREVI, Milano, 1996, 400; KOSTORIS, sub art. 11 l. 8 agosto 1995, n. 332, in AA. Vv., *Modifiche al codice di procedura penale. Nuovi diritti della difesa e riforma della custodia cautelare*, Padova, 1995, 151; MANZIONE, *Arresto*, in *Digesto delle discipline penalistiche*, XI, Torino, 1996, 425; MARANDOLA, *L'interrogatorio di garanzia*, cit., 206.

³³ According to this statement, the last judicial branch shall be freed to give a judgment. In fact, we say that, when the Public prosecutor before taking his decision as regards the petition against the rejection of the personal precautionary measure, adduces new probative evidences, that are already the reasons for which the investigative judge has renewed a precautionary as provided for by art. 291 c.p.p., the reviewing court cannot deliver any judgment and this petition will be found inadmissible: see Cass. pen., sez. I, 13.12.2005, p.m. in proc. Romito, in *CED Cass.*, n. 233272.

innovation as regards the foregoing trend of the joint sitting of the divisions of the Court of Cassation³⁴.

At last, finally, the above mentioned evolution and involution is enriched by the elements coming from the joint tension which aims to guarantee – with effectiveness – the protection for the citizen. This information seems to be important mostly according with the perspective to have a right view of the purpose and of the function of the jurisdiction.

The prevention even through a wider control of the territory, more incisive methods of investigation, new kind of crimes, increase of the already existing punishments, are elements that become part of the strengthening of the arrest of suspect and the apprehension *flagrante delicto* and of the strong request of precautionary measures.

This last outlook is a question that foresees a substantial anticipated liability judgment and a pressing request to have real punishments, and it confirms the more and more accentuated trend to set the preventive moment over the precautionary one. According to this point of view is really emblematic the idea that imprisonment is the only solution for crimes which cause a strong social alert and the difficulty to imagine a *status libertatis* for people that have soiled their hands with many foul deeds.

As we can deduce from these few information the future of today is no more the future of yesterday.

³⁴ We speak about the Cass. pen., sez. un., 20.04.2004, Donelli and others, in *CED Cass.*, n. 227358 according to which when the Public prosecutor, before taking his decision as regards the petition against the rejection of the personal precautionary measure claim, renews the claim towards the same indicted person and for the same crime, pleading new probative evidences (already existing or intervening) the judge cannot decide as regards this precautionary claim, in abeyance of the appeal.

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TAMÁS HARDI, PHD, ASSOCIATE PROFESSOR AND RESEARCH FELLOW*
*Center for Regional Studies, West-Hungarian Research Institute,
Hungarian Academy of Sciences*

FEATURES OF BORDER REGIONS, TRANS BORDER CO-OPERATION AND MOVEMENTS ACROSS THE HUNGARIAN-SLOVAKIAN BORDER

Abstract: *Along the internal borders of the European Union it is an ever more important issue whether the integration of the states will bring about the integration of the cross-border regions as well. The possibility is given, the borders can be crossed without any problem, the movements of the citizens and the businesses are free from any obstacles. The issue of integration is of special importance in the border regions: the other state and its citizens are “physically close”; a single space built on geographical logics can be created in the everyday life. It is a question, however, how the border affects the lives of the citizens in the border region. Do they actually use the other side of the border? Can the border region of the neighbour state become part of their everyday lives? In the use of workplaces and economic opportunities which factor will be stronger: the nation state traditions or the logics of the geographical proximity?*

The answers to the questions above are different in all various border regions. Integration is influenced by the historical past; the ethnic and geographical conditions, the economic development and the differences of this, and not last the disparities in the political, administrative and public services systems of the neighbour states.

Keywords: *border region, Trans border co-operation, Hungarian-Slovakian border, Trans border commuting*

JEL classification: R 12, R 58

1. Introduction

The basis of our study is an empirical survey conducted in the Slovak-Hungarian border region. Due to historical, ethnic and spatial structural characteristics this region always had strong internal relations, even in the decades when

* E-mail: hardit@rkk.hu

the separating character of the borders was dominant. In Europe there are still border regions where a “wall” between the two border regions continues to exist, despite the existing formalised relations and the virtualised borders.¹ The number and volume of interactions do not increase as dynamically as one would expect. In other places the inhabitants of the border region have a varied system of relations to the other side of the border, irrespective of the relationship between the two states and the officially functioning cross-border organisations. The opening of the border will in all cases lead to the increase in the number of cross-border movements and the variety of their purposes. Krakover², however, emphasises that the opening of the border will not always bring tangible results, especially in situations where no significant commercial relationships can be created between the two separated countries (e.g. due to the weakness of the economy). Accordingly, short-term interests (such as the incubation of economic units in their infancy, and protectionism) act against the opening of the border. Our experiences suggest that this phenomenon does not necessarily take place at the state level; it can also be seen at certain sections of the borders where the general socio-economic conditions are bad. To the opposite, a dense network of personal and economic relations can be born at the common border of countries not in the best relationship with each other, if the permeability of the borders is given.

The relationship between Slovakia and Hungary is not free from conflicts. The relationship was conflict-burdened during the 20th century history of the two countries, as well (including the relationship of Hungary to the former Czechoslovakia), but the tensions are especially serious at the time of the birth of this essay. Nevertheless considerable personal and economic movements and cooperation characterise the common border region of the two states, and along all Hungarian borders this is the one where real cross-border regions can be born in our opinion.

The aim of our survey was to find out of what types, frequency and intensity the personal movements across the border are, and how these are affected by the accession of the two respective states to the European Union. From among the movements we analysed those that have become or may become part of the everyday lives of the population of the border region: cross-border commuting to work, migrations and the use of public services (education and health care). In order to obtain this information we asked 2000 inhabitants, and also another 500 commuting employees in a questionnaire survey; in addition, we made in-depth interviews at the offices, local governments, public service providers and non-governmental organisations concerned.

¹ A. Paasi, E-K. Prokkola, “Territorial Dynamics, Cross-border Work and Everyday Life in the Finnish-Swedish Border Area”, *Space and Polity*, 12:1, 2008, pp. 13-29.

² Sh. Krakover, *Boundary Openness Model Applied to Israel, Egypt and Gaza strip Tri-border Area*, Paper presented at the European Regional Science Association Summer Institute, Are, 1997

For the designation of the research area we had to define a functional border region. The administrative borders (of counties and districts) were not suitable for this, because these areas are too extended in some cases and contain parts that do not have evident functional relations on the other side of the border. In other cases, areas with strong cross-border relations reached beyond the boundaries of the administrative units along the border. To eliminate this problem we used a research area designated by our former researches: it was a zone home to approximately 2 million inhabitants on the two sides of the 679-kilometre-long state border.

For the definition of the research area we used the dynamic border region classification of *Martinez* who derives the types of border regions from the number and depth of cross-border interactions and accordingly differentiates among alienated, co-existing, mutually cooperating and integrated border regions.³ This reveals that the historical role of the border changes. Thinking further on these grounds we can see that the historical changes modify the relationship between the states and accordingly the functions of the state border, on the one hand; and the different borders separate areas of different geographical endowments, on the other hand. The characteristics of the state borders are in a close interrelation not only with the characteristics of the states that they surround but also the characteristics of the respective border areas. Accordingly, the functional classification featured above and the individual categories by *Martinez* are not only the respective states of a temporal change but can also be *spatial types* following the uniqueness of the border regions.⁴ In other words, areas of different geographical endowments have different chances for the creation of interrelated cross-border regions.

Along the less and less separating borders of these days, the basis for the definition of a border region can be the existence of cross-border interactions as a common feature determining a region. Today, when the borders are permeable, those areas are considered as border regions where the everyday life of the inhabitants is basically influenced by the interactions with the neighbouring border area; *cross-border regions* are those where these interactions create a spatially designable intensive system of relations. Literature on spatial borders more and more frequently refers to the fact of practical life that the sharp separation of regions (of areas belonging to different states in this place) are an obsolete approach now and we can more and more often see the birth of zones of transitory character among

³ O. J. Martinez, "The Dynamics of Border Interaction: New Approaches to Border Analysis", C. H. Schofield (Ed.), *Global Boundaries (World Boundaries Series 1)*, Routledge, London–New York, 1994, pp. 1-15.

⁴ T. Hardi, *Az egységes határrégiók kialakulásának feltételei – lehetséges határrégiók a Kárpát-medencében (Conditions of the birth of single border regions – possible border regions in the Carpathian Basin)*, Doctoral thesis, PTE KTK "Regionális politika és gazdaságtan" PhD. Program, 2001

the systems – i.e. border regions.⁵ These border regions, coming from their geographical (social, economic and spatial structural) endowments, can be of different width and depth on the different sides of the border. Within these areas can those special spatial units be born that we can call *cross-border regions*?

2. The Hungarian–Slovak border region

The Slovak-Hungarian border section is 679 kilometres long; this is the longest border section of Hungary. Moving from west to east along the border the development disparities are definite. A speciality of the border region is that even on the Slovakian side of the border the number and proportion of the Hungarian ethnic population is significant; there are settlements and areas where Slovak citizens with Hungarian ethnicity are the majority.

In the border region the integration of the population and the economic actors is increasing. Approximately 30 thousand employees from Slovakia work in Hungary, and commuting from Hungary to Slovakia has also appeared by now. More and more businesses have locations in the neighbour country, other choose school or even placed of residence in the neighbour state. The agglomeration of Bratislava, the capital city of Slovakia, has reached Hungary by now, several hundreds of Slovakian families have bought homes in the villages along the border of Northwest Hungary, in fact, the extension of the public transport of Bratislava towards Hungary is an issue today. At the same time, Budapest has a strong gravity on the border areas of Central Slovakia. On both sides we find smaller towns in the proximity of the border whose theoretical (and more and more often the practical) catchments areas reach into the other side of the border and integrate smaller areas. For a part of the population it has become natural by now to do the shopping or use services on the other side of the border. Due to the common past there are also family and friendly relations.

The accession of the two states to the European Union in 2004 and to the Schengen Agreement later also contributed to the development of the everyday relations, but the process has decades of history by now. The occasionally “cool” relationship of the two states cannot be felt in the micro-level relations; in the economically more advanced areas of the borders we can see the first steps of the birth of single border regions. The private sector is ahead of the official relations. A part of the inhabitants and the economic sector “use” the other side of the border in their everyday lives. The separating role of the “mental border” is less of a problem here than in some other European border areas. In the areas more

⁵ T. Fleischer, “Régiók, határok, hálózatok (Regions, borders, networks)”, *Tér és Társadalom*, 3-4, 2001, pp. 55-67; G. Novotny, “Határon átnyúló regionális hálózatok Európában (Cross-border regional networks in Europe)”, A. Buday-Sántha, G. Lux (szerk.), *Évkönyv 2006*. PTE KTK Regionális Politika és Gazdaságtan Doktori Iskola, Pécs, 2007, pp. 385-408.

developed economically (especially in the western part, the areas along the axis of the Danube River, belonging to the hinterland of three capital cities: Vienna, Bratislava and Budapest) the joint development is very dynamic. The rapid economic development of Slovakia has also given a great momentum to the integration, and now areas at the same level of development are building a common cross-border region and urban network. On the eastern part of the border this dynamism is less palpable. This is an area where less developed regions meet each other. Nevertheless the city of Košice and its environment is developing, and the labour market of this region is now seeking skilled employees on the Hungarian side of the border.

Of course there are still many obstacles to the complete integration. The national systems (education, health care, public administration, bureaucracy etc.) still have difficulties in handling the natural processes of cross-border areas. Those who cross the borders are actually foreign citizens but still “local inhabitants”. It is difficult to put them into the traditional categories of “domestic” and “foreign” citizens, and the administrative problems coming from this may cause difficulties e.g. in the joint and thus more rational use of health care institutions. These problems often lead to harmful phenomena; some use the existing differences for e.g. tax evasion purposes. Our experiences suggest that these phenomena are important but their significance is relatively small compared to those natural processes that bind the border regions and strengthen its integration.

The Slovak-Hungarian state border is situated in an area that belonged to a single state formation, the Kingdom of Hungary or the Austro-Hungarian Monarchy until the end of World War I. The peace treaty closing World War I created the state border between Czechoslovakia and Hungary. The state border did not follow the ethnic borders; large areas of Hungarian ethnic majority were annexed to Czechoslovakia. In the peace treaty of 1920 the designation of the border was mainly based on economic, military-strategic and transport geographical considerations.⁶ The network of personal relations so important for the organisation of the everyday life, the aspects of the settlement network and the ethnic aspects were more or less neglected. The border was moved northward after the Munich Treaty of 1938, and this situation existed until the end of World War II. The ceasefire agreement at the end of the war restored the conditions before 1938, and then the peace treaty annexed another small area to Czechoslovakia in the Bratislava region. After the disintegration of Czechoslovakia, Slovakia inherited the state borders.

The border regions have a multi-ethnic character. On the Slovak side, along the whole border section the proportion of the Hungarian ethnic minority is significant, in fact there are still Hungarian ethnic majority areas to date, especially in the western areas where in some districts Hungarians make more than 80% of the population. (For the whole of Slovakia, the share of Hungarian speaking citi-

⁶ A. Hevesi, K. Kocsis, *A magyar-szlovák határvidék földrajza (Geography of the Hungarian-Slovak border region)*, Liliium Aurum, Dunaszerdahely, 2003

zens is 9.67, and the majority of them live in the border zone.) In the eastern part of the border region the situation is somewhat different; here we find areas and villages of both Hungarian and Slovak majority.

On the Hungarian side we find inhabitants and villages of Slovak ethnicity as well. Although the share of Slovaks from the total population of Hungary is small (0.17%), along the border we find several villages with Slovak ethnic inhabitants. (A significant part of the Slovaks in Hungary live far away from the Hungarian–Slovakian border region, in the southeastern part of Hungary.)

In economic sense, in the western part of the border region (the Danubian border) we find the most developed areas of the two countries. In Slovakia the three adjacent west Slovak districts (Bratislava, Trnava and Nitra) produce half of the Slovakian GDP; the share of Budapest and the three counties along the border (Pest, Komárom-Esztergom and Győr-Moson-Sopron) from the Hungarian GDP produced is just as high. Especially in Slovakia this proportion seems to be growing. On the other hand, the development level of the eastern areas is below average in both countries, poor regions are neighbour to each other; it is true, however, that the city of Košice stands out as a developing economic island in Slovakia.

3. Contacts, relations between people

During the research we also focused on the relations of the inhabitants in the border region to the other side of the border. Because of the ethnic composition, however, it was not enough to differentiate the respondents according to their nationality; ethnic belonging was also to be considered. In our questionnaire survey, 40% of the respondents in Slovakia were of Slovak ethnicity, following the ethnic composition of the research area. At the evaluation of the responses we differentiated among the groups of respondents who were Slovaks in Slovakia, Hungarians in Slovakia and Hungarian citizens. Unfortunately there were very few Slovak respondents living in Hungary in the sample, which did not allow us to treat them as a separate group; we analysed their relations with in-depth interviews.

According to our experiences there is a clear-cut asymmetry in the citizens' relations across the two border regions. In general we can say that the Slovakian side – irrespective of the ethnic belonging of the respondents – has much more intensive relationships to Hungary than the Hungarian side has in Slovakia. Among the Hungarian respondents living in Slovakia almost every respondent “uses” the Hungarian side, as do a significant proportion of the Slovak respondents, whereas the intensity of the relationships of the Hungarian citizens to Slovakia is much lower. This is not a unique phenomenon; Anderson and O’Dowd (1999) emphasise that the cross-border relations are asymmetric as there are differences among the border regions. The reasons for this asymmetry in our case are as follows:

For the Hungarians in Slovakia, keeping in touch with the Hungarian areas close to them is also keeping in touch with the mother country, i.e. there is also an ethnic-emotional motivation behind the relations;

For the inhabitants on the Slovak side, language use is less of a problem than for the inhabitants of the Hungarian side. The Slovak citizens with Hungarian ethnicity evidently speak Hungarian, and even a significant part (82%) of the Slovaks understand or speak Hungarian. On the other hand, the proportion of Slovak speaking inhabitants on the Hungarian side is negligible (6.8%). During the daily travels this is not an obstacle, as in the Slovak areas along the border Hungarian language can be used almost everywhere, but e.g. the use of services is made difficult by the lack of language skills.

Our analyses reveal this asymmetry as well. Among all inhabitants in the border region the proportion of those who have never been to the other side is small. On the whole, 80% of our respondents have already been to the other side of the border, which is a proportion similar to those typical in other border regions;⁷ e.g. in the Austrian–Hungarian border region only 10% of the Hungarians and 20% of the Austrians declared that they had never crossed the border. A basic finding of our survey is that more inhabitants visit Hungary from Slovakia than from the opposite direction. As regards the respondents of the questionnaire survey in Slovakia, 96.1% have already been to Hungary, whereas this proportion is only 79.7% among the Hungarian respondents. The travel intensity of the Hungarians living in Slovakia is high: 97% of them have already visited Hungary, c.f. 94% of the Slovaks in Slovakia. The lowest proportion of visits to the other side is among the Hungarian citizens: only 79.9% of them have already crossed the border to Slovakia. It is interesting that the least active group of cross-border movements is the Hungarian citizens.

Of course only a smaller share of the inhabitants has living friendships or family relations, but the asymmetry can be seen in this respect too.⁸ A larger part of the Slovakian citizens have relations in Hungary than Hungarians have in Slovakia; the average Slovak citizens, on the other hand, has a larger number of relationships than their Hungarian counterparts have.

⁷ T. Hardi, "A határ és az ember", M. Nárai, J. Rechnitzer (szerk.), *Elválaszt és összeköt – a határ (The border – that connects and separates)*, MTA RKK, Pécs–Győr, 1999, pp. 159-189.

⁸ Z. Csizmadia, "Társadalmi kapcsolatok a szlovák–magyar határtérségben (Social Networks in the Slovakian–Hungarian Cross-border Region)", *Tér és Társadalom*, 3, 2008, pp. 27-50.

Figure 1: Probable frequency of the relationships and the types of relationships

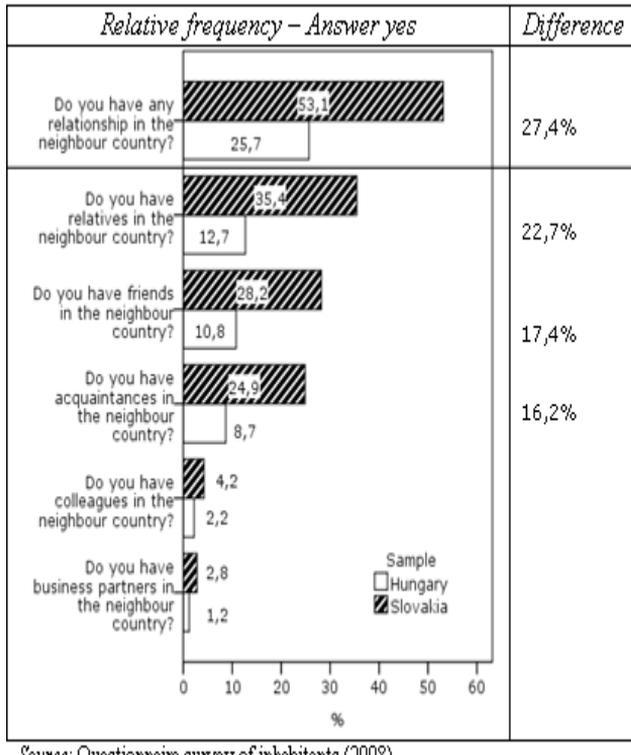
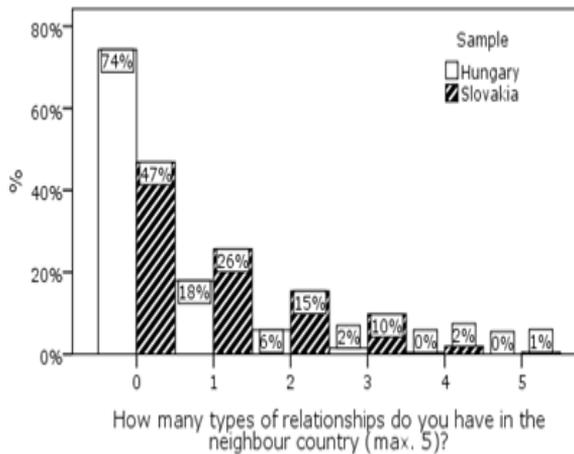


Figure 2: Number of Different Kinds of Relations in the Other Side of the Border

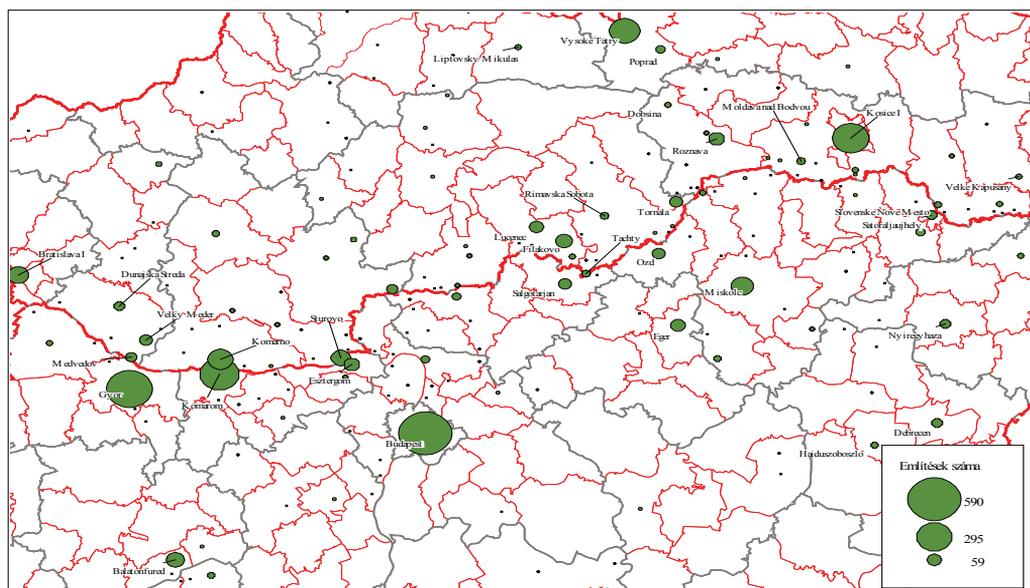


Source: Z. Csizmadia, “Társadalmi kapcsolatok a szlovák–magyar határtérségben (Social Networks in the Slovakian–Hungarian Cross-border Region)”, *Tér és Társadalom*, 3, 2008, pp. 27-50.

In the case of strong relations, most Slovakian respondents have relatives or friends in the capital city, followed by the big cities and the local centres along the border. A similar logic can be seen in the weak relations too; the dominance of the capital city can also be seen here. The situation Komárom is to be separately mentioned; it is the third destination in the number of relations in each type of relation, after Budapest and Győr, despite its much smaller population.

Of course the list is not suitable for drawing far-reaching conclusions, but it is useful to demonstrate the major junctions of the integrations mechanisms in the border region through the interpersonal ties.

Figure 3: *Destinations of the Cross-border Travels*



Source: questionnaire survey (2008)

4. Changing movements

The spatial movements of people are usually motivated by some economic necessity or benefit. Economic benefit does not only mean the profit that can be realised through an economic activity (business or employment) but also the better access of the individual to certain functions or services (education, health care, transport infrastructure, housing) with less travel or at a lower cost, maybe in better quality. The ground of the cross-borders movements is the benefit deriving from them.

The other side of the border, due to the spatial organising activity of the nation state, is not our natural action space. In order to use the other side of the border more or less regularly for our daily routine activities we must have a benefit that makes us manage the obstacles coming from the existence of the state border (border checks, different social and economic environment, mental border, different currency etc.). The benefit we can realise must be bigger than the obstacle to overcome. This is usually true for the cross-border, international migrations too. What makes movements between border regions different, however, is the fact the spatial proximity makes the benefits deriving from the differences accessible, so the benefits in our daily routine activities are accessible within the range of our local and micro-regional movements.

In the case of the Slovak–Hungarian border we can talk about “traditional” cross-border movements. Even in the socialist times there was e.g. mutual cross-border employment and shopping tourism. In the recent decades the use of institutions has become more and more widespread, e.g. a significant number of Slovak students learn and study in the educational institutions of Hungary. The demand for the use of the hospitals closer in space, although in the territory of the other country, has also appeared. Since the EU accession it has become frequent that Hungarian businesses locate to the other side of the border (for the more business-friendly taxation system) and the relocation of residences, the movement of the inhabitants to the other side of the border has started too. The sub urbanisation of Bratislava and Košice has already reached the border areas of Hungary, while in the case of smaller towns the Hungarian inhabitants buy real estates on the Slovak side. In this essay two movements are to be selected: the sub urbanisation of Bratislava and cross-border commuting for employment reasons.

5. Dilemmas of the penetration of the Bratislava agglomeration into Hungary

Bratislava, a dynamically developing capital city has created, similarly to other European cities, a suburban zone of considerable size and rapid growth around itself. Due to the special location of the Slovakian capital city – close to the border – and the characteristics of the real estate market, this suburban zone has already penetrated into the Hungarian and Austrian side of the state border too, and a further dynamic strengthening of this sub urbanisation process is expected, especially on the Hungarian side, coming from the peculiarities of the transport network. A total of 3 to 5 thousand Slovak citizens are estimated to have moved to the Hungarian border region until the autumn of 2008.

Sub urbanisation as an urban development process is a development faze that naturally takes place in the life of each big city, and this process has impacts on both the city itself and its environment. Besides the “traditional” suburban

impacts, in this case the advantages and disadvantages typical of the cross-border urban regions – the existence of the border and the socio-economic, linguistic and ethnic features of the two states – also have to be considered. The following issues arise (just to mention a few of them): how will a Hungarian local government provide public services (education, health care etc.) for the in-moving Slovak speaking population (without Hungarian nationality); what network cooperation can be built out among the neighbouring Hungarian and Slovak municipalities to tackle the problems; is there anything that can be done to the issue of taxation (the in-movers pay taxes in Slovakia but use some of the public services in Hungary); how will the newly arriving groups integrate into the society of the receiving settlements and will ethnic segregation processes start and ethnic conflicts appear?

6. Cross-border commuting and the local labour market

The interesting thing about cross-border commuting is that it is an international migration in the legal sense, but mostly within local circumstances. This phenomenon is different from the traditional employment “abroad” as the employees live in the neighbour state but have their place of work in another state. This situation differentiates these employees from other foreigners, and their special situation raises a number of issues, from the organisation of daily transport through the use of public services to taxation and the conversion of the incomes. According to our survey, some 10% of the inhabitants living in the Slovakian border region has already worked or is presently working, maybe planning to work in Hungary. Through their families then cross-border employment concerns a much bigger population.

We encounter a phenomenon that is already familiar to us within the nation state – now, however, certain local labour market areas reach across the nearby state borders and build out some of their relations on the other side too, using the arising opportunities (permeability of the borders, institutional integration, and the improvement of the accessibility of the neighbour border region in the broader sense of the word).

Since the turn of the millennium one of the most dynamically developing cross-border movements has been commuting to work. Mutual employment has traditionally existed in the region. The axes of industrial development and the lack of language and cultural barriers were already given in the socialist era, but the economic decline in the years following the systemic change temporarily brought an end to cross-border mutual employment. After the years of stagnation, from 1999 on the number of employees commuting from Slovakia to Hungary to work rapidly increased. In the western border region there were higher unemployment rates on the Slovak side than in Hungary, whereas on the Hungarian side there were large industrial centres that had already exhausted their local labour pool.

The small number of bridges sets regular commuting back, however. Considerable indicators of the relations of Mosonmagyaróvár, Győr and Komárom were the bridges across the Danube River (and the same role is assigned to the rebuilt Mária Valéria Bridge in Esztergom and its surroundings). Ferry as a means of transport is rather uncertain and largely depends on weather conditions changing with the seasons. After 1999 the development of commuting was also assisted by the framework agreement between the two states, as it allowed more and more people to find employment in another country (evidently it was Hungary in the first place), in fact, the limits were set so high in the year prior to the EU accession that the barriers to the movements of labour were actually eliminated in practice. The May of 2004, the time of the accession did not reach labour market unprepared. In 2005 the number of Slovak citizens employed in Hungary was estimated to be around 30 thousand, and this number has remained more or less stable with some ups and downs. Since the accession to the Union, Slovakia has been going through a very rapid economic development, which of course affects the labour market of Slovakia among other things. Accordingly the number of commuters in the western border region is decreasing, it is expected to stabilise at a normal level and probably those will choose employment in Hungary for whom a nearby Hungarian town or city is a spatial advantage. At the same time a process of opposite direction has started too. Hungarian employees are attracted to Slovakia by Slovak businesses. It is mainly structural problems, i.e. the tackling of the lack of experts for the management of which they are looking for skilled workers in Hungary. From Komárom-Esztergom County e.g. people commute as far as to Trnava to work, employed in the automotive industry. The phenomenon of the most recent times is that in the eastern areas struck by significantly higher unemployment the Slovak entrepreneurs are recruiting Hungarian labour force. Also here the demand for skilled labour is what prevails, especially in peripheral border regions from where the majority of the skilled workers have already moved out.

We only have estimations concerning the breakdown of the 30 thousand employees. Looking at them from spatial aspects, approximately two-thirds of them are from the border districts of West Slovakia, from the Dunajská Streda, Komárno, Nove Zamky and Levice districts inhabited by mixed population, i.e. both Hungarians and Slovaks. In December 2007 a total of 9,780 persons from these four districts most concerned in this respect were employed directly by Hungarian firms – 2,200 employees from the Dunajská Streda, 6,000 from the Komárno, 1,200 from the Nove Zamky and 380 from the Levice district.⁹ The rest, i.e. approximately 10,000–10,200 persons found employment in Hungary via Slovak labour recruitment agencies. We lack exact figures of the similar breakdown of the approximately 10 thousand employees living in East and Central Slovakia; we only presume that mostly the same tendencies are also valid in their case as in West Slovakia.

⁹ Source: Eures Danubius Conference, Dunajská Streda, March 14th, 2008.

During our researches we found out that the phenomenon of cross-border employment in the region does not only depend on the elements of economic boom. The respondents thought it was important to have higher salaries in the neighbour country, but the spatial proximity of the workplace was just as important. We can say with certainty that the commuting employment in our region is not a traditional international migration; it is based on the classic urban-rural relations. Its intensity and volume are influenced by the wages available, but we also have to see that the majority of the commuters have more poorly paid jobs where the wage differences will not significantly change across the two countries. The introduction of Euro in Slovakia will evidently set back movements to some extent, but it will not eliminate them. It is worth continuing the professional talks in this field and promoting an even broader cooperation in the fields of vocational training and retraining etc., strengthening thereby the cross-border labour districts.

7. Conclusion

At the evaluation of the situation of our border region we have to emphasise that the two states became members of the European Union and the Schengen zone at the same time. The opportunities offered by these integrations are multiplied in the border region by the fact that the state border separates areas whose common development is promoted by the common language, Hungarian, which the Hungarian citizens in Slovakia and the majority of the Slovak citizens in Slovakia speak or at least understand. The theoretical (and more and more frequently the actual) hinterlands of the cities along the border penetrate into the other side of the border and integrate smaller or larger areas. The interesting feature of these processes is that they take place at the level of everyday life; for both the inhabitants and the entrepreneurs it is becoming more and more natural to “use” the other side of the border.

Regular cross-border movements only concern a relatively small share of the total population of the border region. On the Hungarian side this is relevant for 1 to 2% of the total population, whereas some 20 to 30% of the inhabitants on the Slovak side are involved in such movements. The main driving forces of the movements are economic growth, economic interests and the characteristics of the spatial structure (revival of the centre and hinterland relations). The EU accession promoted the increase of the intensity of the movements in all fields and directions. The differences of the national systems (social security, training, taxation etc.) promote the penetration of the shadow or black economy; also, they set back the simplification of the affairs of everyday life.

Approximately 30 thousand employees from Slovakia work in Hungary, and commuting from Hungary to Slovakia has also appeared by now. More and more businesses have locations in the neighbour country; others choose school or even

place of residence in the neighbour state. These phenomena have been reinforced by the accession to the Union, as the macro-level processes offered new possibilities. The possibility of free movement, employment, and migration and business foundation has found a fertile soil here, the old phenomenon could live on in new dimensions and new phenomena have also appeared. Whoever thought that the agglomeration of Bratislava would reach Hungary and hundreds of Slovak families buy flats in Rajka and its surroundings, raising the issue of extending the route of the local bus line of Bratislava to Rajka? Whoever thought we would be able to go to school (or maybe visit the nearest hospital) across Schengen border?

Today this is already reality, but change is so rapid that the driving forces and motivations are almost unknown. Of course there are still many obstacles to complete integration. The national systems (education, health care, public administration, bureaucracy etc.) still have difficulties in handling the natural processes of the border regions. Those who cross the borders are actually foreign citizens but still “local inhabitants”. It is difficult to put them into the traditional categories of “domestic” and “foreign” citizens, and the administrative problems coming from this may cause difficulties e.g. in the joint and thus more rational use of health care institutions. These problems often lead to harmful phenomena; some use the existing differences e.g. for tax evasion purposes. Our experiences suggest that these phenomena are important but their significance is relatively small compared to those natural processes that connect the border regions and strengthen its integration.

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ASSISTANT PROFESSOR REMENYI PETER, PHD*
*Department of Political Geography and Regional Development,
Institute of Geography, University of Pécs*

INTERNATIONAL INSTITUTIONAL CO-OPERATIONS IN THE BORDER AREAS OF HUNGARY AND SERBIA

Abstract: *The relations between Serbia and Hungary have several aspects, one of them being the trans-border institutionalized co-operations. These institutionalized trans-border co-operations include in our view first of all the sister cities and the euro regions. According to our opinion these are the basis of the harmonic and balanced relation between the two states. Their bottom-up built structures; the civil and non-governmental initiatives are essential elements of an efficient co-operation. In our paper we examine the existing structures in this area, arguing that their setup follow a dual system. Duality in this case means that the sister city movement is ethnic-based (practically a Hungarian-Hungarian co-operation) while euro regions have more rational objectives where ethnicity is not considered important, only efficiency and the basic principles of EU's regional policy.*

Key words: *international co-operation, sister city, euro region, Hungary, Serbia, trans-border relations*

JEL classification: R 12, R 58

1. Theoretical considerations

In this study we survey co-operations 1) that are not state level collaborations (regional, county, settlement or institutional) and 2) in the border regions they are made on areas that belong to at least two countries. By border region we mean those areas, on the life, which the state-border has, a significant effect. Its confinement can be materialized in many ways; we chose three counties of the Southern Great Plain for our present study.

The formation of collaboration along the borders can be traced back to the heroic age of European integration. The first spontaneous forming from below

* E-mail: remko@gamma.ttk.pte.hu

then slowly institutionalizing co-operations was established on the German-French-Benelux border regions. These co-operations were brought into life by the harmoniously developing regional processes deformed by state borders that were strengthened by the long, shared past of the region, the areas that changed hands several times, the partially overlapping ethnic settlements and the economic interdependency. As a result of decades-long development, community policy and the changes of directives the spontaneously starting co-operations became part of the accentuated funding areas of the European Union. That is true for both the internal and external borders of the Union. In case of external borders providing stability is a significant aspect, forming good neighbour policy and in certain cases preparation for expansion.

Besides the effectiveness of continually strengthening general EU preferences every part of the border henceforward preserves its classical bilateral nature, in so far as the actual (border) problems determine the qualitative and quantitative figures of the cooperation. As a result of this it is possible, moreover necessary to set broad goals on local and international levels, at the same time at the time of planning and intervention we cannot become detached from the realities of the given border part.

2. Confining the surveyed region

For simplicity, we determine the surveyed region and the scope of settlements on an administrative basis in our study. Therefore, we considered the Southern Great Plain region (Bács-Kiskun, Békés and Csongrád counties) on the Hungarian and Autonomous Province of Vojvodina on the Serbian side. Obviously, other Hungarian settlements and organizations also have Serbian connections, or the Hungarian participants do not only keep up institutional relations with their partners in Vojvodina, but at the same time the most intensive and regional and local co-operations appear in the relation of the above mentioned two regions. Within this regional confinement further concentration can also be observed that lets us conclude that Csongrád county and the settlements of the county and the former Bács county part of Bács-Kiskun county cultivate the most intensive connections, while the orientation of the northern areas of the latter and Békés county and its settlements are different.

3. The surveyed co-operations

In case of the institutionalized connections, we examined those co-operations which are in connection with the administrative system (regions, counties and settlements). We believe that the collaboration of these elements mean the

framework for further co-operation. In case of the smaller settlements this is obvious, since the inter-institutional co-operations and co-operation between civil organizations after reaching a certain level are conceptualized in municipal contracts, sister city agreements are formed. The process also happens the other way around. The agreement between municipalities needs to be filled by content and that is the task of local institutions and civil organizations. Therefore, below a certain level treating co-operations between settlement and between institutions separately does not provide extra information.

At the same time in case of a certain institutional circle, it may be justified. Those institutions having high autonomy, their dependency from their settlements or county appear in a more indirect form, therefore the independent and administrative unit-free international presence may be significant. These institutions are higher education institutions, certain professional organizations (chambers) and local directorates of certain deconcentrated state organs (MÁV Hungarian State Railways, Police, authorities for Environment, Nature and Water etc.). Concerning their unique situation or in cases we think their roles are relevant we will elaborate on the international (here in connection with Serbia) collaboration of these organizations.

4. About the Hungarian institutional co-operation

Today, there are many forms of international co-operations in Hungary. We are only going to deal with the institutionalized ones, especially those that can regionally be well confineable. This decision is justified by subsidiarity principle, which says that local and regional co-operation and intervention are only efficient if the decisions are made locally according to those locally involved. Accordingly, one can categorize co-operation as follows:

- bilateral inter-settlement co-operation (sister town, partnership towns)
- bilateral co-operation (sister counties) between counties (administrational meso-levels)
- multilateral co-operation between settlements and/or counties
- Euro-regional co-operation
- institutional co-operation

5. Institutional co-operations between settlements and counties

The roots of the sister city movements date back longer, but they spread only in the decades after the Second World War. Originally, the movement started as a co-operation between those settlements of different countries, which had something in common, shared the same problems, characteristics, had shared

history or maybe they had connections in the historic past. In the early days of the movement, it was an important aspect of co-operation to get acquainted with the culture, customs, art etc. of the inhabitants of the other sister city. Usually the co-operation starts with the (civil) institutions of the settlements or with the co-operation between the municipal corporations, which in many cases are followed by economic co-operation as well.

The home of sister city movement is in Europe and until today most of the sister cities can be found here, however the movement spread fast all around the world. At the beginning of the year 2000 there were more than 30 000 registered sister town relationships in the world.

After the changes of regimes in Central Europe, there were more and more “eastern” “western” sister city relationships and their co-operations expanded to new areas: supports were provided by the wealthier town. The help could even be money, used but still functioning equipment (fire-engine), knowledge etc.

During the 1990s, Hungarian settlements benefitted from this, but by the year 2000, the trend seemed to be turning around. Today, it is more typical that Hungarian settlements provide aid to those Romanian, Ukrainian, Serbian or other sister cities in worse situation.

There is an important characteristic of the Hungarian sister city movement, which cannot be traced in the case of all other countries. This is the preference of Hungarian-Hungarian sister city relationship in forming these partnerships. The high number of Hungarian minorities abroad, their sporadic settlement structures and their usually difficult situation may be the reason that in forming relationships the geographical situation is of secondary importance to national interests and national values. It can be observed in the cases of Ukrainian, Serbian and Romanian settlements in more disadvantageous situation.

Today in Hungary, the number of sister city relationships are over 2000, but they do not have an autonomous organization, their most notable supporting and organizing institution is the National Association of Settlement Municipalities. On international level, the most important European organization representing these interests is the Council of European Municipalities and Regions (CEMR).

There is a special case of co-operation when not towns but higher-level administrative units take part in the co-operation. This usually concerns counties or regions. In Hungary, municipality connects to counties, thus the sister-county relationships are made mainly within the country. The Hungarian planning statistical regions take part in co-operations only through their work-organizations (regional development agency) and they take part mainly in project-based co-operations. Even if the partner groups of euro-regional co-operation are from a neighbouring country (e.g. Burgenland), in Hungary it is the counties, who would decide one by one about partaking.

From the co-operation point of view, the county level co-operations similar to those of sister cities are the so-called “soft” co-operation. It largely concen-

trates around culture, sport, education and youth relations. The accented parts are the exchange of experience, making declarations together, arranging collective programmes, exhibitions, arranging fairs together and taking part in each other's programmes etc.

There are non-bilateral but so-called multilateral co-operations as well, which are not really characteristic of our region, not only directed towards some Serbian regions (for example: Bács-Kiskun county taking part in Assembly of European Wine Regions or in Central and South Eastern European Urban And Regional Cooperation Network). Many times within these co-operations, there are tighter bilateral co-operations, but these are formed along other aims or interests.

6. The sister city and sister-county co-operation in the surveyed regions

Many settlements of the Southern Great Plain have Serbian sister cities. In our study we concentrate on larger settlements (towns) starting from the assumption that this settlement circle have resources that may be a good basis for potential projects or has the potential to exceed the traditional inter-municipal and inter-institutional (school, pensioner club or dance groups etc.) co-operations. Our study involves the small region centres of the three counties assuming that the international relations of small region centres may have exploitable advantages for the other settlements of the small regions.

The following conclusions can be drawn from the table above:

- On the Hungarian side Csongrád county leads in keeping contact with Serbia. Out of its seven micro-regions six (except Kistelek) have a sister city in Serbia, moreover Csongrád county and the Autonomous Province of Vojvodina are sister-counties of one another. It has partly historical reasons, as the agglomeration of Szeged used to expand to today's Bačka and the traditional axis of transportation reaches Vojvodina through Csongrád. Furthermore, Szeged is a regional centre with such complex function which is not only an orientation point for the southern Hungarian areas but also for the Hungarians in Vojvodina, in certain cases (culture, language, Hungarian higher education and certain commercial functions) the number one centre. This strengthens the traditionally strong Szeged-Subotica co-operation.
- In Bács-Kiskun County, besides the partner connections between the county itself and Vojvodina only the border settlements and small regional centres in a close proximity to the border have Serbian partners. The location of the micro-regions with sister cities shows strong correlation with the former Bács-Bodrog county. The region of Upper-Bácska

includes four small regions today (that of Baja, Bácsalmás, Jánoshalma and Kiskunhalas), all of them having institutional sister city connection with Serbia. From a different aspect out of the non-Bácska small regions of Bács-Kiskun county (Kunszentmiklós, Kecskemét, Kalocsa, Kiskörös, Kiskunfélegyháza and Kiskunmajsa) only one (Kiskunmajsa) has a Serbian sister city. Obviously this also have historical reasons, the inhabitants of the Upper-Bácska areas lived in the same county with that of the settlements south from today's border for centuries, the Soviet-Yugoslavian alienation following the Second World War put an end to these co-operations, economic, family and institutional etc. connections. With the Serbian consolidation the former connections seem to revive and this fact strengthen the bipolarity of Bács-Kiskun county and Bácska's autonomy from the Kecskemét-centred settlement that are now in the agglomeration of Budapest. It has to be emphasized that the centre (Kecskemét) of the county sharing the longest border with Serbia – having official connection with Vojvodina – does not have a Serbian sister city.

- Békés County not having a border with Serbia is understandably not prominent in establishing connections with Vojvodina. Only the county capital has an “obligatory” Serbian sister city (Zrenjanin since 1966) and Békés itself has a newfangled (Novi Itebej – 2006) agreement, the other small regions have traditional international partners mainly in Romania, between Arad and Oradea. The neighbouring towns, Békés and Békéscsaba also chose neighbouring settlements as partners from Vojvodina, too.
- The sister city connections are only attained in settlements with Hungarian inhabitants so the earlier mentioned Hungarian feature (the demand for Hungarian-Hungarian relations) is dominant. In choosing sister cities, it happened to be an accented aspect like often the similarity in size or functional similarity.
- It is partly the result of the above-mentioned facts that the regional allocation of Serbian sister cities can be well confined. Settlements of Csongrád county, mainly formed institutional connections with settlements in Northeast-Bačka along the Tisza, the inhabitants of upper-Bačka with that of Northwest-Bačka, while the two towns in Békés have sister cities in Banat.
- Connections are usually formed between settlements similar in size and in the number of inhabitants. The largest difference – except between Békés and Novi Itebej, where it is almost 10.000 in number – is about threefold (Kiskunhalas-Subotica, Mórahalom-Temerin).
- Beside the traditional Szeged-Subotica collaboration with a great past, the partnership between Baja-Sombor is also remarkable.

- The majority of the affected questionee highlighted the difficulty of keeping contact, its expensive nature and its circumstantiality (visa) as the main problem.

Table 1: *The Serbian sister cities of the small region centres of the Southern Great Plain region*

Settlement	county	The Serbian sister city
Baja	Bács-Kiskun	Sombor
Kiskunhalas	Bács-Kiskun	Kanjiža, Subotica
Kecskemét	Bács-Kiskun	-
Bácsalmás	Bács-Kiskun	Bajmok, Bezdan
Kiskunmajsa	Bács-Kiskun	Bačka Topola
Kiskörös	Bács-Kiskun	-
Kalocsa	Bács-Kiskun	-
Kunszentmiklós	Bács-Kiskun	-
Kiskunfélegyháza	Bács-Kiskun	-
Jánoshalma	Bács-Kiskun	Temerin, Srbobran
Békéscsaba	Békés	Zrenjanin
Orosháza	Békés	-
Mezőkovácsháza	Békés	-
Gyula	Békés	-
Sarkad	Békés	-
Békés	Békés	Novi Itebej
Szarvas	Békés	-
Szeghalom	Békés	-
Kistelek	Csongrád	-
Szeged	Csongrád	Subotica
Makó	Csongrád	Ada
Hódmezővásárhely	Csongrád	Senta
Mórahalom	Csongrád	Temerin
Csongrád	Csongrád	Bečeј
Szentes	Csongrád	Bačka Topola

7. The sister-county co-operations

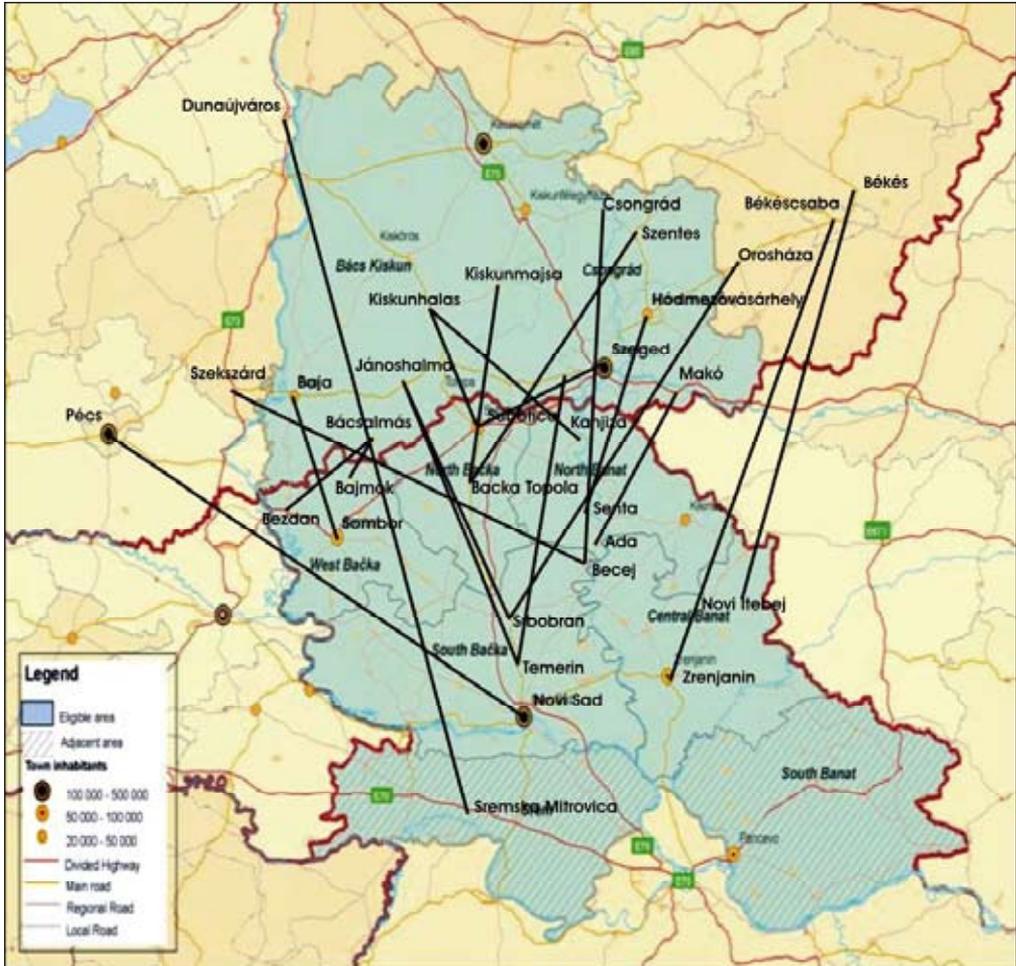
The collaboration agreement between Csongrád County and the Autonomous Province of Vojvodina was signed on 26 March 1990. Prior to this, Csongrád County formed decades-long connections with the province that was renewed after the change of the Hungarian political system. Due to the Yugoslavian wars and its consequences, collaboration between the two municipalities could not be unbroken and smooth. However, Csongrád county aspired to help Vojvodina even in this delicate political situation bearing the interest of the Hungarians in Vojvodina in mind. The good relationship between the county and the province had a pivotal role in the formation of the Danube-Kris-Mures-Tisa Euroregion (DKMT). These connections are mostly formal with framework-nature, the concrete activity is partly carried out by county institutions, but mainly by collaboration between the settlement municipalities of the counties and the municipalities in Vojvodina together, the most prominent of which is the Szeged-Subotica cooperation. Since the formation of the DKMT Euroregion, collaboration between counties lost some of its importance, but at the same time in certain areas it remained determining. These are the local political collaboration (since the county has municipal and political functions and institutional system), the organization of the local Hungarian-Hungarian connections (the philosophy of the euroregion is studiously multicultural) or such embedded co-operations that are materialized by county institutions, such as chambers.

Bács-Kiskun county also keeps long standing connections with Vojvodina, until recently it could be well seen in the collaboration between the Bačka areas that got to the two sides of the border. It was in 2007 when the official contacts were made between the bodies of Bács-Kiskun county and the Autonomous Province of Vojvodina, when the Hungarian county sent an introductory delegation to Serbia. During this, both parties expressed the wish to continue the already existing collaborative work and made a declaration about partnership. Amongst the co-operational aims put down in the contract the mutual partaking in EU financed projects took the first place, and besides that formation of institutional connections, their developments and the vitalization of economic and trade connections also appeared as aims. In order to reach these aims the partners formed a work group.

A good example of the old connections is the report of the county's general assembly of 29 February 2008 about the county's foreign affairs. In 2007 regardless of the cooperation agreement the county institutions and the members of the county assembly participated in several professional events in Vojvodina (conferences, exhibitions and trainings) and likewise. The professional areas of the co-operations are tolerance, equal rights, folk art, library science, professional archival collaboration and the areas of astronomy. Their regional appearance

in Vojvodina is connected to several settlements (including Novi Sad, Bačka Topola, Senta, Pančevo and Subotica).

Figure 1: The main Hungarian-Serbian sister cities, Ed. by author, base map: www.nfu.hu



8. Sister cities

The sister city connections of the surveyed region can be assorted according to the history and formation of collaboration as well. There are co-operations dating back to the times prior to the Treaty of Trianon (Szeged-Subotica), to their 20th century formalization was only necessary because of formalities. Another group of the collaborations is the connections made in the 60s, formed in the heroic era of sister city movements but often in cases when the collaborations have no historical background the choice could have been according to size,

function, economic branches or any other viewpoints (Békéscsaba-Zrenjanin). The third group consists of sister city pairs whose connections were made in the times of the change of the Hungarian political system. Here the motivations are also manifold but demand for cultivating Hungarian language and culture (Békéscsaba-Novi Itebej). We are going to show an example of each type now.

8.1. Szeged-Subotica

Historically, the Szeged-Subotica connection as a formal sister city contract exists since 1966. The connections of settlements having good functions contemplating one another were interrupted by the world wars and their consequences. The reviving connections are typically, in an unconcealed way and consequently are Hungarian-Hungarian relations. It does not mean discrimination on ethnical basis but based on what the questioned people say a working cooperation is when both the organizers and the controllers are Hungarian, therefore a straight consequence is that the Hungarian interests dominate.

The main areas of collaborations are culture, education and arts. In this, schools and art groups are present together, the Hungarian schools of Subotica received books as gifts, the teacher and student exchanges are regular as well as the training programmes in Hungarian. Important collaborations were formed in the field of tourism, which is mainly represented in shared marketing strategies and appearing together in fairs. There is an initiation to improve a mutual regional airport meaning that with the improvements of Szeged Airport the two towns would have a shared airport.

The political sphere also keeps strong connections, they have a general assembly meeting annually, they accepted several declarations (e.g. fight against drugs). At the same time, the internal politics of both countries make their influence felt. In 2002, the formation of the socialist leadership of Szeged created a disturbance in the bilateral connections that arouse suspicion in Subotica. The biggest problem for the Hungarian side is the large number of the small and diverse Hungarian political and other organizations in Vojvodina. Therefore, it is hard to decide which organizations to prefer when making connections.

The leadership of the town and its international relations division has very little information on the collaboration between civilian and religious organizations over the border. Those both exist but the city only knows about the concrete agreements and actions where they asked for help officially. At the moment, synchronization of the civilian organizations of Szeged and the operation of the town leadership is in progress that would make it possible to know more about their role in international relations. Out of these, the municipality emphasized the environmental protection and pensioner organizations for showing high-level activity. The civilian connections are also almost only Hungarian-Hungarian relations.

Subotica just like the other t sister city of Szeged receives annual invitation and participates in the 'Szeged Day' programmes.

8.2. Békéscsaba-Zrenjanin

The Municipality of Békéscsaba Town of County Rank made an agreement with Zrenjanin in the former Yugoslavia in 1965. The town is now located in the Autonomous Province of Vojvodina, in the Banat region.

At the time of choosing it as sister city, it was an important factor to find a town similar in size, its settlement structure, economy, industry and hospitality. Békéscsaba also had an aspiration for choosing a sister city inhabited by Hungarians.

From the very beginning, the main areas of collaboration were establishing cultural and economic connections and these remained the dominant areas up today. It took long years until connections between schools and educational institutions were formed.

Sport is one of the most important fields of cooperation. Shooters, fencers, swimmers, bowling and chess players, basketball players and athletes are in connection with sport clubs in Zrenjanin.

The Chamber of Békés County Trade and Industry coordinate economic collaboration. They provide the possibility for Zrenjanin to exhibit on Csaba-expo and Szeged-Expo. Meetings between the sister cities are held twice or three times annually.

The efficiency of collaboration is hardened by the difficult procedure of crossing the border and getting visa, and by the small frame amount of the towns available for international relations.

8.3. Szentes-Bačka Topola

Szentes has a sister city connection with Bačka Topola since 1969, which was ceremoniously renewed several times (in 1989, 1991 and 1998). The cooperation includes fields of culture, sport, health care and trade. Within the framework of sister city co-operations, doctors and health care professionals of Vojvodina regularly participate in health care conferences organized in Szentes. There is a friendly connection between the Red Cross organizations of the two towns. In the mid-90s during the Yugoslavian wars, Szentes helped the inhabitants of Bačka Topola with regular support so to say that the sister city cooperation showed a gesture of solidarity even in hard times. The cultural cooperation agreement signed 12 December 1998 includes collaboration between elementary and secondary schools, educational, cultural and sport competitions, organization of events and professional cooperation of teachers. There is also a good connection between libraries, institutions, music schools and civil organizations (exchange of art events and media collaboration). In Szentes the Educational

Centre is responsible for preparing the work schedule of the two towns that regularly includes shared exhibitions, dance shows, literary, cultural and folk art programmes, performances of theatrical groups, choirs and bands etc. There is a vivid connection between the agricultural high schools, students from Szentes participated in the plough competition in Serbia, and their teachers visited the 40th anniversary of the Serbian agricultural school.

8.4. Békés-Novi Itebej

Békés has a sister city connection with Novi Itebej since 7 September 2007. In the 1780s, 60 families from Békés emigrated to Novi Itebej. The settlement was named after this event. Based on this the idea of having the 1000-inhabitant Novi Itebej as sister city came up and the sister city contract was signed recently. The present connections mainly include cultural collaborations but the action plan of 2008 expanded these collaborations to the possibility of mutual INTER-REG tenders, too. A further aim is to ensure exchange of experience in the fields of economy, agriculture and education.

The municipalities, the major's offices and the cultural centres (in Novi Itebej the community centre) of both towns participate in the cooperation. Traditionalist associations, folk dance groups and sport clubs give each other the possibility to perform.

Since this is not a long-standing connection, it is impossible to present long-term economic significance coming from the sister city collaboration yet, however the significance of tourism may already be shown. Delegations of the two sister cities are mutually invited to different occasions: such as the Madzagfalvi Days in Békés or the Winter Meeting of Itebej and the Village Day in Novi Itebej.

The cooperation according to the financial possibilities is eligible, obviously the frequency of the visits could be increased but it would result in further expenses for both parties. Certain forums for example agricultural forums could be organized where professionals of Novi Itebej and Békés could present their experiences and talk about their work processes.

Summarizing the connections of sister-counties and sister cities, we can say that in the Hungarian-Serbian relations the existence of Hungarian-Hungarian connections is extremely important. The historical and traditional connections are also significant. Even though economic matters are treated with emphasis everywhere, the main areas of co-operation are institutional (educational etc.), cultural, sport or scientific.

9. Euro regions

By Euro-regional co-operations we mean the institutionalized co-operations financed by the European Union, which are in harmony with the EU principles and expand to two or more neighbouring, bordering regions or other units of area. The organization and content of co-operations can be remarkably diverse without strict rules and regulations. In general, the Euroregions unite the working co-operations of their areas and those outstretching the borders in an umbrella organization. Their financing is multi-channelled, consists of the participants own resources, membership fees, EU and state resources and sometimes private capital. It exists on every part of the Hungarian border, or at least on paper Hungary has this kind of cooperation with all its neighbouring countries. The oldest and most well functioning is the one between Western Transdanubia and Burgenland, called West-Pannon Euroregion. In the Hungarian-Slovakian relation more euroregions were established. One has a town-region nature, which agglomerates part of Esztergom that is now in Slovakia therefore it is dominantly a Hungarian-Hungarian cooperation (Ister-Granum). Nevertheless, at the same time there are broad, mixed-inhabitant, Hungarian-Slovakian co-operations as well (Vág-Danube-Ipoly and West-Pannon euroregions). In Hungarian-Slovenian and Hungarian-Croatian relations, we can only talk about euroregions in theory since neither the Murania nor the Danube-Drava-Sava work in practice. There are not any significant projects or substantial collaborations. In the Hungarian-Romanian-Ukrainian relations, the largest euroregion is the Carpathian Euroregion, which is far too big to work efficiently. Partitive members, parties with adverse interests, difficult and diverging financial possibilities, can characterize it. The only euroregion including both Hungary and Serbia is the Danube-Kris-Mures-Tisa Euroregion, which is the most effective, most active and has the highest prestige in our country. (However, in the Danube-Drava-Sava Euroregion Vojvodina and Zombor are participating as observers, but due to the lack of intensity and activity it is not significant in this context as a Hungarian-Serbian cooperation surface.)

9.1. *The DKMT Euroregion*

Bács-Kiskun, Jász-Nagykun-Szolnok, Csongrád and Békés counties, the Autonomous Province of Vojvodina and Timiș, Arad, Caras-Severin and Hunedoara counties formed the Danube-Kris-Mures-Tisa Euroregion in November 1997. Since then first Jász-Nagykun-Szolnok and in 2008 Békés counties resigned from the cooperation, as so far they had no tangible advantage from it.

The main political decision-making institution of the euroregion is the general assembly consisting of the leaders of the regional municipalities, their president is elected from their members for a year with the principle of rotation

amongst the members. The task of the secretariat and the coordination committee is the preparation of decisions and handling administration. They establish more work committees to plan and work out project proposals in connection with the subject.

The structure and operation of the euroregion changed significantly in 2003 when DKMT Non-profit Public Benefit Limited was established. The Ltd is of high significance since, as an economic entity suitable for receiving EU funds, work out developmental projects and professional management. With the Ltd, the operative, often boring and tiring everyday work got into new hands. For the international co-operations the politicians managing the administrative units of the euroregions did not receive allowance, their work even in solving the problems of their 'homeland' required their full attendance. Everyday contact is important and essential for the formation of a well functioning, efficient international cooperation but at the same time, its efficacy is questionable if carried out by politicians lacking the time and energy and without having an organization that would do it as job requirement. In case of euroregional co-operations that only exist on paper the main operational insufficiency is the lack of operative management by a corporate body (e.g. Danube-Drava-Sava euroregion), while the successful ones just emphasize its importance (besides DKMT cf. Ister-Granum and West-Pannon).

Besides the everyday communication, continual project management and developmental work, the sudden increase of tender activity is the important proceeds of the Ltd's establishment. Without EU resources, the euroregion can mainly carry out shared activities by using their own resources and by knowing the financial possibilities of the municipalities their supply mainly exhaust in the protocol visits and a few studies. Without an economic entity, they have no chance to receive EU sources. In parallel with the establishment of the Ltd the decision-making mechanism of the euroregion also changed, the so far consensual decision-making was replaced by the principle of majority voting.

The three defining settlements of the euroregion are Szeged, Timișoara and Novi Sad. At the time of formation, Szeged had a significant advantage over the others justified by its imminent union membership and relative advancement. Since then, Timișoara showed considerable economic growth and it was soon followed by the other sectors. This Romanian city of over 300 thousand inhabitants today is the most important city of the euroregion. Novi Sad still has the marks of the war, embargo and NATO bombings but with its dynamically growing population it is the second biggest city of Serbia and as the centre of the widening Autonomous Vojvodina it may be in an advantageous situation in the long-term. These three settlements (and the regions they determine) compete and cooperate in the region at the same time. The cooperation and the rational distribution of tasks (e.g. regional airport, industrial parks stretching over the border and the realisation of grand health care cooperation) is still obstructed

by legal and administrative issues (the Schengen Agreement divides the region into 3 parts, obligatory visa system for Serbian citizens), not to mention the difficulties of giving up the individual, but often referred to as national interests (it is not easy in the German-Belgian-Dutch relation not even in the Hungarian-Romanian-Serbian relation).

Figure 2: *The Danube-Kris-Mures-Tisa Euroregion* (www.dkmt.net)



9.2. The most significant projects of DKMT Euroregion

The Euroregion during its existence carried out several significant projects. Before the existence of the Ltd these numbers were short, the volume of projects were small. Some of them were the following: preparing simplified studies in connection to infrastructural developments, publication of similar topic papers in three different languages and the most notable Euroregion lobbying was the opening of Kiszombor border crossing point, which shortened the Szeged-Timişoara distance by 70 km. After the establishment of the DKMT Ltd the number of projects was increasing, they started to think more in projects, a lot more sources were accessible, which improved intensity and volume of co-

operation and increased the number of activities. The projects included the “obligatory” events, for example common cultural events (Thousand Faces of Europe), which encouraged knowing each other’s culture better and aimed to intensify the relationship between the people. They arranged programmes to the economic sphere as well; there were trade fairs and businessmen meetings in many cases divided into branches. The euroregion launched several large-scale projects that are on the one hand still in progress, but on the other hand, that would even rebound to any decades-long and traditional, much richer euroregions’ honour, and thirdly in case they materialize successfully, the DKMT can become the topmost functioning international cooperation of Hungary and the whole of Central-Europe.

9.3. *Euro-regional Information Centre (ERIC)*

The four-language media co-operation of the three countries has its own radio program and news webpage. Their main task is to increase the efficiency of communication not only for a small number of elite (economic and political) but also for all the citizens. The project started from the basic idea that a coherent and an intensively co-operating region could only emerge if the information flow to the different member countries is strong and reaches out to most of the inhabitants. Establishing the regional identity or “spiritus loci” is pivotal for working and co-operating regions. The politicians of DKMT Euro-region and Development Non-profit Public Benefit Limited recognised this. The free and open news-feed allows every citizen to participate in any cultural, scientific, economic or sport events within the region but even over state borders, because these information never crossed borders before but it is crucial for a well working region.

10. Tourism – thematic travel destinations

The tourism collaboration was slow at the beginning, all three parties wanted to receive tourists from the other two. After overcoming this attitude, they came up with a complex touristic product, which is capable of reaching beyond the region, even cross state borders as a destination. The thematic travel destinations are good examples of the developmental potential in local resources, the potentials working in networks and the efficiency of well-formulated co-operation in the interests of all sides. The thematic travel destinations extend to spa tours, Art Nouveau architecture trips and to visiting industrial monuments. Thematic tours expanding all three countries can be present at the market of all three and it can be presented at three different tourism fairs in three different countries, which increase the effectiveness of the marketing.

11. Security without borders – disaster recovery

The most important and probably the greatest co-operative project is connecting to disaster management (mainly flood-control). The three-nation disaster management team consists of professionals from each country, they are equipped with a mobile village, water purifiers, mobile meteorological station etc. and they take part in a unified training, which was worked out by Hungarian specialists and was accredited by the UNO. The action team was formed with the funds of the EU to deal with the frequent floods in the region (this is the lowest area of the Carpathian-Basin), but in the long run they are aiming to help outside this region. During the April exercises in Titel, next to the many positive outcomes there were mistakes became known as well. Despite the well preparedness, the collective practices, the high tech equipment in a crisis under the pressure of quick decision making the faults in communication, not understanding each other, misinterpretation or even the slower understanding could cause enormous damage.

12. Triplex industrial park

One of the most significant economic reviving project plans is Triplex-Confinium industrial park at the Hungarian-Serbian-Romanian tripoint. This industrial park might play an important role in the economic development of the region because it extends to all three countries thus it integrates all the advantages of the three. The Romanian taxation system together with the Serbian-Russian free trade treaty and the highly qualified Hungarian workforce could be an attractive combination. There would be a border crossing point and trafficking infrastructural developments in connection to the industrial park as well.

13. Health care

The Euro-region started – if it comes to life - an exemplary and grandiose project in 2007. This is a co-operative health care system, which was born from the ideas of a more balanced exploitation of the different capacity in each country, geographic rationality, the better exploitation of different facilities and the rationally shared co-operative developments. There are different capacities at areas belonging to the region in the different fields of medicine. If more people use these capacities, they would be more efficient to maintain. For “consumers” it is also an important point, that in case of a planned operation to avoid longer waiting lists they may go to a neighbouring country and they might get a treatment faster. There are areas in the region, where hospitals are closer in space and

time in the neighbouring country (e.g. Makó). In these cases, the over-border treatment could save lives. The different environmental potentials (medicinal waters and mountain heath-resorts) can justify the over-the-border medical treatments and the co-operative developments, obtaining and operating expensive medical equipment would mean their maximal integration. To carry out the project successfully, there are several legal and administrative obstacles to overcome and many interest groups needed to be convinced about the advantages of the project for all the parties. However, the initiation is not without example, there is a similar working system at the German-Belgian-Holland Meuse-Rhin Euro-region.

14. Infrastructure

Next to the many successful and promising projects, we need to mention that the biggest Euro-regional projects are connected to infrastructural development from the beginnings, which not simply developments but renewals or reconstruction because of the special history of the Carpathian-Basin. These projects exceed the competence of the Euro-region and the co-operation lobbyist seems to be not enough to convince the competent national authorities.

The main infrastructure projects are the following:

- Making the Tisa international waterway and improve its navigability
- Making the Bega navigable
- Rebuilding the Csanád-Magyarcsanád Maros-bridge
- Rebuilding the Timișoara-Szeged-Subotica-Bácsalmás-Baja railway
- Rösztke-Belgrade motorway
- Banat road – Belgrade-Pančevo-Kikinda-Tripoint (Triplex)-Deszk
- Establishing a new border crossing point between Caras-Severin and Vojvodina

15. Institutional co-operations

The institutional co-operations of Szeged-Timișoara-Novi Sad universities are standing out from other institutional co-operations, which not only extends to many research fields (material sciences, medical sciences, environment protection etc.) but it also includes the exchange programs for students, lecturers and the “tours” to the partner universities. They exchange their thoughts; they deal with the questions of Euro-regional co-operation and its social and environmental relations in detail. Unfortunately, the results of these university researches economizing and socialising on a restricted way, which caused by the great distance (mainly mental) between the economic and social partakers and

the universities and governmentally subsidised research facilities, and the lack of sources that they use for research and development.

From the examination of Euro-regional and sister city/county relationships we conclude that while the latter keeps the Hungarian-Hungarian relationships with the tools of language, culture, education, folklore and civilian relations, the Euro-regional co-operation mostly tries to help regional development within the region representing Euro-regional general interests independent from Hungarian-Hungarian co-operations.

16. Conclusions

Collecting our conclusions into articles, we can say the following about institutional co-operations in the border areas of Hungary and Serbia:

- In connection to co-operation, there are both Hungarian-Hungarian and Hungarian-Serbian institutionalized co-operations accounting to the special ethnical and geographical constellation of the state of Hungary and Serbia. The former developed in the framework of sister city movement, which naturally has institutional units as well (educational, cultural and traditionalistic). We can characterize the latter by Euro-regional (DKMT) and institutional (universities, chambers) co-operations. The organizational principle is clearly ethnical in the former but it is geographical supplemented with features of the sector concerning the latter.
- The most significant obstacle of the co-operation in the region is the language boundary. We can rely upon Hungarian as an interlanguage limitedly, there is a need for more a suitable lingua franca (e.g. English) and both partners need to support the most comprehensive acquisition of that language. Next to the above, it would be advisable for the partaking nations to know each other's languages (Hungarian, Romanian, Serbian), however the positive traditions it is not characteristic of this region today.
- A possible solution to the above issues is to work out mutual scholarship programmes and to strengthen its financing, not only at university level but also for secondary schools students. In this kind of movements, beside the traditionally partaking minority students one should pay emphasised attention to students of other nationalities, especially the Serbs. Many of them have never been abroad, they consider the EU member Romania and especially Hungary almost as "the west". The education of students from Serbia in Hungary may contribute to bettering of attitudes towards each other and it may strengthen the regional identity. This is the basic principle of a successful and efficiently working Euro-region.
- It is also important to support the co-operation between research facilities, institutions and enterprises – co-operation between the universities

and tripoint industrial park. It is crucial that the enterprises settling in the region could use the great potentials and intellectual capital of research facilities unlimited. This may be achieved by an industrial park for the three countries and innovation transfer centre connected to it. Furthermore, the coordinated development, investment plans and specializations of research facilities, similarly to the processes planned in the health care sector might contribute to the efficiency of this sector and it helps in the international competition as well.

- It is necessary to eliminate the narrowest cross-section of the region, the difficulties in communication. One element of this is the infrastructural development, by strengthening the road- and railway networks the regions will be closer to each other, the accessibility improves, thus the integration may become more immersed. It could have further stabilizing effect on Serbia.
- Another essential element of increasing the efficiency of communication is to revise the visa system concerning Serbia.

For Serbia and for the region, there is exploitable experience knowing the border relations of Hungary:

- First of all, in the case of the Serbian citizens living outside the Serb borders, from the mother country this kind of activity could be the minimal care. Sister city co-operations may help a lot to minority Serbian settlements. As we saw this in Hungary, these co-operations are on ethnic grounds and they have a distinguished role in maintaining the identity by language, customs, traditions and culture.
- Co-operations established by geographical principles (Euro-regions, which can be established in theory along every new border of the post-Yugoslav area) are the successors of division of labour and collaboration thus, they could be capable of cross-border actions despite the changed political and geographical framework. The European Union mostly supports these actions so they can be used to fund raising as well.
- There are some examples of the combination of the two in Hungary, but to present them in this paper, we had no opportunity. We are witnessing the re-inhabitation of the beyond-the-border agglomeration of Esztergom on the Hungarian-Slovakian border, which connects the ethnic and geographic principle together. In other words, the Slovakian agglomeration of the town is ethnically still Hungarian. These settlements are rebuilding the old geographical connections, which result in increasing the “natural” town-countryside interactions in this town-deprived area. Co-operation of this kind may be possible in many places along the Serbian border in the near future.

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ASSOCIATE PROFESSOR NORBERT PAP, PHD*
*Department for Political Geography and Regional Development,
Institute of Geography, Faculty of Sciences, University of Pécs*
ASSISTANT PROFESSOR BERNADETT SZABÓ-KOVÁCS, PHD
*Department for General and Applied Environment Geography
Institute of Geography, Faculty of Sciences, University of Pécs*

THE IMPORTANCE OF MICRO-REGIONAL ORGANISATIONS/ASSOCIATIONS IN HUNGARY

Abstract: *The phenomena of the population decrease in Hungary (which appeared in 1981), and even more so the accelerating depopulation of some rural areas, the rapid change of the concentration and urbanisation processes of the settlements triggered by the conditions of the market economy. The recommendations and expectations of the European Union all require(d) changes also on different levels (region, county, micro-region, etc) in the organisation of the nation space.*

The concept of micro-region means several spatial and functional designations. Micro-regions have a different meaning for the different sectors: public administration, legal administration, sociology, geography, or spatial development, or even politics.

The number of municipal associations and the system of statistical micro-regions (LAU 1.) started to converge both in number and spatial coverage. Due to the strong motivation of getting development resources, the freedom of association secured in the Constitution did not mean much any longer, the associations (171 associations) were formed everywhere in Hungary by 2007. In the study we are going show the developing concept and many types of micro-regional formations.

Key words: *regional development, micro-regions, local governments, efficiency, Hungary*

JEL classification: R 12, R 58

* E-mail: pnorbert@gamma.ttk.pte.hu

1. Introduction

A number of concepts were made for the “ideal” spatial division of the present Hungary during the 20th century. The system most favoured by both the administration and the state spatial policy was the county system, which went through transformations as a consequence of the two World Wars. The number of counties, due to the need of rationalisation, first decreased, from 34 in 1920 to 25 during the reform of 1923. The next significant change took place in 1950, when no more than 19 counties were designated from the former 25 counties, after some integration. In addition to the number of the counties, their size changed too. Obviously the county system followed the changes with some flexibility.

The reform of public administration and spatial organisation was continuously on the agenda in the last century. We can see spatial divisions containing small counties, middle-size counties, large counties, divisions with three, four, six, seven, eight or nine regions etc. These spatial units were defined as economic districts, macro-regions, catchments areas etc.

The reforms envisaged a “better”, more efficient system of spatial organisation different from the previous ones, on the basis of different rational considerations. The traditional spatial system, however, proved to be stronger than the rational arguments.

The roots of the great changes are to be found in the time of the economic and political systemic change. The phenomena of the population decrease (which appeared in 1981), and even more so the accelerating depopulation of some rural areas, the rapid change of the concentration and urbanisation processes of the settlements triggered by the conditions of the market economy, the recommendations and expectations of the European Union all require(d) changes also in the organisation of the nation space.

Table 1: The change of the number of population in Hungary, 1920-2001

Population number, population density, natural increase, 1870-2001								
Year	Population	Population density	Population in percent of the		Time	Actual increase or decrease	Average annual increase or decrease, in per cent	
			census of 1870.	previous census				
Existing civil population								
1870	5 011 310	53.9	100					
1880	5 329 191	57.3	106.3		106.3	1871-1880	317 881	0.56
1890	6 009 351	64.6	119.9		112.8	1881-1890	680 160	1.21
1900	6 803 727	73.1	135.8		113.2	1891-1900	794 376	1.25
Existing population								
1900	6 854 415	73.7	136.8			1891-1900		
1910	7 612 114	81.8	151.9		111.1	1901-1910	757 699	1.05
1920	7 986 875	85.9	159.4		104.9	1911-1920	374 761	0.48
1930	8 685 109	93.4	173.3		108.7	1921-1930	698 234	0.84
1941	9 316 074	100.1	185.9		107.3	1931-1941	630 965	0.7
1949	9 204 799	98.9	183.7		98.8	1941-1948	-111 275	-0.15
1960	9 961 044	107.1	198.8		108.2	1949-1959	756 245	0.72
1970	10 322 099	111	206		103.6	1960-1969	361 055	0.36
Constant population								
1970	10 292 758	110.6	205.4					
1980	10 701 063	115	213.5		104	1970-1979	408 305	0.39
1990	10 381 959	111.6	207.2		97	1980-1989	-319 104	-0.3
2001	10 078 138	108.3	201.1		97.1	1990-2001	-303 821	-0.27
Residents								
1970	10 300 996	110.7	205.6					
1980	10 709 463	115.1	213.7		104	1970-1979	408 467	0.39
1990	10 374 823	111.5	207		96.9	1980-1989	-334 640	-0.32
2001	10 198 315	109.6	203.5		98.3	1990-2001	-176 508	-0.15

Source: By the author on the basis of HCSO data

Table 2: *The NUTS system in Hungary in 2008*

	Specification of the level	Number of units belonging to the level	Average number of municipalities per unit	Average population of the levels
NUTS 1	Country	1	3175	10045000
NUTS 2	Region	7	453.57	1435000
NUTS 3	County/capital city	20	158.75	502250
LAU 1	Micro-region	173	18.35	58063.58
LAU 2	Municipality	3175	1	3163.77

Source: By the author on the basis of HCSO data

2. Researches of the authors and the methods applied

In Tolna County in Hungary an extended research was carried out in 2003-2004. We had a representative sample of 520 persons then, and we looked at the different activities, the attitudes from the aspect of settlement and regional development of the population, of no less than 108 municipalities and a large number (over 150) of businesses, of whom we also had a representative sample. The findings were published in two volumes (*Pap, N. Ed. 2005: Terület- és településfejlesztés Tolna megyében – Settlement and regional development in Tolna county. Babits Kiadó, Szekszárd, p. 427.* and *Pap, N. ed. 2007: Tolna – a rural area in Central Europe. Regional and local development in Tolna County, Hungary, LOMART Publisher, 164 p.*). The surveys placed this rural area of South Transdanubia in an international dimension.

Bernadett Szabó-Kovács in her doctoral researches focused on the environmental issues of the micro-regions, her main field of research is the region of South Transdanubia. She has participated several times in the elaboration of concepts for the moderation or improvement of the impact of socio-economic processes on the natural environment – at micro-regional, county and regional level as well. She had an active role in the research called “Health damages caused by environmental strain and the self-evaluation of the health condition of the population”, in Baranya county in 2001 and in the whole of South Transdanubia in 2002. In 2004 she participated in the survey of the conditions and development possibilities of the inhabited outskirts of settlements in Tolna County.

In the last 15 years we participated jointly in several (approximately 30) applied researches in the field of settlement and regional development (most of these were regional / micro-regional and macro-regional surveys). During these works we gained a thorough knowledge of the problems of South Transdanubia, an important intermediary region.

The surveys of South Transdanubia lasted for a longer period in time, in several phases. The complex survey of the region took place in 1998-2000, on the assignment of the South Transdanubian Regional Development Council for the first time, and then we partially repeated the examination in 2006. In both surveys we participated as lead researchers (responsible for the methodological issues).

Figure 1: Regions, countries and micro-regions



3. The definition of micro-region

The concept of micro-region means several spatial and functional designations. Micro-regions have a different meaning for the different sectors: public administration, legal administration, sociology, geography, or spatial development, or even politics.

For the definition of the concept of micro-region geographers and researchers of other social sciences use several approaches. We can see micro-region as a **spatial unit with an adjective**: a “small region”.¹ Its size is relatively easily defin-

¹ B. Csátári: “A kistérség fogalma (The concept of micro-regions)”, In: Csefkó, F. (ed.): *Kistérségeknek kistérségekről (To micro-regions about micro-regions)*, Dunaholding City Menedzser Kft., Budapest, 1995, pp. 11-15.

B. Csátári, “Criteria of rurality for the Hungarian micro-regions: Major problems facing rural areas in Hungary”, In: Barta, Gy. – Fekete G. É. – Kukorelli Szörényiné, I. – Timár,

able: micro-regions are spatial units bigger than the administrative areas of the municipalities but smaller than the counties. They are units defined the spatial connections between villages, or between a village and a town, mostly for the satisfaction of the everyday needs of the population. Micro-regional analyses can also have a **geographical-historical approach**. Some of the names of the micro-regions have a deep-rooted geographical, spatial meaning in the minds of the local population: Hegyhát (Hill Ridge), Völgység (Valleys), Kiskunság etc. These define and contain certain physical, geographical, environmental endowments and designations, centuries-long traditional local – small town, county borough – market relations, in several cases religious, congregation links.²

Éva G. Fekete approaches the definition of the concept of micro-region from the aspect of the **contacts born in a catchments area**. In her researches she found that the two most essential bases of the designation of a micro-region are voluntariness and horizontality (assuming a sort of hierarchy within the system of the respective micro-regions).³

István Bakos defines micro-regions from the aspect of the **geographical space**, i.e. micro-regions are units – comprehensible and personally experienced by the local residents – of the geographical space, within which the municipal communities are bound together by common interests and a regional identity, and no other municipalities can be linked to them on the same grounds. The bases of the common interests and regional identity are the consciously experienced common past, the common features of the culture building from the past, the belonging to a geographical area allowing the same economic and social activities, horizontal links built on the functional (economic, human services, infrastructure, community) interdependence and on intensive communication.⁴

The legal definition of the concept of micro-region is still not settled; despite the fact that some progress took place in this respect in the last two decades, the definition of the micro-regions, and their place and functions in spatial organisation are still unclear. As synonyms of the micro-regions several concepts are used, taken from the previous legal regulation: district, environs, catchments area, small region etc. We also see micro-regional associations in the texts, but this is a concept unknown to the legal regulation in effect in Hungary. The unclearness makes it difficult to define the concept, the content and the functions of the micro-regions and

J. (eds.): *Hungarian Spaces and Places: Patterns of Transition*, Centre for Regional Studies of the Hungarian Academy of Sciences, Pécs, 2005, pp. 466-482.

² B. Csátári, 1995, *ibid.*

³ G., Fekete, É. Bodolai: *Kistérségi szerveződések megjelenése a területfejlesztésben (Micro-regional organisations in spatial development)*, North Hungarian Department of the Centre for Regional Studies of the Hungarian Academy of Sciences, Miskolc, 1995

⁴ I. Bakos: *Területfejlesztési stratégiák és programok tervezésének módszertana (Methodology for the planning of spatial development strategies and programmes)*, Miskolc, Bíbor kiadó, 2001, p. 141.

the appearance of unequivocal professional language. The legal regulation offers very little help for the clarification of the concept of micro-regions:

- In the **Constitution of the Republic of Hungary (Act No. XX. of 1949)** we cannot see micro-regions either in the regulations concerning the spatial division of Hungary or the basic rules concerning the system of local governments: micro-regions are not defined either as a geographical or an administrative units (only the possibility of voluntary and free associations is mentioned).
- The **Act on Local Self-governments (Act. No. LXV. of 1990)** does not mention the concept of micro-region, either. Although the Act contains the specification “district” in the paragraphs on the tasks and competencies of the county self-governments, these districts are not related to the spatial units called micro-regions.
- The **Act on the associations and cooperations of the municipal governments (Act No. CXXXV. of 1997)** does not use the notion of micro-region, either, but it mentions the expansion of the cooperation of municipal governments and the deepening of the spatial relations.
- The **Act on spatial development and physical planning (Act No. XXI. of 1996)** contains the concept of the micro-region, but does not specify the place and function of the micro-regions in the organisational system of spatial development, the definition or regulation of the operation and organisation of the micro-regions. Par. 5. of the Act defines the concepts of region of priority, micro-region i.e. small region, region and environs.⁵
- The above definitions – especially those concerning the environs – are development-centred; they reinforce the planning and development directions of the micro-regional and municipal relations and do not give enough help for the interpretation of the joint operation, public services and administration. The work of the actually founded micro-regional associations (or councils) is also characterised by this uniformity.

⁵ Basic definitions. 5. § For the purposes for this Act:

- f) *region of priority: a regional unit covering one or more counties (the capital), or a particular area thereof, which shall be managed jointly from social, economic or environmental aspects, to the unified planning or development of which national interests or goals defined in other legal rules are also attached (the metropolitan conurbation, recreation areas of priority, regions of landscape conservation areas or national parks shared by several counties, border or other peculiar regions)*
- g) *environs: a small region with a town centre, a self-organized unit of area established for the co-ordination of developments;*
- h) *small region: a unit of area which can be delimited on the basis of the totality of functional relationships between communities, the aggregate of self-organized adjacent communities maintaining intensive relationship with each other;*
- i) *region: summarizing description of various units of area (region, county, region of priority and small region)*

4. History of the formation of the micro-regional system

In the early 1990s, with the act on local governments entering into force, the former so-called urban area (or environs) based administrative system ceased to exist in Hungary. At the time of the systemic change the independence, sovereignty of the settlements was extremely evaluated. The traditionally strong counties lost much of their weight, too. The issue of the restoration of districts, environs was not a priority. At the same time, in some areas of the operation of state administration some “micro-regional” organisational forms survived, previously created for the districts or urban areas (justice, land registry offices etc.). The local bodies of representatives, and the mayors, hardly able to imagine the opportunities lying in the sovereignty of the municipalities, soon had to face the hard limits of the economy of scales in settlement operation and development.

The act on local governments defined those frameworks within which the municipalities could make associations for the maintenance of certain institutions or the provision of public services. The act – besides placing the sovereignty of the settlements and municipalities at the top of the priorities – allowed a large freedom for the municipalities to make associations. The state support systems and the EU Phare programme preferred the formation of micro-regional associations. At the same time there were many hard feelings in the local societies, the local political elite against the municipal cooperation, the reason for which, among other things, was the anti-democratic spatial organisational practice of the state socialist system.

Despite the hardships, some 130 local and micro-regional associations were founded until 1994, in various forms. In these associations not only municipalities participated, often did non-governmental organisations, businesses etc. as well. Some associations had village, other town centres. The experiences of the previous urban area cooperation largely influenced – and still influence today, actually – the micro-regional cooperation.

Act No. XXI. of 1996, by the creation of the institutional system of regional development and the definition of the new support systems, strongly preferred the formation of associations at micro-regional level, giving a considerable momentum for the municipalities. Soon almost each of the nearly 3,200 municipalities of Hungary joined a micro-regional association; there were very few municipalities as exceptional cases to stay out of any association.

Cooperation based on voluntariness, the joint assertion of the own interests, the implementation of joint infrastructure investments, the operation of joint services led to the birth of a new, organically developed spatial structure. The formation of the system of municipal associations is not a finished process; it is still going on. Until 2001 approximately 260-270 municipal associations were created in Hungary.⁶ The

⁶ Z. Hajdú, *Magyarország közigazgatási földrajza (Administrative geography of Hungary)*, Dialóg Campus Kiadó, Budapest-Pécs, 2001, p. 224.

operational efficiency of the associations was very different, their level of organisation and cooperation willingness also showed significant differences.

A special form of the associations was the so-called SAPARD micro-regional type. These associations allied for the reception of the pre-accession support of the EU called SAPARD. The number of such associations reached 191 by the time of Hungary's accession to the EU in 2004. Their operation concentrated on the elaboration of their rural development programmes. In many cases the spatial frameworks of the SAPARD regions were the same as the boundaries of the spatial development associations. In some cases, however, strange anomalies could be seen. Fired by individual ambitions or bad relationship between certain settlements, associations including a very small number of municipalities were created too.

Another spatial structure, created irrespective of the previous system, was established with statistical purposes and keeping the statistical system of the European Union in mind. This was the so-called NUTS IV/LAU1 level. The Hungarian Central Statistical Office made a catchments area survey in 1991–1993. The new micro-regional data collection and processing system was introduced on 1 January 1994. A total of 138 micro-regional statistical units were designated in Hungary, which completely covered the territory of the country. On the basis of the experiences the system was amended in 1997, specifying a total of 150 micro-regions. The micro-regions could not cross the county borders, although the original ideas had not excluded this possibility. They had no direct role in state administration, but during their designation the competency areas of the already mentioned state administrative organs were also considered.

The system of micro-regions was once again amended in late 2003. Their number increased to 168. As the local demands exceeded the actual increase, another five micro-regions were designated in 2007. At the time of the compilation of this essay there are 173 statistical micro-regions in Hungary.

The system of micro-regions is projected to split further; the number of units will increase. This is partly due to the fact that several settlements have been lately awarded the town rank,⁷ and these new towns set as a goal to strengthen their micro-regional role.

The act on regional development greatly evaluated the micro-regional system of the Hungarian Central Statistical Office, as spatial units of regional development and physical planning. The Act No XXI of 1996, in § 14, par. 1 e) says “the members of the County Regional Development Council are representatives of the municipal associations for regional development in the county, one representative from each association”. This way the micro-regional associations were given an

⁷ In Hungary the municipalities can be either villages or towns/cities. The bigger and more developed villages can apply to gain the town status. The condition of the award of the title is the quality of urbanisation and the micro-regional functions. Becoming a micro-regional centre may be a strong evidence of having micro-regional central functions (the author).

important role within the frameworks of the statistical system in local development policy and in the creation of the county development councils that played a key role in distribution of the decentralised development resources. Another fact that evaluated the micro-regional statistical level was the definition of the eligible regions at the micro-regional level.

The number of municipal associations and the system of statistical micro-regions (LAU 1.) started to converge both in number and spatial coverage. The decisive push for this was the Government Decree 65/2004 (15 April), with the creation of the multi-purpose micro-regional associations. Due to the strong motivation of getting development resources, the freedom of association secured in the Constitution did not mean much any longer, the associations (171 associations) were formed everywhere in Hungary by 2007, except two large micro-regions with large population (Budapest and Debrecen). It was typical, at the same time that the municipalities tried to keep cooperation at the lowest possible level and keep as much as possible of their sovereignty.

5. The Hungarian micro-regional model

In the recent years a large number of association forms, micro-regions with different functions co-existed in Hungary, all created primarily for spatial development, although with different focuses.

The role and significance of the micro-regional or municipal associations – i.e. bottom-up spatial organisations meeting the actual geographical, economic and service needs – is not disputed any more. As regards their functional role, on the other hand, the situation is still unclear and contradictory.

On the basis of the free right of the municipalities to associate, real micro-regional level relations and cooperation have been made in the last 15 years. After the elimination of the council system and after the birth of a large number of municipalities, the central state could only handle regional developments with difficulties, as it was more problematic to keep in direct and continuous touch with 3,200 municipal governments. The municipal governments with low capacity, in the scarcity of financial and human resources had no chance to represent themselves and implement developments on their own. This push from two sides made the municipal governments create comprehensive inter-municipal cooperation covering several fields, and later these associations strengthened. The foundation of this process was often the designation of the statistical micro-region based on the formerly existing district and urban environs division.

The majority of the micro-regional organisations operate as interest groups, foundations, public foundations, targeted associations, social organisations, societies or municipal associations. A smaller part of the micro-regional associations, however, do not fit into any legal category, as they operated as simple consulting

forums, loose organisations.⁸ By their character they can be of two basic types: regional development and so-called rural development associations.

*5.1. Regional development municipal associations
and the experiences of their operation*

In accordance with the regulations of the act on regional development and physical planning, the bodies of representatives of the municipalities can create regional development associations having independent legal status, for the harmonised development of the municipalities, the elaboration of joint regional development programmes and the creation of common financial means serving the implementation of the developments. The legislator preferred the creation of spatial organisations on the basis of the NUTS IV./LAU 1. System. However, because of the constitutional protection it was not obligatory to found associations matching the statistical micro-regions – although this was the solution supported by the act.

The associations did not make sets without overlaps in the territory of the country: there are municipalities that were members in several associations, which were allowed by the legal regulation of the time.

The act on regional development was the first legal regulation of high level which institutionally included the micro-regions – through their associations for regional development purposes – into the process of spatial development. The micro-regions in this approach can be regarded as planning and development spatial units where the majority of the economic, trade and commercial, infrastructure and provision, administrative and social relations and spatial processes connected to the everyday needs of the rural population take place. Their main task in regional development is the harmonised development of the co-existing municipalities, taking the common objectives of the municipalities into consideration, the preparation of the necessary planning documents (or the assignment of an external actor to prepare them), the creation of a common financial fund for the implementation of the developments and the building of the regional identity.⁹

The associations and the districts of the Hungarian Central Statistical Office usually did not coincide, which had some legal advantages, because of the access to decentralised resources. Supports finance some programme implemented in some eligible micro-region, and the designation of the eligible micro-regions also

⁸ E. Pfeil: *A térségi együttműködés lehetséges szerepe a terület- és településfejlesztésben I. (The possible role of regional cooperations in spatial and settlement development I.)*, Comitatus, No. 1. 1996

⁹ B. Csatári: *A magyarországi kistérségek néhány jellegzetessége (Some characteristics of the micro-regions of Hungary)*, Falu-Város-Régió 10. sz., 1996, pp. 6-9; Gy. Winkler: *Területfejlesztés. Kistérségek. Egyetemi jegyzet. (Regional development. Micro-regions. University notes.)*, Eötvös Lóránd University, Budapest, 1999, p. 110; I. Szörényiné Kukorelli: *A kistérségi szerveződések finanszírozási lehetőségei I. (Financing possibilities of the micro-regional organisations I.)*, Comitatus, 12.sz., 1999, pp. 7-15.

affect the distribution among the counties – meanwhile the association operated totally irrespective of the micro-regional system.

In the initial period, instead of the real spatial development demands of the municipalities, this sort of cooperation supported the development and renovation needs of the respective municipalities, improving the chances of interest assertion. Later, however, a growing number of real spatial development tasks and common ideas were raised, which was strongly motivated by the breakdown of the financial means of spatial development according to functions (spatial equalisation fund, targeted decentralised fund). The main elements of the programmes were the joint construction of roads, canalisation systems, and waste deposits. The enlargement of the tender system, however, brought a new difficulty for the micro-regional development associations of the municipalities: they lacked the organisational background with sufficient skills to make the complicated and difficult preparations of the tenders.

5.2. Experiences of the operation of rural development (SAPARD) micro-region associations

At the summit of the prime ministers of the European Union in Berlin in the spring of 1999 the so-called pre-accession aid programmes were approved, including the SAPARD programme. SAPARD was an initiative of the European Union for the 10 countries wishing to join the Union at that time (Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Poland, Hungary, Romania, Slovakia, Slovenia) in the field of agriculture and rural development. It was a community support for the measures promoting the accession in the preparation period. During the SAPARD planning each country had to make their own seven-year (2000-2006) national, regional, county and micro-regional agricultural and rural development plans, in which planning process had to follow the objectives of the Common Agricultural Policy of the European Union.

The SAPARD associations created as voluntary organisations of the municipalities gather the municipalities jointly applying for the SAPARD supports of the European Union. The making of the Union's SAPARD agricultural and rural development programmes, started in 1998-99, was based on the micro-regional associations; those settlements that were members in more than one association had to choose one in the case of SAPARD programming. The associations created usually did not follow the boundaries of the statistical micro-regions designated by the Hungarian Central Statistical Office, and the number of municipalities in the respective associations was rather different, too.

While the National Regional Development Concept defined the smallest units of spatial development in the micro-regions, the statistical units (NUTS IV./LAU 1.), – following the system of the HCSO –, and the intervention areas were also

designated accordingly, the SAPARD programme was built on functional micro-regions (i.e. the actually operating associations).

The rural development associations failed to meet the expectations against them, because the Hungarian government was extremely slow to accredit the institutional system. The launch of the programme had some three years delay, and the tenders could only be submitted in the few months prior to the accession of Hungary to the EU in May 2004. One of the few results of the SAPARD micro-regional associations was the strengthening of the culture of planning in the rural municipalities. The SAPARD plans were single documents covering the whole of Hungary, and this experience proved to be important in the planning activities carried out later.

5.3. Multi-purpose micro-regional associations

The Hungarian government created, as a basic form of the effective support, a government decree on the support of the multi-purpose micro-regional associations (Decree No. 65/2004., 15 April). This decree allows the provision of a part of the public services of the municipalities, and the micro-regional development tasks in micro-regional development associations within the boundaries of the respective micro-region.

One of the aims of the support for multi-purpose micro-regional cooperation is to promote with state finances the regional cooperation, improve the level of services provided for the inhabitants, make these services more efficient, improve the equality of chances of those who live in smaller settlements, and promote the implementation of the micro-regional spatial development projects and modernise the public administration at the level of the micro-regions. The organisation of certain public services at the level of the micro-regions may provide a more efficient and higher standard provision for the inhabitants than in the case of the services provided by each individual settlement.

The decree did not (could not) oblige the municipalities to make multi-purpose micro-regional associations, but only those associations were eligible for central support that accepted the defined conditions (matching the statistical micro-regional division, joint provision of at least three municipal public services for at least three years etc.).

The government decree's regulations included the condition that in one given statistical micro-region only one multi-purpose micro-regional association could be made, and also that a municipality could join at any time a multi-purpose micro-regional association. This new regulation does not concern the presently operating micro-regional association forms and cooperation; there is no legal responsibility to convert them into multi-purpose micro-regional associations.

The multi-purpose micro-regional associations can provide, in accordance with the conditions defined by law, public services in the following fields: pub-

lic education, social and child welfare institutions, basic social and child welfare services, basic health services, public libraries, waste management, joint organisation of the collection and neutralisation of animal wastes, road management (road operation and maintenance) tasks, the joint organisation and implementation of public procurement procedures, internal control tasks, creation of joint housing construction regulations and joint physical plans, and the modernisation of public administration at micro-regional level.

One of the selected objectives of the modernisation programme of public services launched by the government is to take the services as close to the citizens as possible. This is allowed by the administrative skills and the technical basis concentrated in the micro-regional centres to be created.

Many municipalities used the possibility to gain support from the tender system announced for multi-purpose micro-regional associations. Until 30 of June 2004, of the maximum possible 166 multi-purpose micro-regional associations (Budapest and Debrecen made two independent micro-regions on their own and were not eligible for support) no less than 75, until 15 February a total of 118 multi-purpose micro-regional associations were established. All associations were created by 2007.

In those micro-regions where the multi-purpose micro-regional association involving every municipality of the micro-region was created, these associations provide a rather narrow range of municipal government tasks specified in contract, and also provide micro-regional development tasks. In the micro-regions where the multi-purpose micro-regional association did not involve every municipality of the micro-region, micro-regional development councils were established for the spatial development tasks as organisations responsible for the harmonisation of spatial development responsibilities in the whole territory of the micro-region, including each settlement. All multi-purpose micro-regional associations are obliged to provide spatial development tasks for the whole of the micro-region, including all other municipalities, so in these micro-regions it is the multi-purpose micro-regional association that acts as the micro-regional development council.

6. The barriers to micro-regional cooperation

In Hungary there are several barriers to micro-regional cooperations. The first such barrier is the situation of the counties, as the willingness of the micro-regional associations to associate with the county self-governments is weak or non-existing. The reason for this is to be found in the cooperations forced in the state socialist period: the counties ruled over the municipalities, the municipalities have negative experiences concerning the distribution of the resources, and

the weakening of the counties' financial stands make the municipalities strive for sovereignty.

The central budget only has limited stimulations for the municipalities to associate with each other. The majority of the central support used at the local level – the major part of the normative supports – does not stimulate the creation of associations.

The majority of the central finances arrive at sovereign municipalities, joint tenders have only been supported recently by the state, and a very positive progress can be seen in this field in the most recent times.

According to the OECD¹⁰ the central government, instead of providing finances for the municipality through supports, should let the municipalities collect a certain part of the VAT, the road tax and PIT. Presently the centralised collection and distribution of the taxes appears as a support at the municipal governments, and the government also covers the costs of the distribution.

The birth of associations also has barriers in (local) politics. The mayors have a strong dependence on the body of representatives. The cooperation among the municipalities is problematic and awkward. The acquisition of the consent of the bodies, the general assembly (in case of the association of more than two bodies of representatives) and the partners is a painstaking and lengthy process.

The relations between towns and villages have problems too. The reasons for this also go back to the times of state socialism, as the villages were in a disadvantaged position in the inter-municipal relations. Following the systemic change the local governments of the villages refused to cooperate with the towns and cities. It often happened that micro-regional development associations were made without a single town or city. This problem of the urban-village relationship is a barrier to effective cooperation at micro-regional level.

The cooperation between the public and the private sector is missing too. The municipal governments create the major part of the partnerships, but private businesses and non-governmental organisations participate in them in exceptional cases, only.

7. Typology problems of the micro-regions

7.1. According to their characteristics and positions in the spatial structure

The operational conditions of the micro-regional associations show significant differences depending on their positions in the spatial structure. Depending on what functions the central settlement of the micro-region has, to what

¹⁰ Gy. Horváth: *OECD Területi vizsgálatok. Magyarország. (OECD regional analyses. Hungary)*, Centre for Regional Studies of the Hungarian Academy of Sciences, Pécs., 2001

extent it is able to provide meso-level functions and how effectively it can implement spatial organisational tasks, the micro-region (al association)s have to follow different principles and strategies in the organisation and operation of the micro-regions.

Below we outline four probable basic situations and on the basis of this we defined four basic types of the micro-regions.

The micro-regions are situated in the *direct vicinity of big cities* (e.g. Pécs, Győr, or Miskolc). In this case the dominant relation among the municipalities cooperating in the micro-region is not village to small town or village-to-village relationship. The real processes of sub-urbanisation around the big city make the village to big city relation the dominant forces of the spatial structure. No real cooperation can be found in this case between the big city and the villages, due to the large size difference and often the intellectual gap. A small town operating in the shadow of a big city cannot become a real factor in the organisation of space. A specific *asymmetric position* emerges between the big city and its suburban zone. The settlements in the suburban zone are to a large extent at the mercy of the processes going on in the big city. Efficient micro-regional development is possible with taking the sub-urbanisation processes into consideration, relying on the resources offered by the big city.

The *micro-regions can be found on an outer periphery*. In this case the relations of the micro-region are to a large extent determined by asymmetries and flows coming from the border situation. The birth of micro-regions of this outer periphery type was built on conscious discrimination of the decades gone by. Depriving the municipalities of the resources in the “hostile” border regions, i.e. in the southern and western border areas, and the isolation (low number of border crossing stations) at all border sections resulted in the birth of declining border micro-regions. In these micro-regions the existence or non-existence of the border crossing stations is of vital importance. The key element in the development of such micro-regions is the development of communication.

The *micro-regions on an inner periphery* are areas with an urban void, and can be found at county or regional borders. The developments of the last decades preferred the county seat towns. The micro-regions around small towns or villages with deficient central functions, far away from the county centres at the border of two or three counties, struggle with the lack of spatial organisational power. The lack of a clear-cut hierarchy among the settlements may lead to rivalry. The micro-regions lack those businesses, institutions and human resources on which an effective development strategy can be built. The main task is the development of human resources.

The *real suburban micro-region* is actually but an ideal micro-region. A strong and symbolic relationship is created between the small town and its surrounding villages. The small town provides services for its catchments area, and the institutions of the small town serve several regional purposes too. The central

functions of the lead settlement cannot be disputed. The municipalities communicate with each other. The developments implemented in the small town, e.g. an industrial park or a human resources development project, serve the whole of the micro-region.

7.2. Clearly classifiable areas on sectoral or population grounds

- The *tourism or holiday region* type micro-regions build their development activity on outstanding tourism attractions, or are recreational zones in the direct neighbourhood of urban areas.
- The *industrial areas* are regions dominated by industry, heavy industry or energetics. They are partly the same as the areas of industrial restructuring.
- The *areas of rural development* are of strong rural character. They are characterised by small sized settlements, ageing population and deficient public services. The most important, in many places the only resource is land and agriculture.
- The micro-regions in the *agglomerations* of big cities – especially in Budapest – organise their lives connected to the sub-urbanisation processes of the big cities.
- We can also designate micro-regions by specific *ethnic characteristics*. The micro-regions with a high proportion of Roma, or the ones with Germans or inhabitants of Székely origin all have characteristic features differentiating them from other micro-regions.

7.3. Classification according to settlement structure

We can also classify the micro-regions in accordance with the settlement structure.

We can differentiate then among the following types:

- Micro-regions dominated by small villages;
- micro-regions dominated by large villages, they are mostly typical in the Great Hungarian Plain;
- urbanised micro-regions;
- micro-regions with balanced settlement structure.

The differences of the micro-regions coming from the settlement structures have different consequences in the development of infrastructure, the organisation of services, including public services and also in other fields.

7.4. Classification according to development objectives

Classification with an economic view refers to the depth of the organic cooperation of the micro-regions. György Winkler in his book called “Kistérségek (Micro-regions)” differentiates between micro-regions interested in long-term objectives and ones interested in short-term goals.

7.5. Classification according to size efficiency

We can also classify the micro-regional associations on the grounds whether the financial power and the human resources of the municipalities participating in the association can safeguard the effective operation or not. To reach the “critical mass” necessary for operability, the number, educational level and also the healthy age composition of the inhabitants living in the territories of the municipalities play a very important role. The third factor may be the businesses operating in the territory of the micro-regional association. Their number, capital assets and social embeddedness are indispensable parts of the critical mass of the association.

How can we grab the problem of the “critical mass” in the three factors?

The membership fees paid by the participating municipalities basically determine the budget of the associations. The basis of this is the number of population. The solvency of the municipal self-governments is limited: the maintenance of the necessary management, the provision of own resources needed for the applications are a much too big burden below a certain number of inhabitants.

The educational level and work skills of the inhabitants, and thereby the volume of taxes, personal income tax paid by them determine the financial means of the municipalities. Local economic development, business development activity, the ability to attract working capital is all closely related to the adequate number of well-trained and busy labour force. The requirement of the dialogue with the society, the partnership also necessitates the organisation of the local society to some extent. The non-governmental organisations and the social groups collected by them are all parts of the “critical mass”.

The role of the businesses lies in the provision of workplaces, paying local taxes, and in renewal capacity, innovation. The businesses are the most important group of partners for the management of the micro-regions. Coming from their capital assets they may have a selected role in the tendering activity.

Those associations that do not reach the “critical mass” will cease to exist after shorter or longer period of stagnation, having lost their hopes.

8. Conclusion: The future of the micro-regions?

1. *The micro-regions become permanent elements in the Hungarian spatial structure.* This is guaranteed by the contradiction between the presently very fragmented local governmental structure and the requirements of the economy of scales. One of the dominant problems/contradictions will probably be the issue of the division of tasks among the micro-regions and the municipalities. The constitutional settling of the positions of the micro-regions, however, is still an issue.

2. *The issue of spatiality will remain the long-term problem of the micro-regional organisations.* The present tendency will remain: the number of micro-regional associations will increase and their size decrease. The micro-regional associations will of course not reach the optimal (?) spatial size.

3. *The dependence of the operation of the micro-regional organisations on personalities will remain, although will lessen.* Organisation built on real spatial relations will be hindered by the compromises coming from the administrative division. In the rural micro-regions the micro-regional associations may easily become unstable due to their strong dependence on certain persons; the efficiency of their operation will be very uneven.

4. *The setting up of a staff of experts able to efficiently work in micro-regional frameworks will probably happen in this period.* It is a very important issue if a training/higher education form capable of the targeted and efficient provision of this staff of experts is created or not. The will for this is given. The versatility of the problem makes it possible that a range of experts completing different training forms, in accordance with the tasks, can only guarantee the necessary competencies.

5. *Spatial development remains what it is today: the “Wild West” of the public sector and the private sector.* It is uncertain now what motivations this staff of experts will have. It is possible, depending on the reform of public administration, that an organisation of bureaucratic character (of public officers) is created, with well-defined professional and moral requirements. This can be a step forward. However, the continuation of the reform of public administration is unlikely. The other – more feasible – possibility is the survival of the present semi-market, semi-NGO, semi-bureaucratic conditions and the strengthening of a less transparent, self-made system.

6. *The micro-regions will have new functions; besides one-sided resource acquisition they will be responsible for the organisation of public services at regional level.* This means that the organisational system of the micro-regions will turn into a structured, “bureaucratic” form. It is a question, however, how much this sort of operation will characterise the organisational system. It will probably remain for a long time a responsibility of secondary importance, after the resource acquisition activity.

7. *New types of micro-regions with new characteristics will be born.* Communities applying radical (or as they say: alternative) development strategies, settlements and regions successfully integrating into the global world order will appear and transform the present typology.

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ASSISTANT PROFESSOR NATAŠA STANOJEVIĆ, PHD*
Faculty of International Economy, Megatrend University, Belgrade
JELENA BATIĆ, M.A.
Faculty of International Economy, Megatrend University, Belgrade

QUANTITATIVE ANALYSIS OF SERBIA'S EXPORT POTENTIAL TO NORTH AFRICAN COUNTRIES

Abstract: *The main goal of this paper is to identify Serbia's export potentials (both export destinations and value of export) to the region of North Africa. Export potentials are identified through the construction of an econometric (gravity) model of Serbian export, and then by its implementation vis-à-vis the countries of North Africa. The model includes not just economic (GDP) but other specific geographic and political variables - geographical distance, size of population, common border and economic-political distance (preferential arrangements), etc. By applying this model, the potential value of Serbia's exports to each North African country will be calculated.*

Key words: *international trade, gravity model, export potential, geographical distance*

JEL classification: F 14, C 53

1. Introduction

There exists a general consensus that Serbia's economic recovery can be the most rapidly accelerated by an expansion of exports. As Serbia is a relatively small country, its long-term growth cannot be based only on placing goods on the domestic market and, having in mind the current financial crisis, even the present state cannot be sustained without additional foreign currency inflows.

The main feature of Serbia's foreign trade is the constant, rapid growth of the trade deficit. The cause of such a state is not the current global economic and financial crisis, although it has contributed to an even quicker and more pronounced manifestation of those weaknesses. For years, our country's main trading partners have been EU member countries. Since during the past two decades these countries have categorized Serbia within the group of risky trad-

* E-mail: nstanojevic@megatrend.edu.rs

ing partners, Serbia's total trading volume, especially exports to the EU, is quite low. The trade in which Serbia already registered a high deficit has decreased due to the economic recession that has directly hit the EU's most developed economies. Those countries have seen a significant drop in foreign trade volume in general, including that with Serbia. An increase in Serbian exports to the European Union cannot be expected for years to come.

However, such limiting factors do not exist when it comes to export to other regions and, thus, finding new markets is of key importance. Either new export destinations need to be identified or it should be determined which current export markets have additional "space" for Serbian products.

The main goal of this paper is to identify Serbia's export potentials (both export destinations and value of export) to the region of North Africa. Due to numerous economic and geographical characteristics, we have identified that region as an adequate export market.

Export potentials are identified by the construction of an econometric (gravity) model, which includes not just economic (GDP) but other specific factors of exchange between two countries - geographical distance, size of population, existence of preferential arrangements or membership in the same economic integration, etc. First, the appropriate parameters for each variable (through a large number of observations) are calculated, statistically significant variables are built into the model, and then the model is applied.

By applying such an obtained gravity model to Serbia's exports into each of the five countries of North Africa, we can precisely determine the value of goods from Serbia that those countries' markets can absorb. By comparing potential exports that are obtained in this way with actual exports, we can see which export destinations are the most open, i.e. we can mark the countries with the most free "space" for import from Serbia.

Although it is obvious, even without a more detailed analysis, that these potentials are unused, we think that results showing exports whose potential is several times greater than realized would point to the necessity of a closer examination of the needs of the North African markets and an intensification of efforts to place products for which demand exists.

2. An econometric model of Serbia's export - Procedure and results of the model's evaluation -

The standard framework for analyzing export destinations and, more precisely, trade flow potentials, includes the application of a gravity model. In spite of some theoretical controversies, the gravity model has proven to be a quite applicable instrument for explaining and predicting bilateral trade. It has often

been used for testing the efficiency of trade agreements and organizations such as NAFTA or WTO.

The gravity model is based on economic variables (most frequently GDP) and geographical distance between two countries' economic centers. According to the principle of gravitational convergence, bilateral trade between two regions or countries is directly proportional to their gross domestic product and inversely proportional to the distance between them. Besides the above, the model often includes variables such as price level, common language, tariffs, colonial history (whether country 1 ever colonized country 2), etc.

2.1. Methodology

The choice of markets according to which parameters for the model are determined is based on the quantitative share of Serbia's export to those countries. A total of 42 countries are included in the evaluation of the model. The chosen countries absorb almost all of Serbia's exports. The period encompassed by the construction of the model is 4 years: 2005-2008.

The parameters are determined by way of *panel analysis*, which we consider to be more appropriate for models than time series and cross-sectional data that are static in time. Panel data allow a much larger number of observations than time series, while at the same time allowing insight into their changes in time.

Due to the large number of countries and the observed period, each parameter of the model is evaluated with 168 observations. The model is evaluated with the OLS (ordinary least squares) method, while parameters are determined by establishing a relationship between independent variables with the sought phenomenon – potential export, the *method of multiple regressions*.

Most of the data about Serbia's export to individual countries were taken from the Serbian Republic Bureau of Statistics,¹ while for a smaller number of countries for which data from this source were inaccessible; data from the United Nations were used.²

2.2. Model variables

When evaluating the model variables, the most important task is to determine the parameters (coefficients) that fit the investigated economic, social, geographical and other factors included in the gravity model. The coefficients determine the measure in which individual independent variables (countries' GDP, distance, and economic-political distance) affect the dependent variable – Serbia's export. The coefficients show which of the given variables are statisti-

¹ Republic Bureau of Statistics: webrzs.stat.gov.rs

² UN United Nations Commodity Trade Statistics Database: comtrade.un.org

cally significant for Serbia's export and in what measure and, in accordance with this, will be included in the model (equation).

Five variables were tested in this model, but only four were included in the model as statistically significant. The degree of these factors' influence on Serbia's exports is pretty uneven. The tested variables are:

- The *GDP* of 42 countries that we marked as the most important export destination, considering the value of exports. This includes 28 countries with the largest receptive markets for Serbian exports, according to the rankings of the Republic Bureau of Statistics, plus 5 Middle Eastern countries and an additional 9 countries – 3 of the most significant export markets on 3 continents (South America, Africa, Asia), which are not included in the first group of 28 countries. The data is provided by the World Bank.³ The expected sign is positive, since purchasing power determines the scope of import to a great degree. *GDP* per capita is used equally often but in this model demand is determined by overall *GDP* to a greater extent. Namely, total gross domestic product also explains the size of the emitting market, which carries greater significance for exports than individual purchasing power. Although it is the most frequent variable in gravity models, the *GDP* of the receiving market shows a relatively weak relationship (small correlation coefficient) with Serbia's export. Regardless of that, this variable is included in the model because it still shows statistical significance and, together with other factors, helps explain the observed phenomenon in the greatest possible measure.
- In the model, *Serbia's GDP* had a much greater effect on Serbia's export than the *GDP* of the receiving markets. The connection between economic growth and export growth has shown itself to be more direct and more influential. In a simple regression, if we were to examine only its influence on the observed phenomenon, that variable would have a coefficient of determination of about 0.31, i.e. it would explain almost a third of the changes in export value.
- Transport costs in the export of any product have an exceptionally big influence on demand. *Distance* between markets is the most frequently used as a representative of transport costs. Even when transport costs fall due to technical developments and new technologies, as well as because of trade liberalization, distance continues to exert significant influence on the value and quantity of export. That is why the most significant trade partners are always neighboring countries, which applies for Serbia as well. Still, by no means are export destinations limited to European countries. The geographical distance from North African countries is not significantly greater than that of many European markets, and is actually smaller in many cases. In the evaluation of this model, the distance

³ World bank: *Data - Key Development Data & Statistics*

used was the distance in kilometers between Belgrade and the capitals of the countries included in the model. The obtained model shows that Serbia's exports significantly depend on geographical distance, which is negatively related to export quantity. The influence of distance on Serbia's export is so great that, in a simple regression, viewed as the sole factor of export, its share in the value of exports would be 57%.

- Size of population is a frequent variable in the export gravity model, as it connects market size and export value. However, when tested on the example of Serbia's export to 42 countries, it did not show itself to be statistically relevant and was, thus, not included in the model.
- The economic-political distance between two countries cannot be measured, so we use a dummy variable, evaluating economic relations and the institutional base for their improvement with zero or one. The data used for evaluating this variable were mostly taken from the Foreign Ministry of Serbia,⁴ which provides a detailed overview of bilateral agreements and treaties related to economic cooperation, as well as of the scope and purpose of mutual investments, joint projects, expert training, the presence of companies from the given country, etc. Artificial variable P takes on the value of 1 in cases where Serbia has certain preferential arrangements, agreements on trade concessions, significant investments in the Serbian economy, company presence, etc., or the value of 0 if economic relations are relatively undeveloped and unregulated. That factor demonstrated significant influence in the model of Serbia's export – in a simple regression, as the sole factor it would explain 28% of the changes in the value of exports.

2.3. Results of the evaluation of the model

By the said procedure were calculated the values of the constant obtained through multiple regression, as well as the parameters that represent the factors included in the regression analysis. Also given in addition to these values, which will subsequently be applied in the model, is the *standard error* of the constant and each parameter, as well as the *P-value*, which indicates the statistical probability of each of them.

The parameters of the gravity model of Serbia's export have the following values:

⁴ Ministry of Foreign Affairs of the Republic of Serbia: www.mfa.gov.yu/Srpski/spopol/Bilateral

Table 1: *Model parameters*

Parameter	Parameter value	Standard error	T-statistic	P-value
α	3.0295	2.63601	1.14928	0.0045
β_1	0.560394	0.0466861	12.0034	0.0000
β_2	0.814331	0.250337	3.25294	0.0014
β_3	-2.08202	0.0915762	-22.7354	0.0000
β_4	0.573528	0.164901	3.47802	0.0006

Where:

α model constant

β_1 parameter for the GDP of the export market

β_2 parameter for the GDP of Serbia

β_3 parameter for geographical distance

β_4 parameter for economic-political distance

As the P-value is lower than 0.01, it is clear that there is a statistically significant connection between the variables, with a 99% degree of reliability.

The coefficient of determination (R²) shows that the model entirely explains 86.8874 % of changes in the dependent variable, i.e. that Serbia's export to a given country depends almost 87% on factors that are included in the model. The model's standard error, as a measure of the reliability of the evaluation, equals 0.941105, while the median absolute error (average residual value) equals only 0.72877, which is another indication of the model's reliability.

The result is expressed by the model of linear multiple regression, which describes the relationship between Serbia's export, as a dependent variable, and four independent variables.

By including statistically significant variables in **the gravity model of Serbia's export**, we obtain the following equation:

$$X = \alpha + \beta_1 Y_r + \beta_2 Y_s - \beta_3 D + \beta_4 P + u$$

Where:

X potential exports to a given country

α evaluated value of the constant

Y_r GDP - gross domestic product of the receiving markets (in millions \$)

Y_j GDP - gross domestic product of Serbia (in millions \$)

D distance from Belgrade to the capital of the importing country (in km)

P dummy variable for economic-political distance

β_1 β_2 β_3 and β_4 parameters of appropriate independent variables

u model error

Since the countries included in the testing of the model cover practically Serbia's entire export and due to the large number of observations, the obtained model and coefficients are not limited to the North African region alone but can be used to calculate Serbia's potential export to any country or region in the world.

3. Application of the gravity model of Serbia's exports to the countries of North Africa

The North African region comprises 5 countries and about 150 million inhabitants, with an area of almost 6 million square kilometers and relatively monolithic economies and, as such, represents a large market open to many kinds of products. Geographical proximity, economic compatibility and existing (although neglected) traditional trade ties between Serbia and the North African countries represent additional reasons for a closer examination of possibilities of increasing the scope of Serbia's foreign trade in the direction of these markets.

The most important relatively long-term economic factor of trade is the complementarity of the economies. In cases where economies have a similar structure, as is the case with the monolithic economies of the Middle East and North Africa, although the results of applying the gravity model⁵ undoubtedly point to the hungry export markets of neighboring countries, the significance of the evaluation is substantially reduced, since these countries do not have anything to export to one another and have yet to develop the production of articles for which there is a demand in neighboring markets.

On the other hand, the compatibility of Serbia's and the North African countries' economies is quite pronounced. Due to unfavorable climatic conditions, African countries are not able to develop agriculture to a significant extent or, due to a lack of water, even many branches of industry. Contrary to them, Serbia enjoys extremely favorable conditions for agricultural development, as well as a broad range of food products, and significant production in many industrial branches that do not exist in North Africa. Furthermore, these countries have open markets, with the same standards as those of the EU, but without limitations to import from Serbia. These facts only serve to additionally affirm the choice of export destinations obtained by applying the gravity model.

There are also numerous non-economic factors that often stand as the main reason for the disproportion between real and potential exports. In periods of war and economic sanctions, to which North African countries as well as Serbia are frequently exposed, economic indicators do not reflect the true state of

⁵ N. Stanojević: "Disproporcije stvarne i potencijalne intraregionalne razmene u regionu Bliskog istoka i Severne Afrike", *Megatend revija*, Vol. 4 (2), Beograd, 2007

affairs. That is why data for such periods are usually exempted from conclusions in econometric analyses.

By applying the obtained econometric model to Serbia's export into each of these five countries, we can precisely determine the value of goods from Serbia that these markets can absorb. Comparison between potential export obtained in this way and real export clearly shows which export directions are the most open, i.e. the countries with the most free "space" for imports from Serbia are identified.

...

Data on Serbia's exports to North African countries and GDP are expressed in millions of US dollars. As with the testing of the model, the data used were those of the Serbian Republic Bureau of Statistics⁶ and the UN for export⁷ and of the World Bank⁸ for GDP for 2008. Distance between capitals is expressed in kilometers. Economic relations between Serbia and North African countries are presently neglected, even though some of them (Libya) were among Serbia's most important export markets until the 1990s. Today there are essentially no special preferential arrangements, concessions or joint projects, which is why the appropriate coefficient for these countries is multiplied by zero. As this coefficient is pretty high, improvement of this factor would significantly increase the values of potential export.

According to the gravity model formula that has been determined, Serbia's potential export to a given country is determined in the following way: all known variables – the export country's three-year average GDP, the importing country's three-year average GDP, the distance between them and the economic-political distance are multiplied by the appropriate parameters, previously obtained in the described way.

$$X = 3.0295 + 0.560394 * Y_r + 0.814331 * Y_s - 2.08202 * D + 0.573528 * P + 0.941105$$

By using such a model, Serbia's potential export to North African countries acquires the following values.

⁶ Republic Bureau of Statistics - - webrzs.stat.gov.rs

⁷ United Nations Commodity Trade Statistics Database comtrade.un.org

⁸ World bank Data - Key Development Data & Statistics

Table 2: Results of the model's application

Country	Potential export (a) millions \$	Current export (b) millions \$	Ratio of potential to actual export (b:a)
Algeria	57.26152	7.0168	0.12254
Libya	33.66629	3.446399	0.102369
Egypt	76.83882	17.17717	0.223548
Morocco	14.82666	2.279881	0.153769
Tunisia	48.74629	0.636474	0.013057
Total	231.3396	30.556724	

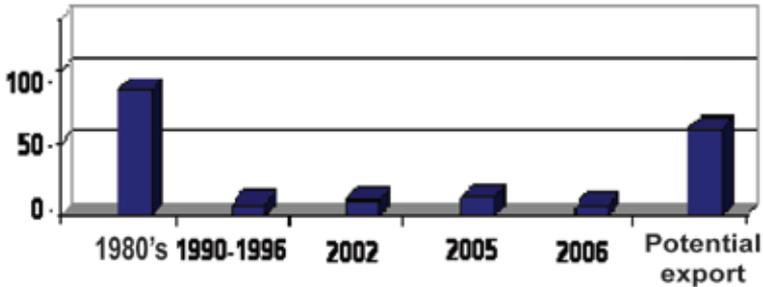
An analysis of potential trade destinations shows that Serbia has not taken advantage of the potentials for export to North African countries. As expected, potential export is several times greater than existing export.

Until the start of the Yugoslavian crisis at the beginning of the 1990s, export to the countries of North Africa was in fact several times greater than today. Mutual trade was at a negligible level until sanctions against Serbia were lifted in 2001, when export to some North African countries began to rise, although at a very slow pace. Today, Serbia's export to North African countries equals only 1% of its total export.

If we bear in mind the positive experience from the previous period, the complementarity of the economies, the belonging of all the countries to the Euro-Mediterranean region and the results obtained through the application of the gravity model, we may conclude that the current scope of trade is far below the capacities and interests of both sides.

Serbia-Algeria

During the 1980s, former Yugoslavia's export (in which export from Serbia made up one third of the total) to Algeria ranged between 140 and 250 million USD. More precisely, until 1992, visible trade between Serbia and Algeria equaled about 100 million USD annually. In the first half of the 1990s, export fell to about one million and import to about 7 million USD (or about 8 million USD in total trade), while at the end of the 1990s total trade between Serbia and Algeria came to less than 3 million USD annually. After a decade-long stall in economic cooperation, trade and economic cooperation in general began to intensify beginning with 2000. By 2003, trade with Algeria rose to about 11.2 (2002) million USD.

Graph 1: *Value of trade with Algeria*

The interest of our firms for returning to the Algerian market has once again risen and, according to the information of the Ministry of Foreign Affairs, business arrangements have been made by Energoprojekt, Hidrotehnika-Hidroenergetika, Hemofarm, Minel, Ekoprodukt, and others. Energoprojekt has made the biggest deals (a number of contracts totaling several million USD in value), while Hemofarm and Minel annual exports equal 3-4 million USD. Trade continued to intensify in 2004, 2005 and 2006, when, according to UN data, exports reached 7.2-13 million USD, while imports came to only 47,000-200,000 USD.

What is interesting is that data of the Algerian side drastically differ from the data of the Republic Bureau of Statistics, as well as from the UN data, which are almost identical. According to the data of the Ministry of Foreign Affairs obtained from Algerian customs, trade volume in 2004 reached 51 million USD, with our exports equaling about 12 million and imports 39 million USD, as opposed to the 46,000 USD recorded by the former sources. The imports were exclusively oil, gas and their derivatives, but there is no data that identified our importers.

In both cases, according to the results gained by applying the gravity model, even such a level of export is still lower than the potential level, which equals more than 57 million USD. In the first case, real export equals only 12% (Table 2) of the potential, while in the second case Serbia's export to Algeria can be only several million USD higher than today's.

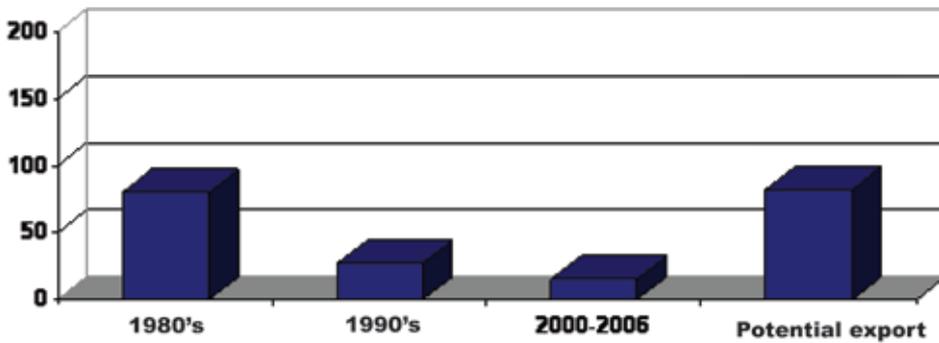
The products to focus on are those that already participate in exports, i.e. electrical machines and appliances, pharmaceutical products, iron and steel, consumer goods, agricultural equipment, food products. All the preconditions for the export of these products already exist, which means that the level of export can only intensify. In addition, many of Serbia's products have not had a significant share in export until now, while the Algerian market has a demand for them. These are grains and food products, as Algerian production does not come close to satisfying domestic needs and the country spends more than 3

billion USD per year on their import, as well as pharmaceutical products and electrical equipment.

Serbia-Egypt

During the 1980s, Serbia's exports to Egypt equaled about 80 million USD, while imports came to about 20 million USD. In the case of Egypt, export has fallen to less than a third or 20-35 million USD, which is still considerably greater than exports to the remaining North African countries. It has continued to decline during the 2000s, falling to 10-22 million USD, while imports have equaled only 3-4 million USD (with the exception of 2006, when they equaled 9 million USD).

Graph 2: *Serbia's export to Egypt (in millions USD)*



The results obtained by applying the gravity model (Table 2) show that Serbia's potential export to Egypt comes to almost 77 million USD, which is close to the level of export during the 1980s. The ratio of real to potential export equals 0.223, which means that the Egyptian market can absorb 5.5 times more exports from Serbia than today.

The products that are traditionally present in our export to Egypt and for which there is probably still some free space on the Egyptian market are primarily road vehicles and tractors. In this area, cooperation already exists with the Serbian companies Zastava and IMR. In addition to automobiles and tractors, the most represented Serbian products on the Egyptian market are special purpose products, non-ferrous metallurgy, rubber products, and timber products.

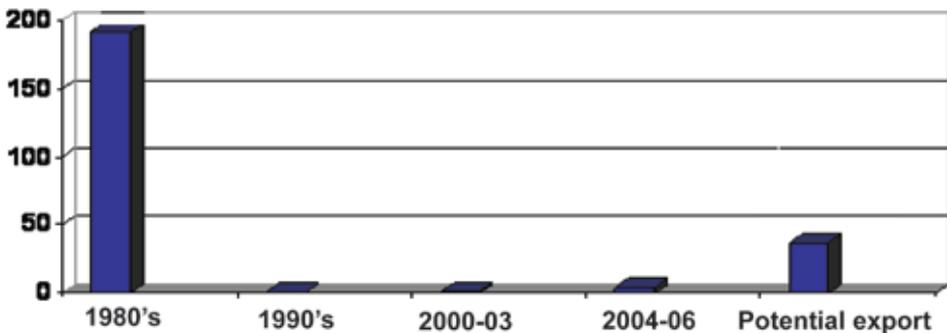
Similarly to other North African countries, Serbia has a special interest for establishing cooperation with Egypt in the area of construction, in which Serbian companies used to hold much more significant and valuable projects. Secondly, as in other countries of the region, agricultural products would certainly find

a place on the Egyptian market. The country's agriculture, although somewhat more diverse than that of Libya and Algeria, cannot meet its own food needs.

Serbia-Libya

Libya was one of the most important economic partners until 1990, when our companies realized large investment projects in that country, and Yugoslavia's exports, until sanctions were imposed in 1992, reached up to 200 million USD per year, while imports were even greater – up to 430 million USD annually. In the period of sanctions and the international isolation of both countries, visible trade was practically halted, with the value of export being on average about 700 times smaller, or about 300,000 USD. This trend did not improve significantly even after 2000, amounting to less than 1 million USD until 2004. According to the data of the Serbian Bureau of Statistics and the UN database, exports equaled 4.5 million USD in 2004, 3.9 million USD in 2005, and 3.4 million USD in 2006.

Graph 3: Value of Serbia's export to Libya (in millions USD)



From the results obtained by applying the gravity model, potential Serbian export to Libya could reach 33.6 million USD. The ratio between real and potential export is only 0.10, i.e. potential export is 10 times greater than today's.

What is specific for Libya is that export from the 1980s shows a much greater value than even potential export. The reason for that is in fact economic-political distance, which was small in that period, i.e. bilateral relations at that time were very well developed, close and friendly in the fields of economy, politics, culture, and education, while at present this variable has a value of 0.

The main indicator of export strategy is the export structure from previous years. The Serbian product that has taken the most important place on the Libyan market over the past several years are medicines. According to data of the Republic Bureau for Statistics, over the past several years medicines have been

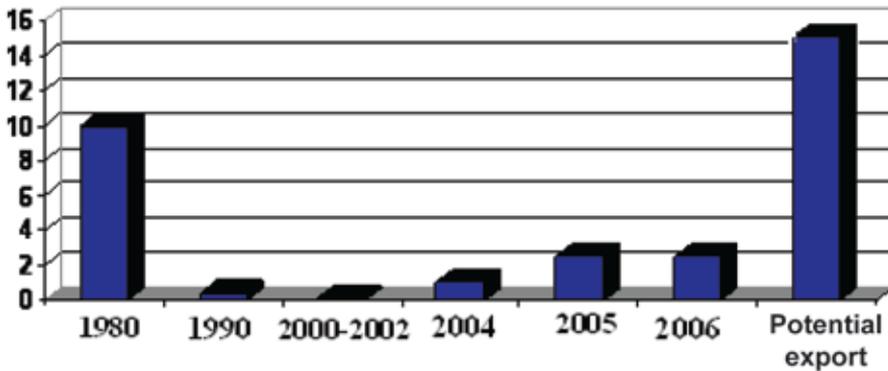
Serbia's most important export article to Libya. In addition to medicines, other items of export were electrical equipment, transport motor vehicles, machines and cables in 2007, combat munition, weapons parts, aircraft, helicopters, parachutes and TV cameras in 2006, casting machines and tools, motor parts, metal processing machines. During 2004, the most significant items of export to Libya were industrial machines, fruit and vine seedlings, industrial machines and devices, scientific and control instruments, iron and steel, special machines, metal products, paper and cellulose products. These are goods that are already present on the Libyan market, so all the export strategy has to do is to focus on intensifying their export.

On the basis of earlier experiences of cooperation with Libya, besides the above-mentioned products, the Libyan market also has a place for food products from Serbia. These have not had a significant place in exports over the past few years, but used to dominate in the former SFRY's export to Libya. Similarly to other North African countries, Libya is not able to meet its own food needs through its own agricultural production. On Serbia's side, in addition to an interest in improving export, there is also an interest in investment in Serbian agriculture for the purposes of joint production to meet Libya's needs. Energoprojekt and PKB have already had success in cooperating with Libya in this field.

Besides export of goods, Serbia can secure significant profits from the already existing but insufficiently exploited cooperation with Libya in many fields. Until the 1990s, construction brought important earnings to Serbian firms and, as Libya invests much in infrastructure, that cooperation can be intensified. Serbia could secure significant earnings from projects in the areas of tourism, waterworks, geological research, etc. According to the estimate of the Ministry of Foreign Affairs, prospects also exist for the joint appearance of Serbian and Libyan companies on the markets of other African countries.

Serbia-Morocco

Before the breakup of Yugoslavia, Serbia's exports to Morocco equaled almost 10 million USD (SFRY exports were 10-20 million, imports 20-30 million USD). During the 1990s, when Serbia was under economic sanctions, average exports were reduced to only 400,000 USD. In 2000-2002, trade with this country almost completely stopped – total exports equaled 23,000-120,000 USD. Visible trade did not revive until 2004, when exports reached 1 million USD, and then grew to about 2.5 million USD in 2005 and 2006, which still comes to only a quarter of former exports.

Graph 4: Serbia's export to Morocco (in millions \$)

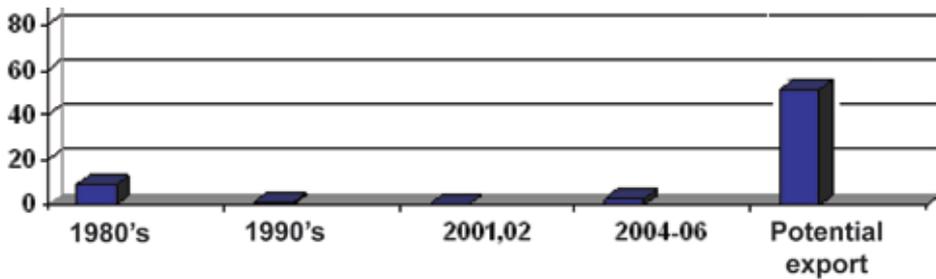
Imports are consistently greater than exports (7.5 million in 2006), as Serbia imports large quantities of raw phosphates from Morocco for the needs of the artificial fertilizer industry. More precisely, Morocco is the most important supplier of this raw material to Serbia, as well as to many other countries.

The results obtained by the use of the gravity model show that, as it is a small and relatively undeveloped country, Serbia's potential export to Morocco comes to only 14.8 million USD (Table 2). Nevertheless, that is 7 times more than the 2.2 million USD of exports that Serbia currently achieves. Another specific feature of trade with Morocco is that, even in periods of the most intense trade, Serbia's exports to that country never came near the export potential.

The products that dominate in export are non-ferrous metals, sheet metals, copper foils, zinc ore and concentrates. It is possible that the export quantity of these products can be increased but, considering the relatively small value of even potential exports, Serbia's economic interest would more likely lie in being able to pay for imported phosphates with the delivery of its own goods.

Serbia-Tunisia

During the 1980s, Serbia's export to Tunisia equaled an average of 9 million USD (SFRY exports equaled 14 million USD, imports 13 million USD). From the beginning of the Yugoslavian crisis until today, trade with Tunisia has consistently fallen. During the 1990s it was about 10 times smaller than in the previous period, or about 1 million USD, and that level has been maintained until today, with the exception of 2006, when the value of exports equaled a mere 0.64 million USD, and imports 3.2 million USD.

Graph 5: Serbia's export to Tunisia (in millions \$)

According to the results obtained by applying the gravity model, Serbian exports to Tunisia could reach almost 50 million USD, or 80 times more than today's 0.6 million USD (Table 2).

According to the data of Serbia's Republic Bureau of Statistics, the biggest share in exports was held by tractors, special and industrial machines, machine parts, eggs and cut timber. We used to export grains, paper, cork and packaging to Tunisia as well, which means that resumption or increase of the export of these products would be relatively easy. From Tunisia we mostly import scientific measuring and broader purpose instruments, as well as smaller quantities of fruit and textile clothing, while former significant imports of phosphates have almost completely dried up.

According to information from the Ministry of Foreign Affairs, an important Serbian export product to Tunisia could be pharmaceutical products. Tunisia is interested in joint investment in the pharmaceutical industry, as well as joint appearance on third markets. Therefore, increased bilateral cooperation with Tunisia would have a positive effect on the development of trade with other Maghreb countries as well.

...

The obtained values of potential exports do not represent maximum values, as the variable for economic-political distance has been excluded. With the restoration of relations with these countries to previous levels, this factor would also participate in potential export, which would in turn acquire much greater values. The following table expresses the values of potential exports in the case that the dummy variable for economic-political distance had a value of 1 instead of 0.

Table 3: *Potential exports with a positive artificial variable*

Country	Potential export millions \$	Potential export with a positive dummy variable
Algeria	57.26152	101.6115
Libya	33.66629	59.74139
Egypt	76.83882	136.3518
Morocco	14.82666	26.31016
Tunisia	48.74629	86.5011
Total	231.3396	410.516

As the obtained results show, with a change in bilateral relations with the countries of the region, the values of potential exports practically double, and are 14 times greater than current exports.

When real exports differ from potential to such a great extent, it is an indicator of possibilities for exporting a very broad range of goods. However, it is still more useful to determine the greatest demand for particular kinds of goods for each individual country. North African markets have a demand for mostly similar types of goods from Serbia. The products that appear on the lists of export articles to each country in the region are, before all, the following:

1) Heavy industry products:

- machine industry (tractors, transport road vehicles, agricultural equipment and machines, industrial machines, plant machines and devices),
- non-ferrous metallurgy (sheet metals, copper foils, zinc ores)
- pharmaceutical industry
- electrical industry (electrical equipment, cables)
- black metallurgy (iron, steel, metal products)
- military industry (weapons parts, aircraft, helicopters, combat munition, parachutes)

To a somewhat lesser extent and in smaller quantity, the following products:

2) Light industries:

- rubber products,
- timber
- paper, cork and cellulose products

Thus, the export strategy should be based on increasing export of these products, i.e. on expanding existing markets.

- 3) Agricultural products and food industry
 - food products
 - grains
 - eggs
 - fruit and vine seedlings

These products do not appear on the list of export articles to North Africa as often as industrial products, even though the need for them in the said countries is quite great. None of the five North African countries has the capacity to satisfy the demands of its own domestic market for agricultural products with its own production, which is why they set aside huge amounts of money for food imports. Since neither the neighboring regions of tropical Africa and the Middle East possess natural conditions for the development of agriculture, this represents a huge export opportunity for Serbia.

4. Conclusion

- Serbia's potential exports to North African countries are much greater than present exports. These countries have "space" to absorb 5 to 10 times more in value of goods from Serbia than what is being imported today. In the case of Tunisia, the figure is 80 times more.
- Among the North African countries, Serbia fulfills the most of its export potential with Egypt, i.e. exports to that country are the closest to the potential.
- The bygone wars and sanctions explain the drastic fall in trade with these countries, but they are not a justification for its continued decline. However, on average, the level of trade with North Africa in the present, stable period continues to decline.
- All the above conclusions point to a need for Serbia's diplomacy, institutions and businessmen to invest much greater effort in intensifying trade with North African countries, before all because the factor of economic-political distance is the only one that can be directly influenced. Distance is a fixed variable, the GDP of export markets cannot be influenced, while one's own GDP changes much harder than relations with countries that also have an interest in cooperation. The reason that is given as an explanation for the, until recently, complete lack of initiative and interest for increasing trade with these countries is Serbia's orientation toward EU, CEFTA and Russian markets. Of course, that is not a justification, for there is no economic logic to limiting one's own exports, especially having in mind the growth of Serbia's already large foreign trade deficit. A second possible explanation for the state's

inactivity is the small value of exports, which would remain relatively small even in case it was to double. However, the application of the gravity model shows that these markets can absorb several times, even several tens of times more in export value from Serbia. Namely, the value of exports to the North African region could reach 231 million as opposed to the current 31 million USD, which should be reason enough to attempt to restore relations to previous levels.

- In a hypothetical situation in which Serbia's diplomatic relations with the North African countries were to be brought back to the level of the 1980s, potential exports to these countries would come to more than 410 million USD, or almost double the potential exports within the current economic-political distance, and almost 14 times greater than current exports.

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SCIENTIFIC ASSOCIATE DRAGAN ĐUKANOVIĆ, PHD*
Institute for International Politics and Economy, Belgrade

ECONOMIC COOPERATION OF SOUTHEAST EUROPEAN COUNTRIES WITHIN THE REGIONAL COOPERATION COUNCIL**

Abstract: *In this article the author analyses the frameworks of economic cooperation among the South East European countries within the Economic and Social Development Unit of the Regional Cooperation Council. Since the end of the process of transformation of the Stability Pact for South Eastern Europe into the Regional Cooperation Council (RCC) on February 2008, its interstate forum has sought to establish new forms of economic cooperation and social development in coordinating and facilitating regional economic initiatives, especially CEFTA 2006, the Investment Compact for South East Europe and the Business Advisory Council.*

The Regional Co-operation Council also focuses on the reforms of employment policies, coordination of the activities of national health services and social dialogue initiatives through the Bucharest Employment Process, the SEE Health Network, the SEE Trade Union Forum and the Adriatic Region Employers' Centre. The Electronic South East Europe Initiative (eSEE), on the other hand, tries to promote the values of the informatics society in the countries of South East Europe under the auspices of the RCC.

Key words: *Regional Cooperation Council, South East Europe, economic and social development*

JEL classification: F 02, F 15

* E-mail: dragandjuk@yahoo.com

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1. Introduction

During the previous two decades many regional multilateral cooperation initiatives in South East Europe have stimulated cooperation in the economic field, as well as the development of small and middle enterprises.¹ In connection with this, dialogue among the region's countries on starting more intense means of economic cooperation was initiated, first within the Central European Initiative – CEI and then within the Black Sea Economic Cooperation.² The process of economic cooperation was also initiated within other regional initiatives, before all within the Southeast European Cooperative Initiative – SECI, after 1996.³

After the founding of the former Stability Pact for South Eastern Europe – SP SEE, in mid 1999, the striving to ensure the economic renewal and development of areas devastated by war became especially pronounced. This was also confirmed by the structure of the former Stability Pact for South Eastern Europe, whose second working table was devoted to economic development.⁴ This working table contained numerous sectors and initiatives for the development of regional trade, regional infrastructure, the advancement of economic reforms and business and the development of information systems.⁵ The Charter of the Stability Pact for South Eastern Europe, which was in fact the founding document of this interstate forum, provided for the necessity of strengthening “economic cooperation in the region and the region's cooperation with the rest of Europe and the world.”⁶ The advancement of private business was also listed among the priorities of the former Stability Pact for South Eastern Europe.

The Organization for Economic Cooperation and Development – OECD and the United Kingdom of Great Britain and Northern Ireland jointly prepared the Investment Compact for South East Europe in 2000, which contained, among other things, a framework for the protection of foreign investment as well as numerous anti-corruption mechanisms. The regional investment framework

¹ See: D. Lopandić, *Regionalne inicijative u Jugoistočnoj Evropi: institucionalni oblici i programi multilateralne saradnje na Balkanu*, Institut za međunarodnu politiku i privredu, Evropski pokret u Srbiji, Beograd, 2001, p. 235.

² Ibidem, pp. 73-77. and 88-91.

³ Ibidem, pp. 136-137.

⁴ J. Minić, J. Kronja: *Regionalna saradnja za razvoj i evropsku integraciju*, Evropski pokret u Srbiji, Beograd, Albanian Institute for International Studies, Tirana, Center for Institutional Development, Skoplje, Evropski pokret u Crnoj Gori, Podgorica, Helsinški komitet za ljudska prava u Bosni i Hercegovini, Sarajevo, Institut za međunarodne odnose, Zagreb, Kosovski institut za politička istraživanja i razvoj, Priština, 2007, pp. 18-19.

⁵ D. Lopandić: *Regionalne inicijative u Jugoistočnoj Evropi: institucionalni oblici i programi multilateralne saradnje na Balkanu*, op. cit., pp. 148-150.

⁶ “Chapter of the Stability Pact for South Eastern Europe”, Cologne, June 10th, 1999, III Goals, 10, paragraph 6.

adopted by Southeast European countries on June 27, 2006 was the first concrete act of the Investment Compact.

The framework of the said area of economic cooperation, under the auspices of the former Stability Pact for South Eastern Europe also provided for the continuing of the work of the Business Advisory Council – BAC, which was formed in 1996. Its membership was made up of representatives of the most influential multinational companies from the United States and European Union member states.

In addition to the above economic cooperation initiatives, an initiative for the introduction of electronic trade and electronic government in South Eastern Europe was formed in Istanbul in October 2000, first under the name *eBalkans*, which has since become *eSEE (Electronic South East Europe Initiative)*.

The process of the transformation of the Stability Pact for South Eastern Europe into the Regional Cooperation Council – RCC, between the beginning of May 2006 until the end of February 2008, saw the rationalization and “channeling” of numerous initiatives for regional cooperation in economics and social development, which existed either within this forum or outside it.⁷ Moreover, economic and social development became one of the five priorities of the activity of the Regional Cooperation Council, in the fields of infrastructure and energy, as well as cooperation in the fields of security, the legal system and internal affairs, and the building of human resources and interparliamentary cooperation.

2. Economic development initiatives within the Regional Cooperation Council

After the successfully executed transformation of the Stability Pact for South Eastern Europe into the Regional Cooperation Council at the end of February 2008, the development of market economies and the strengthening of social cohesion in South East Europe continued to be perceived as priorities for the full stabilization of conditions in the region.⁸ In connection with this, a separate Economic and Social Development Unit was formed within the Regional Cooperation Council. The channeling of a large number of initiatives that came about within the Stability Pact for South Eastern Europe since 1999, which were devoted to the economic development of the region's states, was accompanied by support from the World Bank, the European Bank for Reconstruction and Development, the European Investment Bank and the European Development Bank.⁹

⁷ See: D. Đukanović: “Transformacija Pakta za stabilnost u Jugoistočnoj Evropi – novi podsticaji regionalnoj saradnji”, in: D. Đukanović (ed.), *Međudržavni forumi za saradnju u Evropi – uporedni modeli*, Institut za međunarodnu politiku i privredu, Beograd, 2007, pp. 173-190.

⁸ “Economic and Social Development”, *Regional Cooperation Council*, Sarajevo, Official Website: http://www.rcc.int/index.php?action=page&id=5&link_id=12, September 15th, 2009

⁹ Ibidem

In connection with that, the Regional Cooperation Council shall continue to contribute to ensuring support for foreign investors, market liberalization and the development of small and middle enterprises.¹⁰ At the same time, it also supports the development of employment policy in the states of South East Europe, as well as the modernization of public health systems.

The key activities of the Regional Cooperation Council in the area of economic development are realized through the Investment Compact for South East Europe, CEFTA 2006 and the Business Advisory Council. The Regional Cooperation Council does much to support their work and coordinate certain activities of the above initiatives, and ensures financial aid from donors.

a) Investment Compact for South East Europe

The Investment Compact for South East Europe was signed in 2000, within the Organization for Economic Cooperation and Development (OECD), with the support of Great Britain. Its most important goal is to ensure the unhindered development of the private sector and secure a more favorable investment climate in the countries of South East Europe. The Investment Compact for South East Europe provides for the supervision and evaluation of the favorableness of the investment climate, the stimulation of economic system reforms and the strengthening of the private sector.¹¹

Two periodicals are also published within the auspices of the Investment Compact for South East Europe, on the topic of the status of small and middle enterprises in the countries in the region, as well as reform indices.¹² The South East Europe Investment Committee – SEEIC was formed in Paris in April 2007, with the participation of representatives of the OECD and local governments.¹³ In addition, one of the most important meetings of the Investment Compact for South East Europe was held in Paris in November 2006, with the goals of stimulating market competitiveness, increasing foreign investments and overcoming their fragmentary nature.¹⁴

b) CEFTA 2006

CEFTA 2006 is an arrangement by which a tariff-free zone was established for Western Balkan countries (Albania, Bosnia and Herzegovina, Montenegro, Croatia, Serbia, Macedonia, as well as Kosovo in accordance with United Nations

¹⁰ Ibidem

¹¹ See: *Designing the Future*, Investment Compact for South East Europe, Stability Pact for South Eastern Europe, OECD, 2006, pp. 4-6.

¹² These are the *Small and Medium Enterprise Policy Index* and *Investment Reform Index*.

¹³ J. Minić, Jasminka Kronja: *Regionalna saradnja za razvoj i evropsku integraciju*, ibid., pp. 28-29.

¹⁴ See more on the official web site of the Investment Compact for South East Europe: www.investmentcompact.org

Security Council Resolution 1244) and Moldova.¹⁵ The founding act of CEFTA 2006 came into force in November 2007, while the Secretariat and Joint Committee were formed in the meantime.¹⁶

In connection with this, the Regional Cooperation Council provided significant support for the opening of the CEFTA 2006 Secretariat in Brussels, and also supported the intensifying of relations and the strengthening of coordination with the Investment Compact for South East Europe and the South East Europe Investment Committee.¹⁷

c) Business Advisory Council

The next important initiative within the Regional Cooperation Council is the Business Advisory Council – BAC, which was formed back in 1996 within the South East Europe Cooperation Initiative (SECI) and includes around forty businessmen from twenty countries in the region and around it.¹⁸ Its priority goal is to establish the most intensive cooperation with the private sector. Toward that end, regular meetings are held every three months in the region's capitals.¹⁹

International financial institutions and the European Commission support the work of the Business Advisory Council, providing financial support for its activities.²⁰ At the same time, the Council stimulates the establishing of more intense relations between the private sector and the public administration (*public-private partnership*), promoting investment, business development and a favorable environment for the development of the private sector.

Despite the fact that the global economic crisis has hit all the South East European countries, the Regional Cooperation Council has not given up on the initiative of forming the South East Europe Investment Bank – SEEIB, which was first promoted in 2006, and in connection with which consultations were held on June 17, 2009, with the Nordic Investment Bank from Helsinki, which is prepared to take on an advisory role in the process of establishing the new regional bank.²¹

¹⁵ P. Bijelić: "Trgovinska integracija Srbije: CEFTA, Evropska unija i Svetska trgovinska organizacija", in: Edita Stojić-Karanović (ed.), *CEFTA i interesi Srbije*, Institut za međunarodnu politiku i privredu, Beograd, 2008, pp. 83-102.

¹⁶ About CEFTA 2006, see: <http://www.cefta2006.com>

¹⁷ "Economic and Social Development", Regional Cooperation Council, Sarajevo, Official Website, *ibid*.

¹⁸ *Ibidem*

¹⁹ "The Regional Cooperation Council Annual Report – 2008–2009", The Secretariat, Regional Co-operation Council, Sarajevo, 2009, pp. 24-25.

²⁰ On the origins and development of the Business Advisory Council, see: <http://www.bac-see.net/index.php>.

²¹ "Report of the activities of the Regional Cooperation Council Secretariat by the Secretary General of the RCC", H. Bišćević, Regional Cooperation Council Secretariat Sarajevo, September 15th, 2009, pp. 15-18.

3. Institutional frameworks for cooperation in the area of social development within the Regional Cooperation Council

The social development of South East European countries is another priority of the activities of the Regional Cooperation Council, That is why the Bucharest Employment Process, the SEE Health Network, the SEE Trade Union Forum and the Adriatic Region Employers Centre are the leading forums for cooperation in the said field.

On the other hand, the Electronic Southeast Europe Initiative – eSEE has the goal of contributing to the development of information technologies and, in areas of business advancement, the development of public administration, health care and education.

a) *Bucharest Employment Process/ South East European Employment Network*

At a meeting of South East European ministers for social policy and employment, held in Bucharest on October 30 and 31, 2003, a special declaration that emphasized the necessity of redefining employment policies in the countries of the region was signed.²² This gathering received support from the International Labor Organization and the Council of Europe.

In mid 2009, the Bucharest Employment Process changed its name to the South East European Employment Network – SEEEN,²³ whose seat will be determined in the near future.

The Regional Cooperation Council shall in the future coordinate and supervise the work of this initiative, with the priority task of defining employment policies on the national and regional levels that will be able to take on the challenges of the global economic crisis.²⁴

b) *South East European Health Network*

Beginning with next year, the permanent seat of the South East European Health Network will be in Skoplje, even though the organization was founded in Sofia in mid 2001. At a meeting of health ministers of South East European countries, held in Bucharest on June ²⁷, 2009, a “Memorandum of Understanding” was signed²⁵ to the effect that another such meeting should be held during 2010, at which a schedule of future activities of the South East European Health Network will be laid out in greater detail.

²² “The Bucharest Declaration – South East Europe Conference on Employment”, Bucharest, October 30-31st, 2003

²³ “Report of the activities of the Regional Cooperation Council Secretariat by the Secretary General of the RCC”, *ibid.*, pp. 15-18.

²⁴ “Economic and Social Development”, *Regional Cooperation Council*, Sarajevo, Official Website, *ibid.*

²⁵ “Memorandum on Understanding”, SEE Health Network, Bucharest, June 25-27th, 2009

The Regional Cooperation Council shall continue to support the South East European Health Network in the future, albeit not financially but, rather, in the form of presenting national health systems' projects (individual or regional) to international donors.²⁶ It is very important to note that, within the framework of this initiative, several centers for the advancement of public health, donation of organs for transplantation, blood transfusion and health system development shall be founded,²⁷ with secured maximum political and expert support of the Regional Cooperation Council.

c) *SEE Trade Union Forum*

Even during times of economic crisis, the Regional Cooperation Council is striving to support a permanent social dialogue between employee and employer representatives, as well as representatives of national governments. In that context, the SEE Trade Union Forum is engaging in activities whose goal is to, together with national trade unions, promote social dialogue during the process of economic reforms and transition, as well as to supervise protection of employee rights.²⁸

The SEE Trade Union Forum holds frequent meetings with trade unions from countries in the region, at which conclusions and recommendations are presented.²⁹ This forum does not have a permanent seat, although its activities are most often coordinated from Zagreb and Sarajevo.

d) *Adriatic Region Employers Centre*

The International Organisation of Employers was the initiator of the founding of the Adriatic Region Employers Centre at the end of March 2008. The seat of this initiative is in Zagreb, and it is made up of representatives of employers' associations of all the South East European countries.³⁰ The basic task of this center is to promote joint projects, cooperation and exchange of experiences related to the business environment and business conditions in the countries in the region.³¹

²⁶ "The Regional Cooperation Council Annual Report – 2008-2009", *ibid.*, pp. 26-27.

²⁷ "Economic and Social Development", *Regional Cooperation Council*, Sarajevo, Official Website, *ibid.*

²⁸ *Ibidem*

²⁹ See: "South East Europe Trade Union Forum and PERC leaders discuss policy to cope with the crisis and advance EU accession", *European Trade Union Confederation*, April 8th, 2009: <http://www.etuc.org/a/6057>, September 15th, 2009

³⁰ "Business initiatives in the Western Balkans are bringing cohesion to the region", *International Organization of Employers*, March 28th, 2008: <http://www.pr9.net/business/assoc/7735march.html>, September 15th, 2009

³¹ *Ibidem.*

On the other hand, as part of efforts to stimulate social dialogue, the Regional Cooperation Council shall support all three sides – representatives of employees and trade unions, employers and state ministries. Also, the RSS shall persist in efforts toward reaching consensus on the most important issues tied to the successful finalization of transition processes and the improvement of conditions for the development of foreign direct investments.

4. Electronic South East Europe Initiative – *eSEE*: stimulus for the modernization of business and public administration

The Electronic South East Europe Initiative (*eSEE*) was launched in Istanbul in 2000. Today, its Secretariat is based in Sarajevo. The Initiative's most important goals are tied to the development of an information society and the advancement of knowledge transfer.³² Its goals are also targeted toward the establishment of regional cooperation and mechanisms of implementing strategies of information society development at country level.³³

Thanks to Agenda Plus,³⁴ adopted in Sarajevo in mid 2007, the Electronic South East Europe Initiative – *eSEE* took on a wholly new intensity of activities. One of the *eSEE*'s newest projects is connected with the formation of an *eGovernance* center, seated in Ljubljana, whose basic task would be to coordinate activities connected with electronic administration and electronic business.³⁵ An accompanying result will be the creation of conditions for total transparency of work of public administrations in South East European countries.

In cooperation with the United Nations Development Program (UNDP), the Regional Cooperation Council shall stimulate the development of *eSEE* and the organization of special ministerial conferences at which future tasks of this initiative would be defined.³⁶

³² “eSEEUROPE”, Internet, <http://www.eseeinitiative.org>, September 15th, 2009

³³ “Economic and Social Development”, Regional Cooperation Council, Sarajevo, Official Website, *ibid.*

³⁴ “eSEE Agenda + for the Development of Information Society in Southeastern Europe – 2007-2012”, Stability Pact – Electronic Southeast Europe Initiative, Sarajevo, June 17th, 2007

³⁵ J. Minić, J. Kronja: *Regionalna saradnja za razvoj i evropsku integraciju*, *ibid.*, pp. 47-48.

³⁶ “Report of the activities of the Regional Cooperation Council Secretariat by the Secretary General of the RCC”, *ibid.*, p. 15.

5. Conclusion

In the wake of the successful transformation of the former Stability Pact for South Eastern Europe into the Regional Cooperation Council, which was completed in February 2008, there is still no adequate coordination of all the initiatives that exist within it, including those in the areas of economic and social development. It is quite realistic to expect that certain problems in the functioning of these initiatives may appear in the future, caused by lack of financial resources and lack of donor interest for serious investments. The Regional Cooperation Council is not able to secure sufficient financial support from its own funds for the majority of the initiatives.

The achievement of social cohesion, which is also one of the basic principles on which the present-day European Union rests, is a goal sought by all the countries of South East Europe and the Regional Cooperation Council. Thus, the stimulation of economic and social development, along with the development of infrastructure and electro-energetic systems, shall certainly contribute to the said process of harmonizing varying degrees of development, both within countries and on the regional level. The development of human potentials, which is also one of the priorities of the work of the Regional Cooperation Council, can significantly contribute to the recovery of the South East European region. Especially important are the activities initiated by the Regional Cooperation Council in connection with the founding of the South East Europe Investment Bank. All activities on coordinating the work of the said initiatives, as well as on the creation of an adequate investment environment are the responsibility of the Economic and Social Development Unit of the Regional Cooperation Council.

In the coming period the Regional Cooperation Council anticipates a multitude of various activities aimed at improving conditions in the countries in the region, in the areas of trade, facilitation of investments, health care, information and communication technologies, employment and social dialogue. All this was also itemized in the very ambitiously conceived program of activities for 2009 and 2010.³⁷ However, it is still evident that only the CEFTA 2006 arrangement has produced significant results in the liberalization of trade between the countries in the region. The remaining initiatives, before all due to the pronounced domination of the jurisdiction of national governments and ministries in the areas of employment, health and social dialogue, have not been able to produce significant results, even though they have existed for almost a decade. They mostly come down to periodic meetings, either at ministerial or lower level.

Without greater financial aid from donors, before all the World Bank, the European Bank for Reconstruction and Development and the European Investment Bank, it will not be easy to implement the development of the ambitiously

³⁷ "Strategic Work Programme of the Regional Cooperation Council 2009-2010", Secretariat, Regional Cooperation Council, Sarajevo, May 14th, 2009

planned activities of the Regional Cooperation Council in the areas of economic and social development. Thus, the activities of the RCC in the said areas are temporarily jeopardized by the effects of the global economic crisis. The same applies when it comes to the reduced flow of foreign direct investments into the countries of South East Europe, for which it may be expected that it will continue to decrease in parallel with the consolidation of the world's leading economies from the effects of the global economic crisis.

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PROFESSOR BOJAN ILIĆ, PHD*

Faculty of Organizational Sciences, Belgrade University, Belgrade

PROFESSOR VESNA MILIĆEVIĆ, PHD

Faculty of Organizational Sciences, Belgrade University, Belgrade

PROFESSOR NATAŠA CVETKOVIĆ, PHD

Faculty of Business Studies, Megatrend University, Belgrade

STRATEGIC COST MANAGEMENT AND THE PRODUCT LIFE CYCLE CONCEPT

Abstract: *This work underscores the essential connection between cost management and the realization of strategic goals related to the achievement of company competitiveness and profitability. Studious analysis points to the fact that effective cost management, especially a well-chosen and successfully realized price strategy in various phases of the product life cycle, will secure adequate placement and the achievement of planned earnings and profits. Focus is placed on calculating the costs of the life cycle, which has gained currency in recent times. The relevance of quality costs in this context is also pointed out. In addition, the role of information technologies in the process of cost management is also considered.*

Key words: *costs, prices, strategic cost management, product life cycle, quality costs*

JEL classification: L 25, L 15

1. Introduction

Costs and prices are significant factors of competitiveness, and have an important effect on company performance. Each company is very sensitive to changes in the price level of its products and services, since they directly reflect on business capability and profits. Price is a factor of competitiveness that is expressed quantitatively and whose relationship with profit is easily observable by managers.

In present-day companies, costs and prices affect business results through incoming and outgoing elements of the process of production/provision of services. Their general effect on results depends on the sum total of positive and negative effects of price changes. The managers of a given company may, partially and

* E-mail: ilic@fon.rs

under certain conditions, influence price levels. However, the company is able to avoid the negative effects of price changes by adjusting product or service quantity, structure and quality. Depending on the factors that influence them it is necessary to analyze cost and price changes in various phases of the life cycle of products and services, in the context of achieving positive long-term business results.

As a newer approach in contemporary management, strategic cost management is a concomitant orientation toward constant cost reduction and strengthening the company's position. The contribution of cost management to the successful determination of strategic goals, the formulation and effective realization of company strategy and increasing profitability is especially valued. Under the conditions of economic crisis or recovery, the need for a more precise calculation of costs and greater visibility of various cost categories becomes especially pronounced.

2. Strategic cost management, the business environment and value creation

Cost management should support the achievement of the company's mission and strategic goals. Under the conditions of the new economy, cost management focuses on easing management's decision-making by providing information on costs and other information in the processes of strategic analysis, strategic choice and strategy implementation in practice. Under conditions of frequent changes in a complex business environment, a company's cost management system must be more dynamic, in order to allow it to deal with the frequently changing environment and an increasing variety of products and production processes, so that strategy implementation becomes easier.¹

In contemporary conditions, the business environment is also characterized by discontinuities, surprises, threats associated with the global economic crisis, technological changes, shorter life cycles of products and services, and the ecological sphere, as well as new challenges and opportunities for companies. All this implies that managers can no longer make business decisions based on the supposition that what happened in the past will continue in the future. Managers should continually evaluate critical factors of business success under conditions when no single business function represents an exclusive determinant of favorable business results, i.e. when there is practically no universal formula for success under conditions of globalization.²

A continual examination of the external environment is relevant, in order to be able to note in a timely manner signs of possibly unfavorable economic

¹ E. Blocher, D. Stout, G. Stokins, K. Chen: *Cost Management, a Strategic Emphasis*, McGraw-Hill, Irwin, Boston, 2008

² V. Milićević, *Strategijsko poslovno planiranje – menadžment pristup*, Fakultet organizacionih nauka, Beograd, 2008

trends, changes in cost structure, demand saturation, the shortening of product and service life cycles, technological substitution, and social discontinuities. Should it appear that a certain market may become unprofitable in the future, managers will seek their opportunities in a new market or a narrower market segment. In addition, permanent quality improvement for the purposes of customer satisfaction, especially in the context of managing customer or user relations, is something that is understood.

In order to be successful, a company must create value for its customers/users of services and other relevant stakeholders in a distinctive manner, through competitive positioning and the integral service that it offers. It is now accepted that strategy is a value-creating skill, which provides a conceptual framework on the basis of which managers can identify chances for providing value to customers, while the company takes the profits. In that sense, strategy is seen as the way in which a company defines its business operations and integrates resources, including non-material ones. Special emphasis is placed on knowledge and external linkages, i.e. the competence of the organization and the customers. In accordance with that, a value-creating system is focused within strategic analysis, within which various economic actors, suppliers, business partners, other members of strategic alliances, and customers/service users act in such a way as to create value in new forms, which implies a new logic of value. In addition, the competences of the organization are primarily related to specific expert knowledge, business processes and techniques that it has accumulated over time and which have been incorporated into the “package” it offers. However, company capabilities are not enough absent the will of customers/service users to pay for them. Thus, a second important advantage for each company lies in having an established customer base.

From the standpoint of achieving competitive advantage, it is desirable for employees to be stimulated to be creative and innovative in finding new and better ways of production, and product and service development. Innovations may also bring lower costs, differentiation or faster responses to opportunities and threats from the external environment, where the capabilities of the organization must come to full light.

The newer approach to strategy from the aspect of costs and achieving business success is that it represents a unique and sustainable way in which the company creates value. Opportunities for creating value are moving from material resource management to management in the sphere of strategies based on knowledge, which affirm intangible resources. This has brought on the need for the development of new “tools,” which in the 21st century denotes assets based on knowledge and strategies of creating value, whose realization they make possible.

The starting premise is that those employed in production and service organizations can effectively implement company strategy, as well as price strategy, when they understand them completely and when they come to understand the

ways in which they may contribute to business success. This is a relevant newer approach, which through the “performance-guided organization” integrates employee and organization performances.

Managers must take into account possible contradictions that appear as a natural part of company operations and development. Before all, they should harmonize, on the one hand, investment into intangible resources for the purpose of attaining long-term earnings growth and, on the other, the lowering of costs tied to short-term financial performances, i.e. to improving results over the short term. This specific articulation, as well as the implementation of early and timely corrective action if needed, becomes more complex in the context of the way in which global recessionary trends and recovery trends affect company operations. The current relevance of the paradigm of cyclical development is evident, both on the macroeconomic and the microeconomic levels.

The strategic system of managing company costs develops strategic information, including financial and non-financial information. Due respect is given to the importance of performance measures, such as growth of earnings from sales and salaries, share price movements, dividend growth, and credit rating. Financial measures show the influence of company policies and procedures on the company’s current financial position and, in accordance with that, on current shareholder earnings. Strategic measures of success include product/service quality, market share, and development prospects. On top of financial measures, non-financial factors show the company’s present and potential competitive position, as measured from three additional perspectives of the balanced scorecard measures: customer perspective, the perspective of internal business processes and the perspective of innovation and learning.³

3. Costs and prices in characteristic phases of the product life cycle

It may be concluded that the life cycle model assumes that, essentially, each product begins to “live” from the moment the idea for it is born. It is created and launched on the market, under certain conditions it experiences an upward path, reaches maturity and, after a period of time, begins to show signs of fatigue and age. If there is no possibility of “reviving” it at that time, then preparations are made for its withdrawal from the market. That means that products have different life cycles and pass through certain phases, such as: (1) the phase of introducing the product on the market, (2) the growth phase, (3) the phase of product maturity, and (4) the phase of product obsolescence. The product life cycle on the

³ R. Kaplan, D. Norton: *The Balanced Scorecard*, Harvard Business School Press, Boston, 1996

market, the key factors, as well as the alternation of differentiation and standardization are shown in Figure 1.⁴

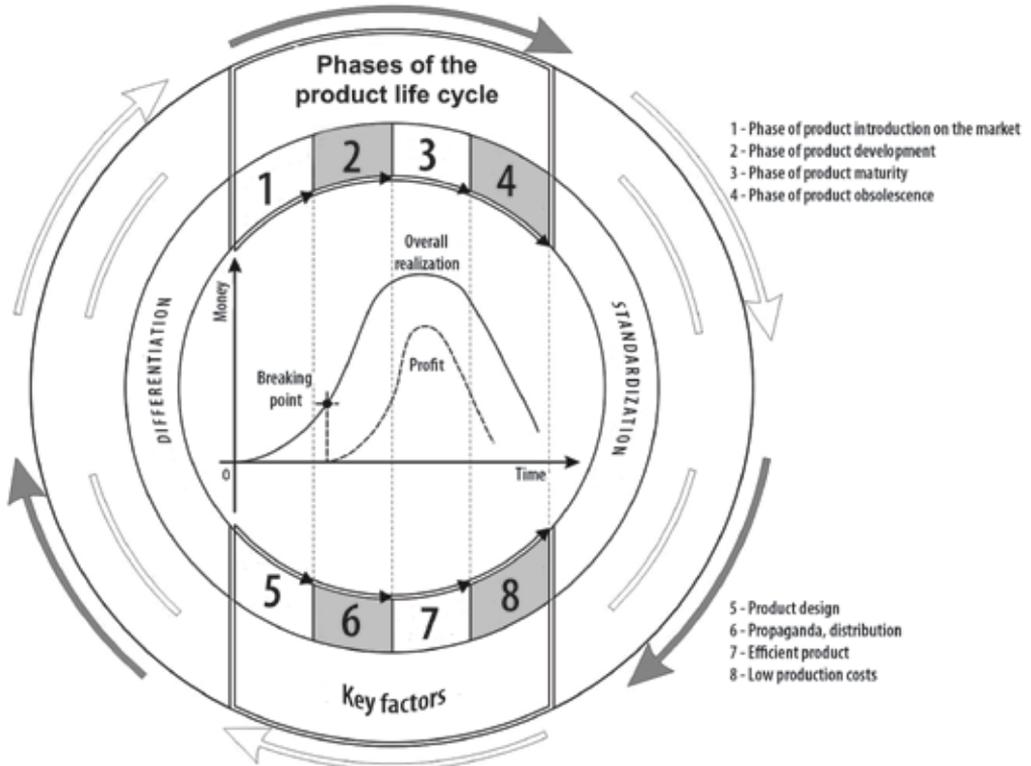
The phase of product introduction on the market represents the product launching phase. It is preceded by a period of conceiving ideas, design and production. It is characterized by high costs, as a result of the slow mastering of the production process, greater spending of materials and longer time of production. Production capacities are still not sufficiently used, since the initial series are small. This phase of the product life cycle is also characterized by high costs of sales and distribution. The product is insufficiently known on the market, so large investment is required for its promotion and faster market penetration. Therefore, the company develops a general business strategy that encompasses price level, product quality level and planned costs of promotion. In the introductory phase, managers often take into account analyses of market conditions, as well as production and marketing costs during the entire projected life cycle of the product, after which they opt for a concrete price strategy, usually with the following available alternatives:

- The manager's first option is a strategy of high prices, high quality and significant outlays for promotion and sales. The company then expects high future profits per product unit and a leading position on the market. It sets a high price for its products, i.e. a price that takes the maximum from the market (a high profit in a short time period).
- The second option is a strategy of high prices with small outlays for promotion. The application of this strategy is possible if there are buyers willing to pay a high price.
- The third option is a strategy of fast market penetration, i.e. forming a low price, accompanied by high outlays for promotion. Sales rise quickly so, even though profit per unit is not high, total profit grows along with increased production. Actually, the low price and the "market penetration" strategies are implemented by companies whose primary goal is to capture a large market share in the shortest time period.⁵

⁴ B. Ilić, V. Milićević: *Menadžment troškova – strategijski okvir*, Fakultet organizacionih nauka, Beograd, 2009

⁵ N. Hanna, H. Dodge: *Pricing - Policies and Procedures*, Macmillan Business, Houndmills, Basingstoke and London, 1997

Figure 1: *Dynamic aspects of the product life cycle on the market*



The above strategies have both advantages and drawbacks, which is why they must be carefully studied and the appropriate ones picked in accordance with results of market research. A badly chosen price strategy on the part of management in the product introduction phase will bear negative effect on the duration of the product life cycle and, thus, on the profit that would be realized in later phases.

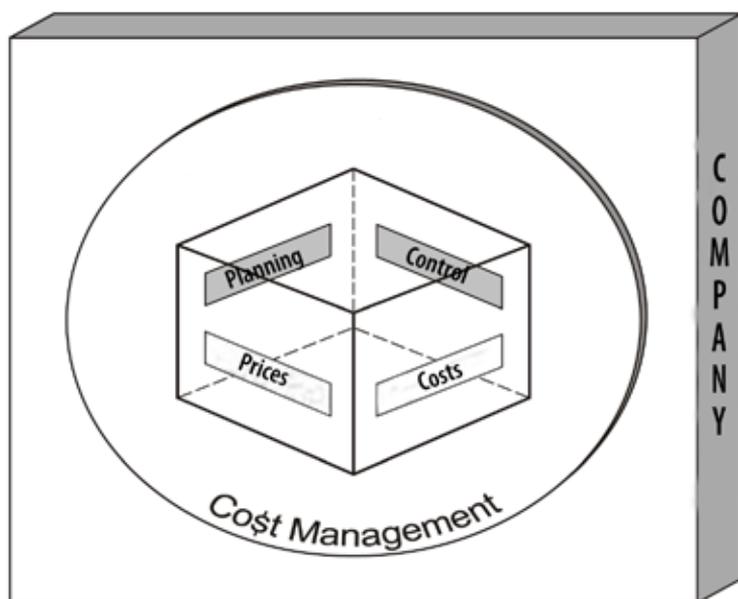
The product development phase is characterized by the fact that the product has been accepted by the market and that sales are growing. This is the phase in which, due to the product's success on the market, the competition masters the production of that same product and its supply grows more and more rapidly. The growth phase is characterized by well-established production, falling costs per product unit and rising profits. However, due to increasing competition, the price is lowered while total profits rise, which is a result of higher production and sales. In order to retain the product's position in this phase for as long as possible, management should also orient its efforts to the realization of non-price factors of competitiveness, such as product quality and design, favorable terms of payment, precision of delivery, and establishing solid business relations with customers.

In the phase of maturity, up to a certain level, buyer interest and sales growth exist for all products. When sales growth is slow or sales are stagnating, that is reflected in lower prices and reduced total profits. Consumers are acquainted with the product and have already-formed buying habits. It is harder to find new sales channels, since the existing network is already saturated. In order to maintain the position of the product, the company endeavors to redesign and modify the product by adding new content in the areas of placement, promotion and distribution.

The product obsolescence phase is characterized by falling sales, further price reduction and lower profits. Thus, the first thing to try in this phase is to lower prices to levels that still, with existing costs, ensure profitable production. If this strategy does not achieve the planned goals, the manager's task is to gradually prepare the product's withdrawal from the market.

It comes out from the above that a well-chosen and properly guided (on the part of management) realization of price strategy in all phases of the life cycle will ensure successful placement and profits from the product. Actually, in order to choose an optimal product/service price, managers must possess information about the ways in which costs are changing at various levels of production. In relation to the costs per product unit, the company also develops an appropriate price strategy, which means that adequate cost and price management is necessary (Figure 2).⁶

Figure 2: Cost and price management



⁶ B. Ilić, V. Milićević: *Menadžment troškova – strategijski okvir*, Fakultet organizacionih nauka, Beograd, 2009

The product life cycle model is now augmented by life cycle costing, a management technique by which product costs are identified, supervised and controlled during its life cycle. This is based on the theoretical approach of differentiating product life cycle, sales life cycle and cost life cycle, where there is an evident analogy between the concept of product life cycle and the concept of the value chain. As the first and the base factor in this approach, product life cycle encompasses all steps, from product design and securing raw materials, to final product delivery and servicing. These steps are: (1) research and development, (2) product design, including the making of prototypes, (3) production, technical inspection, packaging and storage, (4) marketing-promotion and distribution and (5) sales and service. Traditionally, cost management has focused only on costs incurred at the third step, i.e. in production. When things are observed strategically today, the entire cost life cycle should be managed, including pre-production costs, production costs and post-production costs, which mean that the scope of cost overview would have to be expanded.⁷

The costs of products or services are often measured and reported within relatively short periods of time, such as a month or a year. The calculation of life cycle costs ensures a long-term perspective, as it takes into account the entire product/service life cycle, thus allowing a more comprehensive overview of product/service cost and profitability. Thus, for example, a product may have low design costs and much higher marketing costs later on in its life-cycle. In present-day economies, it has been shown that the businesses with high costs in early phases of the product life cycle are: software production, production of specialized industrial and medical equipment, and the pharmaceutical industry, while businesses with high costs in later phases of the product life cycle are: the fashion industry, the cosmetics industry and perfume production. Critical factors of success in the product design phase include: reducing time to market; reducing expected servicing costs, often by way of a simplified design and the use of modular components; using a design that is simple to produce, in order to lower costs and allow flexible production planning.

In this context, strategic price setting depends on the position of the product or service in the sales life cycle. At the beginning of the 21st century, this cycle is becoming shorter (especially in businesses such as consumer electronics in developed market economies). Thus, especially in contemporary business, it is important to have an analysis of the sales life cycle that is related to the sale phases of products or services, from market introduction to decline and withdrawal from the market. As an extension of the analysis of the product life cycle, the first, introductory phase assumes low competition and slow sales growth, as customers become aware of the new product or service. Costs are relatively high, with significant costs of research and development and costs of produc-

⁷ E. Blocher, D. Stout, G. Stokins, K. Chen: *Cost Management, a Strategic Emphasis*, McGraw-Hill, Irwin, Boston, 2008

tion machines and marketing efforts. The prices are relatively high due to high costs. In the second, growth phase, prices rise rapidly with increasing product variety. Competition grows and prices begin to fall. The next phase, maturity, is characterized by falling rates of price increases. The number of competitors declines. Prices continue to fall and differentiation is no longer important. In the decline phase, sales and prices fall, along with the number of competitors. Cost control and an effective distribution network are keys to survival. In the first phase, managers focus on design, differentiation and marketing. The price-forming strategy has special significance in the second phase, when competition sharpens. In the third and fourth phase, managers' attention is turned toward cost control and quality servicing. It may be concluded that the company's strategy for the product or service changes in the course of the sales life cycle, from differentiation in the early phases to cost leadership in the final phases.

In this way, the approach to the strategic setting of prices during the product or service life cycle changes. In the first phase, relatively high prices are set in order to compensate for development costs and to use the advantages of product differentiation and new demand for the product. In the second phase, prices remain relatively high, since the company is trying to achieve profitability in a growing market. In later phases, price-setting becomes more competitive, and efforts are made to lower costs before and after the phase of production/service provision.⁸

The calculation of life cycle costs and strategic price-setting apply to the entire product life cycle. While managers used to focus only on production costs, they now look at costs both at the beginning of the process (before production) and at the end of the process (after production) of the product life cycle, in order to obtain a comprehensive analysis of production costs and profitability. Thus, for example, there is a review of the role of product design (at the beginning of the process) in the reduction of production costs and in the last phases of life cycle costs. After that, the calculation of life cycle costs allows for a comprehensive evaluation of the profitability of various products, including costs through the entire product life cycle. Finally, strategic price-setting applies the life cycle concept in making decisions about prices. Strategic price-setting takes into account two significant views of the life cycle.

The cost life cycle represents a flow of activities inside a company, which begin with research and development, followed by product design, production or service provision, marketing, distribution and post-sales services. That is the factual life cycle of the product or service from the standpoint of incurred costs. The cost life cycle concept is analogous to the value chain concept, which emphasizes that each activity must add value for the end user. The sales life cycle is a sequence of phases in the life of a product or service on the market, from their introduction on the market, to sales growth and maturity, to decline and

⁸ J. K. Shim, J. G. Siegel: *Cost Reduction and Control Best Practices*, Institute of Management and Administration, John Wiley & Sons, Inc., Hoboken, New Jersey, 2006

withdrawal from the market. Profit from sales is small at the beginning, peaks during the phase of maturity, and then declines. Both the cost life cycle and the sales life cycle are important for strategic price-setting.

The newer holistic approach integrates the ideas of calculating life cycle costs and activity-based costing (ABC), towards a more effective management of costs in an environment full of uncertainties.⁹ Also important is the prediction of total costs that will come about during the product's life cycle and future risks tied to products and processes, with the help of the method of activity-based life cycle costing, which incorporates risk management and Monte Carlo analytical methods. On the one hand, the product life cycle is becoming ever shorter and, on the other, product development is often more and more capital intensive. Also, the time between the moment of making business decisions and the production of measurable results is shortened, which affects the complexity of managerial decision-making and managers' responsibility.

4. The relevance of quality costs

Under contemporary business conditions, an analysis of a company's position on the market and of its profitability requires an integrated approach that respects the essential importance of information regarding costs, especially quality costs, for managerial decision-making, keeping in mind quality guru J. Juran's method of reviewing these costs.¹⁰

The contemporary approach to management starts from the fact that, during the entire product life cycle, costs related to processes tied to quality are separately reviewed. The best framework for understanding quality costs affirms four categories of such costs: (1) prevention costs, (2) evaluation costs, (3) internal deficiency costs and (4) external deficiency costs.¹¹ This means that, just as the function of quality has evolved from quality control to a number of preventive, quality assurance activities, so have quality costs expanded to the said categories. Experience shows that it is cheaper to prevent defects than to discover and remove them once they happen.

Prevention costs came about in order to ensure that the company produces products in accordance with quality standards. They encompass costs tied to quality engineering, quality training, researching customer needs, and costs of

⁹ J. Emblemsvåg: *Life cycle Costing: Using Activity-Based Costing and Monte Carlo Methods to Manage Future Costs and Risks*, John Wiley & Sons, Inc., New Jersey, 2003

¹⁰ E. Blocher, D. Stout, G. Stokins, K. Chen: *Cost Management, a Strategic Emphasis*, McGraw-Hill, Irwin, Boston, 2008

¹¹ A. Atkinson, R. Banker, R. Kaplan, S. Mark Young: *Management Accounting*, Prentice Hall, Upper Saddle River, New Jersey, 2001

equipment maintenance, costs of securing adequate suppliers in accordance with Total Quality Management (TQM) demands, and information system costs.

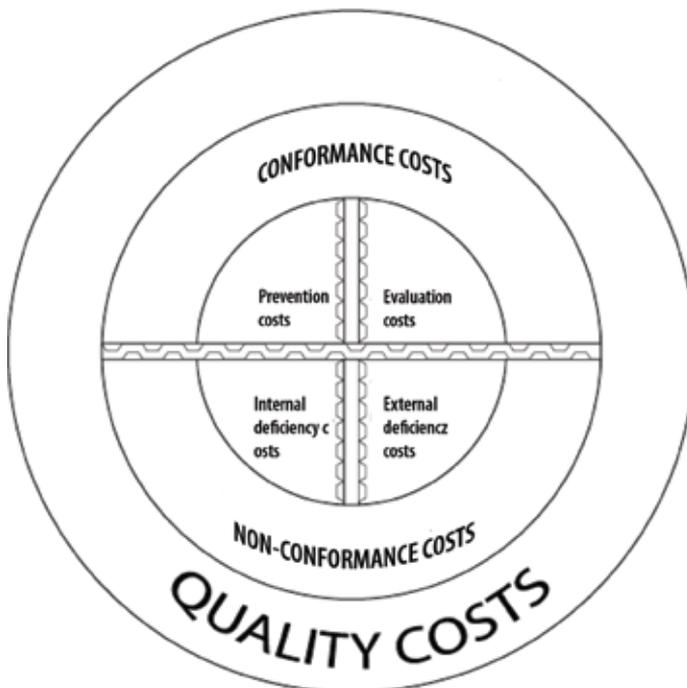
Evaluation costs are connected with product inspection and checking, in order to ensure that they meet both internal and external customer demands, i.e. to determine the harmonization of output with specifications. They include costs of various tests and inspections.

Internal deficiency costs occur when defective components are discovered during the production process, before they are delivered to customers on the outside, and are related to the correction of defective processes and products. From the economic aspect, the important part is that they do not add value.

External deficiency costs are connected with deficiencies discovered by customers, after product delivery. They are related to guarantees, complaints, replacements, repairs, and reestablishing reputation in the long term.

Total quality costs can be observed through two broader categories: conformance costs and non-conformance costs (Figure 3). Conformance costs encompass prevention costs and evaluation costs, since they are wholly incurred in order to make sure that products or services satisfy consumer/service user expectations. Non-conformance costs incorporate costs of internal and external deficiencies, including opportunity costs.

Figure 3: *Quality costs*



It is also important to look at the relationship between price and quality from the buyer's perspective. With more and more products to choose from, and a constant stream of new and complex products, deciding which product to choose is becoming increasingly complicated. Comparison between product models or brands that are offered at different prices is made harder because the buyer lacks complete information about differences in quality. Comparative value can be determined on the basis of the following formula:¹²

$$Cr = \frac{\frac{Qh - Ql}{Ql}}{\frac{Ph - Pl}{Pl}}$$

Where:

Cr - comparative value or relative difference in value between a higher-priced product (H) and a lower-price product (L),

Qh - dimension of quality of product H ,

Ql - dimension of quality of product L ,

Ph - price of product H ,

Pl - price of product L .

In order to apply this formula, it is necessary to possess information about the level of quality and the selling prices of these products.

Most buyers assume that higher quality products have a higher price, even though the increase in quality is not proportional to the increase in price. From the economic aspect, it is accepted that the "price-quality" relation is more important when buying more expensive products or using more expensive services, where there is greater risk of making a wrong choice or where there is a pronounced connection between the product/service and the place of purchase. When management is creating its price strategy, it is important that all these considerations be taken into account. This includes acquaintance with untypical ways of reacting to certain products/services.

The price that buyers pay for a product need not be solely related to its physical characteristics and performance but, rather, more to its "total packaging," including, for example, product installation, delivery, technical support, after-sales service, brand, style, guarantee, as well as symbolic characteristics such as prestige and status, which are perceived as delivery of greater value than that of the competition.

¹² M. Milisavljević: *Savremeni strategijski menadžment*, Megatrend univerzitet, Beograd, 2005

5. Role of information technologies in the cost management process

Under conditions of market-based business operations, companies function in a way that requires precise and timely processing of data, on the basis of which managers can successfully make relevant business decisions related to costs and prices. That is why there is an expected high level of interdependence between costs of information technologies and the organization of economic activities in the company. This points to the fact that the implementation of a chosen strategy depends on numerous factors, which are mutually connected. Among these, information technologies play a special role.

Current information technologies allow managers to manage a larger number of functions and to expand the domain of their control. In addition, information technologies allow the decentralization of decision-making, without loss of strategic management control, which means that managers at all levels are stimulated to develop innovative business strategies. Among such information technologies are distributed data processing networks. They support the work of users in groups and lessen the costs of teamwork. In that way, teamwork becomes a more efficient and effective solution. Distributed information systems remove barriers between business functions, as well as those tied to spatial distance, which can play an important role in reducing costs and achieving better business results. In that context, the further development of digital technology is important, especially from the aspect of cost management.

The said conditions can be satisfied by a new kind of computer network, based on the presence of an informational intermediary and open standards developed for the Internet. Contemporary information systems based on Internet technology allow companies to efficiently carry out their business operations. Internet as a global computer network enables the connection of large numbers of sellers and buyers. Today's tendency is for buyers, by way of appropriate multimedia information systems, not only to access information on products/services in various phases of their life cycles, but to be able to complete entire purchasing transactions.

Especially significant is the broad application of multimedia information systems, which allows the retrieval of relevant information in a fast and efficient way and the successful realization of business transactions. These systems are based on a client/server architecture in the environment of the local and telecommunication computer network. On the server side is the base of products as multimedia entities, consisting, among other things, of a base of data on product type, quality, and selling price, and of a base of data on buyers and sellers on the market. The system provides information on relevant data necessary for making business decisions, and for ensuring communication between participants on the product and service market for commercial purposes.¹³ It can, thus, be seen

¹³ V. Filipović, N. Žarkić Joksimović, V. Milićević, B. Ilić, P. Jovanović: "Multimedia Information System for Commodity Exchange Operations Under the Conditions of

that business connectedness and the realization of transactions from the aspect of cost management are successfully conducted electronically.

6. Conclusion

Contemporary strategic cost management must take into account the effects of the product and service life cycle concept on the making of management decisions. Significant from the theoretical aspect are reexaminations of the cyclical movements of economies, the life cycles of certain business activities, company life cycles and the life cycles of products and services. The life cycle concept is linked to strategic management and with the achievement of desired results on the macro, meso and microeconomic levels over a longer period of time.

Proactive cost management takes into account not only the costs of a concrete product, but also costs tied to the development of the product's concept, to design and engineering, to testing, as well as to process planning. It is especially important that quality costs and branding costs be considered during the process of product design itself, starting from the goals that should be met through the realization of the value-creating strategy. In the end, this requires a change of business culture, as well as of ways and methods of measuring performance.

Starting from the theoretical approach of differentiating the product life cycle, the sales life cycle and the cost life cycle, where there is an evident analogy between the concept of the product life cycle and the value chain concept, it is important to bear in mind that the model of the product life cycle is now augmented by the calculation of life cycle costs, which is a management technique that identifies, supervises and controls product costs throughout its life cycle. It ensures a long-term perspective, since it takes into account the entire life cycle of the product or service. It, thus, allows a more comprehensive overview of costs and profitability.

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ZOLTÁN DÖVÉNYI, DSC*

Geographical Research Institute of the Hungarian Academy of Sciences, Budapest

ANITA GYÖRGY-DÁVID

Institute of Geography, Faculty of Sciences University of Pécs

GÁBOR SZALAI

Institute of Geography, Faculty of Sciences University of Pécs

STRUCTURAL AND SPATIAL CHARACTERISTICS OF EMPLOYMENT IN HUNGARY

Abstract: *In Hungary unemployment is differentiated not only spatially but also based on the settlement hierarchy. This means that unemployment is altogether increasing moving downwards in the system. All this alludes to the favoured situation of the cities and the disadvantaged position of the villages. Thus the areas where the city network is dense and consists of well hierarchical, productive elements are in a more favourable position also regarding unemployment. On the contrary, the areas, which are city deficient and those regions where the city network consists of undeveloped small towns and the higher ranked centres are missing, are in a disadvantaged situation.*

Key words: *Labour market, employment, unemployment, Hungary*

JEL classification: J 11, J 64

1. Raising the problem

In the recent years the country reports and evaluations made by the different organizations of the European Union consecutively raise the same problem related to Hungary:

- Inappropriate social embeddings of the Gypsy population, the weakness of the related governmental policies, durability, sometimes increase of the prejudices related to Gypsies.
- Apparently low level of the population's economic activity, disappearance of a significant portion of the working age population from the labour market, inefficient utilization of human resources.

* E-mail: dovenyiz@helka.iif.hu

However, there is a significant difference between the two problems: while the issue of the Gipsies is an already long stressing problem, the excessively low level of the employment evolved only in the recent years. So it is justified seen as a prior economic-social problem that doubtless needs an explanation. Primarily the issue is worth considering in following approaches:

- Demographic background, respectively marginal conditions of the employment's change.
- Long-term development of employment, characteristics of professional realignment and structural changes over space and time.
- Connection between employment and unemployment.
- Expected development of employment in the following period.

Since the employment processes are usually about slow flow, it is inevitable to expose the problem on longer term. For practical reasons this period is the six decades ranging from the end of the 1940s until the recent past. This period is divided by the system change of 1990 in two, definitely different periods:

- In the state socialist period, ranged from the communist takeover in 1948 until the end of the 1980s, the socialist ideology and planned economy influenced the labour market, respectively also the employment, among others also the effective employment was subordinated to these.
- The two decades after the political system change can be seen as a post-socialist phase, where though the market economy dominates, in the employment also the socialist heritage can be traced.

2. Demographic marginal conditions of the employment's formation

The number of people who can be integrated in the labour market is primarily determined by the formation of the population. In this sense the investigated period can be divided into two phases: in 1949-1980 periods, the population grew by one and a half million, on the contrary it decreased by 700 thousand since then. Since neither the increase nor the decrease was even balanced, this means a further problem on the labour market. The strong fluctuation is basically typical for the period 1949-1980: the rapid population growth in the first half of the 1950s was replaced since the beginning of the 1960s by a much moderated pace population growth, and due to the measures in population policy, at the end of the 1960s, but especially at the middle of the 1970s more populous classes followed again. No such big fluctuations occur after 1980, the increasing population loss is more typical in this period: the moderate decrease of the 1980s noticeably accelerated after the system change.

The above described fluctuation of the population means a problem on the labour market in itself, since the system, resp. the economy cannot react with

appropriate flexibility on quick changes. Consequently, the appearance of more populous classes on the labour market usually means the increase of problems of finding a job, this problem is smaller in case of entry of smaller populated classes, or it can even cause a labour shortage.

Since not the whole population but only a portion of it appears on the labour market, the circle must necessarily be narrowed regarding the demographical marginal conditions. The central category in this sense is the population in working age population, since the majority of the employed originates from here. Law regulates the bottom limit of the working age, and the employment statistics is necessarily adjusted to this. The upper limit is usually tied to the retirement age-limits, and follows the changes of those.¹

At the end of the 1940s the population in working age was 5.6 million that meant more than 60% of the population. Following this several censuses registered the increase of the population in working age, and their number reached almost 6.2 million in 1980. Conversely in the 1980s the number decreased with more than 200 thousand, and then in 2001 it hit the highest value of the period (nearly 6.3 million people).

While the decrease of the 1980s can be basically traced back to the worsening demographic situation, the number of those in working age was increased in the 1990s by the temporal improvement of the demographic background (the populous classes born in the 1970s reached the working age) and since the second half of the 1990 also the rise of the retirement age-limit increased the number of those in working age (Table 1).

¹ In Hungary until the mid 1990s the women between 15-55 and men between 15-60 years constituted the population in working age. Following this the upper age limit started to increase gradually to reach the unified set retirement age limit of 62 years. Men already reached this in 2002, but in case of women it is only due to 2010. This all means that the development of population in working age is not only determined by demographical factors but it is shaped by the regulation as well.

Table 1: Basic figures of labour market (1949–2001, 1000 persons; %)

	1949	1960	1970	1980	1990	2001
Population number	9204.8	9961.0	10301.0	10709.5	10375.3	10198.3
Working age population	5608.2	5754.4	6029.4	6175.0	5956.8	6285.4
Number of employed	4084.9	4759.6	4973.9	5068.8	4527.1	3690.2
Ratio of working age population within total population	60.9	57.8	58.5	57.7	57.4	61.6
Ratio of employed within total population	44.4	47.8	48.3	47.3	43.6	36.2
Ratio of employed population within working age population	72.8	82.7	82.5	82.1	76.0	58.7

Source: Central Statistical Office census volumes

Regarding the future it is necessarily worth mentioning that there is no more demographic reserve in the system, there are no populous classes in the population of children age. The problem of the supply is clearly shown by the fact that in 1990 the number of children aged 0-14 exceeded one million, but it did not even hit 800 thousand in 2003. So the increase in number of people in working age is possible by further increase of the retirement age-limit, and also the positive international migration can play some role. The increase of the retirement age-limit would have the further consequence that the portion of women among the population in working age would increase further, since in the senior classes more and more they are in majority. This on-coming could have been seen also in the previous years: in 1990 52.2% of the population in working age was men, in 2003 only 51.4%.

3. Characteristics of the population's economic activity

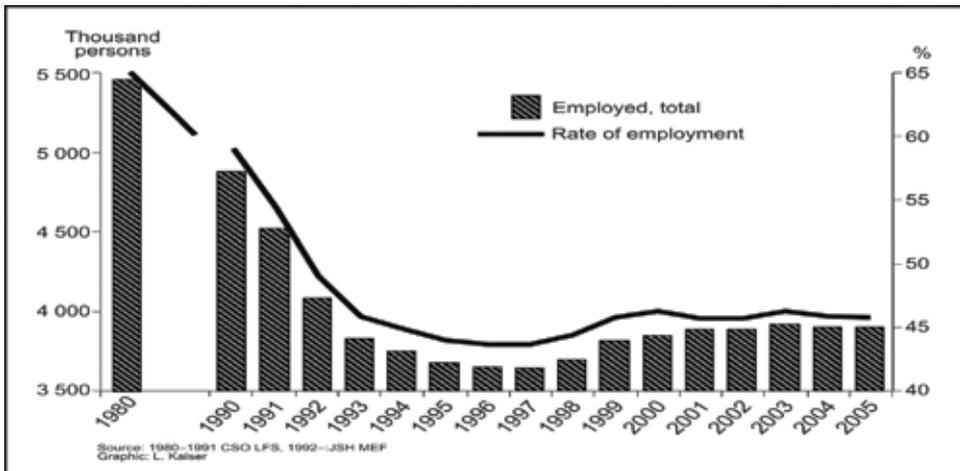
While the demographic marginal conditions of the labour market are actually given and do not really change, respectively cannot be changed significantly in short term, there is broader latitude for exploiting possibilities. This means precisely that the exploitation of the theoretically disposable labour force can range between broader limits, thus the economic activity of the population can show a significant fluctuation.

In the first decades of the state socialism one of the important processes was the increase of the population's economic activity. In 1949-1970 period, the number of employed increased by nearly 900 thousand, the participation rate approached 50%. However, the increase was rather uneven, the majority happened in the 1950s, while in 1960-1970 period the circle of employed broadened by only slightly more than 200 thousand. The 48.3% participation rate registered

in 1970 is the highest in the period, since then the economic activity of the population has been decreasing (Table 1). This means among other things that the low economic activity causing an ever-increasing problem today evolved as a result of a long process.

In the 1970s the number of employed has slightly risen (+95 thousand people), and the census in 1980 registered for the first and the last time more than five million employed, at the same time the participation rate decreased, since the population grew faster than the number of the participants of the labour market. In the 1980s the ratio of employed decreased perceptively (from 47.3% to 43.6%), while their number fall by more than half a million (!). It indicates the strange functioning of the socialist labour market that this significant decrease did not cause any problem. The 1990s meant but a bigger cataclysm, when as a consequence of the system change collapse-like changes happened also on the labour market, so e.g. between 1990 and 2001 the number of employed decreased by 840 thousand, in fact only 36.2% of the population worked (Figure 1).

Figure 1: Change in employment (1980-2005)



For the period since the last census (2001) there is not a full-ranging survey that could fully be matched with the data of the census. So from the comparison of the different databases we can just conclude that there was not substantive improvement in the employment until the summer of 2007, the number of the employed did not even reach 4 million. This is somewhat lower than the slightly 4.1 million value in 1949 that evolved at a population level of 9.2 million, compared to today's population of more than 10 million.

It is not less important to mention that the temporary increase in the rate of participation is almost fully the consequence of the mass initiation of woman in the labour force. This is clearly shown by the number of female employment that

grew between 1949-1960 by almost half a million, and in the 1960s by some 350 thousand, while at the men the modest increase (rich 175 thousand men) of the 1950s was followed by a 144 thousand decrease in the next decade (Table 2).

Table 2: Change in economic activity of the population (1949-2001)

Year	1949		1960		1970		1980		1990		2001	
	Persons	%	Persons	%	Persons	%	Persons	%	Persons	%	Persons	%
Male												
Employed	2892072	65.4	3068489	63.9	2924472	58.6	2866794	55.3	2513659	50.5	2002956	41.2
Unemployed	..	..	..	..	..	..	..	..	84538	1.7	255894	5.3
Inactives	129784	2.9	220335	4.6	625439	12.5	872107	16.8	994397	19.9	1235000	25.5
Dependants	1401564	31.7	1515219	31.5	1442192	28.9	1449808	27.9	1392310	27.9	1356800	28.0
Total	4423420	100.0	4804043	100.0	4992103	100.0	5188709	100.0	4984904	100.0	4850650	100.0
Female												
Employed	1192589	24.9	1691127	32.8	2049474	38.6	2202046	39.9	2013498	37.4	1687313	31.6
Unemployed	..	..	..	..	..	..	..	..	41689	0.8	160316	3.0
Inactives	124972	2.6	216264	4.2	768701	14.5	1330370	24.1	1663858	30.8	2070541	38.7
Dependants	3463548	72.5	3249610	63.0	2490718	46.9	1988338	36.0	1670874	31.0	1429495	26.7
Total	4781379	100.0	5157001	100.0	5308893	100.0	5520754	100.0	5389919	100.0	5347665	100.0
Total												
Employed	4084931	44.4	4759616	47.8	4973946	48.3	5068840	47.3	4527157	43.7	3690269	36.2
Unemployed	..	..	..	..	..	..	..	..	126227	1.2	416210	4.1
Inactives	254756	2.8	436599	4.4	1394140	13.5	2202477	20.6	2658255	25.6	3305541	32.4
Dependants	4865112	52.8	4764829	47.8	3932910	38.2	3438146	32.1	3063184	29.5	2786295	27.3
Total	9204799	100.0	9961044	100.0	10300996	100.0	10709463	100.0	10374823	100.0	10198315	100.0

.. unknown data

Source: Census 2001. 7. Data on employment and daily commuting

The opposing rate of men and women has the consequence that in a relatively short period of time the participation rate of the two genders approached each other significantly. The census in 1949 still registered the traditional labour market division between the genders: while nearly 2/3 of men were employed, it did not even hit 1/4 among women. Due to the continuous work entry of women and the decrease in number of employed men the participation rate of the two genders became much closer to each other by 1970 (58.6, resp. 38.6%).

This process continued even after 1970, and its most apparent phenomenon is the men's "spectacular" exit from the labour market: in 1970-2001 periods, nearly one million men disappeared from the employed, which means a nearly 1/3 decrease. Of course the shrinkage was not even, but the acceleration of the process was observable from decade to decade. So the census in 2001 could register only slightly more than 2 million men employed (Table 2).

At the women the employment still broadened in the 1970s, and it reached its peak in 1980 (2.2 million employed), and since then there is a decrease by

more than half a million until 2001. So in this year the difference between the participation rates of men and women is less than ten percentage points (41.3, resp. 31.6%). The “feminisation” of the domestic labour market is clearly shown by the fact that in 1949 still more than 70% of the employed were men, whereas in 2001 only slightly more than 54%.

The very low economic activity of the Hungarian population is indicated by the development of the ratio of employed among the population in working age. At the beginning of the investigation period, in 1949 nearly 3/4 (72.8%) of the people in working age were employed, which figure increased by narrow ten percentage point due to the employment extension programmes of the 1950s, reaching so 82.7%, which also meant the maximum of the employment rate. After this there is basically no change until 1980, conversely there was a significant decrease in the employment in the last decade of the socialism (1990: 76.0%) that turned after the system change into a quasi nosedive. Consequently, the census in 2001 registered that only 58.7% of the population in working age in Hungary is employed (*Table 1*) which is an unparalleled low value in the European Union.

In international comparison the employment rate of the population between 15-64 years is the most frequently used indicator. This had a mean value of 65% in 2008 in the 27 member states of the European Union; in Hungary it was altogether 56.7% that outranks only Malta. In some older member states of the European Union (e.g. Austria, Denmark, the Netherlands, Great Britain, Sweden) the employment rate exceeds 70%. The incidence of the atypical forms of employment (e.g. part-time job) plays an important role in this, which is still a hardly used method in Hungary.

As it is typical in Europe, the employment level of men is traditionally higher than that of women. This difference existed also in the era of the state socialism, and due to the economic crisis after the system change the gap opened wider: in 1996/97 the difference increased at 14.4 percentage points, but it was even in 2008 still 12.4 percentage points. This meant concretely a 63.0% employment rate for men between 15-64, and 50.6% for women of the same age. The low level of domestic employment is clearly indicated by the fact that the figures above were 9.8, resp. 6.4 percentage point lower in 2005 than the EU-15 average.²

The economic-social changes after 1990 have noticeably restructured the economic activity of some age groups as well. In the case of men there is no change in the fact that the participation is the highest among the 30-34, respectively the 35-39 years old, in these age groups the participation rate increased by 2008 compared to 1992 (84.0-86.7%, resp. 81.0-86.0%). Mainly because of the rise of the retirement age-limit the participation rate also grew at the senior, above 55 years age groups. However, simultaneously the presence of the young men – basically due to the elongation of time spent in education – decreased significantly. This is basically typical for the 15-19 years old, where the 14.6% in

² Társadalmi...2007: *Társadalmi helyzetkép 2005*, KSH, Budapest, p. 185.

1992 dropped to only 3.5 by 2008. Also the expansion of the higher education is indicated by the participation of the 20-24 years old that significantly decreased in this period (64.7%, resp. 42.2%).

In case of women the highest rate of labour market participation was still shown by those between 40-49 years, nevertheless, the rate decreased somewhat (1992: 78.5%, 2008: 75.1%). The girls between 15-19 years basically disappeared from the labour market, in 2008 only 1.9% of them were labour market actors, but there is a significant decrease also at those between 20-24 years (54.0, resp. 31.0%). However, at the same time the labour market participation in older women age groups increased significantly. This is of course not due to the skyrocketed love of work, but an exigency that evolved because of the gradual rise of the previously 55 years retirement age-limit of women. This is clearly reflected by the spectacular increase of the labour market activity of women between 55-59 years: the rate was 18.2% in 1992, 20% in 2000, but in 2008 already 42.6%.³

Also in Hungary there is a strong correlation between the labour market activity and the qualification: the rate of employment increases parallel to the rise of educational level, and this is true both for men and women. There is a multiple difference between unschooled and graduates, and in case of unemployment this realises in the opposite direction.

The spatial inequalities are typical also for the Hungarian labour market, which is also reflected in the figures of the employment rate, additionally these differences even increased in the recent years. In 2005 the employment rate of those between 15-74 years was the highest in Central Hungary (56.6%), while in Northern Hungary it was only 43.6%, and the values of Northern Great Plain and Southern Transdanubia were only slightly higher than this (44.7%, resp. 47.1%).⁴

Besides the above-described transformation of the employment there was a considerable change also among the dependants and inactive persons. The spectacular changes in this field occurred in the 1960s when, due to the significant extension of the pension system, the number of inactive earners increased by nearly one million. Simultaneously, the number of dependants became much lower that is intrinsically a result of a nearly one million (!) decrease in the number of the women (Table 2).

The number of inactive earners increased rapidly also after 1970, and in the first years of the 21st century every third Hungarian citizen belonged to this category. In this field the process of becoming inactive accelerated mainly among women in the last decades: in 1970 there was no significant difference between the inactive ratio of men and that of women (12.5, resp. 13.5%), on the contrary, in 2001 only 1/4 of men, but nearly 40% of women was inactive.

³ Ibidem.

⁴ Ibid.

The situation is directly the opposite in case of dependants, because the women majority of 1949 melted over time, and in 2001 there was hardly any difference in the number of dependant men and women (Table 2).

4. Development of employment re-stratification

The first two decades of the socialism were also the period of the spectacular employment re-stratification. The most apparent change occurred in agriculture, where the number of employed decreased by nearly one million, whereas their ratio was cut in half. So in the agricultural sphere only every fourth active earner worked in 1970. Most of those who quit agriculture went into the industry of construction sector, where the number of active earners increased by more than 1.2 million. Albeit in the whole period the cumulative ratio of the two branches was the highest in 1970, it did not reach 50% (44.2%).

In the socialist economic policy that concentrated mainly on industrial development, the extension of the services was rather slow, the ratio of its employed increased from 24.2% in 1949 only to 30.1% by 1970, which shows a somewhat better picture in absolute terms though, since it covers an increase in the number of tertiary employment from one million to one and a half million. Also in these two decades the proportion of women employed in services increased, but this process will accomplish only later (Table 3).

Table 3: Active earners by economic sector (1949-2001)

Year	1949		1960		1970		1980		1990		2001	
	Persons	%	Persons	%	Persons	%	Persons	%	Persons	%	Persons	%
Male												
Agriculture and forestry	1544656	52.4	1170568	37.0	799549	27.2	612545	21.4	480838	19.1	153975	7.7
Industry	675339	22.9	929874	29.3	1075715	36.7	969638	34.0	798410	31.9	584557	29.2
Construction	92901	3.1	272616	8.6	312685	10.7	342160	11.9	266368	10.6	214776	10.7
Transport	148114	5.0	244551	7.7	267115	9.1	310724	10.8	284503	11.3	207066	10.3
Trade	142046	4.8	148179	4.7	153926	5.2	230230	8.0	237418	9.4	313951	15.7
Other service sector	349926	11.8	402985	12.7	324494	11.1	397537	13.9	445383	17.7	528631	26.4
Total	2952982	100.0	3168773	100.0	2933484	100.0	2865834	100.0	2512920	100.0	2002956	100.0
Female												
Agriculture and forestry	651529	53.8	702162	40.7	482762	23.5	345824	15.7	218420	10.9	49131	2.9
Industry	191818	15.8	449113	26.1	759841	36.9	752387	34.2	598615	29.6	391678	23.2
Construction	3435	0.3	30630	1.8	57359	2.8	59959	2.7	49446	2.5	21604	1.3
Transport	16813	1.4	51770	3.0	77673	3.8	105710	4.8	113840	5.7	81872	4.9
Trade	77944	6.4	160262	9.3	240794	11.7	333748	15.2	335436	16.7	340679	20.2
Other service sector	270628	22.3	328494	19.1	436763	21.3	602193	27.4	696295	34.6	802349	47.5
Total	1212167	100.0	1722431	100.0	2055192	100.0	2199821	100.0	2012052	100.0	1687313	100.0
Total												
Agriculture and forestry	2196185	52.7	1872730	38.2	1282311	25.7	958369	18.9	699258	15.5	203106	5.5
Industry	867157	20.8	1378987	28.2	1835556	36.8	1722025	34.1	1397025	30.9	976235	26.5
Construction	96336	2.3	303246	6.2	370044	7.4	402119	7.9	315814	7.0	236380	6.4
Transport	164927	4.0	296321	6.1	344788	6.9	419434	8.3	398343	8.8	288938	7.8
Trade	219990	5.3	308441	6.3	394720	7.9	563978	11.1	572854	12.7	654630	17.7
Other service sector	620554	14.9	731479	15.0	761257	15.3	999730	19.7	1141678	25.1	1330980	36.1
Total	4165149	100.0	4891204	100.0	4988676	100.0	5065655	100.0	4524972	100.0	3690269	100.0

Source: Central Statistical Office census volumes

Even in 1970, against the doubtless significant re-stratification in employment, extensive areas of the country are about agricultural character regarding employment structure. A considerable part of the Great Plain – primarily in Szabolcs-Szatmár-Bereg, Hajdú-Bihar, Bács-Kiskun, Csongrád County – but also a significant part of the Transdanubian region was of basically agricultural character in 1970. So in this period “the eclipse of the agricultural character” can no way be seen as a very rapid transformation.⁵

⁵ B. Sarfavlí: *Magyarország népességföldrajza*, Tankönyvkiadó, Budapest, 1991, p. 116.

And even less late on, since in the last two decades of the state socialism the emission of employed from the agricultural sector slowed further. So also the census in 1990 still registered that every 6-7th employed worked in agriculture that meant narrow 700 thousand agricultural earners.

After the peak in 1970 the number and ratio of the industrial and construction industrial employment started to decrease, so in 1990 the employed in these sectors figured out only 38% of employed. So the big winner of these two decades is service sector: in 1970 30% of the employment worked in this branch, but in 1990 already more than 46%.

It definitely deserves attention that in the socialist period the employment structure of men and women moved into even different directions. One of the characteristic features is that after 1960 the ratio of agricultural earners decreased faster among women than among men, so in 1990 the ratio of agriculturally employed among men is nearly the double of that of women. In this period the women took a position in the service sector rather than men so already in 1990 the tertiary sector was determinant (57%) in their employment structure, while in case of men this value did not even reach 40% (Table 3).

The next surge of employment re-stratification occurred in the 1990s when the economic-social processes after the system change brought significant transformation also in this field. The switch to market economy mainly affected the production sector heavily; the number of employment rapidly fell in the degrading or bankrupt branches. Proportionally it affected the agriculture strongest, where in 1990-2001 periods the number of employed decreased by half a million, and the portion of it sunk from 15.5% to only 5.5%. Women almost disappeared from the "official" agriculture, the number of employed sank below fifty thousand.

To a lesser extent, but also the weight of industry and construction industry decreased in the employment structure, which meant at the same time further pushing forward of the participation of services. So according to the data of the census 2001, the majority of employed (61.6%) already worked in services. After 1990 the before mentioned differences in the employment structure of men and women became even sharper: women nearly "possessed" the service branch, in 2001 nearly 3/4 of them (72.6%) worked here, whereas hardly more than half (52.4%) of men.

In the previous years there were no further fundamental changes in the employment structure. The number of employed in agriculture decreased further, so in 2006 their ratio sank under 5%, and there was a cutback also in processing industry.⁶

⁶ *Magyarország, 2006*, KSH, Budapest, 2007, p. 100.

5. The connections between employment and unemployment

In this approach the investigated period is divided into two, firmly separated sections. During the years of socialism the employment – like anything else – was approached from ideological point of view. This did not mean less than the declaration of full employment, since in the socialist system there cannot be unemployment. Of course this was rather fiction than reality, and though there was not overt unemployment, but instead there was hidden unemployment and under-employment.

So against the officially announced full-employment, there was always a 1-3% unemployment in the country,⁷ albeit this is a statement based on international experiences and not on concrete data. This estimation does not show by far the rate of the so-called indoor unemployment. Uniquely, the socialism always was guided by hidden unemployment in Hungary: it existed if there was a surplus of labour force, and also if there was a shortage of it. Actually the base of it is the inefficient, lavishing mismanagement that was generally typical for the socialist system. We do not have a special reason to doubt that the estimation is also true for Hungary, according to which in case of appropriate efficiency the production level of the European socialist countries could have been reached with 80% of the applied labour force.⁸ There is estimation precisely for Hungary as well that assumes that ratio of surplus labour force is 15%.⁹

If we wanted to describe the importance of the changes in the labour market with only one datum, it would be enough to tell that in the first couple of years after the system change nearly one and a half million jobs were reduced, more than altogether created during the years of socialism. Regarding the situation in 1994, the number of the active earners was analogous to that of the 1930.¹⁰ The case is further aggravated by the fact that the decrease in number of workplaces already started in the socialist era: if the data can be believed, in 1980-1990 period, every tenth job was liquidated in Hungary. The cutback was also spatially differentiated, there was an over-average decrease in the regions struggling with structural difficulties, so in the areas with small settlements, borderline zones, run-down industrial zones.¹¹

⁷ Zs. Ferge: "Teljes foglalkoztatottság–foglalkoztatáspolitiká–munkanélküliség", *Valóság*, No. 6, 1988, pp. 19-31.

⁸ H. Fassmann: "Phänomene der Transformation: Ökonomische Restrukturierung und Arbeitslosigkeit in Ost-Mitteleuropa", *Petermanns Geographische Mitteilungen*, Vol. 136, No. 1, 1992, pp. 49-59.

⁹ Ludwig Vogler et al.: „Verdeckte Arbeitslosigkeit in der DDR“, *Ifo Studien zur Arbeitsmarktforschung*, Nr. 5, München, 1990

¹⁰ T. Katona: "Magyarország társadalmi és gazdasági fejlődése", in: J. Kovacsics (ed.): *Magyarország történeti demográfiája (896-1995)*, Budapest, 1997, pp. 271-294.

¹¹ P. Meusburger: "Spatial and Social Disparities of Employment and Income in Hungary in the 1990s", in: P. Meusburger, H. Jöns (Eds.): *Transformations in Hungary*, Heidelberg, 2001, pp. 173-206.

Of course the mass liquidation of workplaces had the consequence that the economic activity of the population decreased heavily. This is true also for the transformation independent indicator that is determined by demographical processes: also the ratio of the people between 15-65 years decreased in the population, though it was not too significant.

On the contrary, however, the ratio of the economically active population drastically fell both in the population and the working age population. This resulted in the situation that today the participation rate of the Hungarian population is significantly lower than that of the developed countries (EU, OECD), though in the socialist era it was much higher.

There are several underlying factors behind the considerable decrease of the economic activity. The primary question is of course, where the people who were crowded out from the world of work have gone. In this respect several typical groups can be differentiated:

- At the beginning of the 1990s there was a very generous regulation related to the possibility of early retirement, this was exploited by those who were close to the retirement age-limit.
- Other – sometimes not fully correct – method of going retired is gaining disability pension. This was practically a way to escape unemployment.
- The other way is the shadow economy. Surveys prove that in the middle of the 1990s there was an illegal labour market in every fifth settlement.¹²
- To the big losers of the labour market belong the working pensioners who were quickly crowded out from the world of work. Their number was still 479 thousand in 1987, in 1996 already only 129 thousand, in 2006 even lower, 118 thousand.
- Due to the problems in the labour market a proportion of the working-women became inactive; they went back to the household. Also this plays a role in the significant decrease of the women's economic activity.
- Last, but not least the unemployed, the biggest losers of the labour market transformation, can be mentioned.

According to the available data the deterioration of the employment stopped around 1997-98, since then the number of employed started to increase again and the economic activity of the population improved somewhat. This favourable change lasted only for a short period, and since 2002 the situation turned out to be bad again what was indicated also by the increase of the unemployment.

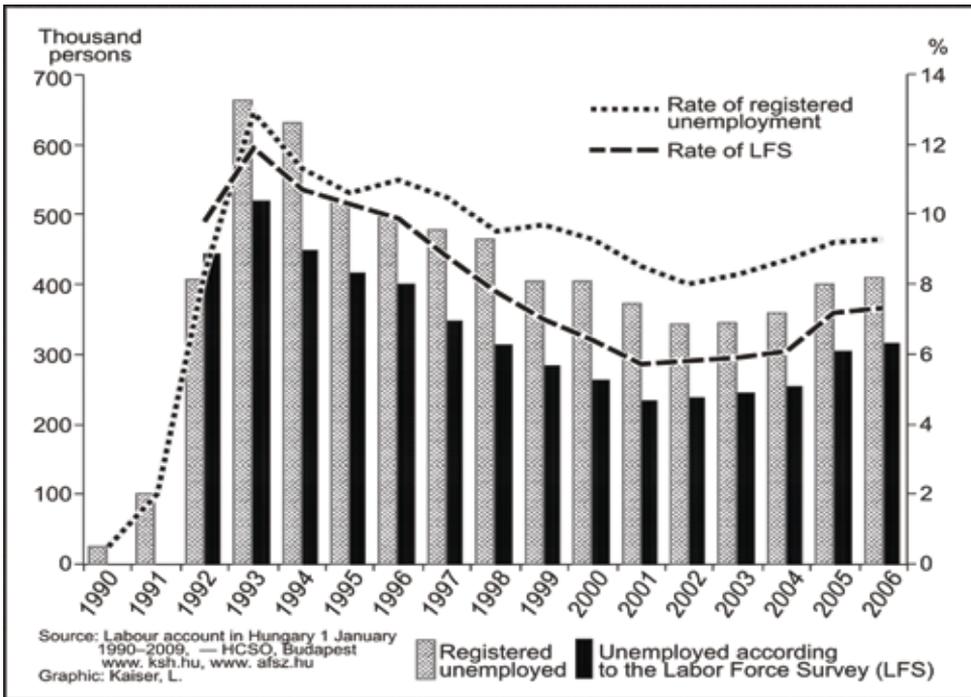
¹² Z. Dövényi: "Informeller Sektor in Ungarn. Wirtschaftliche Bedeutung und regionale Differenzierung von Schwarzmärkten und Schwarzarbeit", in: *Ungarn in Europa. Gesellschaftlicher und raumstruktureller Wandel in Vergangenheit und Gegenwart*, Hrsg.: Albrecht, V., Mezösi, G.. Institut für Didaktik der Geographie Frankfurt am Main. /Natur - Raum - Gesellschaft 1, Frankfurt am Main, 1998, pp. 125-142.

The unemployment definitely takes a prestigious place among the negative signs of economic-social processes related to the system change. There are numerous reasons behind this, of which the most important ones are:

- The Hungarian society was unprepared to the open and quickly multitudinous employment. After the decades of the state socialism that ensured work security and predictable career on the labour market, the totally new circumstances of the market economy were shocking in the world of work.
- Though in different scale, the unemployment means a threatening danger to every social group, so it can be seen as a problem of the whole society. The view, according to which it only perceives the bad and lazy workers, was suddenly crashed: after 1990 the labour market functioned according to totally different principles, and it did not respect the good labour force either.
- The effect of the unemployment was exacerbated not negligibly by the so called two-earner family model that evolved during the socialist system and stayed general even among the conditions of the market economy. In this system the unemployment of only one of the earners could bring the family into a difficult financial situation.
- The unemployment definitely added to the extension of the shadow economy, within that to that of the illegal employment. A portion of people crowded out from the world of work are definitely not workless, but active in the illegal segment of the labour market.
- Also the broadening of the “underclass”, the peripheral groups is connected to unemployment. The marginalization of groups who are permanently crowded out from the legal labour market, who cannot – or do not want to – return there, means an ever increasing problem.
- Unemployment is a good indicator that shows the different performance of the country’s regions, the localization of the areas, which are the winners or exactly the losers of the system change, and in the latter ones it plays a significant role in the degradation, sometimes fragmentation of the local communities.

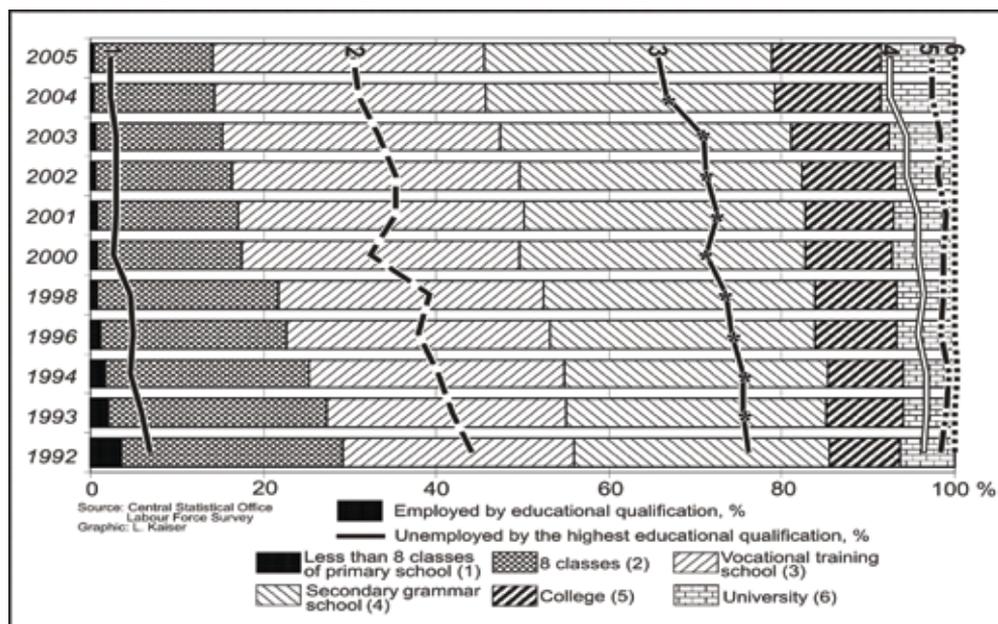
In the two decades since the official admittance of the unemployment (1st of January, 1989) the number and rate of unemployment showed a strong fluctuation. The sharp rise of unemployment started in the autumn of 1990, it culminated in February 1993, when the number of registered unemployed rose above 700 thousand that meant a more than 13% unemployment rate. In the background of the multitudinous unemployment stood the difficulties of the switch from planned to market economy, e.g. the degradation of the economic relations to the former CMEA countries, resp. the difficulties in creating of the Western markets. After this unemployment showed a decreasing tendency until 2002, then it started to rise again, and this was accelerated due to the recent world economic crisis (Figure 2).

Figure 2: Unemployment (1990-2008)



In the last two decades not only the number but also the structure of the unemployment changed. This means that the situation of the single labour market groups changes from time to time, the initial structures did not stiffen at all. This picture is reflected among others by the composition of the unemployed, but also that of the employed based on school education: the two structures became more and more different over time. The people with less than 8 school classes disappeared from the employed almost everywhere, but as hopeless unemployed they also fell out of the unemployment registration. Also the people only with primary school education lost a significant space in the world of work, so it is not surprising that their ratio among the unemployed is the double of that among the employed. The division line is at the end at high-school graduates: their portion is always higher between the employed than at the unemployed. The ratio of the graduates rose both among the employed and unemployed, but in the former case much more dynamically (Figure 3).

Figure 3: Employed and unemployed by educational qualification



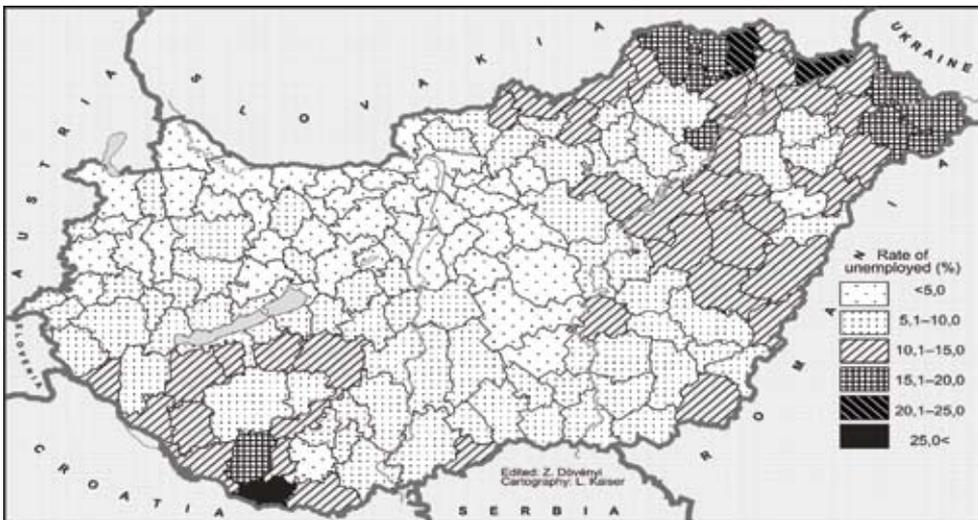
It is a favourable nameable feature of the Hungarian unemployment that it does not hit any age group disproportionately. In the two decades past since the system change there are changes worth mentioning among the registered unemployment basically at the two poles, the youngest and the oldest employed. At the beginning of the 1990s due to the labour market peculiarities inherited from the socialism, unemployment hit the young employed severely, but with the extension of the secondary and higher education their ratio significantly decreased not only among the employed but also among the unemployed. There were opposite changes in case of the above 55 years group: due to the rise of the retirement age-limit an ever bigger portion of them are forced to work, so simultaneously their number and rate among the job seekers is increasing.

One of the interesting peculiarities of the Hungarian labour market is that the employment rate of women, resp. their ratio among the job seekers was for a long time lower than that of men. In the background of this is basically the fact that the mass job liquidations aimed branches where mainly men were employed (e.g. heavy industry, agriculture), and the stability of the jobs was rather typical where women were employed, like e.g. some fields of services. But these differences were slurred over time, so currently there is no significant difference between the genders in this field. Other differences remained though, e.g. the typical unemployed man is a skilled worker, and however in case of women the rate of secondary school graduates is high.

One of the serious problems of the Hungarian unemployment is that a significant ratio of unemployed does not have a chance to return to the legal labour market. The unqualified or non-marketable knowledge possessing unemployed form the group of the “hopeless unemployed” who are more and more forced to earn their living from illegal work and/or social benefits. Gipsies make a significant proportion of this group. Due to lack of data here we have to rely on estimations and model calculations: according to G. Kertesi¹³ the unemployment rate of the Gipsies was close to 50% in the autumn of 1993. The situation did not change basically; by the turn of the millennium an extremely low (roughly 30%) employment rate stabilized itself among the Gipsies, which is coupled by an employment instability that is typical for the third world.¹⁴

As opposed to the structural characteristics, the spatial differences of the unemployment seem to be very stable in Hungary. The regional differences of the unemployment are good expressions of the individual areas’ economic performance, adaptability to the economic crisis. The employment rate is always below the national average in regions with favourable endowments that are able to receive innovation and capital. Accordingly, the rate of the unemployment is permanently low in Budapest and in its broader neighbourhood, as well as in the broad zone next to the Austrian border. On the contrary, unemployment is much higher in the north-eastern part of the country, together with Southern Transdanubia, also within this mainly in the zone next to the country border (Figure 4).

Figure 4: *Unemployment (June 2005)*



¹³ G. Kertesi: “Cigányok a munkaerőpiacon”, *Közgazdasági Szemle*, No. 12, 1994, pp. 991-1023.

¹⁴ G. Kertesi: *A társadalom peremén. Romák a munkaerőpiacon és az iskolában – Osiris*, Budapest, 2005, p. 531.

In Hungary unemployment is differentiated not only spatially but also based on the settlement hierarchy. This means that unemployment is altogether increasing moving downwards in the system. All this alludes to the favoured situation of the cities and the disadvantaged position of the villages. Thus the areas where the city network is dense and consists of well hierarchical, productive elements are in a more favourable position also regarding unemployment. On the contrary, the areas, which are city deficient and those regions where the city network consists of undeveloped small towns and the higher ranked centres are missing, are in a disadvantaged situation.

6. Conclusion: Expected development of the employment

Considering the demographic margin conditions of the future development of the labour market it can be taken almost for granted that a broadening cannot be expected here, thus one has to prepare for the permanent decrease of the population available for the labour market. This process has already started before: the population of the county has been decreasing since 1981, this started at the population of children age (0-14 years) already at the end of the 1970s, and since 2003 the population in working age has been decreasing.

Based on the data of the census in 2001 it can be expected that the population of the country shrinks until 2021 from 10.2 million at 9.72 million, which means an approximately 5% decrease. This relatively propitious value is due to the positive balance of the international migration. The relative modest eclipse of the population affects differently the individual age groups, and it will or can have non-negligible consequences:

The low level of the young age group (0-19 years old) – primarily due to the very low prolificacy of the 1990s – will decrease further, and their ratio shrinks from the 23% in 2001 at app. 20% by 2021. Reviewing the whole period also the 20-59 years old class, that is the most important one regarding the labour market, will decrease, in 2021 the number of people belonging here will already approach 5 million.¹⁵

In light of the above mentioned it is especially important to have a look at the formation of the older class's population (55-64 years old) that is available for the labour market. Opposed to the previous, younger classes an approximately 300 thousand-person increase can be forecasted here, thus in 2021 an approximately 1.4 million population can be expected here. The increase of the oldest population that still can be named to be in working age indicates at the same time one of the biggest population and labour market problems of the forthcoming period, the fast ageing of the population: the rate of the people above 60 years

¹⁵ L. Habliscsek: A területi munkaerő-kínálat előrebecslése 2021-ig. Tartalmi összefoglaló, 2005: www.ofakht.hu

will increase until 2021 from 20% to 26%. Additionally this can be seen as just a sort of introduction, since the really big ageing will happen only later.

Based on the pre-calculations the population decrease of the country will occur spatially differentiated, thus there will be winners and losers on every regional level. On macro-regional level a slight population increase can only be expected in Central Hungary, on the county level, in addition the strong increase of Pest, the population of Fejér and Győr-Moson-Sopron does not change fundamentally, at the same time a more than 10% decrease can be forecasted in Békés, Nógrád and Zala counties.

However, the eclipse of the population, resp. that of the classes in working age does not necessarily result in the decrease of the employed. Hence there are some factors that can significantly influence the participation rate of the inhabitants, even by constant population. In the following period such is by all means the increase of the level of school education.

Since the 1990s the educational efforts strengthened spectacularly in Hungary, the interest grew primarily in the secondary schools giving maturity, but the most spectacular extension can be observed in the higher education. Due to these the “plenty of civilized heads” is evolving. This means in data that the people with less than 8 classes among the population of 15 years and older decreases by 2021 from near one million to app. 200 thousand, while the number of people having only primary education shrinks from near three million to 1.6 million. The number of skilled workers will increase somewhat, but the real big increase will be at the secondary school graduates (from 2.2 million at 3 million) and at the higher education graduates (from 940 thousand at 1.6 million).

Though the alternation of the low educated for higher educated is not a fast process, the labour market effect of the increase of the qualification will noticeably appear until 2021. This is mainly embodied in the rise of the rate of participation. It is enough to mention to highlight the differences that the rate of participation is slightly more than 5% at people with no primary school education and at the graduates it is app. 74%.¹⁶

Of course the participation rate of the population can be influenced by other factors as well, it is enough here to think about the development of the economic situation or the rise of the retirement age-limit. Depending on the fact how the single influencing factors get into the model we can get different data regarding the expected number of economically active population in 2021. According to the so called basic model the number of economically active will be approximately around 4 million, thus it will be lower than in 2001. However, the “optimal version” calculates with 4.4 million economically active, thus it assumes a significant increase.¹⁷ The number of unemployed among the economically active population is expected to decrease and not to reach 300 thousand.

¹⁶ Ibidem.

¹⁷ Ibid.

The period until 2021 can also be regarded as a preparation phase for the following three decades. This does not mean less than that the labour market problems will sharply appear only from the beginning of the 2020s onward which can primarily be embodied in the labour shortage. Since the demographic forecast until 2050 does not promise too many good things to the domestic labour market. Among others it must be expected that the number of people in working age (20-64 years old) will decrease significantly, since also the last more populated class, the generation of the 1970s, exits the labour market. The later/latest forecast that assumes more favourable demographical processes than the previous ones estimates the number of employed around 5 million in 2050, which is much lower than the current value. Since also the number of the population between 0-19 years decreases, permanently more people will exit from than enter into the labour market, so it is expected that the question where the missing labour force can be secured from will arise also in Hungary.

The problem is exacerbated by the fact that this question will arise in the 2020s in several other countries of Europe; so ensuring the labour force can become a general European problem. Departing from this it is expected that the labour market of the old continent will be restructured also in the sense that the rate of guest workers significantly increases on the domestic labour markets. Of course this restructuring will have winners and losers too: the countries offering better conditions can gain labour force from less wealthy countries, and can solve their labour market problems at the expense of those. At this time it will be not only about “brain” but also in general “hard-working hands” drain as well.

Hungary’s position can evolve interestingly in this situation, thus the current tendencies can be continued in bigger scale and with probably different preliminary signs. This can be characterised by the emigration of the Hungarian labour force into more developed countries of Europe that can be more or less counter-balanced by the immigration of people – decisively native Hungarians – from the neighbouring countries. Currently the immigration is noticeably higher, so also the international migration is positive for the country. It is nearly not sure, however, that this remains also in the future, so it would be worth preparing for a situation where Hungary stands in need of labour force from outside the Carpathian Basin. More precisely it should be solved that it does not happen.

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GÁBOR MICHALKÓ, PHD, SENIOR RESEARCH FELLOW*
Geographical Research Institute, Hungarian Academy of Sciences
PROFESSOR TAMARA RÁTZ, PHD
Kodolányi János University College
ASSOCIATE PROFESSOR MÁRTA BAKUCZ, PHD
Faculty of Business and Economics, University of Pécs

A THEORETICAL JOURNEY ALONG THE BORDERS BETWEEN WELFARE AND WELL-BEING: ECONOMIC ASPECTS BASED ON OBSERVATIONS IN HUNGARY **

Abstract: *In the process of achieving happiness, tourism acts as a stimulus for economic activity: if travelling makes you happy, then, in order to achieve your goal, it would be worth your while to undertake any activity which would provide higher personal disposable income. The extra revenue produced and which is available for tourism can generate increasing income not only for the individual households, but also at the national economy level. If travel can positively influence satisfaction with life, the government (through social tourism initiatives) should support participation in travel for those who otherwise – due to their specific circumstances as pensioners, people with large families, students, young people at the start of their career – would either not travel at all, or would not travel sufficiently to generate reasonable income for the tourism industry*

Key words: *tourism, happiness, well being, Hungary*

JEL classification: I 31, L 80

* E-mail:michalko@helka.iif.hu

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1. Introduction

The core meanings of the Hungarian words for “happiness” and “prosperity” are identical – which indicates that anyone with no financial problems is considered by the Hungarian society to have a satisfying and comfortable way of life. Since, during the last 50 years, spending one’s leisure time travelling has gradually become a natural part of life¹, tourism can now be thought of as a normal part of a happy life. Motivation, leisure time, travel-oriented socialisation and personal disposable income are highlighted by expert analysts as the basic theoretical conditions for participating in a journey (e.g. Hall – Page 2002). When analysing tourism demand, the PDI (personal disposable income) factor seemed the essential one in most cases.² This is highlighted by the fact that 40 percent of Hungarian households did not travel in 2007, citing a lack of financial resources as the basic deterrent.³

In our study the main issue for research concerns whether the income factor, travelling and satisfaction with life (happiness) are linked. Our hypothesis is that more of those who live in better financial circumstances take part in tourism, and so, in their case, travelling plays a more essential role in their perception of happiness. In the process of achieving happiness, tourism acts as a stimulus for economic activity: if travelling makes you happy, then, in order to achieve your goal, it would be worth your while to undertake any activity which would provide higher personal disposable income. The extra revenue produced and which is available for tourism can generate increasing income not only for the individual households, but also at the national economy level. If travel can positively influence satisfaction with life, the government (through social tourism initiatives) should support participation in travel for those who otherwise – due to their specific circumstances as pensioners, people with large families, students, young people at the start of their career – would either not travel at all, or would not travel sufficiently to generate reasonable income for the tourism industry. Through such a boost in demand for tourism, the political sphere could even contribute directly to the growth of a psychologically healthier society in which spending on healthcare would decrease and earned income increase.

To deal with the issues arising from the relationships among income, travel and happiness, we assess the outcome of two database analyses. From one we utilise data from a representative survey (undertaken in 2007 by the Hungarian Central Statistical Office) of 11,500 Hungarian households which focused on

¹ J. Czeglédi, *Korunk turizmusa*, Panoráma Kiadó, Budapest, 1982; M. Lengyel: *A turizmus általános elmélete*, Kereskedelmi és Idegenforgalmi Továbbképző Kft, Heller Farkas Gazdasági és Turisztikai Szolgáltatások Főiskolája, Budapest, 2004

² T. Rátz, L. Puczkó: *The Impacts of Tourism: An Introduction*, Hämeenlinna, Häme Polytechnic, 2002

³ Á. Próbald: *Jelentés a turizmus 2007. évi teljesítményéről.*: Központi Statisztikai Hivatal, Budapest, 2008

travel and satisfaction with life, whilst, for the second, we use the data extracted from a non-representative survey conducted in 2008 by the Geographical Research Institute of the Hungarian Academy of Sciences and the Kodolányi János University College, in which 1,424 people were questioned about the role of travel among “happiness factors”.

2. Theoretical approaches to the relationship between tourism and happiness

The interest in the relationship between tourism and happiness has recently become more visible in the international literature (Neal et al. 1999, Richards 1999, Jurowski – Brown 2001, Gilbert–Abdullah 2002, Andereck et al. 2007). The results of earlier investigations – focusing either on the tourists themselves or on local society – provide an adequate theoretical basis for new research trends to emerge, trends with a deeper understanding of the issue.⁴ The researchers broadly agree that the individual’s involvement in tourism rather improves than spoils the quality of life of the person concerned. If someone travels, their demands are satisfied by the consumption of the supply of the tourism destination(s) visited. Should things happen according to their expectations, and then travel assists in generating an overall feeling of satisfaction regarding their own life. In some cases even the journey from home to the destination contributes to the realisation of one’s perception of happiness as initiating an improvement in one’s quality of life. If local residents face the impact of tourist traffic emerging in their environment, then their quality of life changes – essentially in accordance with the intensity of their personal concerns and attitudes. Those who, directly or indirectly, enjoy the benefits of tourism or simply recognise the positive impacts of tourism on the destination in question, become happier, whilst for those who can see only negative effects, their continuous dissatisfaction can lead to their quality of life being spoiled.

The terminology used by the researchers in analysing the connections between tourism and quality of life accords with Veenhoven’s widely accepted concept, i.e. “overall satisfaction with life” and “happiness” are used as synonyms.⁵ Objective well-being (OWB), which can be characterised by objective factors, and Subjective well being (SWB) which requires a subjective approach, can be considered as the pillars of the individual’s quality of life. If someone lives

⁴ J. Dobos, L. Jeffres: “Perceptions of Leisure Opportunities and the Quality of Life in a Metropolitan Area”, *Journal of Leisure Research*, Vol. 25, No. 2, 1993, pp. 203-217; R. Perdue, P. Long, Y. Kang: “Boomtown Tourism and Resident Quality of Life, The Marketing of Gaming to Host Community Residents”, *Journal of Business Research*, Vol. 44, No. 4, 1999, pp. 165-177; J. Neal, M. Uysal, J. Sirgy: “The Effect of Tourism Services on Travelers’ Quality of Life”, *Journal of Travel Research*, Vol. 46, No. 2, 2007, pp. 154-163.

⁵ R. Veenhoven: “Well-being in Nations and Well-being of Nations. Is There a Conflict Between Individual and Society?” *Social Indicators Research*, Vol. 91, No. 1, 2009, pp. 5-21.

a life, which satisfies the requirements laid down by themselves, then they can consider themselves essentially a happy person. This generates the perception of SWB. Taking into account the fact that quality of life is an objective term embodying factors which can, for the most part, be measured also with social indicators, then, as a poor person can be happy, even a rich man can be unhappy. Hence, OWB and SWB do not correlate on every occasion.⁶

Any further specification of the theses, which are treated as self-evident, would require studies based on larger samples, which that might lead to new findings on the symbiotic relationship of happiness and tourism. One missing link is an investigation into the impact of material welfare on tourism-generated happiness, and one of the mechanisms operating in symbiosis is quite familiar. It is well known that tourist travel – which clearly needs material welfare for it to be undertaken – generates a sense of happiness. Less information is available on the effect which travel-induced happiness might have on an individual's material welfare.

In this paper we look for an answer to the paramount questions: what symbiosis is to be found between work and leisure time activities as factors in an individual's happiness, and how can tourism affect this relationship. An important objective is to demonstrate the mechanisms by which the individual's happiness, which is produced by tourism, is transformed into a stimulus for a boost in the economy. Bruni considers the transformation processes between the economy and happiness as a “black box”; and this paper is an attempt to gain insight into it from the standpoint of tourism.⁷

3. Methodology

Since 2004, the Hungarian Central Statistical Office (HSCO) has regularly collected data on the travelling habits of adult (18+) Hungarians. Their surveys are carried out among travellers who spend at least one night in a destination.⁸ In the second half of 2007, the HCSO, in collaboration with specialists from the Ministry of Local Government's Tourist Department, the Hungarian National Tourist Office and the Geographical Research Institute of the Hungarian Academy of Sciences, carried out a questionnaire-based survey in 11,500 households (the sample being representative to the entire Hungarian society). The aim of the research was to investigate the primary interconnections between the travelling activity of Hungarian residents and their life satisfaction. The symbiosis of gen-

⁶ M. Royo: “Well-being and Consumption: Towards a Theoretical Approach Based on Human Needs Satisfaction”, in: L. Bruni, P. Porta, Eds.: *Handbook on the Economics of Happiness*, Edward Elgar, Cheltenham 2007, pp. 151-169.

⁷ L. Bruni: “The Technology of Happiness and the Tradition of Economic Science”, in: L. Bruni, P. Porta, Eds., *Handbook on the Economics of Happiness*, Edward Elgar, Cheltenham, 2007, pp. 127-150.

⁸ Á Próbal, *ibid.*

eral life satisfaction and travelling is examined specifically. The research cooperation between the organisations preparing the survey provided the opportunity for the participants to analyse the real situation (with the help of the cross-tables) according to their own particular interest. Specialists assembled the necessary cross-tables from the HCSO, and in this study, the subjective assessment of the financial condition of the household is used as the independent coefficient.

Table 1: *The socio-demographic features of the survey samples (%)*

Age					
Sample	18-24	25-44	45-64	65 +	
HCSO (representative)	10.9	35.9	33.6	19.6	
KJ College – HAS (home)	32.4	32.5	25.0	10.1	
Sex					
Sample	Male		Female		
HCSO (representative)	46.5		53.5		
KJ College – HAS (home)	47.5		52.5		
Financial condition					
Sample	Very tight	Tight (Moderate)	Average	Good	Very good
HCSO (representative)	12.0	33.5	48.1	6.2	0.2
KJ College – HAS (home)	2.9	17.5	54.8	21.3	3.5

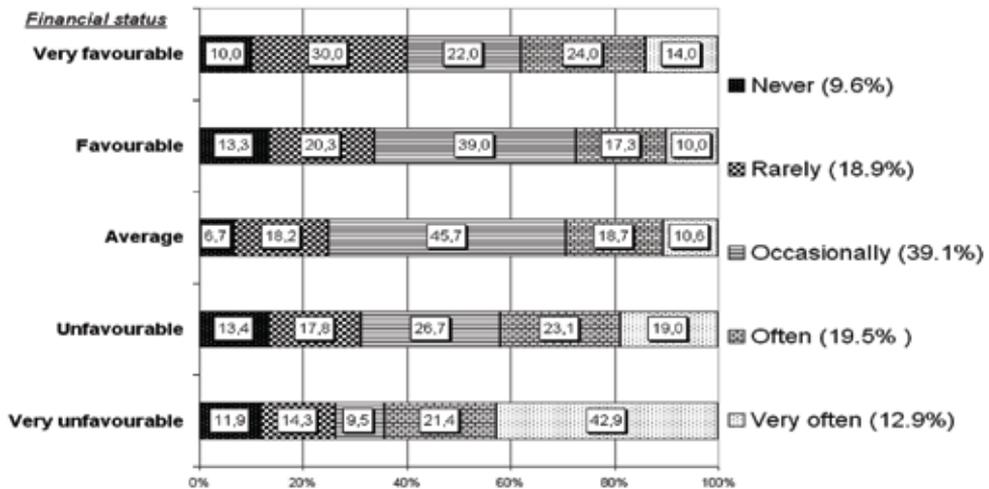
As the representative analysis undertaken by the HCSO aimed mainly to explore the general connections between travel and happiness (SWB), a deeper insight into the roots was attempted in the first half of 2008 by the Geographical Science Institute of HAS and the Kodolányi János University College who sought to obtain more refined results by their own survey of 1,424 people. The students of the Tourism Department of the College carried out the task by means of a non-representative survey with a sample involving persons over 18 years of age in the comfort of their own homes. (See Table 1: “home”). The distribution of the sample of 1,424 is very close in terms of age and gender factors to that provided by the HCSO in their survey of 11,500 respondents (Table 1). The subjective assessment of the financial condition of those surveyed also contains the independent coefficient in the cross-tables created on the basis of this database.

4. Findings

4.1. The recognition of happiness

Most analyses of the quality of life consider it self-evident that people are interested in their own happiness, i.e. they assume that respondents have an exact concept of whether or not they are satisfied with their life. To support the relevance of our research in the field of tourism and quality of life, we asked how frequently respondents thought about their own happiness. 90.4% of those questioned had at least occasionally considered their personal satisfaction with life, whilst 9.6% had never done so (Figure 1). In respect of frequency, it seems that occasional thought is the most typical (39.1%), although frequency varies according to an individual's financial means; a marked deviation from the average can only be seen among people in very unfavourable financial circumstances. Members of this group consider their own level of satisfaction with life quite often, in fact, 42.9% do so at least once per week.

Figure 1: *The frequency of thinking about happiness in relation to income levels (n=1424)*

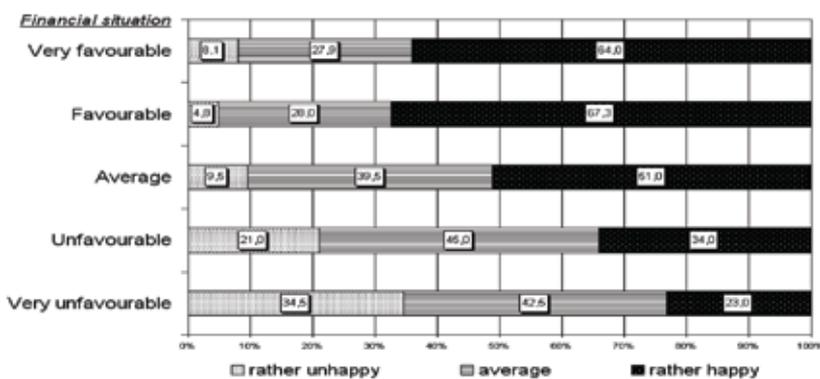


Thinking about happiness is natural human behaviour. Most people, whether rich or poor, assess their satisfaction with life and evaluate their personal destiny using very different criteria. People living in straitened circumstances will probably need to examine themselves more frequently since, in a material society, they have to live with their disadvantage on a daily basis. According to their own scale of values, they will try to compensate by using factors, which may create some balance to their feelings.

4.2. The scale of happiness

Several research projects have affirmed that financial well-being makes only a limited contribution to total happiness, i.e. money alone cannot buy happiness.⁹ A person's wealth, particularly in developed societies, is not in proportion to their happiness-level. Beyond a point specific to the individual, satisfaction with life cannot be improved merely by acquiring material goods. An analysis of happiness in Hungarian society seems to support the results of international research, and an examination of satisfaction with life produces a result somewhat above the median level. On a 1-5 Likert scale (with 1 meaning "totally unhappy" and 5 meaning "totally happy"), the average result was 3.32. People living in poor circumstances show the lowest happiness level (2.80), whilst the richest show the highest (3.93). In order to present the results more systematically, we combined levels 1 and 2, as well as 4 and 5 on the scale, renaming the former "rather unhappy" and the latter "rather happy", while level 3 remains "average". This exercise in compression showed the correlation between financial circumstances and happiness (illustrated by percentages on the "happiness scale" in Figure 2) in a more subtly differentiated way. Between the "living in straitened circumstances" (23%) and "living well" (67.3%) categories, the ratio of those who are quite satisfied with their life gradually grows, whilst, between those "living well" (67.3%) and those "living very well" (64%) some decline can be measured. At the same time, it is a fact that income significantly influences satisfaction with life in Hungarian society and unhappy people can be found in much greater numbers proportionately among the poor (34.5%) than among those who live "well" (4.8%) or even "very well" (8.1%).

Figure 2: The scale of happiness in the Hungarian society (n=11,500)



⁹ L. Becchetti, M. Santoro: "The income-unhappiness paradox: a relational goods/Baumol disease explanation", in: L. Bruni, P. Porta, Eds.: *Handbook on the economics of happiness*, Edward Elgar, Cheltenham, 2007, pp. 239-262.

Several opinion polls (published in the general press rather than in scientific journals) have declared that Hungarians are bad-tempered, pessimists, prone to despair. In spite of this, the Hungarian society recorded a satisfaction level somewhat higher than the median, so we cannot generalise too much about apathy among Hungarians.

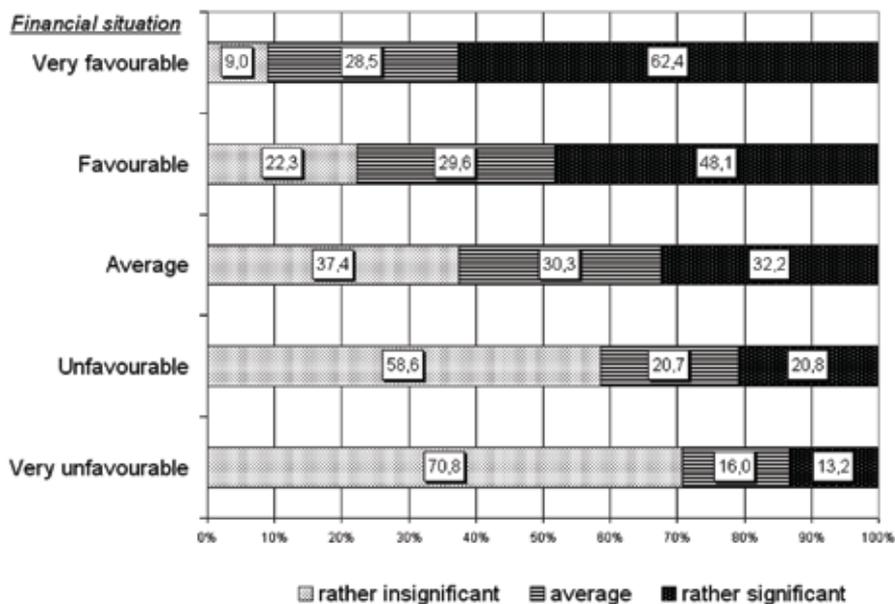
4.3. *The importance of travel*

Travel is an essential element of modern man's leisure activities, and several professions have also developed an increasingly close relationship with tourism. In 2008, UNWTO registered 924 million tourist arrivals, and, according to estimates, the number of domestic tourists could be much greater.¹⁰ Members of Hungarian society are rather active tourists: in 2007, 42.2% of the population undertook a domestic journey of at least two days duration, and the registered number of outward journeys was 1.73 times higher than the population, although 66% were merely day-trips.¹¹

Despite these relatively favourable indicators, the evaluation of the role of travel in life was below expectations. On a 1-5 Likert scale (5 = "Very important" and 1 = "Not important at all"), the Hungarian society's average score in terms of the role of travel in their own life was 2.53. For those who live on a tight budget the figure was 1.88, whilst for those who live well it was 3.63. In order to show the results more systematically, we combined levels 1+2 and 4+5 on the Likert scale, the former being "rather insignificant" and the latter "rather significant". Level 3 remained as "average". On this occasion this scale compression produced self-evaluation of one's financial state (and of the role of travel in life) in a more subtly differentiated way. 70.8% of those living on a tight budget considered the role of travel in their lives as "rather insignificant", whilst 62.4% of those who live very well considered it "rather significant". The significance of travel correlates with an improvement in financial circumstances (Figure 3).

¹⁰ UNWTO: *UNWTO World Tourism Barometer*, Vol. 7, No. 1, UNWTO, Madrid, 2009: http://unwto.org/facts/eng/pdf/barometer/UNWTO_Barom09_1_en_excerpt.pdf

¹¹ A. Próbald: *Jelentés a turizmus 2007. évi teljesítményéről*, Központi Statisztikai Hivatal, Budapest, 2008

Figure 3: The role of travel in the life of Hungarian society (n = 11,500)

Despite the fact that almost half of the population of Hungary are involved in domestic tourism, and that outbound travel is also significant, the role of travel in individuals' life is negligible. On the basis of these results, we can conclude that society does not regard travel as one of its most important life activities, although the importance of travel rises in parallel to the increase of income. (This apparent contradiction might be explained by the fact that statistically measured domestic travel includes VFR (Visiting Friends and Relatives) tourism, which people probably disregard when assessing the role of travel in their lives. Visiting relatives, friends and acquaintances as the prime motivation factor for a domestic journey may be considered as improving one's social relationships rather than as "leisure activity" – which is a tourism category.)

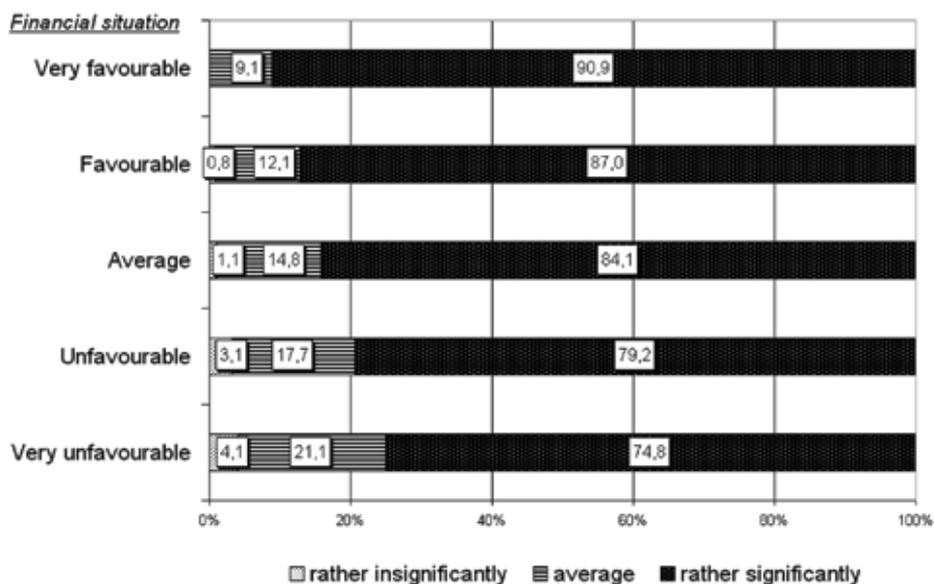
4.4. The function of travel in improving the general well-being

Travelling belongs among the more pleasant activities of life, creating positive images. Considering that one of the most basic elements of tourism is changing one's normal environment, those who participate in tourism satisfy their needs outside their everyday spatial and social environment.¹² As variety is a basic element of human physical and psychological health, the activity of travelling – by adding variety to one's life – can assist considerably in maintaining a balanced

¹² G. Michalkó: *A turizmuselmélet alapjai*. Székesfehérvár, Kodolányi János Főiskola, 2007

condition of the body, i.e. its well-being. Those members of the Hungarian society who participate in tourism assessed the well-being function of travel quite favourably. On a 1-5 Likert-scale (with 5 = “very favourably” and 1 = “very unfavourably”), the average result was 3.99. Replies to this question from those living in very tight financial circumstances produced a mean of 3.87, whilst from those living in very good conditions the mean value was 4.03. To illustrate this more clearly, we once again combined the 1+2 and the 4+5 values of the Likert scale. The new first category was denominated “rather insignificantly” and the latter “rather significantly”, whilst 3 retained its medium-level value. Due to this compression, the financial condition of the individual and the subjective well-being improvement function of travel are reflected more clearly. Regardless of financial condition, travel improves the individual’s subjective well-being, and the wealthier the individual is the more favourable is the impact of participation in tourism on their well-being. 74.8% of those living in very tight circumstances declared travel as a favourable influence on their well-being, whilst, in respect of those living in very good circumstances, this indicator PDI or discretionary income has an important impact on travel decision-making, but the difference in the financial circumstances of tourists influences the subjective well-being function of already completed trips to a very small extent. stood at 90.9% (Figure 4).

Figure 4: *The function of travel in improving well-being in the Hungarian society (n = 11,500)*



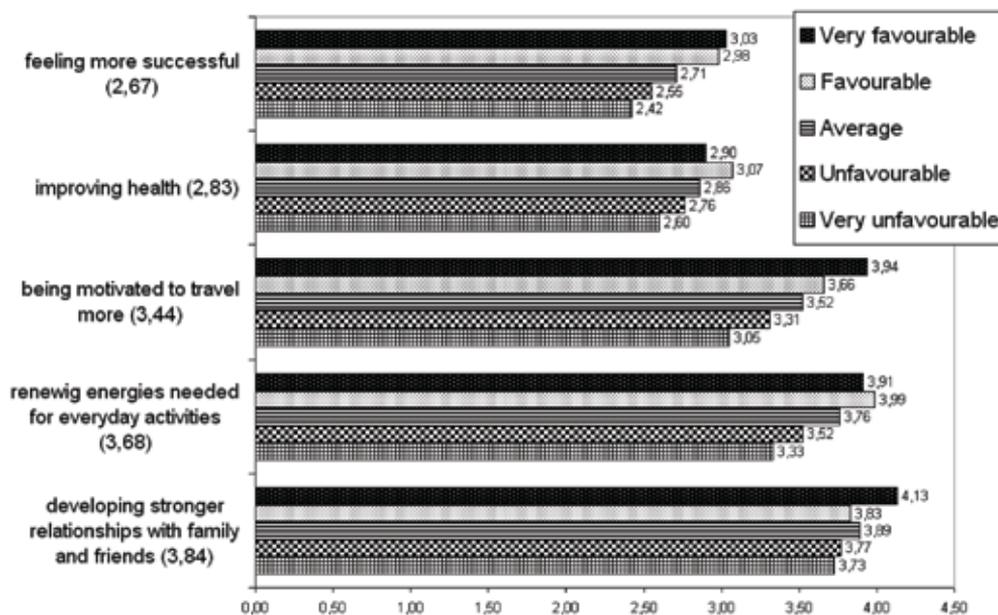
Travel has a favourable impact on the subjective well-being of most respondents, irrespective of their financial conditions. Presumably, therefore, it is neither the destination, nor the services utilised, nor the time spent there, but the involvements in travel itself that produces a more favourable subjective well-being.

4.5. The happiness-increasing function of travel

Travel plays an important role in fulfilling human needs.¹³ Tourist mobility (with the widest range of motivation) influences the perception of satisfaction with life, to the extent to which the individual's expectations are satisfied by tourist services. The successful treatment of an illness through journeying to a health spa, the fulfilment of dreams and desires related to one's career outside one's usual spatial and social environment, a meeting with relatives and friends living far away, or physical, psychological and mental relaxation can all contribute to the subjective quality of life. The travel demand of the Hungarian society essentially serves to maintain relationships with family and friends. On a 1-5 Likert scale (with 5 meaning "very important" and 1 meaning "not important at all"), keeping alive the social connections with those living far away proved the most important factor with a value of 3.84 among the primary given functions of travel. The rejuvenation of the capacity to work (3.68) has 2nd place among the functions fulfilled by travel. As travel is a happiness-generating activity, many would like to experience its pleasures repeatedly and so, after a while, they start to travel just for the sake of a new journey. The Hungarian society accords greater importance to tourist mobility generating more and more travel (3.44) than to improving health (2.83), and travel features the least important among the factors generating an individual's perceived success (2.67).

Financial circumstances generate basic differences in assessing the function of travel. In general we can say that those living under better financial circumstances evaluate all factors more highly than those who live less well. The greatest difference was detected in terms of the function of travel in generating further travel demand: those with very high income rate this at 3.94, whilst those living in very poor financial circumstances recorded 3.05. The smallest difference was shown in terms of social connections to which the wealthiest awarded 4.13 and the poorest 3.73.

¹³ J. Neal, J. Sirgy, M. Uysal: "The Role of Satisfaction with Leisure Travel. Tourism Services and Experience in Satisfaction with Leisure Life and Overall Life", *Journal of Business Research*, Vol. 44, No. 3, 1999, pp. 153-163.

Figure 5: *The function of travel in Hungarian society (n = 11 500)*

Maintaining social connections and meeting the physical, mental and psychological demands of one's daily work are considered the most important functions of travel by the Hungarian society. The perception of success and the improvement of general health are regarded as less important functions. Meriting special attention is the function of travel in stimulating still further tourism demand, since this factor plays an extremely important role in the growth of the tourism industry and, indirectly, in the growth of the economy. This further travel-generating function can be seen most clearly among those living in very good financial circumstances. The function is, presumably, shown by more frequent consumption of (and/or) more expensive services. For the poorer, the possibility of taking part in VFR tourism is the most important function.

5. Travel as a happiness-factor

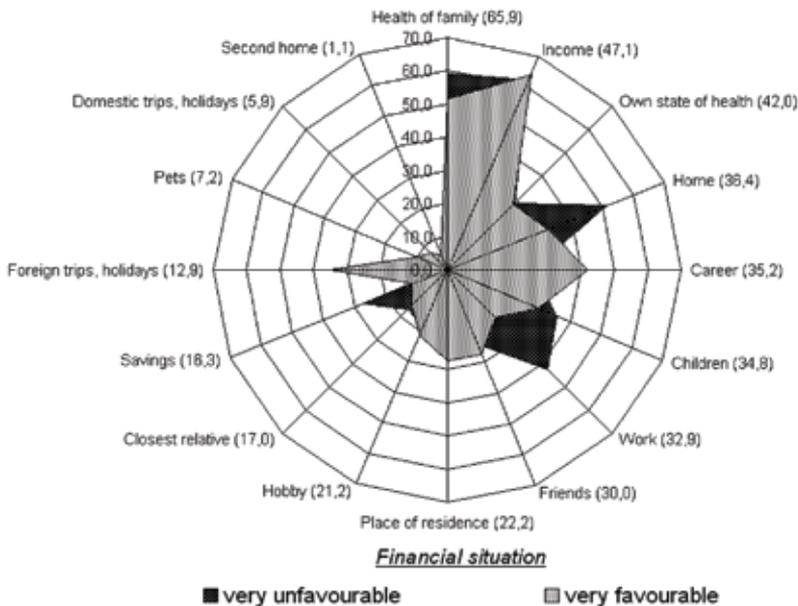
The reference literature dealing with the quality of life is rather economical in respect of the psychological processes of perceived happiness. Most authors consider it self-evident that people think on the basis of different values (Gilbert – Abdullah, 2002).¹⁴

¹⁴ D. Gilbert, J. Abdullah, "A Study of the Impact of the Expectation of a Holiday on an Individual's Sense of Well-being" *Journal of Vacation Marketing*, Vol. 8, no. 4, 2002, pp. 352–361.

Accepting the fact that those questioned are able to consider the factors influencing their subjective quality of life relatively consciously, we started to analyse the weight of travel in relation to potential factors of happiness. Of the 16 primary factors which influence an individual's happiness – expressing the choice of the respondents' in percentage terms –, foreign travel occupies the 13th place and domestic travel the 15th. This may be explained by the high inherent value of fundamental concerns – such as family, health and employment –, to which less vital issues such as travel can hardly compare. Consequently, 65.9% of respondents consider the health of their family first and foremost when they evaluate their own satisfaction with life. This is followed by their income (47.1%) and their own health (42.0%), whilst 20.2% of the respondents mentioned a hobby, 12.9% foreign travel and 5.9% domestic travel among the 5 factors, which they considered when perceiving their own happiness. Regarding the role of travel, essential differences can be noted between the wealthiest and the poorest respondents.

In respect of the importance of domestic travel, only a minimal 3.1% separates those in very bad and those in very good financial circumstances, although, with respect to foreign travel, a substantial difference can be observed: 1.3% of those living with a tight budget, and 35.2% of those who live in very good circumstances mentioned foreign travel as one of the five factors in relation to their own happiness. In the latter case, foreign travel is the fourth most important happiness-generating factor after income (63.7%), the family's state of health (51.4%) and one's career (41.7%).

Figure 6: *The place of travel among happiness-factors, % (n = 1424)*



Although in considering happiness, travel and related memories play a lesser role, health (which is considered the most important value by individuals) has an indirect connection with travel. It is precisely health tourism, which serves to improving the quality of life of those involved. Focusing on relatives and friends is also connected with tourism since keeping contact with them is, in many cases, possible only by travelling. Understanding that most of the poor are excluded from the world of leisure tourism, the role of this factor in searching for happiness in their life is of minor importance. By contrast, the memories of the wealthier of their foreign travel experiences are found among the most important subjective well-being generating factors.

6. Travel as a happiness-generating event

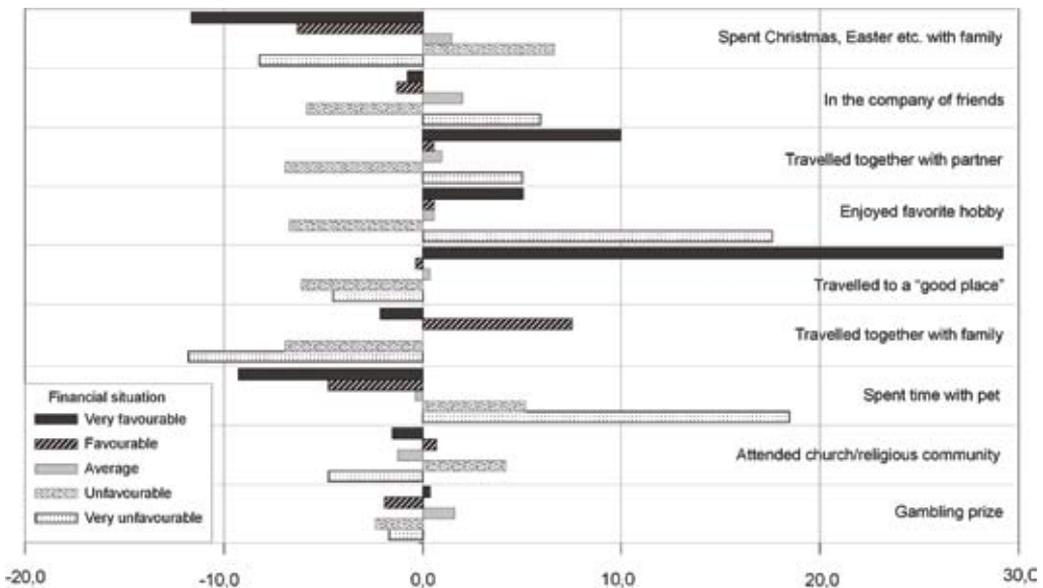
Life events influence the mental condition of an individual to a great extent: we think with pleasure of the positive events, and we can gain strength from them in our more difficult moments, whilst the negative events can even cause psychological illness.¹⁵ The analysis of travel as a life event has largely been neglected in sociology's special literature. Numerous life events are known which have a close connection with travel (e.g., wedding and honeymoon), and several journeys in themselves can be considered as life events (e.g. proposing in a romantic location, a study tour decisive for one's career, the first foreign journey to a country outside the Iron Curtain). At the same time, some life events can be unhesitatingly dubbed negative which may also be connected to travel (serious accident, death), although we suppose that most of the journeys considered as life events generate positive thoughts leading to a perception of happiness. During our research, using a pre-defined list based, respondents had to choose primary life events and more trivial life situations (further: events), the memories of which gave them the most satisfaction (a maximum of 7 from a list of 21) Among the primary events, family holidays spent in the family circle (46.8%) seemed to be the events which generated the most happiness, whilst successful gambling (6.1%) generated the least. Travel occupies a primary place in the order of happiness-generating events. Travelling as a couple (36.1%), travelling to a "nice place" at a faraway destination (30.4%) and travelling together with the family (25.7%) is found among the first 9 happiness-generating factors. To uncover differences in the assessment of groups from different financial backgrounds, we analysed variations from the average in relation to the particular life situations. From the point of view of travel, the biggest difference was recognised in connection with the wealthiest, where travelling to a nice, faraway destination was above the

¹⁵ M. Csíkszentmihályi: *Flow. Az áramlat. A tökéletes élmény pszichológiája*, Akadémiai Kiadó, Budapest, 2001; J. Nagy, *Életesemények vizsgálata Magyarországon. LAM*, Vol. 14, No. 10, 2001, pp. 690-692.

average with 29.2%, whilst travelling as a couple gained 10.0% (Figure 7). It shall be noted though that the happiness-generating role of travel with the family is significantly below average (-11.8% points) for the poorest group.

Events connected to travel are able to generate a perception of happiness, and those involved remind us of them as situations generating the greatest satisfaction of their life. It is particularly travelling as a couple, which generates the most memorable feelings of happiness. One explanation for this can be the fulfilment of young love, a second could be the opportunity for those with families to leave their daily routine, and a third might be that this minimises potential conflict situations. The faraway, nice destinations generate happiness to a greater extent for the wealthy, whilst the poor miss the happy moments of the experience of travelling together with the family.

Figure 7: *The happiness increasing role of life events/life situations (n = 1424)*



7. Conclusions

Thinking about our own happiness, i.e. the subjective assessment of our quality of life, is a common activity. There are very few people who do not compare their life or their circumstances with their own desires. In certain life-situations, or perhaps periodically, most people make their own happiness the subject of serious thought. In this process they form their individual standpoints regarding their overall satisfaction with life based on well-defined happiness factors. Travelling, and especially journeys to domestic destinations made by individuals throughout their lifetime are thought of as less important factors in the percep-

tion of happiness. This is related to the fact that travel itself is not considered to be one of the vital factors of life. However, people are generally conscious of the fact that travel can considerably improve their well-being and plays an important role in satisfying several of their needs. Travel has an essential role in maintaining relationships with relatives, friends, and acquaintances, or in rejuvenating their working capacity. Travel, especially with a partner, is among the most significant and happiness-generating life events or activities and occupies a very prominent place.

An individual's financial circumstances define to a great extent the role of travel in their life, and consequently also influence the function of travel as a happiness-inducing factor. The better one's financial circumstances, the greater the possibility that one is satisfied with life, and, at the same time, that one shows greater willingness to spend their discretionary income on travel. Although the function of travel in terms of improving an individual's well-being is influenced by their financial circumstances, both the poorest and the wealthiest perceive travel as a "feel-good factor". Travelling as a relevant factor of happiness is apparent among those living under very good financial circumstances, but, even in their case, it is particularly travelling abroad, and not domestic mobility, which generates an overall satisfaction with life. Financial circumstances appear as a watershed in relation to life-events connected with travel. The happiness-generating role of the experience of travelling to a distant, attractive place is much more significant among the wealthy, whilst satisfaction related to travelling together with the family can hardly be detected amongst the poor. The role of travel in generating further travel differs greatly according to an individual's financial circumstances. It is mostly among the wealthier where there is the strongest trend for members of the group to undertake more and more journeys. This effect is much less apparent among those living within a very tight budget.

The greatest challenge for researchers dealing with a wide spectrum of happiness-factors is exploring cause-effect relationships. Whilst considering an individual's happiness, health is accorded first place in almost all of the findings of each analysis, but we do not know whether, in reality, the healthiest men are the happiest, or whether health in itself (or somehow symbiotically with other factors) generates happiness. It is the same with tourism. The fact is that travel makes people happier – in other words, those who travel more are happier. This research has contributed to the broadening of knowledge already extant about the quality of life and its relationship to tourism in the sense that successfully showed that financial circumstances effectively influence the perception of happiness generated by travel. Travel makes one happy, but those living in better financial circumstances are happier still.

If the political sphere can recognise the life-quality improving role of travel, and, as a consequence of social tourism initiatives an increasing number of peo-

ple will be able to travel (especially internationally), then the number of citizens satisfied with their life will grow.

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LECTURER VIKTOR PÁL, PhD*
*Department of Social and Economic Geography,
Faculty of Science and Informatics, University of Szeged*
LECTURER LAJOS BOROS, PhD
*Department of Social and Economic Geography,
Faculty of Science and Informatics, University of Szeged*

THE RELATIONSHIP BETWEEN HEALTH POLICY AND SPATIAL JUSTICE – THE CASE OF HUNGARY

Abstract: *The paper deals with the most important connections between the transformations of the Hungarian health care system, the health care policy, and the spatial aspects of the equal opportunities. Based on the content analysis of legal documents we outline the main spatial characteristics of the Hungarian health care reform.*

According to our findings the spatial aspects only appeared in the last stage of the Hungarian health care reform. The duality of efficiency and effectiveness dominates the professional and political debates about the health care delivery system. The main question of these: is it possible to develop a spatial pattern for the health care, which is accessible to everyone but remains possible to be financed?

Keywords: *health care reform, health care system, spatial justice, Hungary*

JEL classification: I 11, I 18

1. Introduction

The health status of the population and the operating of the health care system are two of the most discussed topics in the Hungarian common talk and political debates. Among these the problems and the transformation of the health care system gave rise to the most heated debates. The Hungarian health care delivery system has been constantly changing since the change of regime. This process is often called as a health care reform but there was not a single, sudden change; there were multiple actions, which were often inconsistent with each other.

* E-mail: pal.viktor@geo.u-szeged.hu

The transformation of the health care system is related to various factors but among those the current health care policy is the most important one. The experts of the political parties are on the same opinion about some elements of this policy but there are significant differences among them according to their political ideology. Because of these ideological differences the transformation of the health care system became one of the most debated areas of the political struggles, which have positive and negative effect as well. One of the positive outcomes is that a widespread discourse started regarding the health care system and there is a consensus that the transformation of this system is a must. At the same time the health care became one of the central topics of the electoral campaigns, therefore the professional issues about the health care became political ones, too.

This leads us to the conclusion that the spatial pattern of the health care system – besides the traditions - depends on the current health care policy. Therefore, if we want to study the factors shaping the spatial pattern of the health care system and the spatial aspects of the equal opportunities, we need to analyse the elements of the health care policy.

In this paper we outline the most important connections between the transformations of the Hungarian health care system, the health care policy, and the spatial aspects of the equal opportunities. In the scientific literature there are a lot of articles about the health care reform - but most of these ignore the spatial aspects of the processes.¹ At the same time the spatial problems were the central issues of the transformation of structure in 2006 and generated much controversy. We aim to answer the following questions: which were the most important elements of the transformation of the health care system? How did the health care policy affect the stages of the transformation? How did the health care policy deal with the space in the course of the transformation? How important is the space in the health care policy? How did the transformations in the past years - especially the spatial reorganizations of the hospital treatment regions – influence spatial justice?

2. Data and methods

In the research it was fundamental to identify the appropriate data sources, which reflect the aims of the health policy. These sources are mainly legal documents: regulations and acts. In addition to these, policy drafts, development documents, strategic plans (which are harmonised with the legal acts) and documents or announcements of various health authorities can be used as well.

¹ J. P. Kiss, Zs. Mattányi: "Stroke-ellátó központok és körzeteik optimalizálása a legrövidebb eljutási idő alapjára", *A Magyar Regionális Tudományi Társaság III. Vándorgyűlése*, Sopron, 2005; A. Uzzoli, T. Varga: "A kórházszerkezet átalakítás hatásai a Közép-Magyarországi Régióban", *Comitatus*, 9, 2007, pp. 17-24; A. Uzzoli, T. Varga: "A kórházszerkezet átalakítás hatásai a Közép-Magyarországi Régióban", *Comitatus*, 9, 2007, pp. 17-24.

Because the health policy is formed by various ideologies and principles, the speeches and writings of politicians and the programs of political parties are important resources, too. Finally, the media and the NGOs also influence the processes. Based on these data sources we can describe various aspects of the health policy and can reveal the purposes of those who shape the health policy.

In the research out of the multiple sources we chose to analyse the legal documents related to the medical care. We reviewed the acts and regulations, which aimed to transform the health care delivery system. We made content analysis on these legislative documents to understand which are engaged with the spatial aspects of the health care, and what the contexts of these are.

From the time of the change of regime to September 2008 numerous acts and regulations indicated the stages of the transformation of Hungarian health care.² The first one is from 1991 while the last one is from 2007. 18 acts and 92 regulations were codified in this period. 8 of the acts and 28 of the regulations dealt with the structural transformation of the health care and the details of the transformation process. In lot of cases the spatial aspects appear only in an indirect way in the legislative texts. In 4 acts and 16 regulations the problems related to space and spatial justice appear directly. Reviewing the legislative documents we divided them into thematic groups and valued them in their contexts. Based on a qualitative content analysis we outlined the changes of the health care policy and the spatial consequences of them. We determined the periods of the reform process, too.

3. Theoretical background

As we mentioned in the introduction the “health problem” became a central issue in Hungary because of the negative tendencies of the health status and the problems of the health care system. Nowadays there is a growing interest in social sciences towards these problems and their spatial consequences.³ The paper analyses the processes and their spatial aspects from a geographical point of view. There are several different approaches in geography of health - some of these are related to the medicine (e.g. medico-ecology), or the economy of healthcare (e.g. geography of healthcare), or the intra-discipline discourses of geography (e.g. critical geography of health). Our study uses the critical geography approach, too. This perspective is the part of the transformation of human geography, which took place in the 1990s. This change meant that beside the term “medical geography” the “health geography” also became a widely used expression. This refers to an expansion (and change) in the sub-discipline; the

² net.jogtar.hu

³ M. F. Goodchild, L. Anselin, R. P. Appelbaum, B. H. Harthorn: “Toward spatially integrated social science“, *International Regional Science Review* 23(2), 2000, pp. 139-159.

geography of health represents a more open research practice, which has active interaction with other social sciences.⁴ The previous perspectives had more connection towards medicine and biology. This change was widely debated in “Professional Geographer” where Kearns, R.⁵ urged a move towards the social sciences and the introduction of a so-called “post medical geography”. According to Kearns the cultural geography of well being should be the main research theme of post medical geography. In addition, the geography of health also analyses the healthcare delivery system using integrated interpretation of the whole health problem.

In this process the emergence of the critical thinking was a key step. The critical geography is an approach in human geography, which supports the use of qualitative methods and stands behind the progressive social movements. According to this perspective, the science has to promote the principle of social justice. Critical geography is sensitive to global inequalities and processes, uses interdisciplinary perspectives and emphasises the social relevance of researches.⁶

Since the medical geography traditionally examines inequalities, the spatial justice and solidarity, critical geography is widely used in geographies of health and healthcare as well.

There are several ways in which the critical approach emerges in the analysis of health care. One of these is the notion (and critique) of the differences caused by neo-liberal healthcare policy, which emphasises the importance of the fiscal efficiency. Numerous papers have dealt with the connection between the accessibility of health care services and the spatial pattern of health status.⁷

Spatial justice and accessibility are the two central concepts of this study. In this paper we use the concept of spatial justice as the spatial manifestation of the principle of equal chances. According to the most widely regarded interpretation, equal chances mean that every member of the society has the same chance to attain public and private goods and only the individual’s efforts and performance influence his/her success. This means that everyone has the same

⁴ R. Kearns, G. Moon: “From medical to health geography: novelty, place and theory after a decade of change”, *Progress in Human Geography*, 26, 5, 2002, pp. 605-625.

⁵ R. A. Kearns: “Place and health: towards a reformed medical geography”, *The Professional Geographer*, 45, 1993, pp. 139-147.

⁶ H. Parr: “Medical geography: critical medical and health geography?”, *Progress in Human Geography*, 2, 2004, pp. 246-257; J. Painter: “Critical human geography”, in: R. J. Johnston, D. Gregory, G. Pratt, M. Wats (Eds.): *The dictionary of Human Geography*, Fourth edition, Blackwell, London, 2000, pp. 126-128.

⁷ S. Abouzaid, V. Maio: “The Inequality in Health Care Quality”, *American Journal of Medical Quality*, Vol. 24, 2009, pp. 182-184; G. J. Andrews: “Placing the consumption of private complementary medicine: everyday geographies of older peoples’ use”, *Health & Place* 9, 2003, pp. 337-349; L. Brabyn, P. Beere: “Population access to hospital emergency departments and the impacts of health reform in New Zealand”, *Health Informatics Journal*, Vol. 12, 2006, pp. 227-237; M. Powell: “On the outside looking in: medical geography, medical geographers and access to health care”, *Health & Place*, 1 (1), 1995, pp. 41-50.

rights (equality before law). Other interpretations emphasize the importance of the equality of starting conditions as well.⁸ In our opinion the spatially righteous healthcare provides equal physical accessibility to every member of the society apart from the location of the individual's habitation. We see accessibility as someone's ability to use healthcare services. Physical (e.g. distance, low-quality or inexistent public transit system or road network), personal (e.g. disability, age) and legal factors (e.g. strict determination of treatment districts) all can restrict accessibility.⁹

However the importance of financial aspects is increasing and in lot of cases the principles of efficiency and solidarity are antagonistic in the transformation of healthcare delivery systems. This problem appears in most of the developed countries because of the financial crisis of the modern healthcare systems. In the Western-type welfare states the need for healthcare service increased while these services became more expensive (this is the so-called medical challenge of the financial systems). In addition, these societies have to deal with a demographic crisis as well because of the ageing. As a result of these processes, most of the developed countries started to transform the finance of health care and decrease the treatment capacities. But the rationalization challenges the solidarity and equal chances. Since the regional distribution of capacities were reshaped too, the accessibility to health care services got worse in some areas. Sørensen, J. F. L.¹⁰ for example argues that "rationalization" can cause migration from Danish rural areas. According to Wendt, C.¹¹ the European countries reacted differently to these challenges. Wendt identifies three types of the healthcare systems: (i) health service provision oriented, (ii) universal coverage – controlled access, (iii) low budget – restricted access.

Paton, C.¹² describes the changes of the British healthcare policy from the viewpoint of political economy and argues that the British and European healthcare is at the crossroad of the public and private models. But Kananatu, K.¹³ reveals that the problem of financing and solidarity is present in Asian countries

⁸ Zs. Ferge: *Társadalmi újratermelés és társadalompolitika*, Közgazdasági és Kogi Kiadó, Budapest, 1982

⁹ E. Perlow: "Accessibility: global gateway to health literacy", *Health Promotion Practice*, Vol. 11, 2010, pp. 123-131; N. Yoshida, U. Deichman: "Measurement of Accessibility and Its Applications", *Journal of Infrastructure Development*, Vol. 1, 2009, pp. 1-16.

¹⁰ J. F. L. Sørensen: "The potential migration effect of rural hospital closures: A Danish case study", *Scandinavian Journal of Public Health*, Vol. 36, 2008, pp. 460-466.

¹¹ C. Wendt: "Mapping European healthcare systems: a comparative analysis of financing, service provision and access to healthcare", *Journal of European Social Policy*, 19, 2009, pp. 432-445.

¹² C. Paton: "The state in health: global capitalism, conspiracy, cock-up and competitive change in the NHS", *Public Policy and Administration*, Vol. 16, No. 4, 2001, pp. 61-83.

¹³ K. Kananatu: "Healthcare Financing in Malaysia", *Asia-Pacific Journal of Public Health*, Vol. 14, No. 1, 2002, pp. 23-28.

as well: there is a need for finding an affordable yet quality healthcare system. The post-socialist countries had to deal with similar problems after the collapse of the state socialism.¹⁴

4. The socio-economic background of the health care reform

The transformation of the health care system was motivated by two groups of factors. The first was the worsening health status of the population from the 1970s to the 1990s, the second was the problems regarding to the functioning of health care system.

The epidemiological crisis evolved by the first years of the 1990s decade was characterised by the worsening mortality and morbidity data. The mortality and morbidity indicators were improving after 1945 but after 1966 both groups of indicators showed decline – at first it was a slower process then it became faster. This lasted until the middle of the 1990s when a slight improvement was noticeable.¹⁵ The researchers described the process using mostly the mortality, which is the most common indicator of the health status. This indicator reached its peak in the socialist era between 1981 and 1985. After the change of regime it showed a dramatic increase: in 1993 was the highest mortality rate (14.5 %) in the second half of the 20th Century. This rate is similar to those of the 1930s. After 1993 mortality slightly decreased then was stagnant at a high level while there is a slight improvement during the last years.

Similar processes can be observed regarding life expectancies. The life expectancy at birth of both males and females was constantly growing after the Second World War until 1972. In that year the life expectancy at birth was 72.3 years in the case of women and 66.9 years in the case of men. After that year the male population's life expectancy decreased and reached its nadir with 64.5 years. Because of some improvement in 2003 the women's life expectancy at birth

¹⁴ É. Orosz: "A magyar egészségügy területi egyenlőtlenségei", in: Gy. Enyedi (Ed.): *Társadalmi és Területi egyenlőtlenségek Magyarországon*, Közgazdasági és Jogi Könyvkiadó, Budapest, 1993; É. Orosz: *Félúton vagy tévúton? Egészségügyünk félmúltja és az egészségpolitika alternatívái*, Egészséges Magyarországért Egyesület, Budapest, 2001, p. 323; J. Schlanger: "Healthcare and social care reforms in the Czech Republic", *Transfer: European Review of Labour and Research*, 9, 2003, pp. 137-144.

¹⁵ P. Józán: "A halandóság alapirányzata a 20. században, és az ezredforduló halálozási viszonyai Magyarországon", *Magyar Tudomány*, 4, 2002, pp. 419-439; P. Józán: "Az ipari országok halandóságának néhány jellegzetessége az 1990-es években", in: F. Glatz (Ed.): *Élethelyzet – életminőség, zsákutcák és kiutak. Magyarország az ezredfordulón*, Magyar Tudományos Akadémia Stratégiai Kutatások, Budapest, 2002, pp. 209-242.

was 76.5 years while the men's was 68.3 years. However, we must notice that the latter value is similar to the average of the 1960s.¹⁶

According to these indicators the situation of Hungary was unfavourable compared to the developed countries or to the countries at similar economic development level (e.g. other post-socialist countries) albeit the difference was inferior in the 1960s. Despite of the improving health status of the Hungarian population in the 1990s the gap between the developed countries and Hungary widened.¹⁷ Hungary has one of the less favourable positions among the European countries regarding the life expectancy at birth. While in 1970 the Hungarian males could expect similar length of life than the Austrian ones, in 2000 the Austrians' life expectancy was 8.3 years higher. Noticeably, despite that the Hungarian females' life expectancy constantly grew it is still lower than women's living in countries with similar economic development level.

Beyond the unfavourable macro-indicators there are structural factors that imply deeper problems. The ageing population could cause the high mortality but the increase of mortality was the highest among the middle aged (40-49 years old) men. It is alarming because of the different trends of the two genders; the difference in the life expectancy at birth between men and women is growing (the worst year was 1994: the difference was 9.4 years!¹⁸). The structure of the causes of death is quite similar in Hungary than in the developed countries: this means that the chronic diseases are dominant among the causes of deaths. The leading causes of death are cardiovascular diseases followed by oncological diseases. A significant raise can be observed regarding these two types of causes of death in the younger age groups and Hungary is one of the most affected countries regarding some of the diseases.¹⁹

It is important from the viewpoint of the geography of health that there are significant spatial differences in the worsening of the health status. The earlier demographic analyses based mainly on the mortality statistics showed differences at regional level and by the size and type of settlements.

Some of the problems of the Hungarian health system were already known before the change of regime but the search for solution (the health care reform) accelerated only after 1989. This process was full of contradictions. Therefore, the problems of present time descend from the heritage of the socialist era and the unwanted consequences of the reform. The inherited problems are wide-ranging

¹⁶ K. Kulcsár, J. Bayer (Eds.): *Társadalom, politika, jogrend*, Magyar Tudománytár, MTA Társadalomkutató Központ – Kossuth Könyvkiadó, Budapest, 2003, pp. 178-163.

¹⁷ É. Orosz: "Félúton vagy tévúton? Egészségügyünk félmúltja és az egészségpolitika alternatívái", *Egészséges Magyarországért Egyesület*, Budapest, 2001, p. 323.

¹⁸ There is difference between the males' and females' life expectancy at birth but it is only a few years.

¹⁹ P. Józsan: *A halandóság földrajzi különbségei Magyarországon*, CSO, Budapest, 2001, p. 119.

and this article does not aim to give a detailed overview of them. Instead, we shortly introduce the most important factors. One of them is the above mentioned health status of the population which was constant challenge to the governments and none of them could solve the problem.

The inherited structural and efficiency problems of the health care system form a separate group of factors. A wide gap evolved between the healthcare needs of the society and the economic sustainability. The utilization of the resources was not efficient which caused surplus capacities especially in the hospital treatment. Furthermore, the success of the system was measured by indicators, which showed the quantitative improvement of the resources (e.g. increasing hospital capacity). The performance and the revenue of the medical institutions had no relation; therefore the economic efficiency lost its importance and a wasting system evolved. The guidance of the system was centralised and it reacted slowly to the challenges.

The dualities and contradictions in the health care system are post-socialist heritages, too. For example, despite the excessive capacities the operational costs were at low level and they were decreased. The doctors were underpaid, the condition of the buildings and accessories declined and there were no funds for renovation. The other form of the duality was the emergence of the parasolventia, which meant the evolvement of a semi-legal private sector within the state-owned health care.

The symptoms of the crisis were highlighted in articles by demographers, sociologists and economists in the 1980s.²⁰ Partly as a result of these articles the health policy tried to react to the problems but the changing economic environment made the situation more complicated. The economic output of Hungary dropped significantly after the change of regimes and the state budget had less money to finance the health care system, which was overgrown. The revenues of the National Health Insurance Fund were low while the expenses increased. Because of the liberalisation of the pharmaceutical market the price of the medicines rose. As a consequence the health care system became seriously under funded.

In some cases the actions of the health care reform led to undesired results (e.g. the intention to reduce the role of the hospital-centred medicine strengthened the hospital centrality because of the funding reform) or although the measure wanted to influence one element it, changed the whole system. Many times the conflicting interests of the political sphere and the government produced contradicting actions. There were disagreements about the adequate models as well (e.g. solidarity in “quasi market” conditions, or health care under market conditions, or maintaining the existing system). The government often emphasised the improvement of the economic conditions of the health care as the aim of the reforms, instead of the improvement of the population’s health status.

²⁰ J. Szalai: *Az egészségügy betegségei*, Közgazdasági és Jogi Könyvkiadó, Budapest, 1986

There were regional differences in the health care as well. The researchers revealed some dimensions of these in the 1980s.²¹ These disparities remained partly present in the 1990s but there were some changes as well. According to the analyses there are disparities in the utilization of the public expense, in the use of the medical services and in the distribution of the resources. In the 1990s the regional disparities of the resource-distribution showed further growth instead of equalisation.²²

To sum up, it can be said that a bad health status is accompanied by a health care system, which has complex problems and cannot fulfil its purpose. Hungary could not use the economic growth of the previous years to improve the health status therefore evolved an “economy-health discrepancy”.

The above-mentioned processes show that the health status and the problems of the health care system became ones of the most important social problems in Hungary at the beginning of the 21st Century.

5. Results: the health care reform and its spatial aspects

Although the need of health care reform was obvious at the end of 1980s, it started only after the change of regime. Clashing opinions are articulated in the professional literature about the reforms. Some researches revealed the contradictions of the transformation²³ or analysed the technical details of the process making recommendations.²⁴ Other works reviewed the reforms’ effect on the health care system²⁵, gave international outlook²⁶, summarised the character-

²¹ É. Orosz: “Az egészségügyi infrastruktúra területi különbségeinek vizsgálata”, MTA RKK Eredményei 1. Pécs, 1985; É. Orosz: “Az egészségügy területi egyenlőtlenségei – Az újraértelmezés szükségességéről”, *Tér és Társadalom*, 2, 1989, pp. 3-19.

²² É. Orosz, K. Kovács, Zs. Mogorósy: “Az egészségügy területi egyenlőtlenségei a 90-es évtizedben”, ELTE Szociológiai és Szociálpolitikai Intézet Egészség-gazdaságtani Központ, Budapest, 2001, pp. 47-93; CSO: “A századvég halandóságának földrajzi különbségei Magyarországon”, CSO, Budapest, 2001, p. 125.

²³ É. Orosz: *Félúton vagy tévúton? Egészségügyünk félmúltja és az egészségpolitika alternatívái*, Egészséges Magyarországért Egyesület, Budapest, 2001, p. 323; E. Bugovics: “Az egészségügyi reform esztétikájáról”, *Egészségügyi Gazdasági Szemle* 1, 2008, pp. 3-11.

²⁴ R. Fülöp: “Pazarlás vagy pénzkivonás?”, *Egészségügyi Gazdasági Szemle* 5-6, 2007, pp. 22-25; G.. Simon Kis: “Egészségügyi reform” *Egészségügyi Gazdasági Szemle*, 1, 2008, pp. 2-14.

²⁵ Zs. Füzesi, Cs. Busa, L. Tistyán: “Új, innovatív egészségügyi programok fogadtatása a kistérségekben”, *Egészségügyi Gazdasági Szemle* 3, 2007, pp. 22-27; A. Uzzoli: “A magyar egészségügyi ellátórendszer strukturális átalakításának területi vonatkozásai”, *Tér és Társadalom*, 3, 2007, pp. 103-115.

²⁶ C. Karner: “Nemzetközi egészségügyi finanszírozási modellek és az állam szerepvállalása”, *Egészségügyi Gazdasági Szemle* 2, 2008, pp. 3-15.

istics of Hungarian health policy²⁷ and made some radically new suggestions about the reform and its elements.²⁸

There were several stages of the health care reform. During the period of the antecedents of the reform (1988-89) the crisis of the system was identified. The government decided before the change of regime already that a change to the social security funding is needed and it is necessary to form the appropriate institutions to control them. It became possible to start private entrepreneurship in the health care, too. But almost everything else remained unchanged. Between 1990 and 1994 in the “Action Plan” of the Welfare Ministry the previous ideas remained dominant.²⁹ This Plan aimed to retain the principles of accessibility and equal chances with a health care system financed by social security. In this system the Ministry created a special “internal” market situation and growing competition, therefore enhanced the efficiency. In 1992 the system of family doctors was introduced, while a year later the performance-based financing was inaugurated and the Social Security Councils were founded. The aim of creating of Councils was to decrease the role of the state but soon after their foundation a change of conceptions took place. One of the most heated discussions was about the possibilities of privatization, which remained an open question. In sum, the health care policy was not among the priorities of the social policy. Between 1994 and 1998 the transformation of health care was still not an outstanding topic among the government policies and the health care policy had less importance than before. The most important goal was to decrease the hospital treatment capacity. In 1997 the Health Care Act was codified and the Regional Modernization Program was started. The latter was stopped in 1998 and the Social Security Councils were dismissed. Plans were made to change the funding of health care. In 2000 a so-called “praxis privatisation” took place in the basic health care. As a continuation of the previous debates the politicians started to engage with the problems of health care, and the parties emphasised these problems in their election campaigns as well. But the discussions were simplified into dualities: private or state owned health care, market or redistribution, efficient or effective health care, profit or solidarity etc. The policy tried to rationalise the health care expenses by introducing new bureaucratic control mechanisms e.g. the introduction of the financial contribution of the patient or performance limit in the hospital treatment. The culmination of these processes was the 2006/CXXXII Act about the development of the healthcare delivery system, which inducted a

²⁷ P. Balázs: “Biztosítási reform, jövőkép nélkül”, *Egészségügyi Gazdasági Szemle* 2, 2008, pp. 20-24; Zs. Németh: “Egészség minden szakpolitikában”, *Egészségügyi Gazdasági Szemle*, 5-6, 2007, pp. 40-43.

²⁸ E. Bugovics, Z. Bugovics: “Javaslat a magyarországi kórházak struktúra- és ágyszámváltozásához”, *Egészségügyi Gazdasági Szemle* 3, 2007, pp. 8-15.

²⁹ É. Orosz: “Egészség és egészségügy az ezredfordulón”, in: K. Kulcsár, J. Bayer eds.: *Társadalom, politika, jogrend. Magyar Tudománytár 4*. MTA Társadalomkutató Központ – Kossuth Kiadó, Budapest, 2003, pp. 177-209.

heated debate in the political and public sphere as well. By 2006 the health care became the most discussed social policy issue.

Analysing the stages of the process it is clear that the health care policy conceptions were not coherent and none of the action packages were comprehensive enough. The spatial relations of the health care policy show contradictions. Firstly the spatial aspects often appear in the legislation as problems, which have to be solved in relation to the equal chances. On the other hand these aspects often emerge as a tool for the rational (economical) management – the two are sometimes contradicting.

Nevertheless, the spatial issues came up related to different topics and several elements of the transformation had spatial consequences. The most important ones were the privatisation of pharmacies and praxes, the introduction of the system of family doctors, the free choice of doctors, centralised distribution of the health supply capacities, the introduction of the performance-based accounts, reorganisation of the ambulance service, decrease of hospital capacities, regulation of waiting lists, introduction of the Regional Healthcare Councils, and the systemic changes regarding the public health and prevention.

Reviewing the related legislative texts we can conclude that most of the spatial changes took place in the last period of the reform as the consequences of the 2006/CXXXII Act. The Act almost entirely deals with the rationalisation of the health supply and the hospital treatment capacities – in particular with their spatial aspects. The act and the regulations related to it created a new spatial pattern of the hospital treatment capacities. The reason behind this was that in certain areas there were too many hospitals, while in other regions the healthcare service was missing or not appropriate. 25% of the so-called “active capacities” were unutilised while the quantity of the so-called “treatment capacities” did not cover the needs.

The act used the principle of progressive supply and located the complicated medical procedures in so-called hub hospitals. These institutions were accessible within an hour (this means 50-55 kilometres of distance) from most of the settlements³⁰. Besides these hubs a network of smaller hospitals was formed with basic health supply. These had 30 km radius catchments area. The rules of the regional provision obligation of the institutions were tightened at the same time, which raised questions in relation to the free choice of doctors and equal chances.

The treatment capacities of hubs were determined centrally while the newly established Regional Healthcare Councils (RHC) determined the capacities of the smaller hospitals. However, the RHCs did not want to make the decision, therefore the Secretary of Health made that.³¹ As a consequence, the organisational structure of the hospital treatment transformed completely.

³⁰ The first version of the bill define 31 hub hospitals but later it was completed with 8 other institutions and in the final version 39 hub hospitals were determined.

³¹ S. Joób, M. Zsolt: “Ellátják a kórházak baját”, Index 2006, December 19th: <http://index.hu/politika/belfold/korhaz6967/>, accessed: December 15th, 2009

The government closed several institutions e.g. the National Psychiatric and Neurological Institution or the Schöpf-Merei hospital. In twelve hospitals the therapeutic departments were closed and they were transformed into nursing departments for the elder people and those with chronic illnesses. After these measures new supply and hospitalisation districts were introduced as well, to reduce the flow of the patients. The new structure transformed the capacities of every region and institution. The active capacity decreased from 60 058 to 44 215 while the treatment capacity increased from 20 124 to 27 169. However, there were regional disparities in this process; the region of Central Hungary suffered the biggest loss.

The intention to keep the hospitals mobilised the civil society and the local governments who organised pro-hospital demonstrations together. The towns and cities used the hospitals as an indicator of their success. Some organisations took legal actions against the act and sued that at the Constitutional Court of Hungary. In September 2008 the Constitutional Court invalidated some sections of the act but the decision did not influence the established spatial pattern.

The protests and the inner dilemmas of the health care policy pushed the further measures towards the enhancing of the spatial justice. These measures also showed that the space, distance and accessibility all became key elements in the health care policy. For example, a software was published which allows the user to calculate the accessibility of the health care institutions. There are attempts to develop the patient treatment in the less favourable micro-regions and to increase the number of the ambulance stations by using the funds of the European Union³².

The content of the act and its reception show that the health care policy has a serious moral and theoretical dilemma. The actual health care financing is based on the principles of solidarity and equal chances. Therefore the closure of certain medical institutions caused worse accessibility for a lot of people. The health care system – although its reformers named it as liberalisation - moved towards the Beveridge model. The bureaucratic control grew in the system and the institutions had to be more economical. Besides these, the public opinion interpreted the efforts of the health policy as violence against equal opportunities and spatial accessibility and as the limitation of the free choice of doctors.

6. Conclusions

Summarising the above-presented processes we can conclude that spatial aspects only appeared in the last stage of the Hungarian health care reform. In this stage the main goal was to develop a more efficient system with strong

³² At present time in 29 micro regions there is not patient treatment and in further 18 micro regions it is not appropriate. Nine of these micro regions have not got an ambulance station.

bureaucratic control through the regionally differentiated decrease of the hospital treatment capacities. This effort broke down the previous spatial pattern of the health care and jeopardised the spatial justice, which was an earlier declared principle of the health policy. Partly because of the contradiction, partly because of the civil protests and strong lobbying the decision makers lessened the decrease of the capacities and tried to determine the optimal size of the health provision regions. Therefore, the spatial structure of the hospitals can be seen as a compromise between the two conflicting but essential principles of the health policy: the economic efficiency and the equal chances.

These efforts generated intense debates and conflicts and as a result of the controversies the ideas regarding the decrease of the capacities failed. This leads us to the conclusion that the politicians may assume that the majority of the society would not support such conceptions which puts the accessibility and the spatial justice beyond the economic rationality.

Essentially the above-mentioned discussions are about the problem of accommodating the accessible with the financially sustainable health care. Is it possible to develop a spatial pattern for the health care, which is accessible to everyone but remains possible to be financed?

Based on this debate the research can be extended to multiple directions. Wider range of documents can be analysed, for example, interviews and speeches of politicians or the programs of the political parties. How do the transformations influence the health care opportunities and the health status of Hungarians? Regarding the latter the situation in Hungary is worse than in Western Europe and there are huge regional differences within the country.

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GABRIELLA LUDESCHER, PHD, RESEARCH FELLOW*
*Department of Political Geography and Regional Development,
Institute of Geography, University of Pécs*

THE SOCIAL ENVIRONMENT AND THE INDIVIDUAL ABILITIES OF THE COMPANIES

Abstract: *The current study would like to introduce the importance of the social and individual factors based on the surveys conducted. The author studies the individual characteristics in the frame of a same, but at the same time a bit different social environment. The empirical study was conducted between 2006 and 2009 in three villages of Baranya County (Bükkösd, Himesháza and Szalánta). During the choice of the entrepreneurs the author tried to not to choose from the smallest self-employer entrepreneurs. The number of the agricultural, service provider, machine mechanist entrepreneurs is 24 (10 in Bükkösd, and 7 in Szalánta, 7 in Himesháza), and more companies belong to these entrepreneurs (even five to one entrepreneur). These companies employ altogether minimum 205 persons. 1 The family members have important role in the activities of the company with their regular or occasional labour, even in that case if they are not indicated as employees. That is why the number of the employed people is increasing, and the author has only estimations for the number of these people. Ltd-s, limited partnerships and share companies were also involved in the study.*

Keywords: *entrepreneur, social factors, culture, individual conditions, type of activity, habit, motivation*

JEL classification: M 13, M 14

1. Introduction

The importance of the individual, social and cultural abilities in the company formation are usually bagatelled. The scientists examining the cultural factors of the companies JOSEPH SCHUMPETER (1980), PETER KILBY (1979), PETER

* E-mail: ludescherg@yahoo.com

¹ The biggest employer of Szalánta employed 100 workers in March of 2009. The number of employees was 10-20 persons more in the past years.

MORRIS és ANTHONY SOMERSET (1971), BRIGITTE BERGER (1998), KUCZI TIBOR (2000) consider important the social climate which helps the company to come into being. According to ALEXANDER GERSCHENKRON (1966) it is the task of the élite to create the favourable atmosphere. TALCOTT PARSONS és NEIL SEMELSER (1956), FRED RIGGS (1964), EVERETT HAGEN (1968) and many others emphasise the importance of the values and norms in the creation of the society, which legitimates the companies. Within similar social conditions suitable for company formation, not everyone becomes an entrepreneur. That is why it is important to ask whether who will be an entrepreneur. The personal abilities have important role in the process of being an entrepreneur. While a given person will be an all-time employee, the other one will be an entrepreneur. Everyone has its own properties, there are people who are always on the move, desire the challenges, risk takers, but there are people who set a high value on safety, calmness. According to JOSEPH SCHUMPETER (1982), the psychological characteristics are very important, not only in the company formation, but also in the operation of the companies. The extent of the company motivation depends on the greed of power, the desire to rule, and the ambition of the entrepreneur.

2. The social environment of the companies

There are similarities in the location of the three villages, and the same time there are also determinant differences. Bükkösd can be accessed both on railway and motorway. It is 20km far from Pécs, the deficiencies of its infrastructure were detailed in the study several times: the village does not have pipeline gas supply and does not have any sewer system. There are 76 registered companies in the village (KSH 2008). Himesháza has only roadway access, it is 40 km far from Pécs, its infrastructural properties are convenient, the number of its entrepreneurs is 112 (KSH 2008). From the point of location, Szalánta has the best properties: it is 18 km far from the county center (it is next to the road which connects Harkány with Pécs), but on the other hand it is not advantageous from the point of the infrastructure, because the village has no sewer system. The number of the companies is 109 (KSH 2008).

The author believes that within unfavourable local conditions no company formation happens and the local society will be stagnant. If the economic, infrastructural environment becomes favourable, the entrepreneur mood will become lively. But it is not enough for the change in itself. It is necessary that the institution system of the given society and also the thinking of the people have to be changed.

The Hungarian entrepreneurs suffered several economic and social broke and the effects of these brokes can be experienced in the operation of the current entrepreneurs. The nationalization process which has started in 1946, has

ended to 1949 (with the nationalization of all companies which has more than 10 employees), and involved all the producing and service provider companies.²

“In the beginning of the 50s, with the back forcing of the retail trade and small scale industries, with their organisation into industrial co-operative entities, the nationalization of the producing equipments – except in the agricultural sector - happened.³

Because of the 1948-1949 the high quantity deliveries to the state and the tax obligations (and from 1949 the liquidation of the kulak companies) in 1948-1949, the quantity of lands offered to the state has increased. In 1949 it exceeded the 300,000 hectares, and till the middle of the 50s it exceeded the 900,000 – 950,000 hectares.

“With the reorganisation of the agricultural big farms, the smallholders practically disappeared... The household cooperatives and pay lands (state farms) ensured by the big farms, gave opportunities to produce in small scale. The officially declared goal of this thing is to ensure the family needs in the very bad country food supply situation, and also the creation of the conditions of the additional income which were required because of the low cooperative salaries” .⁴

In the beginning of the 1960s the state has not subsidied, but at the same time has also not restricted the small scale producing, which was replaced by the small-scale factory producing in the second half of the 60s. Due to this fact the so-called household integration system was created.

Since in the 1970s the chemicalization and the mechanized plant cultivation became usual, it was not possible to employ a given part of the employees. That is why they solved the employment with the place outs to the households. In the 1980s the enlargement of the small scale producing was the solution to survive the central withdrawal and salary limitations. Similarly to the cultivation, the stock farming has also been hired and entrepreneurs ran them. This solution led from the part time employment to the full time entrepreneur type employment.⁵

The financial status strenghtening of the agricultural cooperatives made for the country people possible to have a kind of “civilisatoric” development. In the 80s the bigger floored and higher comfort rated real assets has started to appear.

Within the country people the increase in the living standards could be experienced, which can also be seen in the real estate stock.

At the end of the 80s, a new turning point has occured. The decrease of the Eastern agricultural export and the decrease of the related subsidies has made a

² A. BUDAY-SÁNTHA: *Policy of agricoulous-policy of region*, Dialóg Campus Kiadó, Budapest-Pécs, 2001

³ A. BUDAY-SÁNTHA, *ibidem*, p. 75.

⁴ A. BUDAY-SÁNTHA, *ibidem*, p. 91.

⁵ *Ibidem*

huge income loss in the agricultural sector and because of it, the income of the agricultural workers has also dropped.

After 1989 the economic status of Hungary has changed radically. The main load of the general and national-economic crisis has to be worn by the village-country people. The job loss in the industry and the construction sector has also made problems for the village people. On the one hand the “more costly” commuters have been fired so the employers got rid of the travelling costs. On the other hand the decrease of the orders of the urban companies made the entrepreneurs to close the country, village branches. Finally, the decrease of the number of the orders has involved also the industrial, constructional and other complementary activities of the agricultural companies.⁶

In ILLÉS IVÁN'S (1995) opinion the real proletarianisation has begun after the collapse of the “proletarian state”, the progress of the lower middle class has broken at that time. “On the one hand they lost their urban jobs, and on the other hand due to the agricultural price level and the disintegrated or “over-mafiated” stockpile system the possibility of the earnings from the agricultural sector has dropped, the majority of the people has drawn back to the self-consumption, and subsistence farming. Both pillar – in which the former rise in to the middle class status was based - has lost, or at least threatened”.⁷

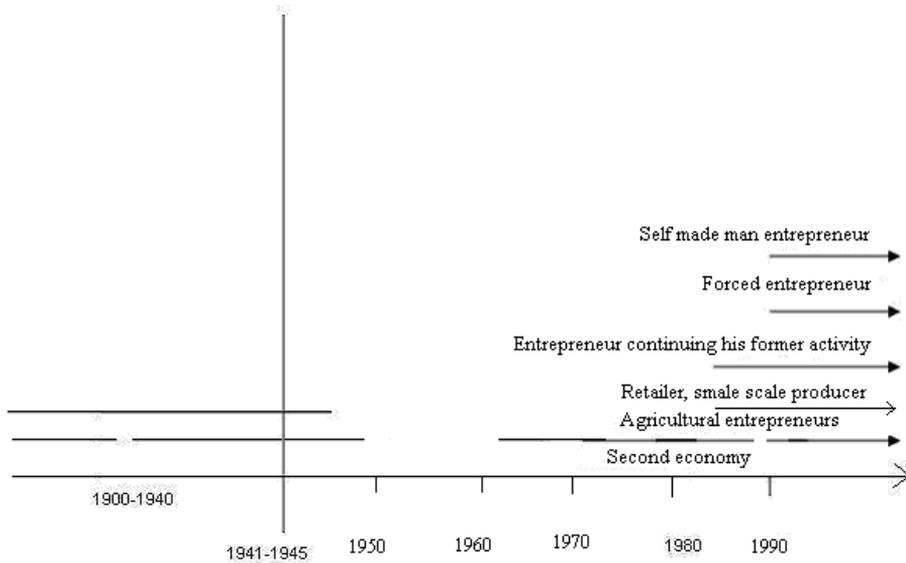
The company formations have generally started after 1989, mainly from the second economy, in the agricultural industry, small-scale commerce and small-scale industry. Additionally, the former “swindlers” and the individuals, with strong abilities opened to be an entrepreneur, left their jobs with the hope to have a better income position and have a bigger independence in their new companies. The type of their companies fitted to their qualifications and former experiences. Those entrepreneurs, who founded “companies” in that time, took a little risk, and done small investment.

In the middle of the 90s, due to the pressure, a new type of entrepreneur appeared. These entrepreneurs have lost their jobs, or the commuter conditions to their workplace have made them impossible to work there. To be able to be self-sustainers, this social class has become self-employed. The investment to the company in these cases are minimal, the majority considers the operation of the company as a temporary solution. However we can find examples that these companies has exceed the operational expectations of the first few days.

In the second half of the 90s the “self made man” entrepreneurs appear. The members of this group have strong inner motivation and they founded their companies to exploit the social possibilities (Fig. 1).

⁶ I. ILLÉS: “Policy of village-policy of agricolous”, Kovács Teréz (Edit.): Third Village Conference from agriculture to rural development, MTA Regionális Kutatások Központja, Pécs, 1995, p. 55.

⁷ Ibidem.

Figure 1: *The social transition of the companies*

Source: Own compilation

The particular social-economic composition of three villages studied appoints to different entrepreneurial characteristics.

Additionally to the past experiences in the company formation the recipientness and the helpfulness of the society is also important. Two social conditions are needed for a company to come into being and operate successfully. On the first hand: the world blended with family relations, friendships and neighbourhoods has not allowed relating indifferently to the entrepreneur. On the other hand if a company wants to be successful, it has to achieve that its environment has to be cooperative in the formation and operation of the “company” (KUCZI 2000).

To fulfill the two requirements, it is necessary that the individuals of the local society have to be connected or at least different interactions have to be done. The culture and the territorial proximity can motivate it. Based on the author’s empirical study it can be observed that the society of Bükkösd has not got such a strong culture or socially lived past which could promote the forming of strong, non-forced companies. Additionally, the local authority does not motivate and help the company formations, and their strenghtening. When determining the village industry tax, the local authority decided to impose a tax rate of 1.7 % based on the net income, or HUF 1000/day daily lump sum. It is not true about the other village studied, Himesháza. The authority and society of Himesháza gives optimal conditions to the forming and operating of the companies. Among

the inhabitants close interactions can be observed in spite of the fact that everyone lives their everyday tightly, and based on the narratives the people have less time to the other people. The operation of smaller communities (folk dance group, sport association, choir etc) helps the contact between the individuals and it gives opportunities to express different questions both from the side of the entrepreneur and the users. The members of the family, the relatives have close relationships with each other; it is not rare that more generations live next to each other.⁸ It is important from more aspects: for example the families, relatives help each other both on the level of ideas and support in the company formation, and if necessary, with their labour or financial resources. During the study the author could observe such an example in which the entrepreneur determined the range of functions that it was built on other company's producing profile.

The biggest support from the local authority to the entrepreneurs that there is no industry tax in the village.⁹

Himesháza has encouraging social-cultural environment, which has a positive effect on the forming and development of companies irrespectively from their industry type.

In case of Szalánta the relation of the local authority to the entrepreneurs can not be considered as supportive: the authority imposed the possible highest industry tax on the local entrepreneurs, which is 2% of the net yearly income, or HUF 1500/day on daily lump sum. The majority of the entrepreneurs consider it as a high rate, and complaints that the local authority does not always take into consideration the interests of the local entrepreneurs. For example in a local authority investment not always the local entrepreneurs are invited to participate.

The working culture of the local society of Szalánta (love of work, moral to work) can produce an entrepreneurial class, but it does not get proper support to operate the companies.

To summarise: during the study of the three villages the author concluded that the forming and operation of the companies are in connection with the special social-cultural environment of the local society.

3. Individual abilities of the entrepreneurs

The entrepreneurs have such individual abilities which strengthen the conditions of the company formation and determine the success of their operation. The determining factors of the individual abilities of the entrepreneurs have been observed by several literature authors.¹⁰

⁸ The number of the divorced or separately living couples is low.

⁹ The local authority has considered to introduce an industry tax in the Autumn of 2008.

¹⁰ J. A. SCHUMPETER: "The Entrepreneur", in.: Lengyel Gy. (edit.): *The Entrepreneur. Szociológiai Füzetek*, 28, ELTE Szociológiai Intézet és Továbbképző központ, Budapest,

These conditions have been explained and defined differently by each author. JOSEPH SCHUMPETER¹¹ stated that the characteristics of the entrepreneurs are in their personality, ethnics and social position. According to Max Weber's¹² explanation the moral is in the background of the economic behaviour.

According to the author it can be expressed based on the individual properties and abilities: who will be an entrepreneur and will he be successful? In spite of this, there is no such personal test, which could help to forecast it. The current study considers determinant, in the forming and activity of the entrepreneurial class, the motivation, the habit, and the work moral and the organisation, direction of the social capital and the relation to their own future.

3.1. Entrepreneurial activity based on the habit

WEBER¹³ in "Protestant Ethic and the Spirit of Capitalism" draw the attention to the fact that the moral is in the background of the economical behaviour. WEBER created types of activity; for this typology we can find references even in the current sociology theoretical literature. WEBER differentiate four kind of activity type: goalrational, value racional, impulsive or emotional and traditional.

It is reasonable from the point of the study to add PARSONS'S (1951) pattern variables. The pattern variables stand in the center of Parson's activity theory and important reference points of the system theory as well. The pattern variables partly refer to the attitude of the active, and partly refer that for the active which side, methods of the existents are important. Based on this, the active always has to choose: (1) from the emotional or emotionally indifferent, (2) from the specific or general (3) from the quality or performance base (4) and from the scattered or defined orientation, point of view.¹⁴

PARSONS worked out the pattern variables from the differentiation of the concept of "community" and "society" of TÖNNIES. Based on Parson's view the active has to analyse the components of the situation not only from the point of view of TÖNNIES, but also based on the above mentioned four point of view.

According to FARKAS ZOLTÁN'S¹⁵ theory the components of the satisfaction of the needs describe the views represented by the pattern variables, so there is

1982, pp. 29-58; M. WEBER: *Studies*, Osiris Kiadó, Budapest, 1998; T. KUCZI: *Small business and social environment*, Replika Könyvek - Mediator Bt. Budapest, 2000; B. BERGER: *The Culture of Modern Entrepreneurship*. -Replika 29 (March), 1998, 2000, pp. 171-184.

¹¹ J. SCHUMPETER, *ibidem*.

¹² M. WEBER: *The Protestant Ethics and the Spirit of Capitalism*, Gondolat Kiadó, Budapest, 1982 [1905]

¹³ M. WEBER: *ibidem*.

¹⁴ T. PARSONS: *The social system*, Free Press, New York, 1951

¹⁵ Z. FARKAS: *The social relations. The theory of the institutional sociology*. Miskolc, Bíbor Kiadó, 2001

only one essential point of view in the background of the four pattern variables. FARKAS introduces that how can the components of the satisfaction of the needs be equivalent with the pattern variables.

The emotional or emotionally indifferent pattern variable tries to achieve the direct satisfaction of the active (i.e. the entrepreneur) or cancel the direct satisfaction and take into consideration the direct consequence of the action. In case of the second pattern variable, the active tries to evaluate the existents from the point of their own motives or from the point of the recognition of the general references. The third example variable refers to that the active takes into consideration other actives based on their "quality" itself, or based on their performance, i.e. based on the consequences of the activity. The last pattern variable involves the choice between the scattered or determined attitude, and it expresses that the existents of the environment are important in their entirety or important only from given point of view.¹⁶

During the analysis of the entrepreneurs the author would like to use Weber's activity types and Parson's pattern variables for first, and with taking into consideration them the author would like to use Farkas' main activity types. The Parson's and Farkas' activity theory were created not for analysing and grouping the entrepreneurs, but to understand the social relations.

The goalrational entrepreneurs do everything for their companies, they are neutral emotionally, they have exact, particular plan for achieving their goals, and they determine tools for that. The quality is the most important point of their business strategy. Parallel with the goalrationality, these entrepreneurs can be described based on the Parson's pattern variables: emotionally neutral, particular, quality and determined habits.

For the first sight the difference between the value racional and the goalrational activity type is not significant, since the activity can be described with the particularity, the quality and the determination. The thing which diferenciate these two active is the emotion, since the value racional does not determine the goals without any emotions as the goalrational. The value racional type, based on the Parson's activity types, is a bit more differentiated in this category, than in the case of the goalrational one. The emotion is the main determinative power within the decisions of the value racional entrepreneurs. The main goal of the entrepreneurs is paralelly with the subsistence is to be able to self-sustainers and their operation to be in line with their principles. This is also true in that case if their activity lead to financial loss. They know their possibilities and tries to achieve the quality but the maximal realisation of these are not always possible due to their value order. These entrepreneurs could ensure their subsistence in other ways.

The people with emotional activity type have good sense to direct a company, but their measures are not always double thoughted and down-to-earthed, because their activities are full of emotions, full of passion. Their activities oper-

¹⁶ PARSONS, *ibidem*; FARKAS, *ibidem*.

ate in general level, because they are significantly disorganised, which can set back their efficient operation in many times. When they start to run their companies they had prominent enthusiasm, plans and investment spirit, but during the times they became disappointed, since the results achieved have significantly lag behind the expectations. So the initiative positive emotional recrudescence led to bad mood and to pessimism. In the case of these entrepreneurs it can be observed that the emotion rules the ratio. In the operation, the performance has a stronger emphasis that the quality.

Finally, “the traditional activity is motivated by deep-rooted habits.”¹⁷ They have determined goals, but it is primarily not concentrate on gaining profit, since the company is run by the love to the given activity. The entrepreneur is motivated by the commitment of the maintaining of the inheritance of the ancestors, however the small scale companies have small term life cycle and only the fragment of them can survive the three generation time.¹⁸

To summarise: during the analysis of the entrepreneurs based on their activity type the author concluded that the entrepreneurs in the given categories (goalrational, value rational etc) perform their activities similarly, since their companies are formed between similar economical-cultural conditions. The habit has an important function in it because these entrepreneurs create and operate their companies based on their activity type.

4. The entrepreneurial motivation

The activity types described above are determined by the constraint and the needs, which FARKAS (2001) considers as an important factor standing in the background of the activities. The author completes it with the idea that from the point of the motivation it is not indifferent that whether the individual acts are motivated by an inner or an outer motivation. “The inner motivation refers to the fact that the activity, the task itself is the rewarder. The outer motivation in the contrary refers to the outer consequences of the activity and refers to the outer prize. The inner and the outer motivation in certain circumstances can be validating at each other’s cost. I.e. if the function of the outer motivations are increasing, this led to the decrease of the importance of the inner motivations, and the opposite of it is also true.”¹⁹

Table 1 introduces the inner-outer motivation and the direct-indirect and needs-constraint combinations.

¹⁷ M. WEBER: *Studies*, Osiris Kiadó, Budapest, 1998, p. 53.

¹⁸ B. BERGER: *The Culture of Modern Entrepreneurship*. –Replika 29 (March), 1998, pp. 171-184.

¹⁹ A. BANDURA: *Social Foundations of Thought and Action: A Social Cognition Theory*, Englewood Cliffs: Prentice Hall, 1986, pp. 243.

Table 1: *The motivations of the entrepreneurs based on the main activity types*

Motivation	Needs - constratin		Effect
Inner	Directly needs motivated	Indirectly needs motivated	Positive
Outer	Directly constraint motivated	Indirectly constraint motivated	Negative

Source: Own compilation

The characteristics of the economic actors who have inner motivation are that at the time of the company formation they were motivated by such factors as self-realisation, professional development, and the not expressed mission. The strongly inner motivated companies are also described by the economical aptitude, the “in good place in good time activity”, which is reflected in the economic situation of the given companies.

The motivators of the outer motivated companies are to ensure the everyday subsistence, and to get the necessary financial goods. They plan in short term; their goals are motivated by to avoid the failures, which deprive the energy from the inner possibilities of the success orientation. Additionally in the case of these entrepreneurs, paralelly to the above mentioned, it is also can be observed the effect of the motivation to the economy. The companies with outer motivation, mainly in Bükkösd, are in the lack of capital and constraint companies. Their operation can be described with instead of the development and continuous operation the survival; instead of the safety the uncertainty. For a better understanding of the relations between the motivation and the operation: for example since the inner motivated entrepreneur during the purchase of a tool tries to meet the new requirements and expectations, on the other hand the outer motivated only decide in this way if his subsistence and the safety of his company is threatened. It is also true that with this motivation the available capital also can be determinant.

Based on the comparing of the analyses it can be observed that those companies that are inner needs motivated, realize their entrepreneurial activities goalracionally. Additionally, based on the study, the goalracional entrepreneurs operate their companies successfully. During the study the author could find an entrepreneur who was constraint motivated in the first times and now he directing a company which is in good economic situation.

5. Entrepreneurial relationship network and relationship capital

The concept – used by the author - of the relationship capital in case of the entrepreneurs was the result of JAMES COLEMAN és PIERRE BOURDIEU works.

COLEMAN, J.²⁰ uses three kind of capital: the financial capital, the human- or knowledge capital and the social or relationship capital. According to COLEMAN each of the three type of the capital can also separately help the individual to reach his goals, additionally the different capital types can be converted to eachother ie. with the help of the knowledge capital we can have relationships, and the relationships can be converted to financial capital etc.

From the point of the relationship network analysis the most important characteristic of the relationship capital analyses that they do not concentrate on the whole relationship network, but concentrates on the relations of the given actors. During the analysis of the relationship network of Bükkösd and Szalánta it is misleading that all the actors are in connection with eachother, but in spite of this fact it does not appear in financial capital form. However the entrepreneurs know eachother, there are in everyday interactions among eachother, but we cannot talk about bussiness-based cooperations. The reason of it is – except in case of the agricultural entrepreneurs – that they have not realised the advantages of the relationships and cooperation, i.e. that the relationship capital similarly to the human capital, increase the performance of the company. They need financial capital to reach the goals but it is only can be received with proper relationship capital.

The reason of the lack of the financial relationship network is that they consider the potential related individuals as concurents, competitors, that is how they would like to protect their market. They search entrepreneurs, business partners for cooperation and relationship building from outside the village.

In case of the entrepreneurs of Himesháza a stronger relationship network was created which is due to the distance from Pécs, and the common culture, in spite of the fact that the ethnic composition of the village was changed strongly in 1945. The mixed marriages and the relatives eliminated the breaking point later and a new cultural unity came into being in the village. The majority of the entrepreneurs interacts eachother for the interest of the local society. We can ask the question: what kind of relationship exists between the local entrepreneurs?

During the study the author concluded the followings:

The entrepreneurs in a given village know eachother, and they benefit from this. They know their acitivities well, which ease the collection of information about the situation of the village, which make the flow of information cheaper and the received information will be more exact.

The relationships achieve their goals if the common interests are in the center eg. the inhabitance of the Strabag firm or the hindering of the building. In Hime-

²⁰ J. COLEMAN: "Social capital in the creation of human capital", *American Journal of Sociology* 94, 1988, pp. 95-120.

sháza during the organising of the programs everyone activate those inner-outer relationships, which can help the most effectively to achieve the common goal.

The fame, the respect, and to be well known mean influence in the important classes, so the entrepreneurs achieved leading positions in the villages.

The entrepreneurs consider a higher importance for the relationships from out of the village and consider benefits, which are realised, in financial capital.

The entrepreneurs have a pulling effect to each other during their activities.

During the interview one question came up: would you like to have such cooperations? The majority of the Bükkösd's and Szalánta's entrepreneurs rejected or reacted indifferently. The author believes that they do not want to formalise the existing informal relationship and relationship capital, since the current version is also enough for them and gives them the proper information and cooperation possibilities.

6. Entrepreneurial future-orientedness, goals

The studies of HIDEG–NOVÁKY²¹ authors showed, that the future-orientedness can be explained to interpret the relation of the individuals and groups (companies, institutions) to the future and the changes happening in the components. The interest and thinking to the future can lead to the activities done for the future, which are the means of expression of the change realisation. The value loaded future-orientedness expresses that what we do for the future is limited and directed by the thinking and attitude of the individuals.

The studies of the author showed that the future-orientedness of the entrepreneurs is determined by the economic state of the village. Those entrepreneurs in Bükkösd who consider the local market as the “business location”, have more gloomy vision and they can not really see the way out, the further step from the current situation. “In a poor village the local service provider becomes also poor”. “If the inhabitants have money than I will also have money” – can be heard during the interviews. The majority of these companies are formed because of outer motivation, and they were not enough established, planned. So their future is formed as spontaneously as their past. All of the interviewed persons are ready for the future planning, especially if they have to act for the interest of their family. They cannot separate fully the vision of their family and their company. During the planning they decide in their family, it is very rare that they ask for professional help. If so, than the main advisor is their accountant.

The negative vision can be seen during the determination of the goals: they find such goals which can give an ideal status and sometimes they are utopic, or they would like to manage to pay back the loan, to sell the goods etc.

²¹ É. HIDEG – E. NOVÁKY: “Individuals, the future-orientedness of the social institutions”, *Future theories 2*, BKE Jövőkutatás Tanszék, Budapest, 1998

There is a strong relationship between the goal orientation and the individual performance. Those who own a prospering activity, their goals will be formed parallelly with that. In spite of the fact that a part of the entrepreneurs are also inner motivated and tries to achieve self-realisation, still they only dare to plane in medium term. The majority of the entrepreneurs would like to maintain their living standards. The future of the entrepreneurs is affected by the fact if there is any proper person who will carry along the direction of the company. The majority of the agricultural entrepreneurs are affected.

To summarise: the author concludes that the effectiveness of the companies is determined by the individual conditions, the reason of the company forming, and the size of the local market. If the habit of the entrepreneur is motivated by the goal rationality and self-realisation, than the vision will be positive. If the company is formed because of constraint, than in general the future of the individuals will be determined by the ensuring of the subsistence and not by the development planning.

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PROFESSOR BRANISLAV PELEVIĆ, PHD*
Faculty of International Economics, Megatrend University, Belgrade

THE MICROECONOMICS OF MIGRANTS' REMITTANCES**

Abstract: *Migrants' remittances represent a fundamental source of external financing for less developed countries. This paper analyzes the motives that drive migrants to transfer a part of their income to their families back home. Besides altruism, other individual motives are also analyzed, such as pure self-interest, exchange, strategic motive and inheritance. Other motives that form a part of familial arrangements are also reviewed, such as co-insurance and loan repayment. The determinants of variously motivated remittances also vary, which is especially important when predicting their future dynamics. Thus, a good knowledge of the microeconomics of remittances is also of particular importance in determining their macroeconomic implications.*

Key words: *remittances, migration, income distribution, private transfers*

JEL classification: F 22, D 31

1. Introduction

Migrants' remittances have been receiving particular attention of late, not only within international organizations that deal with migratory problems, such as, for example, the UNDP, or with the financial aspects of migrations, such as the World Bank or the IMF, but also within the academic community. The reasons for this are quite clear once it is realized that migrants' remittances represent a fundamental source of external financing for less developed countries.

According to the last Balance of Payment Manual,¹ total remittances encompass personal transfers (by those who have lived abroad for more than one year and have resident status), compensation of employees (temporary migrants) and capital transfers between households and social benefits. The total such funds sent by 150 million

* bpelevic@megatrend.edu.rs

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¹ International Monetary Fund: *Balance of Payments and International Investment Position Manual, Sixth Edition* (BPM6), Washington, D.C. December 2008

migrants to their families in less developed countries equaled 328 billion dollars in 2008,² which is more than the sum total of all foreign direct investments, donations and aid transferred by developed countries to less developed ones. This total comes to slightly less than 2% of the GDP of the less developed countries; however, for a considerable number of these, including Serbia, the percentage exceeds 10%.³

It is not rare for theoretical explanations of certain economic phenomena to be formulated with a significant lag relative to their appearance. This was precisely the case with migrants' remittances. Practically until the work of Lucas and Stark,⁴ no serious attempts were made to furnish answers to questions related to remittances, such as: who sends them and why; when do they increase and when do they decrease; are any counter-services expected in return; when is a portion of income set aside as savings and when is it sent to the country of origin, etc.

Microeconomic theory of remittances has managed to harmonize a basically unified explanation for the basic motives behind remittances. To be sure, the relative significance of individual motives varies across different explanations. Also, the classification of remittances from the standpoint of reasons for their sending (individual motives and familial arrangements) is also pretty much agreed upon. However, explanations for remittances and workers' migrations are given separately, as though these processes were not causally linked. It is clear this is not a totally consistent approach, having in mind the fact that remittances are always a consequence of migration but also their cause in a significant portion of cases. As a result, efforts are now underway to integrate the New Economic Theory of Migrations and the Microeconomic Theory of Remittances. One such attempt is presented under.⁵ Unfortunately, space limitations prevent this valuable undertaking from being presented in this work. We shall thus limit ourselves only to the motives that drive migrants to send remittances to their families.

2. Remittance motives

The text that follows shall provide a review of the basic findings relating to motives behind remittances: altruism, pure self-interest, exchange, strategic motive, co-insurance, loan repayment and inheritance. Some of these motives depend on migrants' individual decisions, while others are results of implicit informal agreements between the migrant and his/her family. For each of the motives, variables that influence their dynamics shall be given; in the majority of

² The World Bank: Migration and Development Brief 10, Washington, D.C., July 13th, 2009

³ The World Bank: *Migration and Remittances Factbook 2008*, Washington, D.C. 2008

⁴ R. E. B. Lucas, O. Stark: "Motivation to Remit: Evidence from Botswana", *Journal of Political Economy*, No. 93, 1985, pp. 901-918.

⁵ F. Garip: "Social and Economic Determinants of Migration and Remittances: An Analysis of 22 Thai Villages", Princeton University, Department of Sociology, *Draf.*, 2006

cases, these will be the income of the migrant and his/her family, the migrant's education, length of stay abroad or planned time of return, as well as distance from the family. With some motives, other, specific variables gain in significance.

2.1 Altruism

Perhaps the simplest explanation for the motive behind remittances is linked to the migrants' *altruism*. In going abroad, the migrant is leaving his family, which, differently from him, stays behind to live under the same, modest conditions. Remittances then serve the purpose of closing or easing the gap between the consumption of the migrant and that of his family.

Thus-motivated remittances grow with the migrant's income and the degree of his family's poverty and, expectedly, with the degree of his altruism. There is also a positive link between shifts in the migrant's income and his closeness with his family and income level. Rappaport and Docquier⁶ have shown that, opposite to the migrant's altruism, the family's altruism negatively affects remittances. In other words, the greater the altruism of the receivers, the smaller the remittances – and vice versa. That means that remittances may even decrease, even while the migrant's income rises, if there is a simultaneous growth in the household's income, and if the family's altruism is high. Obviously, the explanation here is also founded in purely emotional considerations. Just as the migrant expresses concern for his family, so does the family care for its member – the migrant, hesitating to accept larger remittances in cases when their own financial situation is improving.

Rappaport and Docquier have pointed to several interesting links between migrant-household altruism on the one hand and shifts in their income, on the other. The formally expressed the said links by developing Stark's model:

$$\frac{\partial T^*}{\partial I^m} > 0 \quad (1),$$

$$\frac{\partial T^*}{\partial I^h} < 0 \quad (2),$$

$$\frac{\partial T^*}{\partial \beta^m} > 0 \quad (3),$$

$$\frac{\partial T^*}{\partial \beta^h} < 0 \quad (4),$$

where T^* is an altruistic transfer, I^m and I^h are incomes of the migrant and recipient household, respectively, β^m and β^h are altruistic parameters - degrees of the migrant's and the household's altruism, $0 \leq \beta^i \leq \frac{1}{2}$.

⁶ H. Rapoport, F. Docquier, "The Economics of Remittances", IZA Discussion Paper No. 1531, 2005

Relations (1) and (3) show that transfers are positively correlated with the migrant's income and the degree of his altruism. Relations (2) and (4) show that transfers decline as household income and the degree of its altruism rise.

This is followed by the development of a very interesting prediction of the pure altruistic hypothesis that "an increase of one dollar in the income of the migrant, coupled with a one dollar drop in the recipient's income, should raise the amount transferred exactly by one dollar".⁷

Formally, this should be expressed as:

$$\frac{\partial T^*}{\partial I^m} - \frac{\partial T^*}{\partial I^h} = 1 \quad (5).$$

It can be clearly shown from the above that transfers are positively correlated both with the differences in the migrant's and the recipient's household income, and the differences between the degrees of altruism.

We are of the opinion, however, that the arithmetic expression given in (5) should not be accepted unconditionally. Namely, it is open to question whether it holds in the case that incomes are shifting in the same direction, i.e., when both the migrant's and the recipient household's income are rising or falling. In other words, the question is whether (5) also necessarily holds true in case of symmetrical income shifts under any combination of altruistic parameters βm and βh . We mention this because it is even intuitively clear that, in case of symmetrical shifts in income, the size of the transfer is greater the greater the difference between the migrant's and the recipient household's degree of altruism, and vice versa. On the other hand, we are also of the opinion that, in a borderline case, with an equal and identically directed shift in income and equal altruism, the size of the transfer equals zero. In other words, under such conditions it is realistic to expect that (in the case of, for example, an equal increase in the incomes of the migrant and the recipient) the migrant's desire to increase the transfer and the reluctance of the recipient household to accept this increased transfer will become equal.

In a further elaboration of the determinants, we can highlight already confirmed views that, in the case of altruism, as is the case with most other motives, remittances decline as the distance between the migrant and his family increases and as elapsed since his departure grows longer. Also, individual remittances are smaller in case of a larger number of migrants from the same family, since each of them expects the others to also take part in helping the household. This determinant of altruistically motivated remittances has been model-tested, with the work under⁸ being the most frequently cited.

⁷ O. Stark, *Altruism and Beyond: An Economic Analysis of Transfers and Exchanges within Families and Groups*. Cambridge, Cambridge University Press, MA, 1995, p. 12.

⁸ B. Benerjee, "The probability, size and uses of remittances of urban to rural areas in India", *Journal of Development Economics* 16, 1984, pp. 293-311.

The influence of the degree of education on altruistically motivated remittances has not been incontestably determined. Nevertheless, the findings presented under⁹ are intriguing, as they say that the level of remittances is negatively correlated with the migrants' education level. Such a conclusion may at first seem strange, since, as a rule, educated workers earn more, which means that their capacity to send a portion of their income back to the home country is also greater. The explanation should thus be sought in the fact that the more highly educated workers usually come from more affluent families, which require less help, meaning that the significance of altruistic motives in such cases is lower. In addition, the tendency with such workers, one welcomed by the host country, is to assimilate more rapidly and easily. As a result, such workers begin to invest in increasing their property and to spend on things that are not characteristic for workers with temporary immigrant status. This obviously results in smaller remittances.

The significance of altruistic motives is indisputable, and thus-motivated remittances are still predominant, which has been confirmed in numerous empirical studies. To be sure, some exaggerate their significance to such an extent that they are talking about a globalization or transnationalization of philanthropy. Still, as shall be seen later, altruistic motives in a pure form were perhaps dominant in earlier periods of migration, while today they tend to be either modified or to appear in combination with other motives.

2.2 Pure self-interest

Totally opposite to altruistic motives are those based on personal interest. Among these, Hager-Zanger and Siegel¹⁰ list intention to return, invest or open expectations of inheritance. While preparing to return, the migrant invests in building a house, in equipping his household and, possibly, in other forms of property that could provide him a base for further work or for collecting rent. Remittance recipients help him in this regard, playing the important role of being his agent. As a rule, they are better informed than the migrant, are well acquainted with conditions in the country, advise him and do not allow his funds to be misallocated or for him to suffer damages or fraud on the part of local partners. The reputation of the migrant and the remittance recipient grows, since the remittances, as a rule, initiate investments which are major by local standards.

For the migrant it is important not only that his agent be well informed but also solidly situated and locally influential. For him, that is a guarantee that his funds will be spent with due consideration. Having this in mind, it is clear that thus-motivated remittances are positively correlated not only with the size of the

⁹ Y. Niimi, Ç. Özden: "Migration and Remittances: Causes and Linkages", World Bank Policy Research Working Paper No. 4087, 2006

¹⁰ J. Hagen-Zanker, M. Siegel, "The Determinants of Remittances: A Review of the Literature", Maastricht Graduate School of Governance Working Paper No. 2007/003, 2007

migrant's income but also with the material status and income of the local remittance recipient. According to this second criterion, altruistic remittances and remittances motivated by personal interests are diametrical opposites. If, for any reason, there was a dilemma as to under which of these categories specific remittances are classified, the distinction between the two would be simply and precisely drawn by the answers to the following questions: What is the material status of the remittance recipient? Are remittances increasing if material status is improving?

However, the demarcation between altruistic and otherwise motivated remittances is not at all simple at times. Hager-Zanger and Siegel present the case when the remittance recipients are the parents and when it is, thus, natural that the remittances are altruistically motivated. Still, pure self-interest can occasionally hide behind seemingly altruistic motives, one based on the expectation of generating a demonstrational effect. While sending remittances to his parents and articulating this as a pure intention of helping them and investing in the advancement of the family, the migrant may actually be setting down the material conditions for his return and, even more so, sending clear signals to his progeny on how they should behave toward him one day.

In that sense, such an articulated, "false" altruism may in time become a model of family behavior in certain environments. A comparative overview of studies conducted for various countries or ethnic communities shows that the intensity of these processes varies significantly, which makes it even more difficult to draw general conclusions. In any case, the demarcation of "pure" altruistic transfers is often not at all simple, which additionally complicates their analysis.

2.3 Exchange

Exchange represents the next frequently present motive. The migrant sends remittances while expecting services in return, such as watching over his children, parents, property, etc. The existence of such a motive clearly confirms that these migrants intend to return to their home country. As with altruistic motives, here, too, remittances grow along with the migrants' income, as it is expected that a more affluent migrant will show greater interest for using services in his home country.

However, the link between recipients' income and transfers is not one-dimensional. Contrary to altruistic remittances, the lower income of the recipient of services may also mean lower remittances, which can easily be explained by the service recipient's lower negotiating strength. In case of the recipients' greater income and, thus, higher service price, it might be expected that the migrant's demand for services would decline. That will certainly be the case if the demand for the transfer recipient's services is flexible in the usual sense. However, if the demand for such services is inelastic, remittances might grow even as the price of services grows.

The link between the size of the transfer and the recipient's income can also be viewed in the context of the transfer recipient's bargaining power. If his income is high, his consumption does not significantly depend on his provision of services to the migrant, which means that he can set a higher price for his services. Of course, the highest price he can demand is the highest existing market price for that particular kind of service. On the other hand, if the recipient's income is low, and, additionally, if the general unemployment level is high, the recipient's willingness to provide the service at a lower price will be greater. To be sure, under any circumstance, the migrant will not be prepared to pay a price higher than the market price, i.e., generally speaking, the price will be acceptable to him as long as it is somewhere between the market price and his opportunity costs.¹¹

2.4 Strategic motive

The reason for sending remittances need not always be direct and obvious. In certain cases, remittances may be sent with an ulterior goal, which, as a result, may not be immediately recognizable. Such is the case with strategically motivated remittances.

The *strategic motive* behind remittances was first introduced by Stark¹², and further developed in several other works, chiefly in Docquier and Rappaport¹³. The basic reason for the appearance of thus motivated remittances lies in the existing asymmetry of information regarding the quality and qualifications of the migrants within their own group. Namely, even though migrants within a single professional group may appear homogenous, differences in their abilities and productivity do exist, even when they possess the same formal qualifications. The migrants themselves are acquainted with these differences, just as they are aware of the different incomes they would be earning had they stayed and worked in their home country.

Employers, however, do not have this information at their disposal. As a result, they treat a migrant group as a homogenous entity and, in determining their individual incomes, have in mind only their average and not their individual productivity. The logic behind this result is analogous to the logic behind the price formation for used automobiles in Akerof's famous work from 1970.

Clearly, such a status does not suit the more highly qualified workers who, at least in the short term, are not able to display their skills fully and distance themselves from the less qualified workers. As a result, the more qualified and

¹¹ H. Rapoport, F. Docquier, "The Economics of Remittances", IZA Discussion Paper No. 1531, 2005, p. 13.

¹² O. Stark, *Altruism and Beyond: An Economic Analysis of Transfers and Exchanges Within Families and Groups*, Cambridge University Press, Cambridge, MA, 1995

¹³ F. Docquier, H. Rapoport, "Are Migrant Minorities Strategically Self-selected?", *Population Economics*, No. 11, 1998, pp. 579-588.

more productive workers wind up earning less, while the less qualified and productive workers earn more.

It is understandable that the more highly qualified workers are not satisfied with such a situation, just as it is perfectly clear that the less qualified workers are enjoying a certain form of rent thanks to the general averaging. Under such circumstances, the more qualified workers are vitally interested in dissuading the less qualified workers from leaving their home country and joining them in emigration. One of the ways of accomplishing this is to send remittances to the less qualified workers and, in this way, “bribe them” to stay in the home country instead of competing with them abroad.

Let us remain here with the explanation this *de facto* strategic game. In the first step, we shall present the original matrix given in Rapoport and Docquier.¹⁴ In the second step, we shall develop this matrix by introducing transfer, in order to, in the end; obtain the identical result as Rappaport and Docquier.

Let us begin with a situation where we have migrant m and (potential) migrant h , with the productivity of the former being $1/\pi$ times greater than the productivity of the latter, ($0 < \pi < 1$). If both were to remain in their home country, their earnings would differ, since there the differences in their productivities would be known, which means that the former would be earning $1/\pi$ times more than the latter, or Ih/π , while the latter would be earning Ih . In the remaining three cases, in which the first, the second, or both the workers emigrate, the situation is the following.

If the first, qualified worker m were to emigrate, while the less qualified worker h stayed home, there would be no competition between them, and the first would be earning Im abroad, while the second would be earning Ih in the home country. In the opposite case, qualified worker m , who would remain in his home country, would continue to earn Ih/π , while less qualified worker h would be earning abroad only a portion of the income that the more qualified worker would be earning, or πIm .

The last case is the most interesting and the most realistic. Both the workers emigrate but, as was previously said, the information is asymmetrical. They are mutually acquainted with the differences in their respective productivities, but their foreign employer is not. Rather, he averages out their incomes, and both receive $Im(1 + \pi) / 2$.

The following payoff matrix shows the possible outcomes of migration (M) and non-migration (NM) of skilled worker m and less skilled worker h .

¹⁴ H. Rapoport, F. Docquier: “The Economics of Remittances”, IZA Discussion Paper No. 1531, 2005

Table 1: *Payoff matrix without transfers*

		Player h	
		M	NM
Player m	M	$I^m (1+ \pi) / 2$ $I^m (1+ \pi) / 2$	I^h I^m
	NM	πI^m	I^h
		I_h/π	I^h/π

Source: H. Rapoport, F. Docquier: “The Economics of Remittances”, IZA Discussion Paper No. 1531, 2005, p. 17

It is obvious that (MM), i.e., the situation in which both the workers emigrate is a Nash equilibrium. It pays more for *m* to emigrate, as his income will then be higher, no matter what player *h* does, i.e.:

$$I_m (1+ \pi) / 2 > I_h/\pi < I_m \tag{6}$$

For the same reasons, it is better for player *h* to emigrate in any case, because:

$$I_m (1+ \pi) / 2 > I_h < \pi I_m \tag{7}$$

Let us now take the situation in which the skilled worker considers bribing the unskilled worker by transferring to him a part of his income, under the condition that the latter stays home. The matrix then changes in the upper right cell, by the size of the added or subtracted transfer.

Table 2: *Payoff matrix with transfers*

		Player h	
		M	NM
Player m	M	$I^m (1+ \pi) / 2$ $I^m (1+ \pi) / 2$	$I^h + T$ $I^m - T$
	NM	πI^m	I^h
		I^h/π	I^h/π

The result will be the migration of the qualified worker and the non-migration of the non-qualified worker, i.e., equilibrium shall be reached in (M, NM) if two preconditions are satisfied.

The first precondition has to do with the qualified worker, who will be prepared to send strategic remittances only if they are less than or equal to the dif-

ference between the income he would be earning if he went abroad alone and the one he would be earning if he didn't succeed in dissuading the less qualified worker from emigrating, i.e.:

$$T \leq I^m - I^m (1 + \pi) / 2,$$

that is,

$$I^m - T \geq I^m (1 + \pi) / 2 \quad (8).$$

The second precondition has to do with the unqualified worker, for whom it pays to receive transfers only if his income back home, plus the transfer, is greater than the income he would be earning abroad, i.e.:

$$I^h + T \geq I^m (1 + \pi) / 2 \quad (9).$$

What comes out of this relation is what Rapoport and Docquier refer to as “minimal optimal transfer,” that is, the smallest strategic remittances required to dissuade the unqualified worker from going abroad and competing with the qualified worker:

$$T^* = I^m (1 + \pi) / 2 - I^h \quad (10).$$

Analogously to such a defined “minimal optimal transfer,” which is related to the *demands* of the unqualified worker, let us introduce one more precondition related to the qualified worker's *willingness*. Let us call it the “maximal relative transfer.” By rearranging relation (8), we easily obtain:

$$T / I^m = (1 - \pi) / 2 \quad (11).$$

This relation shows that the highest percentage of the income that the qualified worker is willing to set aside for transfer equals one half the percentage points by which his productivity surpasses the productivity of the unskilled worker. If, for example, $\pi = 0.4$, which means that the productivity of the qualified worker is 60 percentage points greater, he will be willing to set aside 30% of his income at most.

The limitations of dissuasions from migrations by way of strategic remittances are numerous. Let us mention only one, perhaps the most important. It is assumed that the condition for the strategic games to make sense would be for them to encompass all unqualified workers, i.e., that there are no free riders. It is also expected that employers average out the wages they pay out, having in mind the same group of unqualified workers. In other words, the condition is that the set of unqualified workers that the qualified workers are trying to influence matches the set observed by the employers. That, however, is most often not the

case when dealing with multiethnic migrant communities. Qualified workers may influence their unqualified countrymen, but not other unqualified workers from other ethnic communities. It is then possible for a good implicit agreement between countrymen to be spoiled due to the interests of unqualified workers from other ethnic communities. To be sure, the problem might then be solved by an interest-based association of all the qualified workers, but that would present such a complicated task that it would be hard to believe in its plausibility.

Even though the intentions behind strategic remittances are totally different from those standing behind altruistic remittances, their determinants contain numerous similarities. Thus, the level of strategic remittances, as with altruistic remittances, is positively correlated with the migrants' income and education. Namely, the higher the qualified workers' income and education, the greater the possibility for them to drop due to competition coming from unqualified workers, based on the employers' imperfect informedness. In other words, the "stakes in the game" rise along with the income and education levels of the qualified workers.

Unfavorable economic conditions and shocks in the home country (country of emigration) also increase these transfers, as the tendencies toward migrations under such conditions rise. That is especially true for the poorest segments of the population who are, as a rule, less qualified. Larger differences in qualifications also mean a greater danger of a significant lowering of the income of qualified workers, which additionally stimulates them to intensify remittances.

Strategic remittances are negatively correlated with the income level in the home country (country of emigration) and time spent in emigration. In the first case, differences in income at home and abroad are smaller, which means that the price of dissuasion (talking unqualified workers out of emigrating) is also lower. In the second case, it is thought that, with the passage of time, qualified workers have the possibility of affirming themselves and distancing themselves from the unqualified workers, which, as a result, decreases or erases the need for strategic remittances.

2.5 Co-insurance

Differing economic conditions in the home and the host country often represent a motive for sending remittances that basically have the character of intra-familial co-insurance. The possibility of divergent economic shifts in the country of immigration and the country of origin is not small when we bear in mind two facts. The first is that, as a rule, migrants come from less developed countries that are most frequently rural and, thus, greatly dependent on weather conditions, which means that their incomes are quite unstable and uncertain. Second, especially at the beginning of their residence abroad, migrants are insufficiently positioned professionally, with a high probability of their incomes varying or of

unemployment. Hence, the possibility of financial problems arising on the side of the migrant or the side of the transfer recipient is not small.

Similarly as with altruistic remittances, the migrant is willing to help his family, which stayed behind in the home country but – differently from those – only in cases when the family finds itself caught in a sort of a temporary depression or shock. Naturally, the onset of such circumstances is a clear signal for the migrant to increase his remittances, which will be greater to the extent that the risk of onset of unfavorable conditions is greater. Conversely, the migrant expects his family to act in a similar way and help him in case the country of his immigration has been hit by unfavorable circumstances, if his income decreases or if he becomes unemployed. The goal of such remittances is, obviously, through some type of implicit contractual relationship, to activate mutual help in case of shock or temporary but severe economic downturn. This secures a dispersion of risk from such circumstances and prevents or cushions the worsening of the entire family's economic situation, i.e., of both the migrant and the family members who have stayed behind in the home country.

Such remittances do not depend on the migrant's income or education levels. Also, no empirical study has proven that they are conditioned upon the number of migrants in a family or their intention to return to their home country. Thus, the only thing that is certain is that they are determined by the migrant's and his family's sensitivity to economic instabilities and shocks. To be sure, recent findings, presented under,¹⁵ that remittances depend to a significant degree on migrants' personal and family plans tied to their place of residence and work are intriguing. In that sense, especially interesting is the finding according to which the full regulation of right of residence and work status, as well as migrants' obtainment of all citizens' rights, increase the level of their remittances, which is contrary to claims that migrants' assimilation lowers the level of remittances. This finding may be interpreted through the fact that migrants with fully regulated citizen status are able to travel back and forth to their country of origin without hindrance, without fearing loss of their obtained rights. In that way, they are establishing a certain type of multiple migration, in which their remittances in the process of locational risk dispersion also represent some sort of insurance, especially from eventually unfavorable conditions in the country of immigration.

As Piracha i Zhu¹⁶ have shown, migrants' borderline tendency to save is 40% greater than that of domestic workers. This is explained by the fact that migrants act with caution under conditions of uncertainty regarding future income and their legal status. In that sense, their savings represent a rational act of insur-

¹⁵ E. Holst, A. Schäfer, M. Schrooten, "Gender, Migration, Remittances: Evidence from Germany", SOEP Paper No. 111, DIW Berlin Discussion Paper No. 800, 2008

¹⁶ M. Piracha, Y. Zhu: "Precautionary Savings by Natives and Immigrants in Germany", Discussion Papers KDPE 0821, University of Kent, Department of Economics, 2008

ance from undesirable events in the future. What conclusion from the standpoint of the savings-remittance relationship may be drawn from such claims? It would seem that it would certainly not be one-dimensional. If expectations of future events connected with income and legal status are positive, it is realistic to assume that savings in the host country would decrease and that remittances would increase. This would be the case regardless of whether migrants are closer to assimilation or to return to the home country. In case of assimilation being closer, reducing savings and a possible increase in remittances would be the result of a "release" or relaxation from the pressure of uncertainty, but also a possibility for a part of the selfish motives to be replaced by altruistic or familial motives. A similar scenario could be expected in the case that, under conditions of positive expectations, migrants make a decision to return. In that case, savings in the country of immigration and remittances to the home country behave like exclusive substitutes.

The same thesis was proven by Bouhga-Hagbe¹⁷, where a distinction was made between permanent and temporary migrants and the logical substitutionality of remittances and savings confirmed: in the case of temporary migrants, the decision about returning home has matured and the closer the time of return is, the higher the level of remittances, while the level of savings in the host country declines.

2.6 Loan repayment

Families may frequently decide, especially under conditions of an undeveloped financial market, to opt for investments that increase income instead of for co-insurance that secures a stable income. One of the ways of accomplishing this is to invest in the education of a family member who will, upon completing school, emigrate. It is obvious that, in that case, the family takes on the role of creditor that enters into an implicit family contract with the potential migrant. Of course, as is emphasized in the most frequently cited work concerning this type of remittance,¹⁸ such an informal contract makes sense for the family only if the implicit rate according to which it lends (invests in education) is higher than the market interest rate.

Upon leaving the country, the family member begins to pay back the implicit credit by way of remittances. It is expected that the migrant shall gain in affirmation with time, resulting in a higher income and higher transfers of this kind. However, after a certain amount of time has passed, obligations vis-à-vis this credit decrease. That means that, generally speaking, such remittances rise dur-

¹⁷ J. Bouhga-Hagbe: "Altruism and Workers' Remittances: Evidence from Selected Countries in the Middle East and Central Asia", IMF Working Paper No. 06/130, 2006

¹⁸ B. Poirine, "A Theory of Remittances as an Implicit Family Loan Arrangement", *World Development*, 25, 5, 1997, pp. 589-611

ing the initial period of migration, reach their maximum and then begin to decline, in the shape of an inverted *U*-curve.

In the more mature phases of migration, when he has already significantly paid off his credit, the migrant may decide to credit another migrant. He may then assume the role of the family and find himself in the twofold role of outgoing debtor and incoming creditor. If that should happen, then the falling segment of the *U*-curve of remittances in the function of time becomes flatter.

Thus defined remittances are definitely positively correlated with migrants' income and education, as it is assumed that both are a result of investment on the part of the family. Such remittances are, quite the opposite of all other remittances, also greater when the migrant's distance from his family is greater, since investments are greater in that case as well. As for the relationship between these transfers and family income, however, a unique link has not been proven. On the one hand, it is clear that more affluent families have greater capacities to invest in the education and migration of their members. However, on the other hand, it is also clear that such families, differently from poorer families, have less need for such arrangements.

2.7 Inheritance

One tried method for a family to ensure regular and ample remittances is the conditioning of inheritance. A family that possesses property that a migrant can inherit monitors his behavior and measures whether the transfers he is sending are sufficient. In case it evaluates that they aren't, he is threatened with being excluded from the inheritance. It is obvious that here remittances are treated as an expression of loyalty to the family, while punishment in the form of exclusion from inheritance comes as a result of their irregularity or insufficiency.

Most such transfers clearly depend on the size of the inheritance and the probability that the migrant will be able to enjoy it. Also, in the same positive direction, such remittances will be larger when the migrant is more affluent and when he can choose whether he will invest in his inheritance or opt for savings or some other form of investment. Conversely, such transfers decline with the migrant's degree of risk aversion, having in mind that this kind of investment is much riskier than savings or some other forms of safe investment.

The link between the number of family members and size of transfer is not simple. If the number is relatively small and, as a result, the inheritance is divided into fewer parts, competition may form between the inheritors, causing remittances to rise. However, if the number of successors is large and individual inheritances relatively small, the migrant's interest and the remittances may decline or even disappear. That is why the curve of remittances in the function of the number of inheritors, just like that of remittances in the function of time with loan repayments, has an inverse *U* shape.

3. Conclusion

It is clear from the above that remittances according to the motives of their sending often cannot be clearly demarcated. For example, behind altruistic transfers may lie completely personal motives, just as, for example, seemingly pure self-interest remittances may also benefit the family. Thus, the motives behind remittances are most often mixed and rarely unique. The relative significance of individual motives behind remittances may be determined indirectly, by monitoring the movements of total remittances, in the function of their basic determinants. The following table may help in that regard. The (+) sign shows the existence of a positive link between remittance size and an individual determinant, the (-) sign shows that the link is negative, while the (+/-) sign shows that both links are possible. An empty field was left where links were not confirmed or were only on the level of intuition.

Table 3: *The basic determinants of remittances*

	Altruism	Pure self-interest	Exchange	Strategic motive	Coinurance	Loan Repayment	Inheritance
Migrant income	+	+	+	+		+	+
Migrant educat.			+/-	+		+	
Time since arr.	-					Inverse U shape effect	
No. of migrants in family	-						Inverse U shape effect
Recipient income	-	+	+/-	-	-	+/-	
Recipient shock	+		+/-	+	+	+	

Note: Reworked on the basis of H. Rapoport, F. Docquier: "The Economics of Remittances", IZA Discussion Paper No. 1531, 2005, and J. Hagen-Zanker, M. Siegel: "The Determinants of Remittances: A Review of the Literature", Maas-tricht Graduate School of Governance Working Paper No. 2007/003, 2007

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PROFESSOR MILAN B. VEMIĆ, PHD*
Faculty for Management Studies, Novi Sad
PROFESSOR MILAN LJ. STAMATOVIĆ, PHD
Faculty for Management Studies, Novi Sad

THE IMPORTANCE OF PRIVATE INVESTORS IN THE FINANCING OF RURAL ENTREPRENEURSHIP IN SERBIA

Abstract: *This paper addresses issues of regional development from the point of view of rural entrepreneurship. The authors analyze the financing of entrepreneurship through development and attracting of private investors. In such contest, special attention is devoted to specific characteristics of “business angels” as well as to the development of financing model of rural entrepreneurship through stock exchanges.*

The research is based on the experiences of The Republic of Serbia. Through the analysis of documentation related to the financing of entrepreneurship the paper will assess the current capacity for sustainable and local development of rural regions, with a focus on Serbia and other economies in transition. In a case study undertaken in Serbia with semi-structured interviews of carefully chosen representatives of local authority and active third sector stakeholders in rural development, authors of the paper will then examine the specific possibilities of increasing the currently insufficient role of private investors and will extend for discussion a model for benchmarking stock exchanges as a prerequisite for stock exchange based financing of rural entrepreneurship.

Research presented in this paper will nominate for further discussion a thesis that exchanging visits to key stock exchanges in the region of South East Europe is one of the avenues to attract investors to rural regions.

Keywords: *financing, entrepreneurship, rural development, benchmarking, exchanges, investors*

JEL classification: R 11, L 26

* E-mail: milanvemicl@yahoo.com

1. Introduction

The hard reality of economic development is that private investors may potentially have a crucial role in financing rural entrepreneurship and SMEs and that this is currently not the case in some transition economies. This paper will elaborate the possible contribution of private investors to the regional and rural development of Serbia and other economies in transition. Private investors can be classified as internal, meaning peasants and other residents of rural areas, and external, meaning investors from external sub-rural or urban environments. By definition, both categories of investors search for entrepreneurial projects, which normally offer both profits and risks, but there is a significant difference between them.

Family estate in rural environment, as opposed to *agricultural family estate* or *peasant estate* as an independent agricultural and social unit based on ownership and/or usage of product resources and family management in *agriculture*, is both the place of living and the place of rural entrepreneurial activity. These facts affect the selection and appraisal of investments in rural environment in many ways. A peasant, i.e. internal investor, is at the same time an owner of an estate, the manager and a worker on the estate.

In other economic sectors, the director is a manager of the company, shareholders are the owners and many other experts also work in the company. This means that the choice of criteria for appraisal of investments in rural environment does not consider only profit maximization. Indeed, countryside investments often serve to improve social status (e.g. a purchase of a new tractor), or working conditions on the estate, or they can represent the realization of an old dream on revitalizing traditional crafts which no longer have a secure market.

However, considering the development of rural entrepreneurship and the theory of profit,¹ a peasant's aim should be investment of his own or borrowed sources of finance in order to achieve greater profit than investment in an alternative activity and greater than interest on savings. The interest on savings in relation to rate of profit on investments is considered as a borderline criterion for entrepreneurial ventures.

There is always a risk for a peasant's investment, especially if it is an investment in agricultural production because of its specifics (weather conditions, biologic potential of plants and animals, and finally the market of agricultural products). Most peasants avoid risky investments because they know that in the case of bankruptcy, they can lose, not only 'enterprises', but also the business as a whole and even their estates.

For potential external private investors in rural environments, there are certain other pre-conditions, or limits, which, by the example of development in Serbia, preclude faster capital, flow to small enterprises in rural regions.

¹ F. H. Knight: *Risk, Uncertainty and Profit*, Harper, New York, 1921, pp. 8-10.

2. Preconditions for investing in rural entrepreneurship

Stemming from the semi-structured interviews carried out in four Serbian districts (Šumadija, Pomoravlje, Jablanicas and Pčinja) the identified pre-conditions of investing into rural SME are hereby classified as follows:²

- 1) The arrangement of production factors and available infrastructure in rural environment is a crucial factor without which, under unchanged other circumstances, further preconditions cannot be expressive enough. Besides capital, we particularly have in mind land, workforce and the organization, which was originally emphasized by Alfred Marshall as the fourth production factor.³ In the sense of this paper an organization represents entrepreneurs with entrepreneurial skills and abilities prepared to take risk when forming a legal entity and undertaking an investment.
- 2) Unregulated land and uneducated workforce preclude investments into non- agricultural activities and this is one of the main aims of integral rural development in most countries including Serbia.
- 3) It is known that financial markets, including credit markets, enable the process of transferring sources of finance and knowledge towards profitable projects. The financial market in Serbia, for example is rudimentarily developed and as such it does not enable financing of entrepreneurs and efficient transformation into an SME, particularly in rural environments.
- 4) Building saving habits and an increase in long-term savings in banks as a long-term source of finance represents a special factor of more successful financing of rural SMEs.
- 5) The number and power of financial mediators is an important factor for linking free sources of finance with appropriate demand among investors. Alternative financial institutions, discussed hereinafter, are also seen as important factors of strengthening financial markets.
- 6) Stability and security of the regulatory environment directly decreases the risk of private investments. Bearers of economic policy should therefore pay special attention to this matter.
- 7) Availability and quality of rural development plans and various profitable investment projects in rural environments.

In the last few years SME are the only structure that had continuously created profits and shown the largest possible business effectiveness. That was definitely supported by the characteristics of these enterprises such as: vitality, flexibility, broader possibilities for specialization, easier management, ability to invest more

² M. Vemić: *Development of the systemic model of management of rural entrepreneurship*, doctoral dissertation, Faculty for Management Studies, Novi Sad, 2005, pp. 332-333.

³ H. L. Hanson: *A Textbook of Economics*, Seventh Edition, Macdonald and Evans, London, 1977, pp. 49-51

quickly, better export opportunities, easier innovation and offensive entrepreneurial spirit. The development of SME in Serbia has been based primarily on investments in joint stock capital, which represents personal investments of one or more owners into the enterprise or in business. Sometimes, such joint stock capital is labeled risk capital because investors take responsibilities for eventual losses of their assets if the enterprise were not successful. However, if the venture was successful, then they share the profit in accordance with the profit margin.

In the countries with developed market economy the most frequent sources of joint stock capital are: personal savings, “friends and relatives”, “angels”, partners, corporations, investment companies and public sales of stocks. The role of business angels, private investment funds and stock exchanges is of particular importance in the financing of rural entrepreneurship.

3. Elaboration of “Business Angels” as a source of financing expansive entrepreneurship in Serbia

When elaborating institutions and infrastructure for financing entrepreneurship and small enterprises, it is essential to mention the so-called business angels. Business angels are private investors (“rich individuals”) that invest money in new enterprises or in enterprises that are founded in exchange for stocks or share in them. Angels are primarily source of starting capital in companies that are in the starting phase or in the development phase. Their role in the financing of SME is really important.

Thus, in Anglo-Saxon economies they are seen as the only external investors of the early phases of business development and this makes their role extremely significant for small enterprises. Business angels usually invest capital on an informal basis and into projects, which are similar to their former entrepreneurial experience. In the USA for example, the presence of business angels is a stepping-stone in business development. There are significant investments of business angels in this country and their amount is usually between \$50,000 and \$500,000.⁴ Using the Atlas Method, which is the World Bank’s official estimate of the size of economies by which the US GNI per capita is 8.33 times larger than that of Serbia⁵ it derives that, *ceteris paribus*, business angels, as currently missing financial institutions in Serbia, could approximately invest between \$6,000 and \$60,000 per one investment.

One of the key reasons why there are not enough business angels in Serbia, except a few of them in major cities, is the fact that entrepreneurship, as such,

⁴ R. Smith: *Entrepreneurial Finance*, John Willey and Sons, London, 2000, pp. 37-38.

⁵ WORLD BANK ORG: retrieved August 2, 2009, from <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf>

exists for a relatively short period of time. In 1988⁶ the first enterprise law was enacted legalizing market forces as the basis for regulation of economic life and proclaiming profit as the main aim of enterprises. Therefore, entrepreneurs have not had enough time to make a more surplus capital which would be available for investment in new entrepreneurial ventures.

The situation is similar in many other developing and transition economies which try to compensate this by forming the so-called micro credit organizations to finance early business development phases. Contribution of microcredit organizations has obviously been quite significant in some countries such as Bosnia and Herzegovina.⁷

As it is not exclusively reserved for the business early development phases, the timing of business angel appearance is shown best in the table below.

Table 1: Timing of business angel appearance

SME sources of finance in different phases of life cycle	Savings, friends partners	Business angels, risk capital, leasing	Credits, factoring and leasing	Securities	Public debt Acquisition and possible sale
1. Development and start-up	x				
2. Early growth	x	xx	x		
3. Accelerated growth and consolidation		xx	x	x	
4. Aging			x	x	
5. Transfer or succession				x	
6. Leaving a project				x	x
7. Death					x

Not all the business angels appear in the early financing phases. The moment of entering a business depends on inherent risk and the rate of return of invested risk capital. Those business angels who invest capital during *the mezzanine phase*⁸ are exposed to less risk of losing an investment than in earlier phases because there are chances for appreciation of company's founding capital at the time of initial public offering and appearance on the stock exchange. None of the

⁶ Official Gazette SFRY 77/1988, and amendments no. 40/89

⁷ M. Vemić: *The emerging role of microfinance, Some Lessons from Bosnia*, retrieved August 2, 2009, from http://www.uncdf.org/english/microfinance/pubs/newsletter/pages/2005_02/news_bosnia.php

⁸ G. Bannock, W. Manser: *Dictionary of Finance*, Penguin books, London, 1989

financing phases are exclusively reserved for only one sources of finance. Since the appearance of business angels and *mezzanine sources of finance*⁹ is typical for the early phases of company's development, initial public offering and appearance on the stock exchange occur later because it requires company's maturity and a change of ownership of capital. Stock financing is comfortably linked with appearance of business angels. In addition, it enables further growth of company's own capital and ensures its overall development.

Business angels may be a co-financing source during the development business phase when an entrepreneur already manages to get underwritten or bank financing and in this case, it is so-called *hybrid financing*. This term implicates presence of different financial resources, which give an entrepreneur a comfort to optimize the capital structure and to diversify risk.¹⁰

At the end of this consideration, let us reflect on main problems with the sources of finance in Serbia and other transition economies.

Stemming from the already mentioned semi-structured interviews carried out in four Serbian districts following is our classification of identified problems with sources of finance:

1) Unfortunately, the shown model of financing entrepreneurship and small enterprises has not still become popular enough; 2) basically, the only exceptions are the large cities such as Belgrade, as extremely urban area with developed bank network and other financial infrastructure; 3) even in the Serbian urban areas, there cannot be mention of different kinds of non-bank hybrid sources of finance; 4) as a result rural environments drop far behind when sources of finance and financial infrastructure are concerned; this often leaves rural entrepreneurs without sources of finance. This was also appropriately observed by Smallbone D., based on Zucchini's research from 1997 that "...while the stock exchanges in progressive countries of transition developed relatively fast, the national markets of risk capital are literally non-existent whereas the bank system is very inadequate...";¹¹ 5) in most rural areas of Serbia, there is only one or two bank branches and the only mitigating circumstance is that for smaller credits these banks do not have to ask for approval for from the main office in Belgrade.

⁹ J. Downes, J. E. Goodman: *Dictionary of Finance and Investment Terms*, Barrons Educational Series, New York/ London, 1985

¹⁰ J. P. Williamson: *Investment Banking Handbook*, John Wiley & Sons, New York, 1988, pp. 164-169.

¹¹ *Proceedings of the International Conference on Problems and Factors of Success in Business Perspectives of Upcoming Markets and Transitional Economies*: Bishkek: Kyrgyzstan, April 2004, pp. 128-143.

In short, arrival of business angels in rural environments will depend on the following few main factors:

- The level of financial risk versus potential profit in rural environment;
- Rate of diffusing financial innovation from urban to rural environment;
- Capability of urban and rural environments to form a savings pool and to build synergistic effects of between development capital and risk capital;
- Availability of profitable entrepreneurial ideas in rural environments;
- Level of education rate and entrepreneurial abilities of rural managers.
- Finally one more feature of business angels must not be forgotten: they invest in committed and educated entrepreneurs who know what they want in business and they perform monitoring and control of their business. After all, it has to do with investment of own capital.

Unless these conditions are fulfilled, it seems unrealistic to expect sustainable expansion of small and medium enterprises in rural environments of Serbia, and likewise faster development of these areas also seems unlikely.

4. Elaboration of private investment funds and venture capital funds as potential sources of finance for expansive rural businesses

Private investment funds represent a special form of investment that differs significantly from both opened and closed investment funds. Their business is often not regulated by the securities law, but rather by company law and/or law on investment funds. They are organized as limited liability companies and are available only for large individual investors, since the minimal start-up investment is €50.000 in Serbia,¹² whereas this limit is bigger in other countries. Generally, a smaller number of investors exist within these funds: rich individuals, investment banks, private or public pension funds, foundations, corporations, or other institutionalized investors. Capital collected in this way can be invested further, in expansive rural companies which are too risky for standard capital markets and bank loans, or perhaps they do not have long enough business history to be acceptable for bank credits. Therefore, an alternative for rural bank credits is *equity*, a financing method for enterprises that is often more suitable than a typical bank credit. Arrival of private investment funds in rural environments will depend on similar conditions already mentioned for business angels, but we leave aside these details and explain the functioning model instead.

Private investment funds function by investing in a part of companies' capital (ownership), at different development phases, acquiring a minority or majority stake, aiming to increase company value and sell its shares at an appropriate medium term. These funds almost never stay more than ten years, and usually,

¹² Official Gazette of Serbia 46/2006, article 74

they come out after 5 to 7 years in order to achieve a multiple return on invested capital: the average internal rate of return (IRR) is 20-25% per annum. Profits of private investment funds depend on increase of value of the recipient company. It is therefore important to make a right choice of a company for investment. After all this is also the crucial issue when choosing formerly described securities. Activities which private investment funds undertake in order to increase the company's value relate to restructuring, often requiring huge investments, provision of know how that will allow further company expansion, development of new technologies, optimization of costs and strengthening of company's financial position.

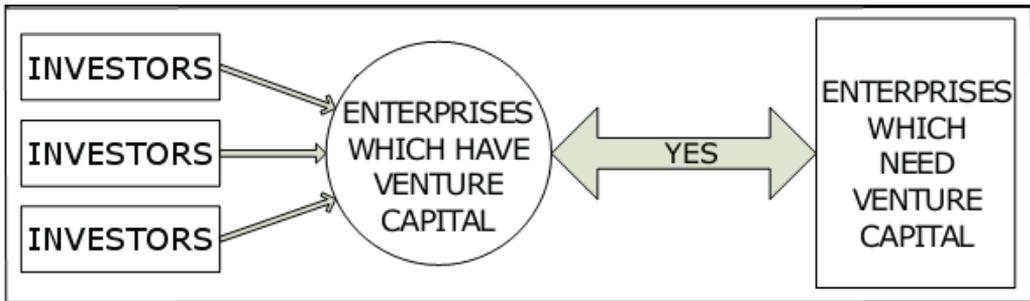
Private investment funds perform detailed analyses on how different companies do business before making an investment and define entry and exit strategies as well as the various activities required to achieve desired goals. Some of the exit strategies include: initial public offering and listing in stock exchanges, selling a company, or a joint venture. These forms of investment certainly represent a chance for development of perspective and expansive rural enterprises, which lack development capital as described above, but at the same time they represent a limiting factor for private investment funds since they frequently own the entire share in a company. However, as the share of capital is not standardized like with companies on the stock exchange private investment funds can dispose with their investment more flexibly than on stock exchanges.

Very popular funds are the so-called *venture capital funds*, funds, which invest in start-up companies and offer the possibility of expert advice and consulting services. The risk they take in this case is very high, but higher profit can be expected once the company becomes established.

Venture capital funds actively take part in company management enabling the recipient company to use their human resources, i.e. professionals who take part in daily operations and company's development, thus helping the entrepreneur to stand out against competition. When investing, venture capital funds also make an effort to diversify risk by developing a portfolio of several valuable young companies creating a unique venture fund. In many cases, they co-invest with other VC companies. Frequently, the capital of several such companies is invested on the same project. Examples of a few world renowned companies which used this form of finance include: *Apple, Federal Express, Intel, and Microsoft*.

The systemic model of a functioning VC company can be depicted as follows:

Figure 1: A functioning model of VC Company

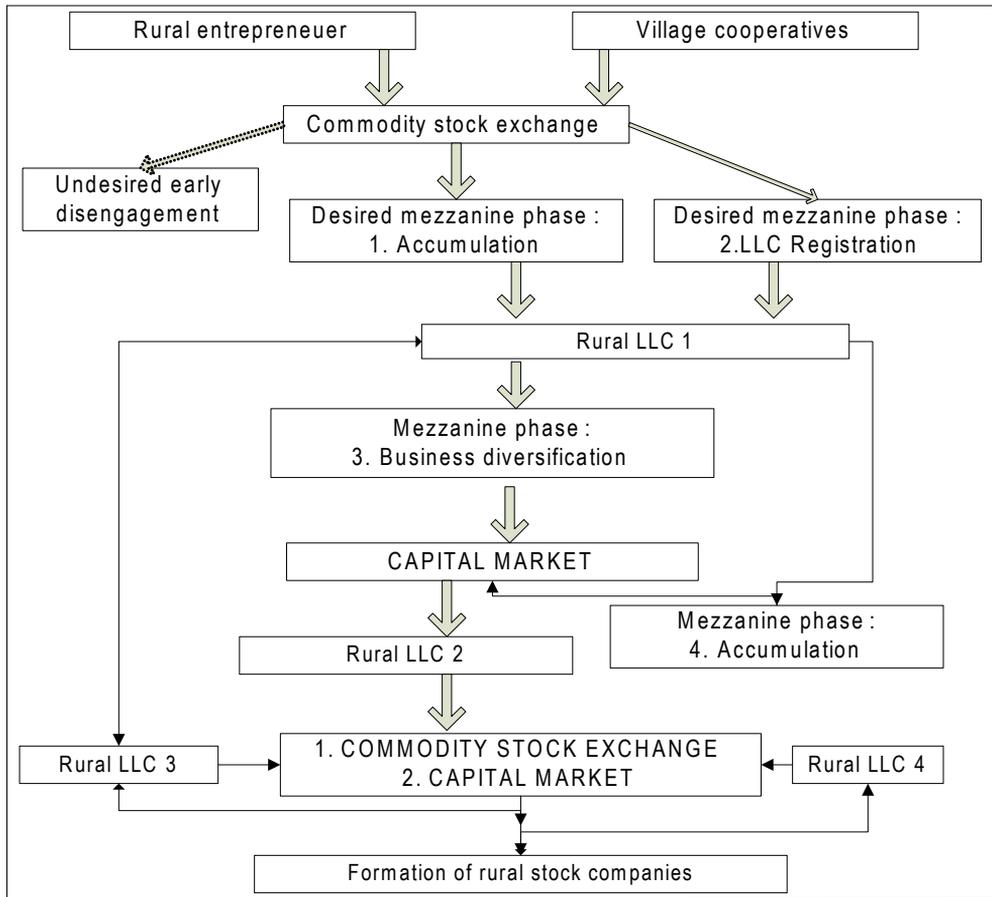


It is important to notice the level of risk which these funds have to bear, since, as opposed to typical bank loan, venture capital funds achieves their profit by increasing the profitability of the recipient company. Therefore, profits of venture capital investors exclusively depend on the recipient company's success. Contrary to that, in the case when a bank lends its capital, the risk is quite lower and the bank is entitled to charge lending rates and be refunded as contracted, regardless of the recipient company's market success.

5. Modeling stock exchange financing of rural entrepreneurships and SME

With the gradual development of rural businesses and growth of productive capability of rural SMEs, it becomes essential to focus attention on well functioning stock exchanges that can serve these clients as well and not only businesses in urban areas. Following is a scheme for the development of a functioning model of stock exchanges also serving expansive rural SMEs:

Figure 2: A model for establishing the stock exchange based financing of SMEs in the function of rural development



It can be clearly seen from the above illustration that the model for establishing stock exchange based financing of SMEs in the function of rural development is a gradual one which requires several steps including business diversification, company registration and appearance on both commodity and capital exchanges.

5.1. Learning from leading stock exchanges in the region for benchmarking

Raising awareness about possible models of stock exchange based financing is the best way to improve the strategy and investment capacity of national stock exchanges. Ministries of Finance, associations of banks and other financial organizations should organize a few well targeted visits to leading stock

exchanges in transition for the purpose of benchmarking. In the context of stock exchange based financing of rural entrepreneurship *Benchmarking* represents systematic and continuous processes of measurement and comparison of stock exchange processes and activities of one stock exchange in relation to business processes and activities of a selected stock exchange. Normally the selected benchmark is a leader in the region or in the world, in order to obtain information that will assist organizations to improve their stock exchange performances. Benchmarks to be used are valid current/historic conditions and indicators on capital markets.

It is essential that preparation of benchmarking visits includes providing detailed information to host countries about the visitors, stock exchange products that would be interesting, planned financial infrastructure, etc., but also the contacts at the highest level with the public sector, entrepreneurs and companies. This would help the visitors from transition economies such as Serbia to develop a deeper understanding of crucial success factors in these countries. The idea to return benchmarking visits should be supported, as this is a way to build markets.

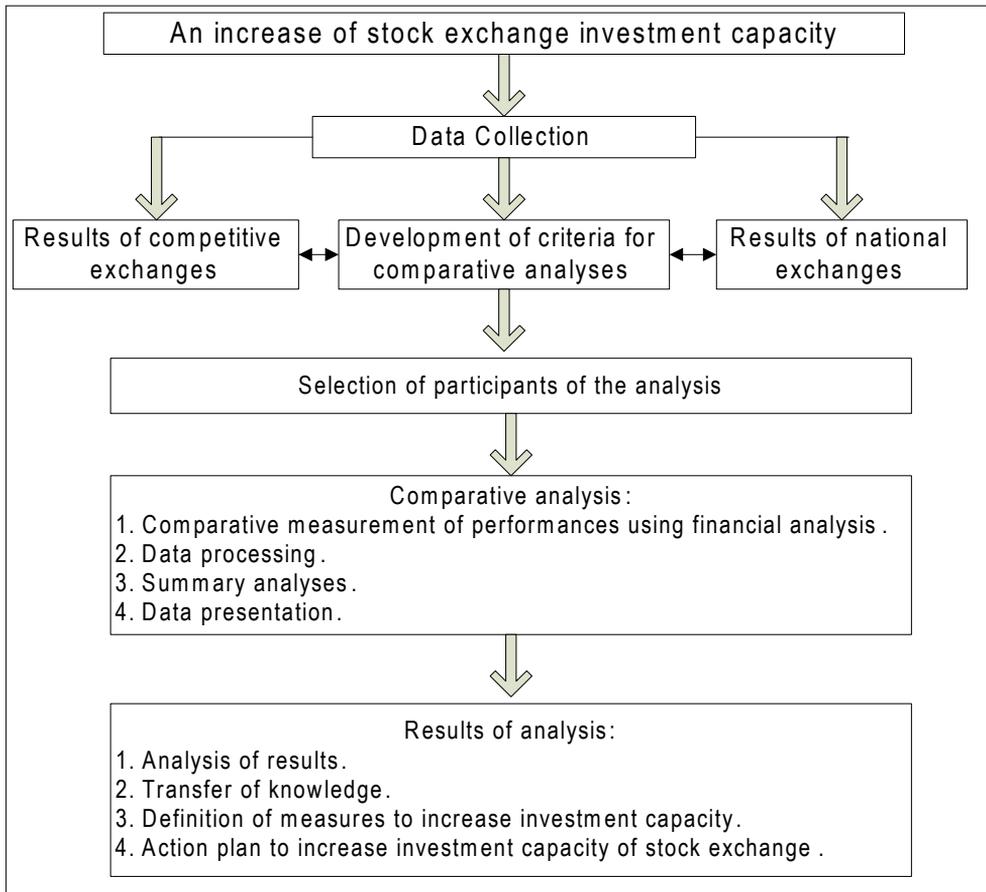
One of the main results of benchmarking visits would be creation of information frameworks on stock exchanges in the countries of the region, and would enable various market players to collect and analyze activities of the main stock exchange events and related opportunities for rural entrepreneurship. The information framework can relate to market materials, solutions for communication infrastructure, promotion and marketing activities, government regulations and possible rural development subsidies.

Following is our conceptual model for benchmarking stock exchanges that can be applied to attract and develop private investment for rural entrepreneurship.

5.2. Development of a model of establishing of benchmarking stock exchanges as a pre-condition for development of stock exchanges

It clearly proceeds from our illustration that the key to successful benchmarking of stock exchange investment capacity for rural development is to analyze national and competitive exchanges side by side using comparative financial analysis¹³ and to transfer appropriate knowledge.

¹³ B. Stavrić, M. Stamatović: *Menadžment*, Fakultet za finansijski menadžment i osiguranje, Beograd, 2003, pp. 512-513.

Figure 3: Model of benchmarking stock exchanges

6. Conclusions

It could be said that the basis of development of all other product and service markets is the platform of financial market, both money market and capital market, which is set in high quality. While, through money markets, enterprises obtain resources to maintain current liquidity, through capital markets, they acquire resources, which are necessary to finance their business development, and therefore it is said that a well functioning capital market¹⁴ is the engine of economic development.

Developed capital markets facilitate the connection of subjects which have excesses of financial resources to the subjects which lack financial resources,

¹⁴ M. Vemić: *Nauka o finansijskom menadžmentu*, Cekom books, Novi Sad, 2008, pp. 267-308.

i.e. they connect two significant macroeconomic categories – savings and investments.

Capital markets enable normal and undisturbed function of a national economy.¹⁵ All the events in real processes of social reproduction are reflected on them. They represent one of the main postulates of market economy. In its extent, various financial institutions do business. The institutions can be classified into deposit ones, such as banks, savings and credit associations, etc., and on the other hand, there are so-called non-deposit institutions, like insurance companies, pension funds and finally, investment funds which bring freedom on the market. Investment funds¹⁶ and business angels exist in the developed western economies for more than half a century now and their expansive development followed the globalization of the world capital markets and the world economy in general. As such investment funds represent very significant intermediary financial organizations or institutional investors¹⁷ which collect disposable resources from their investors and then place them into short term and long term investments and different financial forms. Their appearance will certainly accelerate the reform and development of the financial sector in Serbia and other developing economies, and their overall process of restructuring, privatization and transition.

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¹⁵ Ibidem

¹⁶ M. Vemić: *Nauka o finansijskom menadžmentu*, 2008, pp. 331-352.

¹⁷ M. Vemić: "Pojam, uloga i značaj investicionih fondova kao učesnika na finansijskom tržištu", *Zbornik radova Pravnog fakulteta u Beogradu*, 2006, pp. 905-922.

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SLAVKO SIMIĆ, MSc^{*}
BRoSS-Trade L.L.C., Banja Luka

CONTROLLING AND IT'S APPLICATION IN SMALL AND MIDDLE ENTERPRISES IN BOSNIA AND HERZEGOVINA

Abstract: *Controlling is one of the most important business functions in companies, and it solves concrete problems of internal and external adapting to all incoming changes in companies. This work will attempt to explain the basic concept of controlling. Controlling is not well known as a business function in our society, so I shall provide some general data regarding controlling, its classification into strategic and operational controlling, as well as analyze the results of a survey. The controlling function in SMEs will become increasingly important in the future, and it is expected that its application will continue to expand.*

Key words: *strategic controlling, operational controlling, SME, B&H*

JEL classification: L 25, M 40

1. Introduction

The concept of controlling has been known in West European countries and the US for centuries, providing support to companies in their business activity throughout its historical development. Once institutes and professional periodicals devoted to controlling were established (in the US, Germany, Austria and other European countries), controlling was no longer just an integral part of economic literature in companies, but was increasingly viewed in practice as unavoidable and irreplaceable support for managing companies. The creation and development of controlling stemmed from the characteristics and practical needs of business management, and today it represents one of the most important functions in the process of solving concrete problems related to companies' internal and external adjustment to changes. We are witnessing new global tendencies and accelerating globalization in all segments, and are affected by increasingly frequent changes in relations between the hyper-supply and demand for goods

^{*} E-mail: bono@blic.net

and services, which is creating additional problems for management. Contemporary business conditions require both contemporary instruments and conceptions for the best possible functioning.

In comparison with other economic segments in the company, the long presence of controlling in the US and some European countries, i.e. in Austria and Germany, has allowed its organization and the application of its instruments to be researched to a greater extent, allowing for insight into its current state. Due to the opening of new markets in East European countries and after the breakup of the Eastern bloc countries and Yugoslavia, questions were raised as to whether companies in these countries were now making a departure from the former planned economy and seeking, with the aid of controlling, to come to terms with the greater dynamism and complexity of doing business, as well as to increase their competitiveness on the market.

Research regarding controlling in small and medium companies has so far been conducted in only one part of Europe, which means that knowledge is almost completely lacking when it comes to other European countries. If we except some individual research, it was impossible to find, even after a detailed search through professional periodicals and books, studies dealing with controlling and its application in small and middle enterprises. Such a situation served as an impetus to conduct research in one transition country, which not only had to undergo the transformation from a planned to a market economy but also had the misfortune of going through a four-year civil war.

The survey was conducted in small and middle enterprises (SME) in Bosnia and Herzegovina (B-H). The obtained information and data analysis should show us the current state of controlling in practice, i.e.:

- the degree to which controlling is applied,
- which persons are charged with performing this function,
- what instruments of controlling are most frequently applied in the company's business practice,
- the reasons for the (non)application of instruments of controlling.

In addition, another goal of this work is to arouse the interest of our businessmen to introduce and develop controlling here, as well as to stimulate further research of this, still insufficiently researched business function.

2. The historical development of controlling

The roots of controlling go back as early as the 15th century, to the royal court of England, where a section was established in the state administration, in which a controller (the name of the position was *Countroullour*) was charged

with checking entries on incoming and outgoing monies and goods.¹ In French-speaking areas, controlling was translated as *Controle de Gestion*,² which means management control, and it was registered as an official court function. By the 1960s, controlling was established in 50% of the most important French companies, all of which had a controlling sector within them. The development of controlling can be traced back to the United States: in 1878, Congress legislated the creation of the positions of *Comptroller, auditor, treasurer and six commissioners of accounts*, which supervised the balance between state expenditures and the state budget. These official positions were the roots of today's office of the *Comptroller General*, which heads the *General Accounting Office* in the US.³

According to Jackson,⁴ the main reasons for the creation of controlling lie in the increasing number of accounting tasks that outstripped the capacities of the director or the person responsible for finances. Other important reasons mentioned in literature include legal reasons, tax matters that could not be handled through existing company structure, complex forms of financing, uncertainty of the environment in which the company operates, growing pressure from the competition, company globalization and expansion (problems in coordination and communication). To these can be added the increased share of fixed costs in company capital as an industrial-technological substitution of human capital and development, and the use of new, more complex instruments for improving management.

About 125 years ago, one company in the US, *Atchinson, Topeka & Santa Fe Railway System*, introduced the position of controller.⁵ His tasks were financial-economic in nature, i.e. managing the company's finances, capital and security. The first industrial company with the job position of controller was the *General Electric Company* in 1892. According to some surveys, in 1900 the position of controller existed in 8 out of 175 American companies. A survey conducted in 1948 revealed that, out of 195 surveyed companies, as many as 143 had introduced such a task sector, with an average age of 22 years.⁶ The first association of controllers in the US was formed in 1931, under the name of the *Controllers*

¹ P. Horvath: *Controlling*, 9th edition, Vahlen, Munchen, 2003, p. 25.

² „Controle de Gestion“ in French: <http://www.eudict.com>

³ P. Horvath: *ibid*, p. 24.

⁴ Excerpts from the article “The Comptroller: His Functions and Organization” by J. Hugh Jackson on the emergence of comptrollers, 1949: <https://www.schaeffer-poeschel.de/download/leseproben/978-3-7910-2759-3.pdf>.

⁵ “The usual initial term *Comptroller* stems from a mistake in translation from the French language. The more accurate *Controller* is now the most frequently used to denote the carrier of the function, whose area of activity is referred to as *Controllership*. The exception are public affairs, in which the positions of *Comptrollers of the Currency* or *Comptroller General of the United States* continue to exist.” Source: quoted from N. Osmanagić Bedenik: *Kontroling – Abeceda poslovnog uspijeha*, Školska knjiga, Zagreb, 2004, p. 28.

⁶ P. Horvath, *Controlling*, 9th edition, Vahlen, Munchen, 2003, p. 27.

Institute of America.⁷ In 1962, it changed its name to the *Financial Executive Institute (FEI)*. The organization numbered about 5000 members at the time, both in the US and Canada. *The Controller* magazine was established three years later (*The Financial Executive* since 1962), and the *Controllershship Foundation* research institute was established ten years hence (the *Financial Executives Research Foundation* since 1962).⁸

Differently from the US, controlling was not introduced in some West European firms until the 1950s. Initially, the presence of *two financial chiefs in a single company* did not inspire confidence, but that was later overcome. At the end of the 1960s (in Italy and Germany), the position of controller could be found only in “German daughter-firms” of American companies, while over 50% of France’s most important firms had an established sector for controlling. The operational environment was static, without major changes (companies worked under stable business conditions – changes were rare, while demand outstripped supply, which meant that just about everything that was produced could be sold, available information about the business environment was relatively reliable, which made planning and forecasting reliable and quite precise). Companies could attain their goals by orienting themselves toward internal factors, most often cost rationalization. Through its *inward* orientation, controlling was fulfilling the function of documentation, control, and rationalization of operations, being oriented toward the past, order and preciseness. It was most often performed by the head of accounting, whose position then carried the name of *registrator*. Analysis has shown that the controller’s task structure was very similar to the task catalogue defined by the FEI, and that accounting, balancing, taxes, cost accounting and calculation, and economic counselling were predominant during the initial years.

During the following years, with the exception of counselling, these tasks gradually lost their importance. Thus, during the 1960s, when the business environment was characterized by limited dynamism, the controller functioned as a *navigator*, setting the direction and being oriented toward immediate activities (dynamic changes in the business environment demanded quicker adjustments, while, at the same time, company growth reduced the overall visibility of business processes). At that time, the saturation of demand and increased supply forced companies to orient themselves *outward*, toward the competition in their branch and competition for market share (fighting to fulfill consumer desires, tastes, needs, etc.), as the time when it was thought that everything that was produced could be sold had passed. Thus, it is said that the controller’s function in that period was that of navigator, with the typical domains of his tasks being: reporting, calculation and control of accounts, comparing planned and achieved results, operational planning. As a result, his importance grew until the 1980s.

⁷ The association of controllers, *Controllor’s Institute of America*, subsequently renamed as the *Financial Executives Institute (FEI)*. Source: <http://www.financialexecutives.org>.

⁸ *Controllershship Foundation*. Source: <http://www.financialexecutives.org>.

During that period, the controller most often occupied the position of manager of company planning and analysis.

Subsequently, the controller's tasks shifted from operational duties to strategic planning and planning company policy and goals. During the 1990s, the business environment became extremely dynamic, and the controller began to appear as an *innovator*, actively participating in the problem-solving process and being oriented toward strategizing for the future (during the 1990s, companies were constantly exposed to problems and events, the dynamics and complexity of changes were quite high, while information from the environment was quite uncertain and forecasts less and less useful). Companies are exposed to constant changes and it is necessary to constantly adapt the production program, the market offers increasing numbers of products and services, product life cycles are contracting, capital – although difficult to obtain – is no longer key to business success but, rather, highly qualified and motivated associates. For success in a given business field, it is no longer enough just to consider relations with the competition: the influence of buyers and suppliers, and the appearance of new competitors and substitute products are also important. Companies that achieved their growth in the previous period had the additional problem of having to internally harmonize certain parts and functions. These problems cannot be solved with yesterday's instruments: it is necessary to work on the development of new procedures and the application of new techniques of finding solutions. In that sense, the controller is viewed as an innovator who participates in the problem-solving process and who needs to introduce and develop new instruments that should help company managers to solve problems. Some contemporary instruments are: processing and target costs, the conception of weak production and management, strategic control, development of early warning systems, strategic radar, perception of silent signals, development of a strategic balance sheet, etc. The introduction and application of new instruments is supposed to ease and accelerate the process of rapid company adjustment to sudden changes in the environment, i.e. by way of well-conceived activity, the company itself should influence changes in the environment.

As opposed to the position of the controller as *registrator*, in case of the controller as *navigator* and *innovator*, a pronounced managerial orientation is predominant. It can be said that the controller is becoming a highly specialized associate who supports company management, guiding the company into the profit zone with the aid of his tools or instruments of navigation.

2.1 Controlling, instruments of controlling and the controller's role in the company

Controlling has experienced rapid development in recent years, showing its continued relevance in practice. The term itself, like many other management terms during the past several decades, originated in the US. It comes from

the English word “to control,” which means: (1) to direct, manage, order; (2) to guide, conduct; and (3) to use, master, control.⁹ There is no single definition in literature, and it is in any case difficult to form a single description of the tasks of controlling. What should be understood is that *controlling is not control*, as many interpret it, but a function within a company, whose goal is to extend *expert help to management*, towards the goal of making the most quality (correct and timely) business decisions. Namely, it is a contemporary concept of company management, which increases management effectiveness and efficiency, thus increasing the company’s ability to adjust to internal and external changes, and raising its vitality and market acceptance..

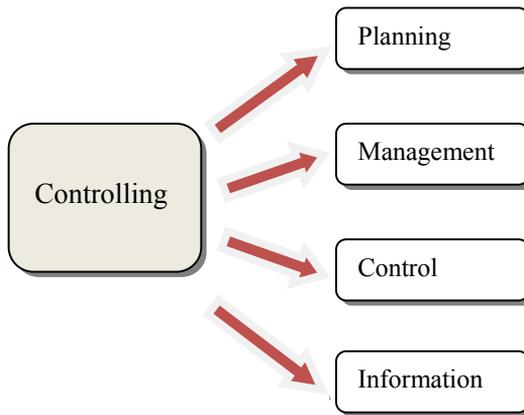


Figure 1: *The basic functions of controlling.*

Figure 1 illustrates that we cannot view controlling solely as a part of the management system, since it also plays a very important role as an auxiliary instrument that is available to management for attaining company goals.

Just as a pilot in an airplane cannot operate without “navigation instruments,” i.e. he cannot fly the plane without a fuel gauge and altitude gauge, cannot reach his final destination safely, on time and according to plan, we can view the function of controlling in the same way – as a process of navigation with instruments attuned to the company’s business goals. Business *organization* is an important area of company management activity, with an accent on the coordination and integration of certain management sub-systems, towards the goal of harmonizing mutual activities. *Controlling* appears as the answer to the increasing need for coordination and integration within the system of management.

⁹ R. Eschenbach, R. Niedermayr: *Controlling*, 2nd edition, Stuttgart, 1996, p. 49.

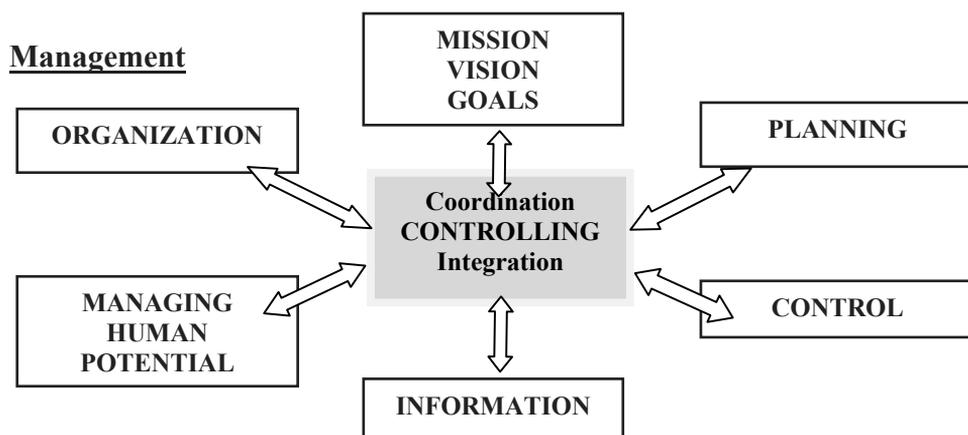


Figure 2: Harmonization of company management subsystems¹⁰

From Figure 2 we can see that controlling holds the central position within the system of management, being tasked with the coordination and integration of the other management sub-systems, which means that it is responsible for shaping and linking the company's value systems,¹¹ as well as control, information, organization and human potential management. It can thus be said that the task of controlling is to support management in running the company.

In order to make a distinction between the *manager* and the *controller*, we should also understand the difference between these two functions. While their activities and goals are analogous, the ways in which they achieve them are different: the *manager* is responsible for defining goals,¹² results, and company success, while the *controller* is, among other things, responsible for their transparency, i.e. for building and using economic instruments for success.

Good controlling aids in the company's navigation, i.e. participates in the management's success through operative and strategic instruments, while management, accepting controlling as a given, is the one that determines the success¹³ of controlling in the company. Through a constant application of instruments of

¹⁰ N. Osmanagić Bedenik: *Kontroloing – Abeceda poslovnog uspjeha*, Školska knjiga, Zagreb, 2004, p. 230.

¹¹ Defining the company's mission and vision.

¹² Care should be taken that goals are SMART (S-specific, M-measurable, A-achievable, R-reliable, T-time-bound).

¹³ *Styles of management* affect the success of controlling: authoritarian, patriarchal and advisory styles of management, when the superior himself makes decisions, convinces and gives orders, appears as a barrier to the development of controlling. Contrary to these styles, cooperative, participative and democratic styles of management, when decisions are made jointly, will spur the development of controlling. It should be emphasized that good controlling does not depend on the controller alone, but can be achieved only with the cooperation of management.

controlling, various techniques and actions that increase coordination and integration, the company's ability to adapt to sudden internal and external changes are improved, allowing for the achievement of set goals and improved market position, and easing the process of making timely and good business decisions on the part of management. The person or persons that perform the controlling function in the company is/are called the *controller*; i.e. a specifically specialized associate who provides support to top management and directs the company, by way of their expertise and adequate application of tools, into the profit zone. The International Group of Controlling – IGC has created a *controller* model, with a description of all the tasks they must perform:¹⁴

- Controllers are concerned with the transparency of results, process and strategy, thus contributing to better business results.
- Controllers coordinate the unified action of goals and plans and organize the reporting of the company's entire operations.
- Controllers moderate the controlling process so that each decision-maker can orient himself in his work toward company goals.
- Controllers secure necessary data and information.
- Controllers order and maintain the systems of controlling.

The company controller acts with his instruments, helping in the execution of *operational*¹⁵ and *strategic*¹⁶ tasks in the company. The instruments of controlling that should be considered as a base for empirical research in small and medium enterprises in Bosnia and Herzegovina are defined in Figure 3, primarily on the basis of their appearance and appropriateness, as well as the results of my years of consulting experience in work with small and middle enterprises.

¹⁴ [Http://www.igc-controlling.org/dt/index_dt.html](http://www.igc-controlling.org/dt/index_dt.html), March, 2008

¹⁵ *Operational* instruments of controlling are based on quantitative key variables, i.e. on numbers from the past or present, using primarily internal information from the company, and its basic task is to help increase *business efficiency*.

¹⁶ *Strategic* instruments of controlling are future-oriented and have the goal and obligation of giving expert support to management in increasing *business effectiveness*, by offering the right things (products and services) at the right time, with the goal of satisfying market.

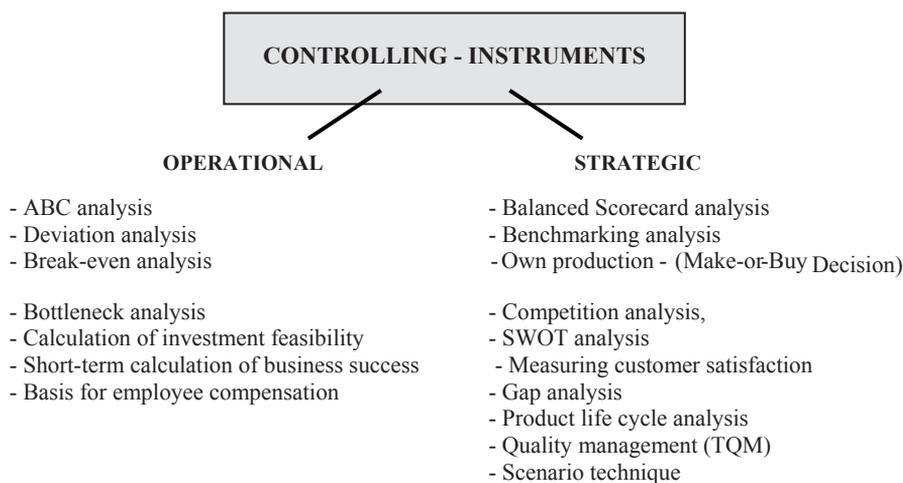


Figure 3: *Instruments of controlling*

Since a detailed research of instruments of controlling has yet to be conducted in small and medium enterprises in Bosnia and Herzegovina, these expert proposals and instrument lists can be viewed as relevant. Of course, there are differences between the said instruments and the choice¹⁷ of instruments from practice in certain European countries where similar research on the application of controlling in small and medium enterprises has been performed.

3. Researching the application of controlling

There are no relevant, available data (either on the Internet or in institutions of higher education) in Bosnia and Herzegovina as to whether any kind of research related to controlling has been conducted in small and medium enterprises. One of the ways to obtain relevant data on its application was to do one's own research. A survey was conducted covering 66 SMEs that met the legal¹⁸ requirements of classification. One survey question dealt with the competence of the person filling out the questionnaire: *what position does the surveyed person hold in the company?* In 59.1% of the cases, the answers were provided by com-

¹⁷ Instruments which some authors have presented in their research as relevant for their field; www.hnafa.de, <http://www.uni-munster.de>, <http://www.bms-consulting.de>, March 2008.

¹⁸ Classification of MSEs, Law on Stimulating the Development of Small and Middle Enterprises, *Official Gazette RS 34/06, Official Register FB-H 19/06*, of March 30th, 2006

pany directors, in 25.8% of the cases by heads of accounting, while only one head of the controlling sector filled out the survey.¹⁹

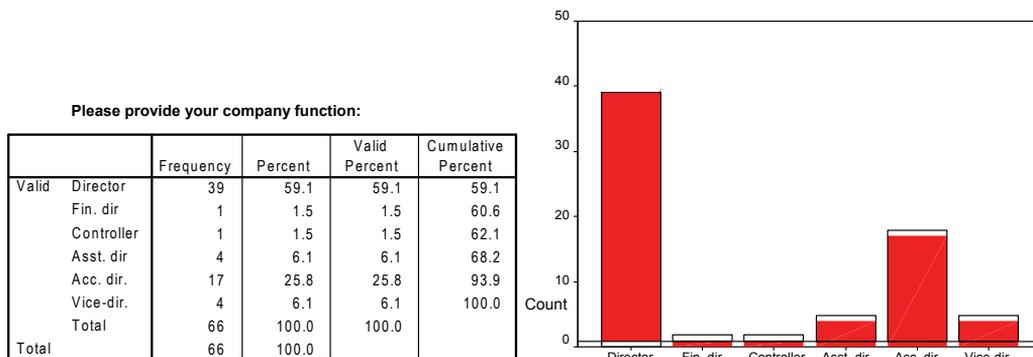


Figure 4: Analysis of the competency of the function of surveyed persons in the company

In order for the survey results to be as objective as possible, those surveyed were previously acquainted with the instruments of operational and strategic controlling that are being applied in MSEs. Below are provided the results of the survey on the application of operational and strategic instruments of controlling, the reasons for the lack of application of controlling instruments, as well as the institutional definition of controlling.

3.1 Results of the analysis of the application of operational instruments of controlling

This part of the work will present analyzed data on the application of *operational instruments of controlling* in MSEs in B-H. The tabular presentation in Figure 5 answers the question: *is a classification of suppliers, goods and tasks according to importance being performed in the company, i.e. is the ABC analysis performed in the company.*²⁰

¹⁹ Competency means that all the given positions possess necessary knowledge on company activities that are relevant to controlling. The persons that filled out the questionnaire belong to top management, where such a function provides them insight into business operations and the organizational structure, which is why their replies have a high degree of accuracy and reliability.

²⁰ ABC analysis serves to increase company economic efficiency by separating essential and less essential variables. ABC analysis ranks problems according to their importance for the set goal, so there are three grades from which the method received its name: A – “very important,” B – “less important,” and C – “unimportant.” It is an instrument of information.

Does your company perform classification of suppliers, goods and tasks according to their importance: Goods

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	12	18.2	18.2	18.2
	Fairly often	5	7.6	7.6	25.8
	Occasionally	8	12.1	12.1	37.9
	Never	37	56.1	56.1	93.9
	Unknown	4	6.1	6.1	100.0
	Total	66	100.0	100.0	
Total		66	100.0		

Does your company perform classification of suppliers, goods and tasks according to their importance: Task

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	12	18.2	18.2	18.2
	Fairly often	9	13.6	13.6	31.8
	Occasionally	13	19.7	19.7	51.5
	Never	22	33.3	33.3	84.8
	Unknown	10	15.2	15.2	100.0
	Total	66	100.0	100.0	
Total		66	100.0		

Does your company perform classification of suppliers, goods and tasks according to their importance: Suppliers

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	14	21.2	21.2	21.2
	Fairly often	17	25.8	25.8	47.0
	Occasionally	14	21.2	21.2	68.2
	Never	14	21.2	21.2	89.4
	Unknown	7	10.6	10.6	100.0
	Total	66	100.0	100.0	
Total		66	100.0		

Figure 5: Degree of use of ABC analysis

On the basis of the obtained data, it may be concluded that the ABC analysis is mostly used in MSEs in B-H, and that suppliers hold a special place in the observed companies. On the other side, classification of tasks is the least used. The values expressed in the tables lead to the assumption that the use of certain classifications declines in proportion to their complexity. Thus, it is easy for companies to classify suppliers, since all they need to do is observe either the value of goods supplied by a supplier relative to the total value of all deliveries, or the importance of the delivered parts for production. It is also easy for merchants to classify goods according to importance, e.g. on the basis of share in total profits. The qualification of tasks according to their importance requires good knowledge of the business value chain, which is difficult to realize in some companies, especially small and middle companies, i.e. it requires more work and time.

Surveyed large companies apply the ABC analysis very often, to all the subjects of classification.

As for *deviation analysis*, it was concluded (see Figure 6) that this is a very frequently applied instrument of controlling, and that control, as one of the four

functions of controlling, does not play an unimportant role in the analyzed companies.²¹

Is comparison of planned and realized profits, costs, liquidity, etc performed in your company, on a planned basis?

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	34	51.5	51.5	51.5
Occasionally	27	40.9	40.9	92.4
Never	5	7.6	7.6	100.0
Total	66	100.0	100.0	
Total	66	100.0		

Is Break Even analysis performed in your company – are total costs covered out of total revenues, i.e. is the Break Even point (BEP) calculated – or the profitability threshold?

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	27	40.9	40.9	40.9
Occasionally	19	28.8	28.8	69.7
Never	12	18.2	18.2	87.9
Unknown	5	7.6	7.6	95.5
Should plan	3	4.5	4.5	100.0
Total	66	100.0	100.0	
Total	66	100.0		

Figure 6: Deviation analysis and break even point-BEP analysis presented tabularly

Definition of the *break even point – BEP or the profitability threshold*, despite their importance and relative ease of calculation, are performed very often in only 40.9% of the companies, while in 28.8% it is performed occasionally. In 18.2% of cases, this sort of analysis is never performed, while 7.6% of the companies are not familiar with this method²² (as shown in the tables in Figure 6).

Although such a low number of companies that use this method was unexpected – bearing in mind its relative ease of use – the reason may be found in the complexity of separating variable and fixed costs. Deviation analysis was a very frequently used instrument in one of the large companies, while it was used occasionally in the second. In both cases, definition of the break even point is performed very often.

As for the question regarding the *calculation of short-term business success and the time interval in which it was performed*, the analysis presented in Figure

²¹ The task of this analysis is to identify the causes and effects of deviation (application of control as a function of controlling), so that, on the basis of this expert evaluation, shortcomings in the processes and bases of predictable variables can be removed, in order to raise the degree in which goals set by the company are achieved.

²² Break-even analysis shows when earnings from turnover cover the company's entire costs; at that level, the company is neither making a loss or a profit.

7 shows that 95.5% of the surveyed companies regularly perform this kind of calculation.²³

YES: In what time intervals is short-term business success calculated?

Is short-term success calculated in your company?				
	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	63	95.5	95.5
	No	3	4.5	100.0
	Total	66	100.0	100.0
Total		66	100.0	

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Monthly	27	40.9	40.9	45.5
	Quarterly	20	30.3	30.3	75.8
	Biannually	14	21.2	21.2	97.0
	Annually	2	3.0	3.0	100.0
	Total	3	4.5	4.5	4.5
Total		66	100.0	100.0	

Figure 7: Calculation of short-term business success

In the surveyed large firms, currency of data plays an important role, which is why these companies receive monthly information about business success. From this it may be gathered that calculation of success makes up a clear, integral part of reports on operations in the surveyed companies, and that it primarily serves as a way of collecting valuable information for running the company. And regularity of calculating success is not the only thing of importance, but also the fact that information about success are available in relatively short time intervals in most of the surveyed companies.

3.2. The application of strategic instruments of controlling

This portion of the work will present the evaluation of results obtained by analyzing the application of instruments of strategic controlling in small and middle enterprises in Bosnia and Herzegovina. The sequence of presenting the strategic instruments of controlling is given on the basis of evaluating data in the context of questionnaire structure, in order to present a better picture of the answers that were given.

The question of whether *benchmarking – comparison of products, services, processes and strategies* with other successful companies is performed in the analyzed companies, was answered as shown in Figure 8.

²³ “The calculation covers the numerical portion of operational planning, relates to a specific time and/or project, and encompasses performance, measures and costs. It is an instrument of management, coordination and control by the decision-maker, towards the goal of achieving business success.

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	29	43.9	43.9	43.9
Occasionally	26	39.4	39.4	83.3
Never	9	13.6	13.6	97.0
Unknown	2	3.0	3.0	100.0
Total	66	100.0	100.0	

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	25	37.9	37.9	37.9
Occasionally	19	28.8	28.8	66.7
Never	21	31.8	31.8	98.5
Unknown	1	1.5	1.5	100.0
Total	66	100.0	100.0	

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	18	27.3	27.3	27.3
Occasionally	19	28.8	28.8	56.1
Never	23	34.8	34.8	90.9
Unknown	6	9.1	9.1	100.0
Total	66	100.0	100.0	

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very often	18	27.3	27.3	27.3
Occasionally	20	30.3	30.3	57.6
Never	24	36.4	36.4	93.9
Unknown	4	6.1	6.1	100.0
Total	66	100.0	100.0	

Figure 8: Benchmarking analysis

Evaluation of the collected information showed that more than a third of the companies regularly perform *comparison of products* and more than a third perform *comparison of services*. *Comparison of strategies and processes* is performed less often. The reason lies in the difficulty of obtaining information about *strategies and processes* in successful companies, but also in the fact that evaluations of own business processes (value creation chain) or strategy setting are not being performed.²⁴ This fits in with the way of functioning of this group of companies, which is characterized by a high level of improvisation in business processes and a lack of basic economic business knowledge on the part of the directors, which reflects on their management capabilities. In the context of the said lack of knowledge, a question arises regarding the ability of these directors to formulate strategy oriented towards long-term business goals, as, logically; strategies can be compared only after a strategy is actually defined.

In two large companies, heterogenous results were obtained regarding *benchmarking*, which does not allow any assumptions to be formed. One company regularly (very often) compares only products and services, while the second company more frequently compares services and strategies.

²⁴ Benchmarking is a technique of comparative analysis of one's own business operations with those of the best company (Best Practices) and, thus, represents a technique of knowledge and learning.

Generally speaking, the data show that benchmarking is not an unfamiliar controlling instrument among the said companies.

The controlling strategic instrument of *alternative scenario analysis* attempts to identify all variables that might exert a significant future influence on the company, in order to evaluate their possible effect. The goal of this process is to support companies in formulating an achievable business strategy.

Do you perform alternative scenario analysis as part of your planning

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Yes	43	65.2	65.2	65.2
No	23	34.8	34.8	100.0
Total	66	100.0	100.0	
Total	66	100.0		

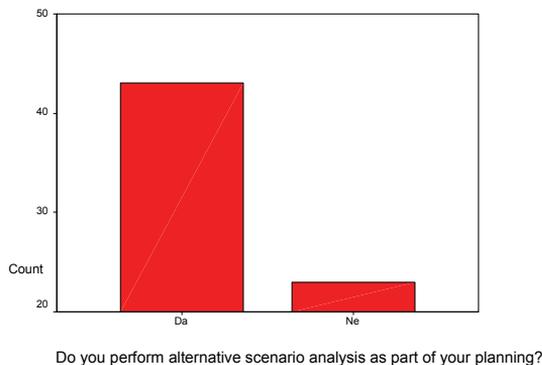


Figure 9: Analysis of creation of alternative scenarios

The survey shows that the creation of *alternative scenarios and their analysis* is performed by 65.2% of the surveyed companies. The remaining 34.8% do not use the scenario technique, which can be explained by the fact that one, not insignificant portion of the surveyed companies did not identify in their planning the most important variables that influence the company's future existence, thus standing unprepared before the dangers of unexpected events that might jeopardize the company. This is also the case with one surveyed large company.

Results of the survey of the application of the strategic instruments of *Balanced-scorecard, gap analysis, analysis of the competition, product life cycle and SWOT* are jointly presented and commented in the tables in Figure 10.

**Which strategic instrument is applied in your company:
SWOT analysis**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	20	30.3	30.3	30.3
	Occasionally	17	25.8	25.8	56.1
	Never	16	24.2	24.2	80.3
	Unknown	12	18.2	18.2	98.5
	Use planned in future	1	1.5	1.5	100.0
Total	Total	66	100.0	100.0	
Total		66	100.0		

**Which strategic instrument is applied in your company:
Balance Scorecard**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	1	1.5	1.5	1.5
	Occasionally	4	6.1	6.1	7.6
	Never	15	22.7	22.7	30.3
	Unknown	42	63.6	63.6	93.9
	Use planned in future	4	6.1	6.1	100.0
Total	Total	66	100.0	100.0	
Total		66	100.0		

**Which strategic instrument is applied in your company:
gap analysis**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	1	1.5	1.5	1.5
	Occasionally	4	6.1	6.1	7.6
	Never	27	40.9	40.9	48.5
	Unknown	21	31.8	31.8	80.3
	Use planned in future	13	19.7	19.7	100.0
Total	Total	66	100.0	100.0	
Total		66	100.0		

**Which strategic instrument is applied in your company:
Analysis of competition**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	18	27.3	27.3	27.3
	Occasionally	17	25.8	25.8	53.0
	Never	16	24.2	24.2	77.3
	Unknown	4	6.1	6.1	83.3
	Use planned in future	11	16.7	16.7	100.0
Total	Total	66	100.0	100.0	
Total		66	100.0		

**Which strategic instrument is applied in your company:
Product life cycle analyses, product life cycle analyses**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very often	4	6.1	6.1	6.1
	Occasionally	10	15.2	15.2	21.2
	Never	23	34.8	34.8	56.1
	Unknown	22	33.3	33.3	89.4
	Use planned in future	7	10.6	10.6	100.0
Total	Total	66	100.0	100.0	
Total		66	100.0		

What was your company's turnover in the previous year: * Which strategic instruments are used in your company: Analysis of competition Cross-tabulation

Count

	Which strategic instruments are used in your company: Analysis of competition					Total
	Very often	Occasionally	Never	Unknown	Use planned in future	
What was your company turnover in million the previous year						
0 - 4 KM	6	6	9	2	6	29
5 - 10 million KM	5	5	5		2	17
11 - 50 million KM	5	6	2	2	3	18
Over 51 million KM	2					2
Total	18	17	16	4	11	66

Figure 10: Strategic instruments of controlling

Figure 10 shows the results of the study conducted in small and medium enterprises in B-H, and the obtained values for five surveyed and analyzed strategic instruments.

Thus, *SWOT analysis*²⁵ is performed in 30.3% of companies very often, and occasionally in 25.8%, making up for a total of 56.1% companies that apply SWOT analysis in small and middle enterprises in B-H.

*Analysis of competition*²⁶ is applied as a strategic instrument in 27.3% of the surveyed companies regularly, and occasionally in 25.5% of the surveyed companies.

In spite of the fact that only one company regularly uses the *BSC-Balanced Scorecard* instrument (created by Norton and Kaplan),²⁷ while four companies use it occasionally, our conclusion is that BSC has experienced a slow expansion among the analyzed companies in B-H and that these numbers are surprising. The reason should be sought in the fact that the BSC instrument was developed in the early 1990s, when war broke out in B-H and that, in the post-war period, in comparison with other countries in which general conditions did not change so extremely in such a short period of time, B-H companies did not have sufficient time to introduce the latest controlling instruments. Having in mind the fact that no similar analyses on the use of BSC in B-H companies were previously performed, it can nevertheless be concluded that progress has been made in the use of this recently introduced instrument of strategic controlling.

In contrast to the above two instruments, the *product life cycle analysis*²⁸ and the *gap analysis*²⁹ are either not used at all in most companies or are unknown

²⁵ "SWOT or TOWS analysis is an acronym standing for: Strength, Weakness, Opportunities and Threats." SWOT analysis is a qualitative analytical method by which, through the valuation of elements within 4 fields of analysis – possibilities, limitations, advantages, shortcomings – the strong and weak sides, and the opportunities and threats of the observed subject or phenomenon are evaluated.

²⁶ The goal of competition analysis is a systematic analysis of the situation, i.e. constant collection of all information needed for defining, defending and improving the competitive position of the given company. In order to better understand the competition, it is necessary to analytically process company data: earnings strength, financial strength, strategic goals, investments, array of products, market position, production capacities, innovative weaknesses, delivery periods, research and development, etc.

²⁷ The Balanced Scorecard-BSC concept allows managers to introduce four new management processes (*financial, buyers, internal business processes, learning and development*), which, alone or combined, contribute to the linking of long-term strategic goals with short-term actions. This approach organizes the company's vision, mission and strategy into a clearly presentable system for measuring results. BSC manages and shapes the overall system of planning, management and control, which was developed by Norton and Kaplan, who first applied it in 1992.

²⁸ PLC- Product Life Cycle Analysis follows the development of the sales, i.e. profits or losses of a certain product relative to a given time period. The analysis is based on the idea that products undergo different phases from the product's development, to its introduction to the market and subsequent withdrawal from the market, and that these phases produce characteristic values for sales or profit/loss.

²⁹ The goal of gap analysis is to identify differences/deviations between projected target quantities and current and historical values. In other words, it is supposed to show the

to them (see Figure 10). A confirmation of the thesis that a deficit in the use of instruments of strategic controlling exists regardless of company size is provided by the replies of two surveyed large companies. One of them occasionally uses analyses of the competition and BSC, and very often uses the life cycle analysis, while the remaining two instruments of strategic planning that were subjects of the survey are totally unknown to it. The second large firm deviates from this thesis, since it uses all five strategic instruments either regularly or occasionally.

3.3. Institutional organization of controlling

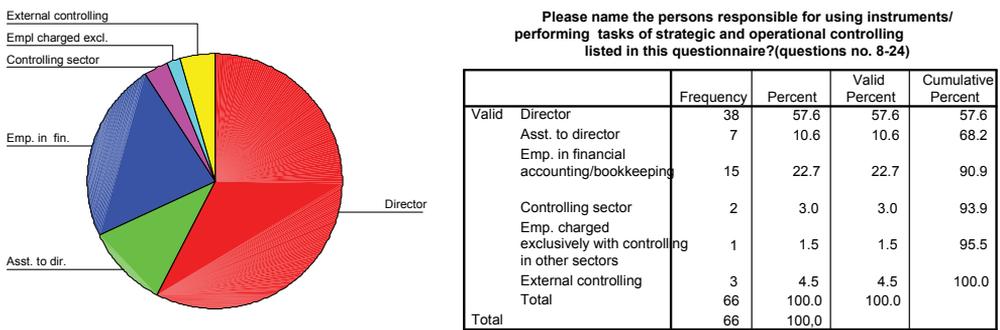


Figure 11: Institutional organization of controlling

Figure 11 gives us the answer to the question, *which person(s) is/are responsible for using instruments/performing tasks of strategic and operational controlling?* The results show that only 3% of surveyed companies have a *separate sector for controlling*. Other forms of organization of controlling are not widespread in the surveyed companies. One firm has employees *charged with controlling who perform their jobs in other company sectors*, while *external controlling* is performed in only three analyzed companies.

Such a result is not surprising in the context of the low division of labor by job function and sector, since it is known that, differently from large companies, small and medium companies are characterized by the accumulation of functions in the person of company “director.”

Confirmation of such organization of controlling is given by the survey conducted in MSEs in B-H, in which 57.6% of controlling tasks are taken on by the *director* personally. The analysis also shows that, after the director, second place in taking on controlling tasks is held by those employed in *financial accounting/*

gaps between planned and achieved performance. The results of the analysis can show two kinds of gaps: strategic and operational gaps.

bookkeeping (22.7% of total cases), while third place is held by *the director's deputies and assistants* (10.6%).

The survey was also supposed to show the reasons for the non-implementation of controlling instruments.

List the reasons why some of the given analyses are not performed in your company: Inability to find employees with appropriate qualifications

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Correct	40	60.6	61.5	61.5
	Mostly correct	6	9.1	9.2	70.8
	More correct than incorrect	2	3.0	3.1	73.8
	Mostly incorrect	3	4.5	4.6	78.5
	Incorrect	14	21.2	21.5	100.0
	Total	65	98.5	100.0	
Missing	System Missing	1	1.5		
	Total	1	1.5		
Total		66	100.0		

Figure 12: Possible causes of non-implementation of controlling instruments in companies

Figure 12 gives us an answer regarding why some analyses (*use of operational and strategic instruments*) are not being used in companies. As for answers regarding *whether it is possible to find on the job market and employ the appropriate person with adequate expert knowledge*, 61.5% of those surveyed replied that it is very difficult to find an adequate and expert individual able to answer all the demands of contemporary business practice.

4. Conclusion

The survey showed that the 20-year long institutionalization of controlling in small and medium companies in B-H matches their typical picture. Due to the low level of division of labor by job function and sectors in small and middle companies, and the accumulation of tasks within the function of director, it is not at all surprising that the director is the one who performs the controlling function in the majority of cases.

The analysis also shows that one of the obstacles to the performance of the controlling function in companies is the inability to find highly qualified, professionally trained workers on the job market. Namely, small and middle companies in Bosnia and Herzegovina are under the daily influence of a large number of factors. Increasing pressure from the competition and the accelerating dynamic of social, economic and political processes will exert even greater pressure on

companies in the future. We are witnessing daily new global movements and accelerating globalization in all segments, and are exposed to ever more frequent changes in relations between supply and demand, which is creating new problems for management. In contemporary, turbulent business conditions, contemporary instruments and conceptions are needed to ensure the best possible functioning. Regardless of size and degree of organization, all companies will strive to remain in business, but only those who work on increasing their own vitality will succeed in this. Vital companies will adapt to changes more quickly. In the same way, the business function of controlling, as a way of solving problems of coordination and integration, will become irreplaceable in entrepreneurial business operations.

It is to be expected that our companies will come to recognize the importance of the function of controlling in the future, and that they will strive to expand it and apply it in practice.

It should be underlined that, with increasing improvement in general conditions and the modernization of educational systems in the near future, we should expect the further development and progress of controlling in our country.

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GORAN NIKOLIĆ, PHD, RESEARCHER-ASSOCIATE*
Institute for European Studies, Belgrade

THE EFFECT OF THE GLOBAL ECONOMIC CRISIS ON CHANGES IN THE STRUCTURE OF SERBIAN VISIBLE EXPORTS

Abstract: *An analysis based on similarity index and trade factor classification indicates that, only seemingly paradoxically, along with the global economic crisis, 2009 brought a mild qualitative improvement in the domestic export structure. Namely, the structure of Serbian merchandise export slightly converged with the structure of merchandise import of developed countries (EU) during 2009. It is to be expected that the recovery of the domestic economy at the beginning of 2010, along with the expected significant inflow of foreign capital in the coming years, which would be accompanied by growth in capital goods imports (replacement of old technology, i.e. restructuring), will also be accompanied by further qualitative improvement of Serbian export, and a recovery of its strong growth.*

Key words: *economic crisis, export structure, Serbia*

JEL classification: F 14, C 42

1. Methodological framework

In analyzing the effects of the global economic crisis on the changed structure of Serbian merchandise export, we will start from the hypothesis that the structure of Serbia's merchandise export, following the full manifestation of the effects of the global economic crisis on Serbia (which, among other things, manifested itself through a significant fall in domestic merchandise export from the end of 2008 and, especially, in 2009, as well as a rapid reduction of export-oriented industrial production), became less convergent with the structure of EU merchandise import in 2009 relative to 2008¹ (as well as to the years following

* E-mail: goranvnikolic@gmail.com

¹ In the period of the first seven months of that year, when exports experienced steady growth and a mild improvement in structure.

the country's opening to the outside²). Due to its advanced trade structure,³ the structure of the EU's merchandise import shall serve as the reference structure, as the eventual use of the structure of global imports, due to its high content of products of a lower phase of finalization, would be inadequate because of its lower "quality" and, in any case, that is not the structure to which Serbia should strive.⁴ Hypothetically, if a more significant growth in Serbian exports were accompanied by growth of the similarity index (and growth in the share of products of a higher phase of processing in exports), one could then talk about a desirable, i.e. quality export growth.⁵ Crespo's study (2005) indicates that the similarity of observed structures is significant, because an eventually higher level of convergence requires lower industrial reallocation, while monetary coordination and

² Since December 2000, when FRY received Autonomous Trade Preferences from the EU.

³ The qualification of the structure as (un)favorable stems from empirical data that show that most developed countries have an export (and import) structure that is predominantly based on products of a high degree of finalization (which bring significantly higher per unit earnings). The exchange structure is an indirect indicator of achieved development; it has been proven that countries in which primary products dominate in exports at a certain achieved level of development must diversify their export supply in the direction of a greater share of more sophisticated products, or their growth will slow.

⁴ The advantage of the EU's exchange structure for the purposes of comparison also stems from the high stability of the export and import structures of this integration (which can be seen on the basis of self similarity indicators for the EU, which are very high; Nikolić, 2004); however, the shortcoming of the import structure is that the EU external imports are to a much greater measure (relative to total EU imports that also encompass internal imports) based on energetics, which makes the structure of EU external imports less quality relative to other developed countries. It should be emphasized that the advantage of comparison with the EU's external import structure lies in the fact that it is not static but that it is continually, gradually improving, while other indicators (if not observed in comparison with other countries) might overestimate eventual shifts that might be characteristic for all world trade (eg. the last few decades have seen an almost continual decrease in the share of primary products in global exchange). The „limiting“ to the EU15 may be justified by a lack of data concerning the EU27, as well as the fact that, due to the higher level of economic development and import structure quality of the „old members,“ their import structure is more suitable for comparison, i.e. for the function of a reference base.

⁵ In the second case, if growth in exports were to be accompanied by a fall in the similarity coefficient, along with a concomittant fall in the share of goods of a higher phase of finalization in Serbia's export, then it is clear that this would be a matter of growth driven by primary products, i.e. non-quality growth. In the third case, if export growth were to be accompanied by a concomittant growth of the similarity coefficient and a fall in the share of industrial products in exports, then that would most likely be a case of a strong structural change in the EU's import demand that was complementary with Serbia's export supply, which would in the coming years, although not in the long term, contribute to export growth. In the fourth case, if a fall in the similarity coefficient were accompanied by growth in the share of industrial products, that would once again be a case of changes in the EU's import demand, i.e. its divergence from Serbia's export supply, which might be initiated by a significant improvement in the EU's import demand, in terms of a higher share of more sophisticated products.

the definition of other joint policies are facilitated, resistance to asymmetrical shocks is increased, the convergence of factor prices is accelerated and the pressure of migratory flows toward the EU is lessened.

In order to eventually prove this hypothesis (i.e. in order to avoid its rejection), we shall use the Cosine and the Finger-Krenin model of measuring similarities (divergences) in the structure of exports and imports (degree of convergence of export vectors and import vectors), which will compare the similarities of Serbia's merchandise export structure and the EU merchandise (external) import demand before and after signed trade agreements. In addition, other methods of determining similarity of structures (Euclidean distance and the Bray-Curtis method) shall also be used.⁶

Coefficients indicate the probability, i.e. intensity of expected total bilateral trade. It should be emphasized that an eventual lessening of the similarity of Serbia's export structure with the EU's import demand does not speak only about a divergence between Serbian exports and the demands of the EU's market but also about a general "distancing" of Serbia's exports from the imports of developed countries' markets, which are characterized by a technologically more advanced trade structure.

The Cosine method determines similarities (divergences) between two structures that are classified in an identical way (eg. into 63 elements). In a concrete case, the E_i vector, which represents the export structure of a given country (i) is taken. The vector is defined by a certain number of elements in n-dimensional space, which has the same number of dimensions as the E_i vector has elements. Vector M_j is taken analogously to vector E_i , and it represents the import (or export) structure of a given country (j). The vector is defined by a certain number of elements in n-dimensional space, which has the same number of dimensions as the E_i vector has elements. Under the condition that the share of all sectors in total exports or total imports is identical (the absolute amounts themselves are not important), the vector's two radii, due to the same coordinates, would have identical positions in multidimensional space, so that the angle between them would equal 0, while the value of the cosine would equal one (which would mean that their merchandise structures are totally identical).

$$\cos_{\cdot j} = \frac{\vec{E}_j * \vec{M}_j}{|\vec{E}_j| * |\vec{M}_j|}$$

OR

⁶ We shall use the export structure according to SITC, i.e. SMTK (two-figured) for Serbia, and the export structure according to SITC (two-figured) for the EU. The analysis also used the similarity of the export merchandise structures of certain transition countries with the imported merchandise structure of the EU, for the purposes of putting Serbia's export structure in a broader context.

$$\text{COS}_{ij} = \frac{\sum_{k=1} E_k * M_k}{\sqrt{(\sum_{k=1} E_k^2) * (\sum_{k=1} M_k^2)}}$$

k – items in the SITC - classification

k=1...239 (for three-figured classification)

or k=1...63 (for two-figured classification)

or k=1...10 (for single-figure classification)

i – exporting country

j – importing country

The Finger-Kreinin Index of Similarity (FKIS) or the Complementarity Coefficient (TCI) measures the degree of similarity (convergence) of export and import merchandise structures, although the mathematical approach is somewhat different. The similarity coefficients are arrived at by summing up the lower of the paired relative values, i.e. elements of two structures (for the exporting and importing country) classified according to SITC (SMTK). The method is non-parametrical, i.e. it is not based on any suppositions on the distribution of variables. Two alternative formulas for calculating this coefficient are given.

$$\text{FKIS}_{ij} = \sum_{k=1} \min (E_{ik}, M_{jk})$$

k – items in the SITC - classification

k = 1...239 (for three-figured classification)

i – exporting country

j – importing country

$$\text{TCI}_{jk} = 1 - \sum_i \frac{|X_j - X_k|}{2}$$

X_{ij} – share of a given sector of country j (in total exports or imports) in the observed year

X_{ik} – share of a given sector of country k (in total exports or imports) in the observed year

j, k – observed countries

i – share of a given sector (two-figured level of SITC, revision 3) in total exports or imports

Taking into account certain deficiencies of these indices, before all the fact that they do not incorporate weights, i.e. the relative weights of the observed sectors, we shall use alternative measures of similarity, based on the determination

of similarities (divergencies) of structures with the aid of distance. The quantification of mobility or the persistence of export or import structures can also be performed with the aid of so-called similarity matrices (the Bray-Curtis and Euclidean index). The so-called Euclidean distance is especially used in geostatistics and biostatistics, and its formula has the following mathematical form:

Euclidean distance

$$d_{jk} = \sqrt{\sum_i (x_j - x_k)^2}$$

X_{ij} – share of a given sector of country j (in total exports or imports) in the observed year

X_{ik} – share of a given sector of country k (in total exports or imports) in the observed year

j, k – observed countries (or the country in different periods)

i – share of a given sector in total exports or imports

The value of this, as well as the following indicator ranges from 0 to 1 and, the closer the value of this index is to 0, the more similar the two structures are, and vice-versa. If the value of the index is equal to one, then the two structures are maximally different while, if it equals 0, then they are totally identical. In the following sections of this work we shall use the inverse values of this as well as the following indicator.

The problem with the previous indicator is that the zeroes in the structure lead to a reduction in distance ("double-zeroes paradox"). Namely, there is a possibility for the structures of two countries without a single common sector (eg. a half sector apiece would have zero share in total exports or imports) to be maximally similar or, which is more common in practice, that a significant number of sectors will have zero share in total exports or imports. That is why a normalized Manhattan distance according to the Bray-Curtis formula is used; as it does not have this problem. It has the following mathematical form:

The Bray-Curtis index

$$d_{jk} = \frac{\sum_i |x_j - x_k|}{\sum_i (x_j + x_k)}$$

X_{ij} – share of a given sector of country j (in total exports or imports) in the observed year

X_{ik} – share of a given sector of country k (in total exports or imports) in the observed year

j, k – observed countries (or the country in different periods)

i – share of a given sector in total exports or imports

The imperfection of all the said indicators lies in the fact that the coefficients themselves, due to structure configurations, may occasionally indicate totally inexplicable values in the economic sense, i.e. they may not always be a true indicator of structure similarities. Thus, it should be born in mind that we are here dealing, before all, with structural analysis and that it can to a large extent overlook the true state of affairs. An indicative example is that of the improvement of similarity coefficients that were partially affected by the more difficult placement of domestic primary products on the EU market in the first half of the 1980s (see Nikolić, 2003). In addition, the findings of this work also indicate that a significantly reduced placement of basic metals is the main reason for its seemingly paradoxical conclusions. The most important handicap of similarity indices is that an eventually more competitive economic structure, in this case that of the EU, might show a lower coefficient (lower similarity), although that is certainly not the case with Serbia.⁷

2. Analysis of changes of similarity indices

Due to a high share of exports to the EU in Serbia's total exports, it is to be expected that the EU's import demand itself to a large extent shapes the Serbian economy's total export structure, i.e. that changes that take place in the structure of Serbia's merchandise exports are to a great extent a consequence of the domestic economy's adjustments to the import demands of its main trade partners, before all the EU countries.

⁷ It should be emphasized that there exists a pronounced sensitivity to the level of disaggregation, which means that, the higher the level of disaggregation, the lower the value of the coefficients.

It is often impossible to detect qualitative improvements among products from the same merchandise group or even customs nomenclature (except indirectly, eg. by way of the unit value of exports). Still, it may be assumed with great certainty that, in recent years, with the entry of foreign companies on the Serbian market, the quality of merchandise has substantially improved, especially that slated for foreign markets. For example, today's (steel) cold rolled sheets of US Steel and those from the end of the 1990s, which were exported at dumping prices (and which the Germans, for example, had to melt down due to their low quality), because of which we even suffered retorsion measures on the part of the EU, are incomparably better, from the aspect of both quality and achieved price (to be sure, the commodity price in dollars has quadrupled in the period between 2003 and mid 2008). The case is similar with copper cathodes and bars, aluminum profiles, many chemical products (especially Henkel's). In addition, we have also seen improvement in the quality of (export) articles in the pharmaceutical field, the cement industry and, to a somewhat lesser degree, the food industry. In any case, wherever foreign capital has arrived, it has brought knowhow, knowledge "spillover," new technologies, captured markets.

Table 1: *Tendencies of similarity coefficients for Serbia's merchandise exports and the EU's external merchandise imports*

year	Complemen. coefficient	Cosine coefficient	Bray-Curtis	Euclid
1990	0.563	0.573	0.941	0.801
2000	0.525	0.505	0.571	0.793
2001	0.561	0.589	/	/
2002	0.556	0.566	/	/
2003	0.569	0.570	0.730	0.811
2004	0.525	0.490	/	0.788
2005	0.515	0.474	0.734	0.781
2006	0.510	0.478	0.667	0.781
2007	0.527	0.505	0.776	0.782
2008	0.555	0.510	0.564	0.794
2009	0.571	0.628	0.581	0.830

Source: RZS, EUROSTAT, COMTRADE

Note: For the coefficients for 2004-09, the structure of the EU's external imports from 2003 was taken (EU15). This approach may be justified by an absence of data for all or most of 2004, as well as the fact of EU expansion, making the new structure (EU25, EU27) uncomparative. Due to the high correlation (0.99) along with high significance (0.000) in comparing the external import structures of the EU15 for successive years (eg. 2002 and 2003), this approach skews the true value of the similarity coefficients of the two structures to a very small extent. The data for 2008 are for the first seven months, before imports started to slow, while the data for 2009 are for the first six months.

The work also considered coefficients for successful transition countries, as the tendencies of the similarity coefficients that show the qualitative changes of Serbian merchandise exports should also be viewed in a broader context, and be compared with the same indicators for transition countries, of which many have achieved significant progress on the plane of export advancement through its structural improvement and absolute growth, which could indicate a desirable future direction for domestic merchandise exports (see Nikolić, 2005). When comparing the structures of Serbia's merchandise exports and the EU's external merchandise imports in the 2000-09 period (with 1990) at the two-figure level of SMTK (revision 3), we obtained the following similarity coefficients of the given structures, which are provided in the following table.

A comparison between Serbia's export structure and the EU's external import demand shows that, in comparison with 1990, 2000 saw a significant

fall in the similarity of the given structures.⁸ Convergencies went on to increase in 2001, but those process quickly ended in the following year. The causes of the “fall of 2002” should be sought in the Serbian economy’s need to increase exports at almost any price, which increased the share of primary products in the export structure, which are much less present in the import structure of the EU or other developed countries (before all, we are talking about growth in the share of sector 0 – Food and Livestock, i.e. the agro-industrial complex, where Serbia holds comparative advantages). During the following year, 2003, significant growth in the similarity coefficients was observed⁹, while 2004 showed a pronounced decrease in the similarity of structures, with the absolute values of coefficients being lower than even their values for 2000. The cause of the fall after 2003 should be sought primarily, just as in 2002, in a strong increase in total exports, which was to a large extent pushed by products of a lower level of finalization, with sector 67 – iron and steel (and 68 – non-ferrous metals) standing out, having almost doubled its share in total exports, while that same sector’s share in EU imports is almost ten times smaller. Mild growth in similarity indicators has been observed since 2006. What is especially interesting is the fact that even 2009, the year of serious economic crisis, did not represent an exception when it came to growth of convergence of the two structures.

Despite periodic declines and increases since 2000, the value of the indicators of similarity of Serbian and relevant import structures (in this case the EU) grew only mildly, which shows that the domestic export structure has practically not changed, i.e. that its unfavorable structure has been retained.

The convergence of the Serbian export structure with the EU’s import demand is one of the smallest among transition countries: we are ranked in front of Romania but trail Hungary, Croatia, Bulgaria, the Czech Republic. Transition countries of Central Europe have experienced growth of their similarity coefficients since they signed their European Agreements at the beginning of the 1990s (and even a bit earlier, with the first EU preferences) and, today, hav-

⁸ After 1990, when the similarity of the two structures (Serbia/EU) was the highest, and comparable with European transition countries (not counting the very end of the 1980s), it experienced a fall, which was to be expected bearing in mind the country’s isolation, i.e. the deterioration of the domestic industrial base and, especially, the export-oriented segment of the economy. Comparing the similarity coefficients with the same coefficients among transition countries, it can be seen that in 1991 Serbia enjoyed a value of given coefficients that was comparable to today’s more advanced countries in transition, while the share of manufactures, as an indirect indicator of export quality, was even slightly higher than the average for today’s advanced transition countries. The values of similarity coefficients were at the same time higher than for most developing countries, but also significantly lower than the coefficients for developed countries. Already in 1996, one could see a dramatic worsening of the Serbian economy’s export structure. – G. Nikolić, 2003

⁹ To be sure, the growth of the similarity coefficients in 2003 can be partially attributed to a strong growth in the share of sector 79 in total exports, which is a consequence of the “problematic” inclusion of ship and airplane repairs.

ing experienced a significant rise of those indices, enjoy a significantly greater convergence of their export structures with the EU's import demand, showing the path that Serbia should take, and it is clear that their experiences in trade and overall economic policy should be studied as much as possible.¹⁰

There is a repeat of what was happening at the end of the 1980s, significant growth in Serbian exports is occurring along with a practical stagnation of similarity coefficients, which indicates that the absolute growth of merchandise exports is substantially based on products of a lower phase of finalization. Looking at the structure of total domestic exports after 2000, it is easily noticeable that strong growth was seen in the shares of sectors 67 (iron and steel), 68 (non-ferrous metals), 69 (metal products, unmentioned), 04 (grains), 06 (sugar), 84 (clothing), which are all work and resource intensive, and which have a substantially smaller share in EU exports or imports. Thus, we can talk about extensive growth in exports (equalling an average of almost 20% during those eight years), which is in the long term unsustainable, although one should not neglect the, frankly small, qualitative advances since 2006, especially the growth in the share of sector 7 (from 11% to 18.5% of total exports in 2009).¹¹

If one compares the structure of Serbian exports on the single-figure and two-figure level of SITC (SMTK) with the same structure of the EU, US, Slovenia and the Czech Republic, the reasons for the relatively low values of the similarity indicators become clear. Namely, while in the case of Serbia a significant share is held by merchandise sectors belonging to sectors 0 and 6 (before all processed products), in the said countries a pronounced share is held by segments of sector 7, which is chiefly made up of more technologically intense products (on the average, about two times greater than the Serbian share), which testifies to the huge qualitative difference between the observed structures.

It would be expected that the structure of domestic exports would have been worsened by the global economic crisis and that the export of goods of a lower

¹⁰ When it comes to the dependence of export growth on growth in similarity, there are many extenuating circumstances, reflected before all in a steady, tendential growth in exports among all the countries in the world. Nor do shifts in the share of exports into the EU in total exports show themselves as a good indicator for comparison with tendencies of similarity coefficients, due to an artificially created very low exchange until 1990 (under real potentials, differently from the interwar period) and its sharp growth. Namely, export into the EU has grown exceptionally among all transition countries, which was a consequence, besides trade agreements and political decisions (these are the so-called European Agreements from the early 1990s, when transition countries were given preferential trade status by the EU, which followed the Cold War-era partial economic and political isolation of these countries).

¹¹ Bearing in mind the country's very low level of exports and high foreign trade imbalance, as well as the relatively short period left for reform measures to produce effect, it seems that Serbia does not really have an alternative. Still, export growth based and sustained upon products of a lower level of finalization is certainly not a desirable path since, in the mid term, such growth may very well experience a slowdown.

finalization level and a lower price on the global market would have intensified. However, what occurred was more-or-less expected by those well acquainted with trends of stock market prices and demand, namely a strong decline in the prices of base metals (and demand for them), and a fall in the price of food on the global market, i.e. products that made up two-fifths of domestic exports in the previous year. Namely, the share of sector 67 fell in the first half of 2009, from 14.6% to 6.6%, while the fall in the share of sector 68 was milder: from 7% to 5%. It's true that the share of food increased, since it has very little elasticity relative to changes in income (IMF, 2009). Still, having in mind the strong growth in the share of sector 84 (from 4.7% to 8%), the overall effect was a reduction in the convergence of the two observed structures.¹²

3. Analysis of changes of factor trade intensity of domestic export

We shall also test the hypothesis on the eventual structural improvement of domestic exports through its classification with the aid of two methods. Table 2 gives the tendencies of domestic exports classified according to factor trade intensity (in accordance with Kandogan, 2005) in the period 1990-2009 and, in order to gain comparative insight, we used the shares of the same groups for a certain number of countries. The said methodology takes into account the prevailing factor trade intensity of SMTK goods sectors.

It may be concluded on the basis of Table 2 that, compared to 1990, there occurred a significant worsening in the structure of domestic exports, which can be seen especially on the basis of the decline in the share of "human and physical capital" intensive goods sectors in exports (which have by far the biggest share among developed countries), as well as on the basis of growth in the share of resource products. After 2006, looking at the share of the "human and physical capital" group, which most defines the sum quality of the export structure, and which is made up of products of a higher phase of finalization, one can speak about mild qualitative improvements in Serbian exports. It is positive that the share of resource intensive products fell after 2006, and especially intensely in 2009, but their still relatively high level indicates that exports are practically based on products of a lower phase of processing, where Serbia holds comparative advantages.¹³

¹² Of course, there was a mild fall in the share of external imports by sectors 67 and 68 in the EU's total imports, but this cannot significantly affect the presented conclusions.

¹³ Thus, according to factor trade intensity of products, Serbia's export structure shows that the majority of domestic export is based on resource (and primary products) and labor-intensive products, and that the situation in that regard has not changed since 2000.

Table 2: Structure of Serbia's exports according to factor trade intensity of products 1990-2009 (as % of total exports)

groups:	1990	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Resource intensive	35.8	48.0	43.9	50.4	44.6	56.8	56.6	57,9	54,4	53,5	47,2
Labor intensive	29.9	24.1	31.8	26.8	25.3	23.4	24.2	23.0	24,1	21,0	24,7
"Human and physical Capital" intensive	33.8	22.6	21.6	20.5	28.5	19.2	18.9	18.9	21,4	24,7	26,4

Source: RZS.

Note: The data for 2008 are for the first seven months, before the slowdown in exports, while the data for 2009 are for the first six months.

When comparing the obtained indicators with the same indicators of the selected countries, it is evident that developed countries, as well as the more advanced transition countries, have a far smaller share of resource intensive products in exports, as well as a higher share of products that are human and physical capital intensive (in the case of developed countries and the more advanced transition countries, on average, resource intensive products make up less than half of the share of total exports).¹⁴

The unfavorable structure of domestic export becomes evident when we classify it into three categories: primary products, labor-intensive industrial products and industrial products in which qualified labor is dominant, and compare the obtained results with those of other countries (in accordance with UNCTAD, 2002). The practical stagnancy of the export structure, following a rapid worsening during the last decade of the previous century, can also be followed on the basis of the low share of industrial products that are qualified labor-intensive, which are a good indicator of the sum quality of export. The share of that group since 2000 has been around one half the value of the same indicator of more advanced transition countries or the EU.¹⁵ On the other hand, the share of products that are low qualified labor-intensive, and especially of primary products, is far higher than that of the observed countries, which indicates an unchanged unfavorable structure of domestic exports and a practical absence of products with a high added value. From 2006 to 2009, there occurred certain positive changes in the export structure, in the direction of an increased share of products with a higher level of qualifications. The share of industrial products with qualified labor equalled 27.4% of total exports in 2009, which is still significantly lower than the share of, for example, Germany, Czech Republic or the US. The

¹⁴ G. Nikolić, 2006

¹⁵ The share of qualified labor-intensive products in total exports equaled 19.2% in Bulgaria in 2004, 19.9% in B-H (2005), 69.1% in Germany (2002), 57.1% in the Czech Republic, 53.4% in Slovenia (2005) 53.4%. – G. Nikolić, 2005

share of primary products (about a third) continues to be far higher than that of developed countries or more advanced transition countries.

Table 3: *Structure of Serbia's exports according to labor force qualification*

	1990	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
industrial	73.9	64.8	65.7	59.7	67.2	63.8	64.4	63.7	66.3	69.1	64.2
Labor intensive (‘Low skill’)	39.4	42.4	44.9	39.8	46.9	42.3	43.2	42.9	42.1	41.2	36.7
Int. qual. labor (‘High skill’)	34.5	22.5	20.8	19.9	20.2	21.5	21.2	20.8	24.2	27.9	27.4
primary	25.5	32.4	31.6	38.0	31.3	35.5	35.3	36.1	33.6	30.1	34.2

Source: RZS.

Note: The data for 2008 are for the first seven months, before the slowdown in exports, while the data for 2009 are for the first six months.

Looking at the factor trade intensity of domestic merchandise exports, what is positive is that, after 2006, and even in 2009, the share of human and physical capital group grew, and that is the group that most defines the sum quality of the export structure. Also favorable is the trend of a fall in the share of resource-intensive products after 2006, and especially intensely in 2009. The second classification that breaks down exports into primary, labor and skill-intensive industrial products, shows two opposing tendencies: a falling share of industrial products that are low qualified labor-intensive, as well as a rise in the share of primary products.

4. Paradoxical improvement in Serbia's export structure in 2009!

The cause of the “unexpected” rise in the quality of exports in 2009 lies, before all, in the fall of revenues from base metal exports, whose share in total exports dramatically dropped and, thus, reduced the divergence between the domestic export demand and the EU's import demand (whose share in sector 67 and 68 is much lower). However, this tendency does not bring any comparative advantage for Serbia, it is of a purely “statistical nature,” as the fall in the share of these two resource-intensive sectors is not a consequence of an increase in the exports of the majority of other sectors. As it is probable that the coming months will see a rise in the prices of metals and food on the global level, it is clear that the similarity coefficient and the factor trade intensity of domestic exports will show statistically less favorable tendencies (i.e. that it will fall or stagnate), but nothing negative will occur, other than an absolute rise in exports in these segments and sectors. Thus, this case shows precisely the imperfections of simi-

larity indicators, which may occasionally show inexplicable tendencies from an economic standpoint.

The global economic crisis brought a strong decline in the prices of base metals (and demand for them), as well as falling food prices on the global market. The share of sector 67 fell in the first half of 2009 by as much as 8 percentage points, while the fall in the share of sector 68 was milder, equalling two percentage points. To be sure, the share of food increased, as it has very little elasticity relative to changes in income. Still, having in mind the strong growth of the share of sector 84, the sum effect was a decrease in the convergence of the two observed structures (domestic exports and EU imports).

Therefore, the key does not lie in the statistical fixing of the structure of domestic export after all, but in its strong growth, which may well be the most strongly propelled by products of a higher phase of processing, which have high prices on the global market. When it comes to prices of products on which Serbia will probably continue to have to rely (and which, thus, it must not neglect, despite their low added value¹⁶), the outlook is optimistic. Namely, the prices of steel, copper, aluminum and food, goods that made up as much as two-fifths of Serbia's merchandise exports in 2008, were recovering during the first half of 2009, and it is realistic to expect their continued growth in the coming period.¹⁷ The growth of the IMF (dollar) index of raw materials (without energents) is encouraging: in June 2009, in comparison to the average for March or the record minimum value in December 2008, it was higher by 16% and 17%, respectively.¹⁸ Growth continued during July (2%) and at the beginning of August. The Bloomberg Reuters-Jefferies CRB index of raw material prices indicates that the minimal value was reached at the beginning of March 2009, and that it has been recovering since then (growth of over 20% by the beginning of August), except for the "stumbling" in June.

In any case, the improvement in the export structure in 2009 is neither sustainable in the long term nor desirable, and it is based on a combination of specific and certainly not favorable circumstances. The global economic crisis hit

¹⁶ Raw material and labor-intensive products, which are exposed to competition from countries with a cheaper labor force, should not be neglected; instead, base branches should be developed into processing branches, which would produce final products with higher added value and prices. In addition, greater efforts are required to find possible niches for broader placement of domestic products.

¹⁷ The price of "Mediterranean" steel, relative to March-April 2009, has risen by almost 20% and 3% in comparison to the end of the previous year, but is still 31.5% lower than the average price in 2008 (which in the second half of the year fell to slightly more than one-third of the price at the beginning of July). The rise of the price of copper in 2009 was more pronounced, about 80% (although its price is still 31% lower than in July 2008). Food prices are also recovering from December's record lows, being 19.6% higher at the end of July (although still about one-fifth lower than in June 2008). July saw a seasonal fall in average global food prices of about 5%.

¹⁸ Although it is still almost one-third below its maximum value from July 2008.

Serbia's merchandise export particularly hard, as it fell in the first half of the year by 23%, although it has been slowing over the past few months (in June, the year-to-year fall equalled 18%). To be sure, imports have been hit even harder (a fall of 30%, which is becoming even steeper), due to the inability of companies to finance them. What is encouraging is the fact that the deseasonal monthly level of exports in June was 3% higher than that in May 2009 (while June imports fell by 1.9%). Looking at global tendencies, it is hard to plan a quick recovery in the growth of domestic exports, although it is realistic to expect, on the basis of the current trend (slowing decline) and the low base at the beginning of 2009, that this may occur at the very beginning of 2010.

The global volume of global trade (goods and services), which is declining at the fastest rate since 1945, should fall by as much as 12.2% (and grow by 1% in 2010), while imports from developing countries in the region and transition countries should fall by 9.6% (and grow by 0.8% in 2010), and exports by 6.5% (with growth of 1.4% in 2010). A somewhat milder decline in exports than imports among these countries, to which Serbia also belongs, is certainly a bright spot for these countries, in a sea of bad news. which for the most part have large external disbalances.

In any case, growth in the price of raw materials, admittedly from a very low level, is a harbinger of coming recovery of industrial activities and GDP. Raw materials, which are tightly connected with the production of capital goods and consumer goods (especially energents and base metals) were the hardest hit, while the fall in food prices was less severe, due to the low elasticity of demand for these goods (IMF, 2009b).

Also, since the crash in raw materials prices in the second half of 2008, the prospects of future prices have been widely debated. Strong upward-sloping curves of future raw materials prices indicated their rise in the coming years, which is consistent with the thesis that raw materials prices would significantly grow once the global economy starts recovering, due to renewed strong increase in demand for raw materials in developing countries and the need to invest in new and expensive capacities.¹⁹

With current demand being below production and growing inventories, prices will predominantly depend on future demand. Using annual data from the 1970-2008 period, the results of analysis, which are of great importance for Serbia (IMF, 2009), suggest the following findings: demand for alluminum and copper strongly responds to changes in GDP (with income elasticity significantly greater than one). For crude oil, income elasticity is substantially smaller than that for metals (less than one), while for wheat the elasticity of demand is prac-

¹⁹ The main factors supporting high raw material prices in recent years, continued strong demand in developing countries and the need to recover growing costs of resource extraction will probably once again come into play along with the recovery.

tically zero.²⁰ The model anticipates, under the condition of unchanged prices, that demand for aluminum will rise at the average rate from the 2006-7 period in 2010 (in the scenario with low growth, i.e. slower recovery of global GDP, that would not happen until 2013). In the case of copper and crude oil, the average growth in demand from 2006-7 will be reached in 2011 under the base scenario (2010 in the rapid growth scenario and 2013 in the slow growth scenario). The model anticipates that demand for wheat will remain strong in all scenarios, which indicates that wheat prices may grow. Generally speaking, if global recovery is slow, demand will also be slow and it is not probable that eventually limited capacities (which otherwise grew rapidly until the crisis) will exert pressure on prices to grow before 2012-2013.²¹

The above findings indicate that we may again see growth in the share of resource products in Serbia's export. That is why the intensifying of foreign capital inflows is of crucial importance (realistically once the economic crisis ends, probably in January 2010), which would be invested in (propulsive) business activities with a higher level of applied technology.

In order to achieve better foreign trade results, Serbia would have to attract FDI in export sectors that are capital or skilled labor-intensive. It is, thus, clear that, without a more serious restructuring of the domestic economy, which would be able to supply the marketplace with more sophisticated products that would be compatible with the import demand of, before all, developed countries, it is not possible to achieve good export results.²²

The Central European countries' progress in transition increasingly moved them toward technologically intensive products, so it is realistic to expect that the evolution of the economic system through privatization and restructuring would improve the structural characteristics of the Serbian economy.²³ Of key significance for this turnaround would be a relatively quick liberalization and significant foreign capital inflows, first through privatization and subsequently through a more favorable institutional infrastructure.²⁴

²⁰ Thus, from the standpoint of demand, the conditions would first be "stretched" on the metals market.

²¹ In the long term, the prices of many raw materials fell relative to the prices of industrial goods and services.

²² There is an important difference between restructuring that improves product quality through improvement of production technology and specialization that practically comes down to changing export quantities as a "response" to liberalization.

²³ Transition countries that are now in the EU experienced a drastic reorientation of their external trade exchange in the direction of the EU during the 1990s and achieved strong export growth into the EU, especially in sector 7 (machines and transport devices), which encompasses products of higher phases of production.

²⁴ Today, the export of these countries is to a great measure the export of multinational companies that are now their residents. In addition, the export of most transition countries to the EU market is several times (even more than tenfold) greater than Serbia's export.

Therefore, the hypothesis from which we started at the beginning of this part of the work, that the structure of Serbia's merchandise export reduced the level of similarity with the structure of the EU's external merchandise imports in 2009, relative to 2008 (i.e. to the start of the global economic crisis), can be rejected. In addition, there was no significant change in the factor trade intensity and the technological structure of domestic merchandise exports in 2009 relative to 2008.

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VIKTOR RADUN, PHD*
International University of Novi Pazar, Serbia

THE GLOBAL ECONOMIC CRISIS: CAUSES, DYNAMICS, CHARACTERISTICS

Abstract: *This paper provides an analysis of the causes, dynamics, factors and characteristics of the current global financial crisis. The essential question the analysis poses is: what is the original source of the crisis and by what mechanism did it expand? The expected continued growth in housing prices was the source of ballooning real estate prices, a phenomenon that was perceived as a housing “boom” or “bubble.”*

The paper identifies the following causes of the crisis: the financialization trend, the deregulation of the financial market and the extremely expansionist monetary policy of the US central bank (the FED). We uncovered the following significant factors: a) the long-term nature of the recession of the US economy; b) the responsibility of the FED; c) the deregulation of the financial market and the creation of financial innovations (securitization, new forms of mortgage obligations); insufficient control and irresponsible behavior on the part of key actors in all phases of financial operations; e) financialization.

The developing real estate “bubble” has been accompanied by a deepening gap between expected and actual values. Discrepancies between expected and actual tendencies and values in each phase of the crisis deepened, creating a fundamental disequilibrium, which was bound to end in a bust.

Key words: *global financial crisis, housing bubble, the USA*

JEL classification: G 21, F 02

1. Causes of the global financial crisis

In the summer of 2007, the US economy was facing the severest financial crisis in recent history. In December of that year, the US National Bureau of Economic Research or NBER officially declared a recession. In summer of 2008, the recession hit a large portion of the global economy, becoming the greatest economic crisis after the great global crisis of 1929-33. The global economic crisis carried over into 2009, with a tendency of continued worsening and expansion.

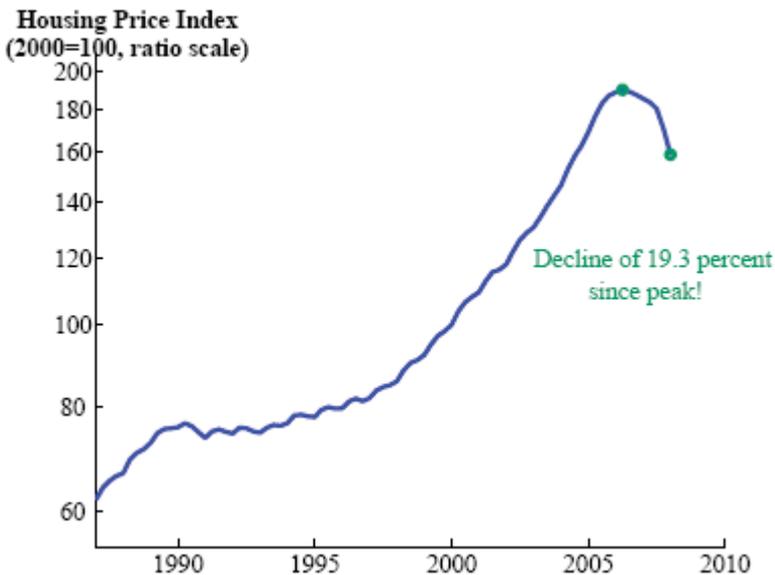
* E-mail: vradun@gmail.com

At the same time, the initial financial crisis has spread to the real economy, thus developing into a general economic crisis.

It is very hard to determine the exact origin and beginning of this tectonic disruption of the global economy. It is certain that the crisis did not begin in 2007, when the problems and mistakes that lay at the base of the crisis merely surfaced and became *visible* to the general public on the global level. A wholly different question is when the disruption occurred and in which sector of the economy. On the other hand, the recession is still in progress and its further development, dynamics and effects on financial and economic flows in general in the US and other economies are still insufficiently clear.

The essential question that the analysis has to answer is: *where did this crisis originate and by which mechanism* did it expand. There is no doubt that the crisis was generated in the US. From the mid 1990s to 2006, housing prices throughout the US grew continually (see figure 1).

Figure 1: US housing price movements, 1992-2010



Source: I. C. Jones, *Current Macroeconomic Events*, August 6th, 2008: <http://elsa.berkeley.edu/~chad/CurrentEvents2008.pdf>

This continuity produced expectations that such a growth trend would continue in the future. Expectations of continued growth in housing prices were the cause of ballooning housing prices and production, while the ballooning itself was a direct product of speculative activity on the part of banks, brokers, agen-

cies and other financial intermediaries, who used the entire situation as fertile soil for achieving high profits.

US analysts refer to this trend of uninterrupted growth as a housing “boom” or “bubble.” The first economist who discovered the existence of a housing bubble was Dean Baker. In his work, *The Run-up in Home Prices: Is it real or is it Another Bubble?*,¹ he showed that housing prices in the period from 1995 to 2002 were higher in real terms by about 30% than the general inflation rate. He interpreted this as a sign of a recession of the US economy, which he in fact predicted in his work.

Analyses show that this boom came about as a consequence of the previous recession of the US economy, which occurred after the bust of the Internet or e-economy, better known as the “dot.com crisis,” at the end of the 20th and the beginning of the 21st centuries.

After the dot.com crisis of 2000, the US economy was faced with the threat of deflation, which was pushing the economy into recession. It was thus necessary to find a mechanism that would pull the country out of recession. The only possibility was to stimulate demand. The most suitable and safest market for investment that could serve as a potential agent of growth of the US economy is the housing market, and that was where the opportunity for new investments and new business ventures was found, as it could spark demand for apartments and houses and, thus, cause an expansion of the struggling US economy.

In the background of such movement of the US economy lay a *long-term trend of capital transfer from the sphere of production of goods and services (industry and trade) to the financial sphere*. That process, called *financialization*, began back with the establishment of the Bretton Woods system, but has become more pronounced in the US economy only in the past several decades. Financialization can be defined as a “form of accumulation in which profit-making appears in an ever-increasing degree, through financial channels instead of trade and production of goods”.² Financialization means capital flight from a low-profit to a high-profit economic sphere – investment in financial instruments. However, that in turn starts a mechanism that is inherent to the financial sphere of economy, i.e. the mechanism of cyclical boom-and-bust movements. The recent history of the US economy has seen the occurrence of three such cycles, at whose base lies a ballooning financial bubble that inevitably bursts and results in a bust. These were the “dot.com bubble,” the “dollar bubble” and the current “housing bubble.”

Within the framework of financialization, the process of the *deregulation of financial markets* should be emphasized. In the first place, there was the repeal of the Glass-Steagall Act in 1999. The Act was adopted in 1933 as a reaction to

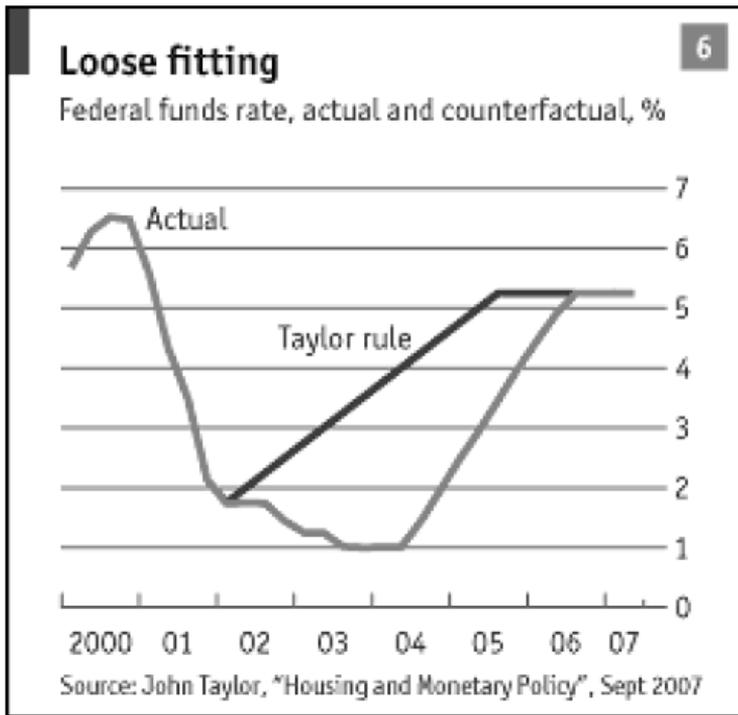
¹ D. Baker: *The Run-up in Home Prices: Is It Real or Is It Another Bubble?*, Center for Economic and Policy Research, 2002

² R. G. Krippner: “The financialization of the American economy”, *Socio-Economic Review*, 3, 2005, str. 174.

the global economic crisis of 1929-33, i.e. as a measure to prevent eventual conflicts of interest in the area of banking, by separating commercial from investment banks and, thus, preventing the financial speculations that had caused the crisis to begin with. According to this law, only investment banks had the right to invest in securities, while commercial banks were barred. The banking sector spent years working on achieving deregulation through the repeal of this law. Its repeal in 1999 was followed by an uncontrolled proliferation of lending, in which various financial institutions, agencies and dealers participated.

A significant role in the generation of the crisis was played by the *US central bank – the Federal Reserve or FED*, which in the period after 2001 conducted an *extremely expansionist monetary policy*. This is shown in Figure 2, where the graph³ illustrates the movement of the federal funds interest rate in the period between 2000 and 2007. As can be seen in the graph, the line of the actual interest rate fell after 2001, reaching an incredible 1% in 2003. This extremely low rate was maintained in 2004, and finally rose gradually to slightly over 5% in 2006.

Figure 2: Actual movements in the federal funds interest rate set by the FED and the projected “normal” movement of the interest rate (Taylor’s Rule) in the 2000-2007



³ J. B. Taylor: *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, Nov. 2008

The line of the actual interest rate set by the FED drastically diverged from the multi-year monetary policy that it conducted during the 1980s. The line labeled as *Taylor's Rule* shows the movement in the interest rate that would be usual, i.e. in accordance with the FED's standard monetary policy. Taylor says the following about this:⁴ "It thus produces the empirical indicator by which the monetary policy during the period was too liberal or "too loose," as *The Economist* called it. That was an unusually large deviation from Taylor's Rule. There has been no greater or more sustained deviation of current FED policy since the turbulent days of the 1970s. Therefore, this is clear proof of the existence of monetary surpluses during the period leading to the housing construction boom."

2. The dynamics of the onset of the global financial crisis

Investment in the housing market gained official support from the US government. The growth of the mortgage market was aided by the activities of three specific financial institutions: one state institution – the *Government National Mortgage Association*, also known as *Ginnie Mae*, and two state-sponsored ones – *The Federal National Mortgage Association (FNMA)*, better known as *Fannie Mae* and *The Federal Home Loan Mortgage Corporation (FHLMC)* or *Freddie Mac*.

These three institutions, along with larger private banks, took the initiative of making it easier for low and middle-income families to secure housing, through the use of various financial innovations, such as securitization and mortgage-backed securities, led by so-called *subprime mortgage loans* and *adjustable rate mortgages*. Such an approach resulted in increased lending activity and a continual rise in housing prices.⁵

The introduction of subprime mortgage loans and the issuing of securities backed by them through the method of *securitization* directly led to the ballooning of the bubble. That process can be briefly described in the following way:

1. Approval of mortgage loans to clients with lower incomes and weaker social status, who were otherwise unable to buy housing on credit.

This possibility was made available through a new approach on the part of lending institutions (banks and other financial institutions), where clients were offered subprime mortgage loans. This lowered criteria in many ways, with the goal of crediting clients who were previously not able to secure loans (those with a lower standard of living and lower income). When approving such loans, banks did not demand down-payments and allowed deferred interest payments or the

⁴ J. B. Taylor: *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, Nov. 2008

⁵ S. A. Holmes: *The New York Times: Fannie Mae Eases Credit To Aid Mortgage Lending*, published: September 30th, 1999

applying of interest to the principal. In conducting such a liberal lending policy, banks were guided by expectations that housing prices would continue their upward trend in the future.

That method stimulated housing demand, which led to a rapid and stable rise in housing prices. At the same time, it opened the door to numerous financial malversations and speculation during the loan approval process. One of the above-mentioned private agencies for rating securities, *Fitch Ratings*, researched the interaction between the tendency of falling housing prices and high-risk securities, and concluded in its report that “in many instances these risks were not controlled through sound underwriting practices... Fitch believes that much of the poor underwriting and fraud associated with the increases in affordability products was masked by the ability of the borrower to refinance or quickly resell the property prior to the loan defaulting, due to rapidly rising home prices”.⁶ Fitch also conducted a research regarding uncollected loans in the early phase, related to subprime securities that it rated itself. The research showed that financial malversations were a significant factor in the low rating of CMOs. The following types of malversations were also identified:

- Obvious fraud in the form of “false reporting of place of residence.” Borrowers falsely reported that they lived on the property, when in fact they did not.
- Weak or non-existent guarantees related to suspicious items on credit reports.
- Inaccurate calculation of the debt-to-income ratio.
- Significant number of first-time home buyers, with poor credit/income ratios.
- Borrowing in the name of other, undisclosed buyers, etc.

2. Repackaging of mortgages into securities, better known as Mortgage-Backed Securities or MBS.

In this phase, the operation of *securitization* was performed, denoting the transformation of high-risk mortgages into securities issued on the basis of those loans. The basic goal of securitization is for banks to secure the greatest possible liquidity of their assets. In traditional banking, loans continue to be marked as assets until their final realization and do not serve to improve bank liquidity. In contemporary banking practice, along with the existence of a free financial market, there appeared the need for banks to somehow place those loans and thus secure greater profitability and liquidity.

That led to the idea of transforming mortgage loans into securities and placing them on the financial market for further trading. Mortgage loans were grouped into pools, which then formed individual securities. These Mort-

⁶ Fitch Rating – US Residential Mortgage Special Report, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance*, November 28th, 2007

gage-Backed Securities or MBS belong to the category of so-called derivative securities. The original purpose of these derivative securities was to lower the risk of reinvestment and increase the liquidity of financial institutions. The most frequently used form of MBS is so-called Collateralized Mortgage Obligations or CMOs.

Collateralized Mortgage Obligations or CMO were issued, in the first place, by three key financial institutions that functioned at US national level: the Government National Mortgage Association or Ginnie Mae and private, US government-sponsored companies – the Federal National Mortgage Association popularly known as Fannie Mae and the Federal Home Loan Mortgage Association, popularly known as Freddie Mac, which also guaranteed them. In addition, CMOs were also issued by private institutions – investment banks, other financial institutions and construction companies. The leading international securities rating agencies gave CMOs the highest possible rating – AAA. Such a high rating, the guarantees issued by authorized financial institutions at government level, as well as the relatively high and safe profits gained by trading in these securities contributed to the broad trading of CMOs on the financial markets. These securities were also bought by large investment banks outside the US, resulting in the expanded investment and trading of CMOs on the international level.

The basic reason why investing in CMOs was so widespread was the fact that these securities were marked as assets by banks and increased bank liquidity. Thus, securitization was stimulated by all means, while investment banks and other financial institutions approached the market aggressively, convincing clients to first take out housing loans and then loans for purchasing cars, for furnishing their homes and for other consumer goods. Approval of these loans was not controlled either by government agencies or companies or credit institutions. The loan approval procedure was quite simple and insufficiently transparent. Loans were approved regardless of clients' credit records. Most often, adjustable interest rates were applied, which were initially relatively low but would subsequently rise. The goal was to stimulate more and faster crediting of the broadest segments of the populace.

3. The rating of the produced CMOs by agencies authorized for rating securities, and their trading on financial markets.

CMOs produced by the process of securitization were rated, usually with the highest possible rating – AAA. The rating of securities in the US was delegated to three authorized private agencies: Standard & Poor's (S&P), Moody's Corporation and Fitch Ratings. There are over 100 agencies on the US securities valuation and rating market, but the above three hold a 95% share of the market. Such an oligopolistic market structure, with the unquestioned domination of the "big three," certainly contributed to the low-quality, irresponsible manner of rating CMOs. The reason for such highly valued CMOs, which also included

so-called subprime mortgage securities, was that those securities were issued by authorized financial institutions. A positive role was also played by the so-called protective trust structure. This was a special financial mechanism ensuring that, even under conditions of mortgage default, the collateral in the trust would be sufficient to cover all the issued tranches.

3. Analysis of the characteristics and factors of the global financial crisis

Issuance on the part of state (and state-sponsored) financial institutions, support from authorized rating agencies and the possibility of their use for the purposes of increasing liquidity have made these CMOs (among which subprime mortgage securities had the largest share) into relatively safe, efficient and attractive financial instruments. However, the safety and broad applicability of CMOs was artificially built up through a complex mechanism behind which stood financial speculation and unrealistic expectations, stoked and supported by the active participation of state institutions. Behind their surface “safety” hid their true weakness – the high level of risk stemming from the structure of the borrowers and their low creditworthiness and investment in unrealistic expectations of continued growth in housing prices.

The activities of financial institutions in lending and creating mortgage securities were characterized by non-transparency, speculation and fraud, with the goal of securing maximum profit on the financial markets. The expansion in housing purchases began to slow. Housing supply overtook housing demand. In the meantime, growing numbers of buyers fell into debt crises, being unable to pay outstanding interest. More and more people lost their mortgages. This, in turn, led to falling housing prices. Housing was being sold at lower prices than before, while buyer interest began to ebb. And that was how the great bubble suddenly began to deflate. The price disruptions caused a chain reaction in the complex chain of securitization and securities trading. The value of CMOs fell, which automatically brought lower liquidity and financial losses on the part of investment banks, investment funds, intermediary companies, insurance companies and other financial actors on financial markets in the US and throughout the world.

A series of different factors led to the onset of the crisis, its ultra-fast deepening and expansion outside the bounds of its epicenter. Our analysis reveals the following significant factors:

The long-term nature of the recession of the US economy and the need to find a certain stimulus that would increase total demand and, thus, revive economic activity;

- The responsibility of the FED for carrying out certain macroeconomic policies;
- Deregulation of the financial markets (repeal of the Glass-Steagall Act) and the creation of financial innovations (securitization, new types of mortgage securities);
- Lack of control and irresponsible behavior on the part of key actors in all phases of financial operations that led to the ballooning of the mortgage bubble (non-transparency, mistakes and oversights in the process of loan approval, irresponsible and “easy” valuation and ranking of produced securities on the part of private agencies responsible for credit ratings).
- Financialization, at the base of which lies an insatiable thirst for profits.

As a result of these factors, credit risks was underestimated, being conditioned by the complexity of the new financial instruments and processes, as well as by expectations of long-term growth of the housing market, which, along with low interest rates and the seeming safety of trading MBOs, stimulated massive trading and investment in MBOs, especially into subprime mortgage securities. In that way, unvalued credit risk became systemic, and that oversight became obvious with the saturation of the housing market and falling housing prices in the US, which started a giant chain reaction in the direction of falling key economic values, first in the US, and then in other economies throughout the world.

Nevertheless, the banks had to react to this lack of transparency and the impossibility of accurately calculating risk. And, thus, in August 2007, there occurred a sudden rise in the margin between the three month LIBOR rate and the overnight indexed swaps or OIS rate, which measures the amount of money available for interbank borrowing.⁷ Banks use this margin for determining their interest rates. The bigger the margin, the less money mass is set aside for borrowing and loans, and more is used for purchasing state bonds. That was a so-called liquidity shock, which exposed the shortcomings of the used CMOs and, thus, suddenly accelerated the fall of CMO and housing prices, which in turn slowed investment activity in the housing sector, threatened the liquidity of financial institutions and caused a series of negative movements in real sectors of the economy.

The complete scheme that expresses the influence and interactions of factors that led to the financial crisis, along with the entire mechanism of crisis generation, is provided in Figure 3.

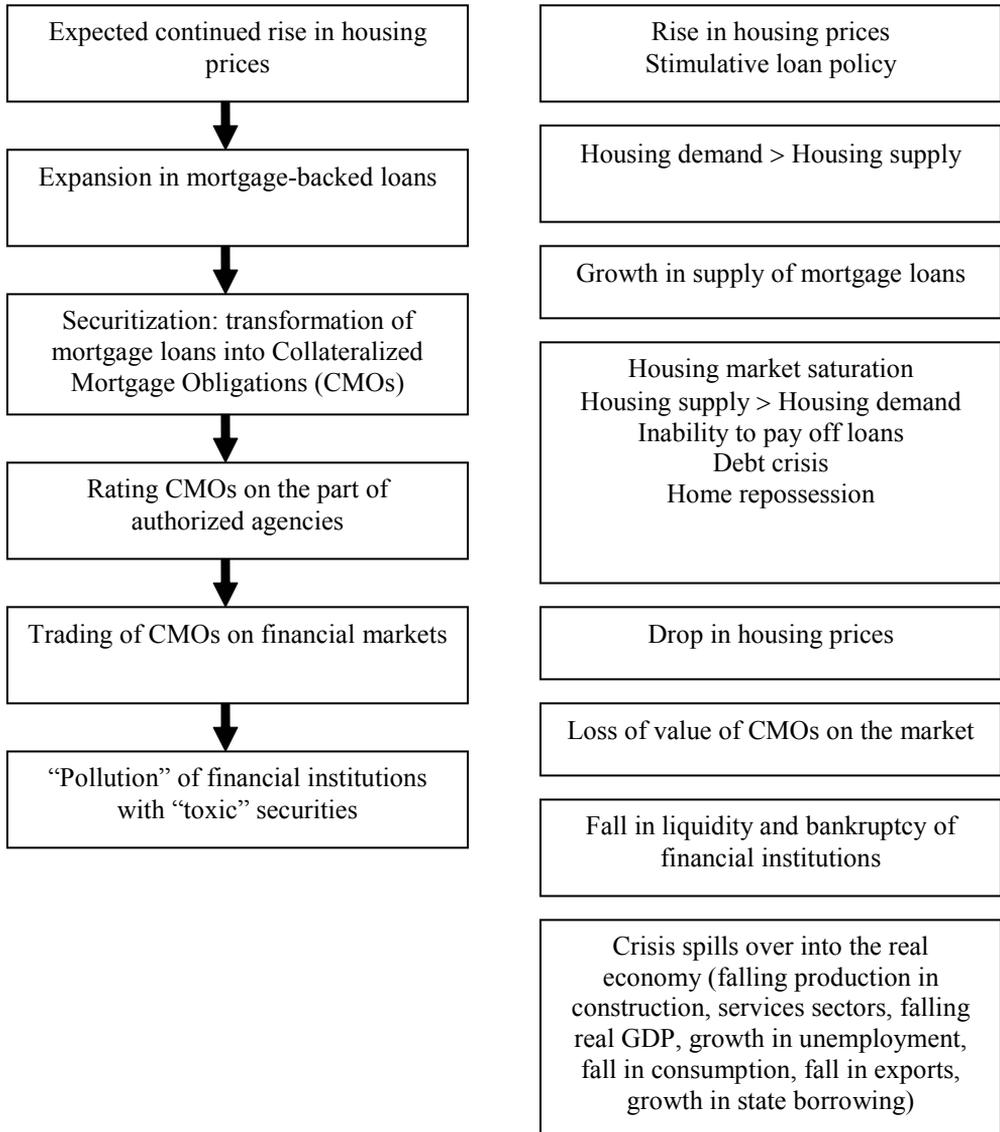
The US economy was hardest hit by recession in 2009. All indicators show drops in value, except for export of goods and services (growth of 2.3% compared to 2008).⁸

⁷ I. C. Jones: *Current Macroeconomic Events*, August 6th, 2008

⁸ The United States of America, Recession deepened by the financial crisis: http://ec.europa.eu/economy_finance/pdf/2008/autumnforecasts/non_usa_en.pdf; Bureau of

Real GDP in 2007 rose by 2% compared to the previous year, but in 2008 it grew by only 1.1% and then fell by 0.5% in 2009. In the last quarter of 2008, real GDP was 6.3% lower than in the previous quarter of that year.

Figure 3: *Factors and phases in the mechanism of the generation of the financial crisis*



the Economic Analysis, National Accounts: <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

Industrial production also fell in 2008 and 2009. In the first quarter of 2009, the decline relative to the first quarter of 2008 equaled 20%. The production level in March 2009 was 1.5% lower than in February 2009.

The fall in personal consumption is a result of growth in unemployment, lower wages, more restrictive loan policies and a general fall in the standard of living, caused by massive mortgage losses.

In March 2009, the unemployment rate reached a record 8.5% on the yearly level, which was 0.4% higher than the previous month. From the beginning of the recession, which was officially pronounced in December 2007, 5.1 million jobs have been lost, with 3.3 million lost in the last 5 months alone. By the end of 2009, the projected unemployment rate in the US equaled 10%.

This interactive network of factors was further aided and significantly accelerated by the global connectedness of various economies. We could say that globalization was that added agent that complicated, accelerated and deepened the effects of all the above factors.

This great financial crisis is being compared with the great global crisis of 1929-1933. However, it also has other parallels in more recent history.

Common to all crises is the cyclical movement of financial activities, the succession of **expansion (boom) and contraction (bust) phases**. There are great historical similarities between the current crisis and some recent ones (the Asian crisis of the 1990s, the dot.com crisis of the 2000s). However, what is characteristic for this crisis is that it “marks the end of one of the longest periods of high profitability, ample equity capital, and abundant credit supply in American banking (1993-2006). For these reasons, the turmoil is much more than a cyclical readjustment in prices, risk appraisal, risk tolerance, or credit supply; it represents an end to important secular trends in asset prices, financial innovation, and financial intermediation, which persisted for more than a decade”⁹

⁹ C. W. Calomiris: *The Subprime Turmoil: What's Old, What's New, and What's Next?*, 2008

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ASSISTANT NIKOLA STAKIĆ, MSc ECONOMICS*
Faculty of Business Studies, Megatrend University, Belgrade

THE PROCESS OF SECURITIZATION AS A FACTOR OF CREATION OF THE GLOBAL FINANCIAL CRISIS

Abstract: *The innovative process of securitization reached its highest values during the onset of the crisis on the US mortgage market. By its proportions, the crisis took on features of a global phenomenon, not only on the mortgage market but in the overall economy. As the crisis gained in importance, so did interest in learning the basic features of securitization, and the mechanism on which it is founded. The attractive model of converting various forms of loans into tradable securities resulted in the creation of speculative bubbles, which overvalued various assets, in the first place real estate. The very nature of securitization, which carries numerous advantages, was served legislators and decision-makers as a useful tool for creating enormous wealth, but also to generate a global financial and, subsequently, economic crisis. An excessively liberal institutional order and the immoderate use of this process did not allow its true value to show, which could be of use to all participants on contemporary financial markets.*

Key words: *securitization, mortgage market, global financial crisis*

JEL classification: G 21, F 02

1. Introduction

The current financial and economic crisis will undoubtedly change economic behavior, both on the micro and macro levels. The effects of the crisis thus far and the coming multi-year challenges on the global level confirm that we are not dealing with an ephemeral phenomenon. Numerous facts and the views of the world's leading economists underscore the importance of this problem, but also point to different possible solutions. That we are dealing with a most serious problem is also testified by the actions of numerous political leaders throughout the world who, despite the various economic doctrines to which they

* E-mail: nstakic@megatrend.edu.rs

adhere, have directly involved themselves in the revitalization of the economic systems of their countries.

What is indisputable is that most economists concur about the cause of the economic crisis, which is quite directly being ascribed to disruptions in the overly liberal US mortgage market, which subsequently spread to other financial market segments as well. This leads to a logical question: can a segment of a single country's financial market shake the entire global economy, in such proportions as to push it to the threshold of global recession? If the answer is positive, it speaks enough about the size and power of the US, but also about the negative side of globalization.

Taking into account the above observations, we should primarily focus on the characteristics of the US mortgage market. An essential feature of this part of the financial market is the appearance of innovative processes of securitization, which directly or indirectly caused the crisis situation. Precisely for these reasons, we should strive to explain the process of securitization with all its advantages and shortcomings. Good acquaintance with this process will open the door to a more efficient institutional ordering of securitization and, thus, the creation of preconditions for maximizing its positive and minimizing its negative effects.

Securitization is the most current research field dealing with financial markets. It has an exceptional micro aspect, for economic actors, banks and financial institutions that, with the aid of securitization, lessen credit risk, manage capital and realize profits – as well as an exceptional macro aspect, with diversification of risk in the economy, increased liquidity and the development of the financial market.

2. The concept of securitization

The process of securitization originated on the mortgage market, where it is most used even today. The revolutionary nature of this process is reflected in the wholly new position of debtors and creditors, as well as in the different nature of financial institutions' business dealings. Securitization allows the avoidance of the traditional process of financial intermediation, directly linking borrowers with the money and capital markets. Numerous new participants are brought into the process: loan originators, finders, securities conduits, credit enhancers, investment bankers and national and global investors.¹ We can define securitization in various ways:

- As a process of mobilizing banks' credit claims by way of securities and their sale on the market.²
- As a process of issuing and selling liquid debt securities to investors, on the basis of a pool of certain assets (illiquid claims), which renounce regular monthly earnings – inflows and serve as collateral for the securities issue.

¹ B. Živković; D. Šoškić: *Finansijska tržišta i institucije*, Ekonomski fakultet, 2005, p. 290.

² M. Kulić: *Finansijska tržišta*, Megatrend univerzitet, 2007, p. 122.

- As an operation of transforming bank loans into obligations issued on the basis of those loans.

When trying to define securitization, many authors make the same mistake by focusing on the process of securitization itself, rather than on its essence and meaning. All definitions of this, in our country still insufficiently known concept, talk about the unique nature of the process i.e. that in the process of securitization financial instruments are transformed and repackaged into securities whose credit rating is raised and which, thus, more easily find investors on the financial market. The issued securities are tied to concrete assets and the cash flow that stems from them, and do not depend on the credit risk of the initial owner of the property. In that way, investors are actually purchasing a share in the said assets and proportional rights that are tied to it, thus making a significant departure from traditional forms of obligations and other debt-based financial instruments.

Securitization allows institutions such as banks and corporations to turn assets that are still not tradable on the market (such as commercial mortgages or car loans) into standardized securities that are tradable on secondary markets. This technique was initially presented as a way of financing American mortgage banks. Subsequently, it came to be applied to other forms of assets, such as credit card and leasing-based claims.

Asset securitization allows companies to more easily obtain liquid funds at lower transaction cost, by eliminating the classic role of financial intermediaries (before all banks), which used to stand between companies and the ultimate sources of money – financial markets. However, the role of banks and intermediaries cannot be avoided totally and in each case, even in the process of securitization.

3. The development of securitization

The process of securitization began during the 1970s, with the structured financing of asset pools composed of mortgages. During the previous decades, banks had been mainly portfolio creditors – they held loans until maturity or until they were paid off early. Those loans were mostly financed by deposits, and sometimes by debt, which represented a direct obligation on the part of the bank (rather than a right to a certain portion of the property).³

After World War II, deposit institutions were no longer able to keep pace with growing demand for housing credits. Like other intermediary financial institutions, sensing the market's potential, banks searched for ways to increase the sources of financing housing loans. In order to attract investors, banks developed a method that separated mortgage pools, dispersed credit risk and structured the cash flows of the initial loans. Although several years had to pass before an effi-

³ Comptroller's Handbook, *Asset Securitization*, 1997, p. 2.

cient structure for securitizing mortgage loans was established, the loan issuers quickly realized that the process was also applicable to other forms of loans.

From the mid 1970s, the combination of more advanced technology and more sophisticated investors established securitization as the fastest growing activity on capital markets. The expansion of all forms of securitization was exceptional, not only of the process itself but also of the number of companies that used it in their business as well as the number of investors involved. Financial intermediation changed so much that only a small number of banks and financial companies continued to engage exclusively in portfolio crediting.

The US market for mortgage-backed securities, i.e. securities that encompass different kinds of obligations insured by mortgage loans, experienced a real boom thanks to the support of government agencies that guaranteed these securities. In order to ease the securitization of non-mortgage assets,⁴ a new participant appeared – credit enhancers. At the beginning, they engaged in the overcollateralization of the pools that formed the assets, in order to avoid default on the basis of mortgage-backed securities' (MBS) principals and interests, due to tardy payments or the early retirement of securities that formed the asset pool.

Table 1: *Securitized financial assets in the US during the 1980s and 1990s*

Fixed interest rate mortgages	Equipment leasing	Student loans
Variable interest rate mortgages	Mobile home loans	Franchise loans
Secondary mortgages on the same property	Loans for floating objects	Aircraft leasing
Home equity loans	Recreational vehicles	Auto dealer papers
Commercial mortgage loans	SBA loans	Variable annuity fees
Car loans	Third World debt	Liens on tax-debtor property
Credit card claims	Junk bonds	Uncollected utility bills

Source: B. Živković; D. Šoškić, *Finansijska tržišta i institucije*, Ekonomski fakultet, 2005, p. 291.

In 1985, the technique of securitization that was developed on the mortgage market was first applied to asset pools that were not made up of mortgage loans – to automobile loans. These loans were a valuable novelty for structured finance.⁵ Their credit period was substantially shorter than that of mortgage loans, which made cash flow movements much more predictable, giving investors more confidence in that form of investment.

The first significant sale of securitized assets based on credit cards happened in 1986, with a total value of 50 million USD in bank claims. This transaction

⁴ A form of assets that can be securitized, other than mortgage loans (equipment leasing, car loans, franchise loans, credit card claims, etc.)

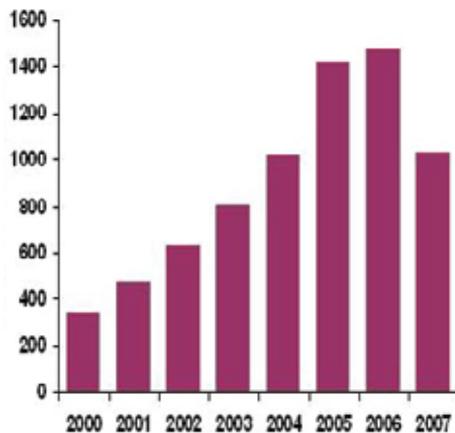
⁵ Comptroller's Handbook, *Asset Securitization*, 1997, p. 3.

showed investors that, if yields are sufficiently high, support for the sale may be expected in spite of greater expected losses and administrative costs than in the case of mortgage loans. After the success of this initial transaction, investors began to widely accept credit card claims as collateral, while banks developed ways of easing the harmonization of cash flows.

The next form of securitization that will certainly experience future growth are nonconsumer assets. The majority of loans to private individuals are “ready” for securitization, before all due to the predictability of cash flows. The diversity of the securitization process, i.e. of the assets used in securitization, can be seen in Table 1. Today, quantitative techniques of credit scoring and credit monitoring are widely present for this form of loan, and the majority of available banking services for private individuals form a totally homogenous debt portfolio. Commercial financing represents the next challenge. Due to the lesser homogeneity of commercial loan portfolios, the potential investor must be acquainted with each individual loan, as well as with the fact that the techniques of measuring and managing portfolio risk are less efficient. Regardless of that, investment bankers and asset owners have shown themselves to be quite innovative in structuring cash flows and enhancing credit ratings.

The process of securitization has taken on huge proportions, especially in the 21st century. The period between 2000 and 2007 was characterized by dynamic growth, where the value of securitized assets on the global level increased almost fivefold! A dramatic fall in the use of the securitization process occurred in 2007, with the first signs of the global financial crisis, which would serve as cause for future reconsiderations of the mechanism itself.

Figure 1: Issue of securitized securities in the world (in billions USD)



Source: Conerly, B; *Why Did the Mortgage Crisis Happen*, Businomics, May 2008, p. 3.

4. Participants in the securitization process

The securitization process disperses risk by segmenting the traditional role of banks into several new, specialized participants: originator (loan issuer), servicer, credit enhancer (rating agency), sponsor, special purpose vehicle (SPV)⁶ and investor. Banks may perform one or more of the tasks of the above participants and, thus, gain an advantage through their expertise and economies of scale. The shape and level of risk to which banks are exposed depends on their inclusion in the process of securitization itself.

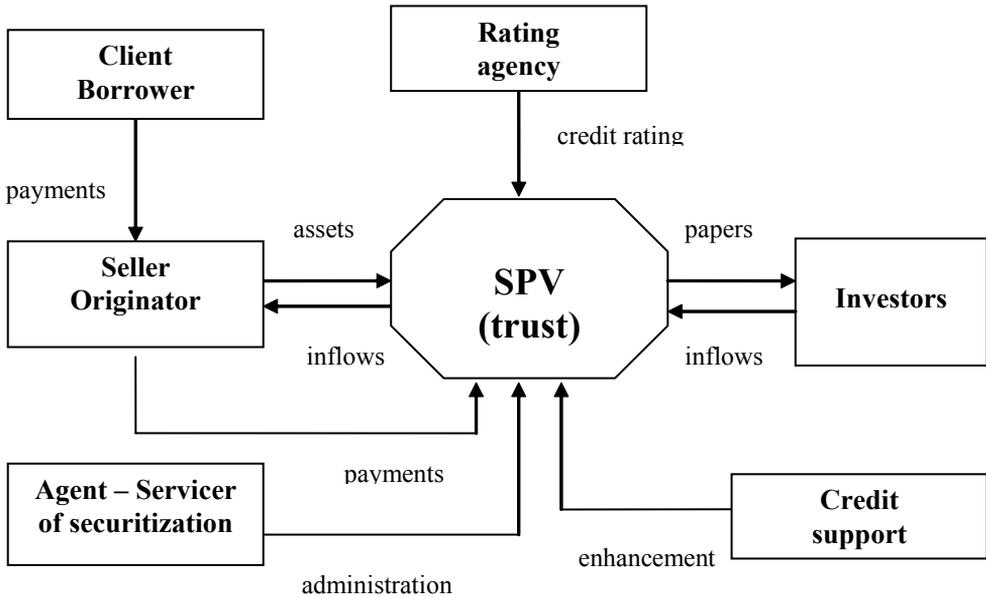
The loan user – borrower is responsible for repaying the underlying loan and, thus, for the ultimate repayment on the basis of mortgage-backed securities. Due to the fact that the users often aren't aware of the fact that their debts have been sold, the bank that issues the loan is able to maintain good relations with their clients. From the standpoint of credit risk, securitization has made possible the practice of grouping borrowers into several categories. At the top of the ladder are borrowers with pretty clean credit histories (A), while at the bottom are borrowers with exceptionally bad credit histories (D).

The **originator** creates and often services the property that is sold or used as collateral for mortgage-backed securities. These are special financial companies of the biggest automobile producers, other financial companies, commercial banks, insurance agencies, IT companies and airlines. Commercial banks mostly create and securitize loans for automobiles, credit card claims, mortgage loans and, more and more often, entrepreneur loans. IT companies and airlines mostly use securitization in order to finance claims based on the sale of their products.

Servicer. The originator of the pool of securitized assets mostly continues to service the securitized portfolio (the only property with an active secondary market for servicing contracts is the mortgage). Servicing encompasses the repayment process for the loan user in the securitized pool, together with a certain fixed fee, as well as accompanying activities in accordance with the servicing contract. Servicing may also include default management, as well as the liquidation of property used as collateral. The servicing of securitized portfolios also encompasses providing administrative support for the benefit of a trust (SPV), which is morally obligated to protect investors' interests. For example, the servicer prepares monthly reports, transfers payments and secures information for the trust on how the assets are being used. Reports are usually done on a monthly level, with a specialized form for each variety. They are distributed to investors, the trust, rating agencies and credit enhancers.

⁶ Some authors use similar terms: SPC (*special purpose company*) or SPE (*special purpose entity*).

Figure 2: Scheme of the securitization process



Source: Author's own scheme.

The special purpose vehicle – SPV books into its balance sheet the assets that are the subject of securitization and, on that basis, issues asset-based securities, which are backed by those same assets. It is most often formed by the loan issuer or, if one exists, the issue sponsor. The usual practice is for it to be established in the form of a trust, in order to take advantage of tax benefits that such companies enjoy. The trust form is necessary so that the SPV can be the formal asset owner and the carrier of obligations toward investors. The SPV coordinates the entire process of cash flow servicing, collects loan interest and principal and pays it (or forwards it) to investors. If a problem appears in the transaction, the company devotes special attention to the obligations and characteristics of all the participants that are connected with securitized papers, especially servicers and credit enhancers. Throughout the entire transaction process, the company receives from the originator (or servicer) periodic financial indicators – the value of collected and paid-out funds, as well as the value of the collateral. It is responsible for the evaluation of this information, in order to ensure that the underlying loan is creating a sufficient cash flow for servicing the securitized papers. The company is also responsible for announcing the event of default, as well as for replacing the servicer in case he is not acting in accordance with the set conditions.

Credit enhancer. The raising of the credit rating is a method used to protect investors in situation in which the cash flows of the assets used as collateral are not sufficient to repay, in the shortest possible time, the interest and principal of the debt of the securitized papers. It is used to improve credit rating and, thereby, the price and tradability of these securities. A general rule is that credit enhancers must not have a credit rating lower than that of the papers that are being securitized. Credit support is most often secured through letters of credit or guarantees of a bank or a highly rated insurance company. Due to the fact that accessible high-ranked credit enhancers are few in number today, internal improvements, such as the creation of subordinated structures of classes or tranches, have become popular with mortgage-backed securities. In that context, we can distinguish several classes: 1) senior debt; 2) mezzanine debt; 3) subordinated debt; risky capital – stock capital (equity).⁷ The more „junior“ classes of securities protect the more „senior“ ones, absorbing risk until they are wholly exhausted.

Rating agencies play a key role in structured finance by evaluating the credit rating of transactions. Such agencies are considered credible, before all because they possess the expertise for evaluating different forms of collateral assets and because they draw no benefit from the results attained by securitized papers (their yields or losses). Rating is very important because potential investors usually accept it from the main state rating agencies in place of due diligence of collateral assets or servicers. Most mortgage-backed securities are rated. Large public issues are rated due to the investment policy of corporate investors, who require certain rating levels. On the other hand, private placements are adequately rated because of insurance companies, which represent important investors and which use ratings for reserving capital on the basis of their investments. Certain institutional investors, such as life insurers, pension funds and, to a lesser extent, commercial banks, may buy a limited quantity of securitized papers rated below the investment threshold. Rating agencies evaluate the four most important characteristics:

- quality of sold assets;
- capabilities and powers of the originator / asset servicer;
- quality of the overall transaction structure and
- quality of credit support.

Rating agencies evaluate the probability of repayment of interest and principal on the basis of securitized papers, in accordance with the terms of the contract. They exclusively focus on the securities' credit risk. As a rule, they do not express their opinion on market risks that may occur through interest rate fluctuations or early repayments, or opinions about the justifiability of certain investors' investments.

⁷ P. Kapor: "Strukturni finansijski instrumenti: CDO, CDS, SCDO, CLN i ABCP", *Poslovnna politika*, mart-april 2008, p. 22.

The sponsor of securitized papers is charged with advising sellers on the ways in which to structure their portfolio, as well as with setting prices and placing these papers on the market for potential investors. They are often engaged due to their good relations with institutional investors, as well as because of their advice regarding the terms and prices that the market demands. They are also acquainted with the legal and structural demands of institutional investors.

Investors. The biggest buyers of securitized papers are usually pension funds, insurance companies, portfolio managers and, to a lesser extent, commercial banks. The most important reason for investing in such securities are the high yields relative to other forms of assets with similar credit risk.

5. Reasons for undertaking securitization

The determining factor that stands behind the process of securitization is the need for banks to realize the value of the assets on their books. These assets most often include mortgage loans, commercial loans, various forms of consumer credits, etc. It is necessary to identify factors that may lead to a situation where financial institutions securitize a portion of their book assets. That may occur for the following reasons⁸:

- if the level of mandatory capital is reduced, which can lead to lower costs or the allocation of capital to more profitable activities;
- if the retention of cheaper financing is sought: most often, the interest on securitized papers is lower than interest on basic, collateral securities. That leads to the creation of surpluses for the originator.
- In other words, the basic reasons for which banks securitize a portion of their book assets are the following (one or more):
- financing with the assets at their disposal;
- balance sheet capital management;
- risk management and transferring credit risk.

5.1. Financing

Banks can use securitization to:

- support accelerated asset growth,
- diversify their financing and lower their financing costs,
- reduce term disharmony.

The global market of asset-backed securitized papers is huge, with annual investments estimated at about 1 trillion USD per year, of which 150 billion is

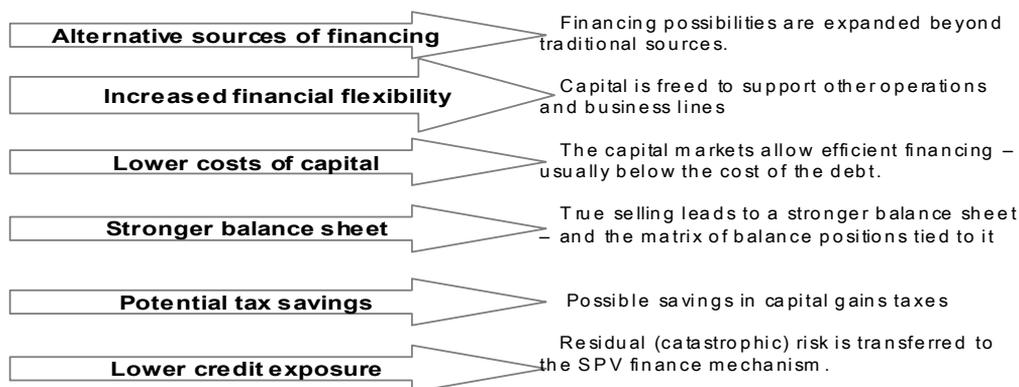
⁸ M. Choudhry: *Corporate Bonds and Structured Financial Products*, Elsevier Finance, 2004, p. 298.

invested on the European market.⁹ Access to these amounts of financing allows banks to strengthen their credit potential in a manner more efficient than traditional forms of financing.

Asset securitization also allows banks to diversify their sources of financing. No bank wants to depend on only one or several financing sources, which can be very risky in times of market uncertainty. Banks strive to optimize their financing, by using various sources: through working with private individuals and businesses and by way of interbank crediting. Securitization plays a key role here. It also allows bankers to reduce their costs of financing, before all through the process of separating the originator's credit rating from that of the institution issuing the securitized papers. Usually, most of the securities issued by SPVs are more highly rated than securities issued directly by originators. While liquidity on the secondary market of asset-backed securities is most often lower than on the commercial papers market, the cost of issuing securitized papers is lower precisely because of their subsequent better rating.

Finally, there is a problem that appears with term disharmony, which is an integral part of harmonizing bank assets and liabilities. They often finance long-term placements, such as mortgage loans, from short-term deposits, such as deposits on-demand or interbank credits. This can be bridged through securitization, where the originating bank sells its claims, whose maturity often matches the maturity of the newly created securities.

Figure 3: *The main benefits of securitization*



Source: P. Ivanović, *Naša realnost i perspektive procesa sekjuritizacije*, International conference on securitization, 2007, p. 6.

⁹ M. Choudhry: *Corporate Bonds and Structured Financial Products*, Elsevier Finance, 2004, p. 299.

5.2. Balance sheet management

Banks use securitization to improve their balance sheets. That allows them to free their capital and diversify its sources. As provided in the rules on capital of the Bank for International Settlement – BIS, known as the Basle rules, banks must keep certain minimum capital amounts relative to their assets, depending on the latter's risk. According to Basle I (rules established in 1988, came into force in 1992), for each 100 USD of risky assets, a bank must set aside at least 8 USD of its own capital; however, the marking of given assets as risky is itself problematic. Let's take the example of cash credits, which are 100% risky regardless of the borrowers' credit rating or the quality of securitized papers they possess. Such irregularities were supposed to be resolved by the so-called Basle II rules, which came into force in 2007. However, since SPVs are not banks, they are not encompassed by the Basle rules, and hold as much capital as they need for carrying out economic activity, taking into account the nature of the assets themselves. That amount is not standardized but is much below the 8% level to which banks must adhere. By selling securities issued on the basis of credit placements, banks "clear" their balance sheets, i.e. credits exit the banks' balance structure. In that way, the bank is able to enter new placements with the obtained funds, on the basis of the same quantity of capital (thus increasing return on equity – ROE). Thanks to the fact that securitization is often viewed, in the accounting sense, as a sale of assets rather than financing (debt-based), the originator does not record the transaction with the liabilities on his balance sheet. Such off-balance sheet financing allows the obtainment of capital without increasing the originator's leverage, i.e. the ratio between debt and own capital in his financial reports.

5.3. Risk management

From the moment that assets are securitized, the originating bank's credit risk exposure is significantly lowered and, if the bank does not retain for itself the newest tranche of issued securities, the risk is totally removed. This is, before all, due to the sale of claims backed by SPV assets. Securitization can also be used for shedding uncollected credit claims from banks' balance sheets. This has a twofold advantage: it removes credit risk and potential negative indicators from the balance sheet, and promptly frees capital for the needs of new placements. Finally, one more advantage may appear: if, after securitization, borrowers begin to meet their credit-based obligations or higher amounts of payments due are collected because credit periods are prolonged, the originator will claim the surplus profit earned by the SPV.

6. Securitization and the global financial crisis

After the outbreak of the crisis on the US mortgage market in the summer of 2007, few people thought that it would affect the entire global economy in such a powerful way. One year later, no one had any doubt that the world was faced with a financial crisis of global proportions, with dramatic macroeconomic and social consequences for many regions and countries. Only a small number of local analysts and politicians would dare claim today that their country is shielded from the effects of the crisis, as it continues to manifest itself more and more frequently and destructively all over the world. Still unknown are its scope, duration and consequences for the future architecture of the global financial system.

The global financial crisis came about, on the one hand, as a result of the desire of financial institutions to diversify risks and turn illiquid assets into liquid papers and, on the other, as a result of insufficient and low-quality information about such, often quite complex securities. In order to consider the true causes of the crisis, it is necessary to go back a decade earlier, when the US experienced an expansion in so-called subprime credits – i.e. the issuing of loans to individuals with high credit risk, most often without a credit history, who overestimated their abilities to repay credits. The largest number of these loans (between 30% and 40%) was used to buy real estate.¹⁰

Partial responsibility for the sudden growth in these high-risk mortgage credits belongs to the US government. Beginning with 1992, towards the goal of realizing its affordable housing program, the US government compelled its two specialized private agencies with state backing, Fannie Mae and Freddie Mac,¹¹ to earmark a significant portion of their loans for individuals who would otherwise not be able to obtain them under market conditions. The trend of granting favorable mortgages gradually grew: in November 2000, Fannie Mae announced that the state was compelling it to issue 50% of its loans to middle and low income families, with the goal of increasing the total value of such loans to 500 billion USD by 2010. Within the same program, the state also stimulated commercial banks to issue subprime (housing) loans.

However, neither the commercial banks nor the specialized agencies retained the subprime loans on their balance sheets, but securitized them, i.e. packaged them into securities and sold them to investors all over the world. Such mortgage-backed securities (MBS) have the problem of informational asymmetry between sellers and buyers, i.e. investors. This informational asymmetry encouraged moral hazard, before all in the cases of Fannie Mae and Freddie Mac, which

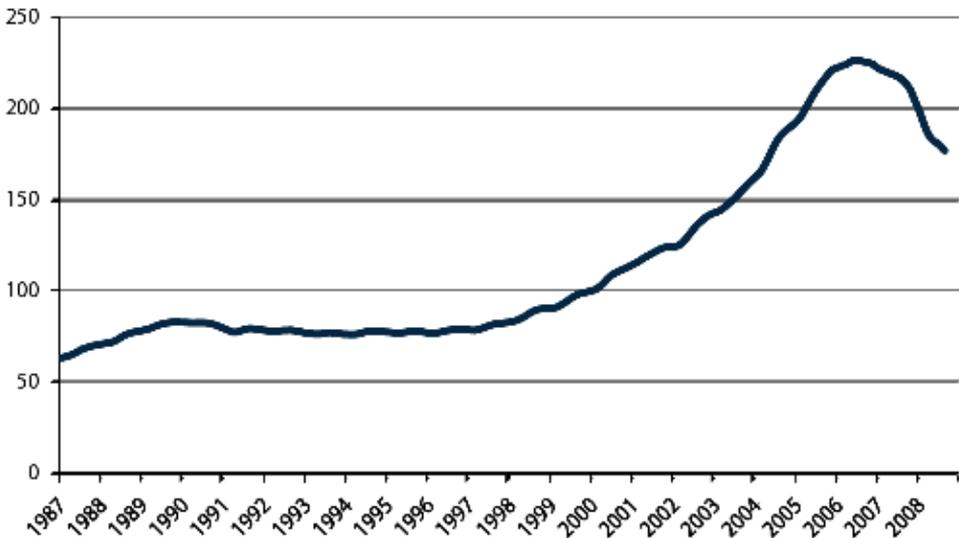
¹⁰ M. Božović, B. Urošević, B. Živković: “Svetska finansijska kriza i Srbija”, *Kvartalni monitor*, No. 14, jul-septembar 2008, p. 94.

¹¹ Fannie Mae was founded in 1938. Its basic function was to create a secondary market for subsidized mortgages intended for the poorer population and American war veterans, which is what it mostly does today. Freddie Mac was created later, its basic task being the securitization of private mortgages intended for the entire marketplace.

were aware that they had the backing of the state and were, thus, willing to take on the great risks of issuing subprime (housing) credits. On the other hand, rating agencies unjustifiably rated a large number of MBSs issued or guaranteed by Fannie Mae and Freddie Mac in the class of least risky debt securities, giving them investment grade ratings in the range of BBB- to first-class AAA. Investment banks and funds, the main buyers of MBSs, also bear a part of the blame, because they did not reexamine the justifiability of these ratings.

Such a system was sustainable as long as the prices of real estate and other collateral rose sufficiently to cover potential losses and defaults. On the one hand, favorable loans generated great demand for housing. On the other hand, the housing bubble was additionally inflated by the US Federal Reserve (FED), with its long-term policy of low interest rates that were supposed to stimulate the domestic economy. Such an expansionist monetary policy led to a situation where cheap capital was being placed in long-term and capital-intensive investment projects, for which housing was the ideal solution.

Figure 4: Index of real estate prices in the US



Source: M. Božović, B. Urošević, B. Živković: "Svetska finansijska kriza i Srbija", *Kvartalni monitor*, br 14, jul-septembar 2008, p. 95.

The so-called bubble began to deflate in mid 2007, when the first massive mortgage defaults began to occur. However, the risk of default is not a problem by itself, as it is calculated by the issuer during credit approval and, as such, calculated into the price of the loan. The problem for investors on the secondary mortgage market turned out to be that lenders were carrying out an unjustifiably

bad conversion of risk, i.e. they were repackaging non-transparent and high-risk loans into practically non-risk securities. That the situation had gotten out of control was realized by Standard&Poor's, which in July 2007 lowered the rating of a significant portion of mortgage-backed securities on the secondary market, nominally worth about 12 billion USD. During August 2007, panic began in the US and Great Britain, as investors realized that their portfolios contained securities that were far riskier than they initially seemed, due to which they initiated a massive sell-off. At the same time, housing demand fell drastically, as favorable mortgage loans were drastically cut, while supply grew as more and more issuers sought to shed housing properties they had gained through foreclosure as soon as possible. The result was that housing prices fell dramatically, while the secondary market for mortgage-backed securities became illiquid. Before the crisis, the proportion between the real and the financial economy was one to ten, i.e. the quantity of money far outstripped its real base. Total global GDP was 60 trillion USD, while the total value of securities on various exchanges equaled more than 700 trillion USD. Since the market contained far more capital than there was real need, this resulted in the performance of highly risky, even assuredly non-performing placements.

7. Conclusion

The modern aspect of globalization, in which there is a high degree of coherence of financial and economic flows, is showing its negative sides. It is not unfounded to observe that the world is a "global village," in which each decision and action may have ramifications throughout the world. Over the last decades, we have witnessed a large number of positive things that the contemporary order brings to humanity. By the same token, we must be prepared to face the negative effects that this process carries.

The concept of securitization was a big unknown for most ordinary people, and even for some experts. That is especially true for continental European countries, which have a somewhat more conservative financial infrastructure. However, as the financial crisis gained steam, the public gradually came to understand the essence of this concept and became acquainted with the characteristics of the US mortgage market.

Numerous actors are talking about the current crisis as a systemic one, underlining the need for changing the entire financial system. Care should be taken with opposing views related to securitization as the cause of the crisis, as we have seen the numerous advantages it offers. It is evident that excessive and uncontrolled use of securitization brought on the current economic crisis, but there is a logical question: who is actually to blame for the current situation? Opinions differ, but one thing is certain – the global financial system and the

current world order must change so that the world can become stronger and more resistant to negative occurrences.

The process of securitization, which is entering its fourth decade of existence, is attracting exceptional interest, not just from economic experts but from the public at large. The reason for that should be sought in its direct effects on the functioning of the entire financial system. The advantages it brings have contributed to the improvement of the position of numerous participants on the financial market. The creation of complex forms of securities has led to a broader dispersion of credit risk, creating better conditions for the achievement of business goals.

As the process gained an increasing share in contemporary markets, its potential shortcomings began to be noticed. After the outbreak of the current global financial crisis, securitization began to be mentioned in a negative light for the first time. Different kinds of financial institutions are facing numerous problems in their financial activity, casting doubt on the very purpose of the process. However, the question that appears is – to what measure is securitization responsible for the current crisis, which is taking on dramatic proportions (the biggest since the Great Depression).

It turns out that the unhindered functioning of securitization did not have the sole aim of enormously enriching certain categories of people and organizations (mostly executives of the biggest global financial institutions) but, instead, had a broader social framework as well. The striving of state leaders (especially in the United States) to secure basic existential needs to all social layers contributed to a massive program of helping families acquire housing. Such a policy has its roots in the recognizable American ideal of regulating the housing problems of the entire American nation, regardless of material status, religion or skin color. That same policy has no rational foundation in real economic capacities for such a huge undertaking. Precisely for those reasons, the best ways for realizing that endeavor were sought, and securitization was the ideal solution.

Economic policy makers did not comprehensively examine the real source of the problem. In most cases, securitization is considered to be responsible for the current situation. However, securitization is only a mechanism defined by the participants on the financial markets. An overly (un)conscious liberal conception on the part of regulatory organs had created apparent advantages for all participants, who believed in the possibility of an unhindered and permanently functioning securitization process. The character and scope of the crisis have led to serious drops of all macroeconomic indicators. The question of the current crisis is a systemic one, demanding the establishment of a new global financial infrastructure, with more just and more defined roles for all participants.

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Book review

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ANA GNJATOVIĆ *

Faculty of Culture and Media, Megatrend University, Belgrade

MANAGEMENT OF ELECTRONIC MEDIA

An essay on the book

“Management of Electronic Media: Radio, Television, Internet”

By Prof. Dragan Nikodijević, PhD, Megatrend University, 2009

Professor Dragan Nikodijević's textbook *Management of Electronic Media* is intended for fourth-year students of the Management in Culture and Media department at the Faculty of Culture and Media of Megatrend University. Megatrend University has already published a number of Professor Nikodijević's textbooks in the areas of culture management and marketing, art, and the media. Readers already familiar with the author's previous opus will encounter something familiar and proven – the book comes in a recognizable format, recognizable cover design and – in recognizable quality.

Management of Electronic Media is a continuation of the previously published *Introduction to Media Management*, in which management in traditional media sectors – print media and cinematography – was covered in detail. From the aspect of the study program, the two works form a unified whole, with some of the general phenomena of the media and media management in practice being dealt with in greater detail in the first study. Nevertheless, *Management of Electronic Media* can stand completely on its own as an autonomous, self-contained work, with the reader's relationship with the previous work being more in the domain of seeking augmentation and deeper knowledge than in seeking additional explanation.

Leading the reader through the paths of management and the phenomena of practical work in electronic media and broadcasting, the author makes a systematic analysis of each electronic medium – radio, television and the Internet, with their historical, technical-technological, and programming specificities, management and advertising characteristics, and the market-economic, ethical and legal aspects of their functioning. The method and logic of structure, combined with clarity of language and ease of style, make the study approachable and comprehensible even for readers without previous knowledge in the media sphere,

* E-mail: agnjatovic@megatrend.edu.rs

and therein lies the added significance of the appearance of this book in our theoretical literature. For, while the necessity of close familiarity with the functioning of broadcast media on the part of their future managers is understood, the significance of even the elementary acquaintance of the public at large (all those who consume and use the media) with media phenomenology has been, thus far, neglected.

Most consumers take in, with more or less satisfaction, the slogans with which they are bombarded, in which information is made analogous to power, *freedom* (Kofi Annan), or termed as the *oxygen of modern times* (Ronald Reagan), but do not venture into a critical analysis of the offered information and its delivery, thus being left only with an isolated unit of knowledge rather than knowledge itself. For, without (critical) consciousness, *information is not knowledge* (Albert Einstein). In seeking the necessary and desired information, distinguishing tones from noise has become a highly demanding process. If in contemporary society *information is the currency of democracy* (Thomas Jefferson), those who cannot influence the democratization (deregulation) of the media directly, should at least try to influence them with their choice – of information they will receive, and of the way in which they use the media.

Professor Nikodijević does not ascribe influence, whether positive or negative, to the media as such, but to the ways in which they are used. The mass media are usually qualified as the Great Evil of modern times, a diktat of the powerful and as the grave-diggers of the cultures of small peoples, but also as a window to the world and the most significant legacy of our society. For example, the Internet is seen in a range of visions, from the dark vision of a service exclusively devoted to exchanging piracy, pornography and emotikons, to the bright image of the Alexandrian Library of modern times. If we were to seek an example of media abuse for ideological purposes and of their use in creating mass psychology, it would not be necessary to go back even as far as Hitler's and Goebbels' propaganda, or to try delving into the political-economic games of global media magnates: it is enough to analyze one's own, direct experience. But even in that case, the malignancy would not lie in the apparatus itself.

Although its subject of interest is a relatively young broadcasting practice, *Management of Electronic Media* makes use of a rich array of literature. The ubiquity and omnipresence of the media and the intensity of their influence on contemporary life have affected and continue to affect leading social theorists. From the social psychology of Gustave Le Bon to the essays of Benjamin and the critical school of Horkheimer and Adorno, McLuhan's and Baudrillard's studies, to contemporary titles from the fields of mediology, communicology, and management, the works cited by the author, although published in a span of more than a century, are equally current.

Recently, on our own terrain, we have seen the appearance of a somewhat larger number of publications that deal with the media and their specificities,

which have not been overlooked in this book, either. But it's as though practice is lagging behind theory, and the economic principles inherited from the industrial age continue to persist. A total transition from an economy based on material goods to one based on knowledge has still not occurred, so the program, i.e. that much glorified information, too often appears as a means of attracting the public's attention, with the help of which the real goal is more easily reached. Most often, that goal is of a commercial nature and, paradoxically, it is also common – for users who finally express their active, consumerist characteristic, for advertisers who, thus, justify the money they've spent, and for the media, whose further existence is thus made possible.

It is as though the integrity of the creation declines along with the growth of already massive competition. Therefore, it is not a surprise that much of the cited literature has a somewhat apocalyptic tone. Still, the tone of *Management of Electronic Media* is not pessimistic, and one could say that it is not even neutral. Going back to the example of film, a medium that has to a great extent mastered its expressive capabilities and established itself as a new art form, Professor Nikodijević leaves the reader with a hope that the laws of promotion will not end up determining the laws of creation, and draws the future manager's attention to the need of finding new original and sustainable creative forms.

Turning to history is one of the characteristics of this study. A historical overview is given for each medium and practically each analyzed phenomenon, one that does not burden and slow the reading but, rather, provides a deeper insight and explanation of current practice. Thus, the author walks us through the history of the older radio, which, program-wise, is more inventive than television today, which looks as though it has yet to recover from the sudden, powerful surge of the Internet, which, again, is still searching for its specific forms and modes of expression.

The brief histories of media also encompass their development on the territory of Serbia, and the entire study is rich with examples from domestic broadcasting practice. The careful, systematic analysis of local conditions represents a valuable contribution to domestic professional literature and to the understanding of the entire media picture of Serbia. At first sight, the picture may appear confusing and demoralizing, for media or informational literacy cannot be expected from a society that is still fighting against the basic, functional illiteracy of its citizens. Still, a mapping of the problem is the beginning of the path toward its solution. Thanks to this study, future media managers will at least be moving along a well-established path. The dedication of the book *to the reconstruction of the Mt. Avala Tower* can symbolically be interpreted in the same spirit.

Book review

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PROFESSOR MILAN VLATKOVIĆ, PHD *
Faculty of Law, Business Academy, Novi Sad

EMPLOYEE LAW

*An essay on the book "Employee Law",
By Professor Živko Kulić, PhD, Megatrend University, 2009*

In 2009, Megatrend University published "Employee Law," a new book-textbook by Professor Živko Kulić, PhD. The expert public is already familiar with Professor Kulić as an author whose specific fields of interest are primarily the general system of labor relations, human resources management and industrial relations. This is best testified by his numerous, professionally noted works published in the last ten years or so, such as *Managing Human Potential*, Radnička štampa, Beograd, 2005; *Comments on the Law on the Amicable Resolution of Labor Suits*, Radnička štampa, Beograd, 2005; *Comments on the Labor Law*, Obrazovni informator, Beograd, 2005; *An Introduction to Law*, Megatrend univerzitet, Beograd, 2005; *Labor Law*, Megatrend univerzitet, Beograd, 2006; *Industrial Relations*, Megatrend univerzitet, Beograd, 2007.

In his new book, Prof. Kulić has entered an extremely interesting field of interest and research, about which there are practically no integral and systematic works in our legal literature. Namely, for more than 60 years, no works devoted specifically to public employees and employee relations have been published here, which is, before all, a consequence of the theoretical and legal-positive view that prevailed here during that time, regarding the essentially equal and equivalent legal-normative position in work of all those employed in the system of associated labor, and the principally analogous processual definition and determination of their material position, i.e. regarding the analogous contentual substance of the "self-management relationship as the ruling social relationship," regardless of the type, content and competencies of employees in their job positions, and of the type of social area in which work was performed. However, after the passage of the Law on State Employees, which, along with the Law on Public Administration of 2005, is supposed to initiate and be the basic legal-normative "motor" of reforming a portion of the public sector, more attention began to be paid to the multi-faceted content and ways of work in certain social

* E-mail: vlatkovicmilan@yahoo.com

areas, and the differentiated position of those employed in various, specific and diversified socially necessary positions, especially those of a public character, and their specific normative shaping, which, again, legally speaking, opens the way for noting and more broadly accepting the various positions, competencies and responsibilities tied to performing such work, as well as the relations that are established within it.

Prof. Kulić's work, thus, merits special attention, as one of the first here to treat the area of employee law in a practically integral manner (the work "Employee Law," by Prof. Milan Vlatković, was published somewhat earlier in the same year). It should also be born in mind that this book is a textbook intended for students at the Faculty for State Administration of Megatrend University, thus requiring a specific and especially careful approach to the new, extremely complex institutes of employee law and employee relations, which are still insufficiently understood and tried in practice here. In our opinion, among the primary characteristics of this work are the following:

The text is characterized by a relatively frequent and close linkage of exegeses and analyses of institutes of employee law and general labor law. This may occasionally seem as an over-burdening of the text, having in mind its basic subject – employee relations and employee law. However, overall, we consider such an approach, especially in certain portions, to be acceptable and justifiable, as it will undoubtedly, in a meaningful way, allow students to understand overall relations in and around work in a descriptive, comparative and comprehensible manner, as well as the differences between employee and general labor-linked legal relations, which is what led to the separate development of employee law and its constitution as a "sub-branch of labor law and, partially, as a separate institute of administrative law," as Prof. Kulić writes on p. 23, which, from a theoretical and positive-legal standpoint, is completely founded.

We would especially like to emphasize that the textbook contains, starting in a large measure from existing employee and general labor legal norms, critical observations and proposals related to new possible, and in any case more useful, ways of ordering and resolving certain issues. This is an especially praiseworthy portion of the textbook, which is written knowledgeable, with a visibly analytical engagement of problems and the enviable skill of an experienced legal writer.

At the same time, the textbook contains text on questions that do not, in the substantial sense and strictly speaking, belong to the sphere of employee law, but are considered to be inferred and given – the parts on state organs, especially organs of state administration by type, with their internal organizational structure, the macro-organization of the republic administration and its legally ordained personal structure, etc. Whatever the reasons, the author has written these portions in a comprehensive manner, with obvious expertise and thoroughness, clearly, precisely and instructively.

The text of the book is firmly and logically structured, so that its parts naturally follow the development and content of the institute of employee law and other, numerous questions that the text treats. Also, the structure of the text is segmented and, in many parts, quite acceptably fragmented, both logically and content-wise. Occasionally, that may seem to come at the expense of presenting individual institutes in their totality, and that the fragmented structure makes them appear “disconnected.” But this is only a first impression, as such a text structure provides unusually broad possibilities for understanding the institute in its genesis, through its prescribed and realized material and processual phase, and teaches its users – the students, that a legal relationship that may, at first sight, appear unified and relatively simple in structure is, in fact, most often a thing of substantial internal complexity, of an evolutive processual nature.

We would especially like to emphasize the author’s striving to define, in a specific and original way, the concept of employee law and its place in the legal system, starting from the nature of the work that public employees perform and the current positive-legal state of affairs. Namely, he considers employee law to be a sub-branch of labor law and, in part, an institute of administrative law, i.e. a new teaching discipline, with the specific features of a separate branch of law and an independent theoretical-scholarly discipline. In our opinion, the author has backed this view with professional, scholarly and didactic arguments that certainly cannot be ignored and, regardless of whether one may agree with this view, the said arguments must be considered and given due attention.

The author considers the key concepts of employee law to be those of the public employee, employee relations and the employee-related legal norm and, in accordance with that, he gives them due attention, presenting them in an expert, clear and understandable manner, with conspicuous informedness and precision, which is an especially significant contribution to understanding and making a distinction between these concepts.

We can observe that the textbook was written in a straightforward, clear and precise style, which is a characteristic worthy of praise. It does not contain unnecessary, superfluous and, for the text, unimportant digressions intended to impress the reader, but is oriented towards the actual purpose of the textbook: to provide students with a sound, lucid instrument for tackling subject matter that is not always simple. Thus, clarity and cogency of presentation are something that deserves to be emphasized in connection with this text.

Finally and to conclude, we consider that, in the subject matter and content that it treats, the text of this book is comprehensive and adequate, containing, in certain sensitive theoretical matters, an innovative approach, based on a professional, scholarly and legal-positive argumentation worthy of esteem, that it is written in a clear and specifically precise style, and that it contains critical presentations of legal solutions and comparative legal observations of importance for students. The book will certainly be of interest to the broader profes-

sional and scholarly public, as it treats questions, institutes and concepts that will be, if they already haven't been, introduced within the first systematic works on employee law into the debate on broader questions dealing with general and specific forms of work and relations, which are posed in relation to work in various social areas.

Book review

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ANA JOVANCAI, M.A. *

Faculty of International Economics, Megatrend University, Belgrade

CHALLENGES OF INTEGRATION

An essay on the book "Economic Policy, Theory, Analysis, Practice"

By Prof. Dragana Gnjatović, PhD and Prof. Vladimir Grbić, PhD

Megatrend University, Belgrade, 2009

For almost the entire previous decade, in spite of the very specific and difficult legacy of the preceding period, the Republic of Serbia has been trying to achieve the most important goal of its national policy, to gain entry into the European Union. The difficulties we have faced on that path and the ones that still lie ahead, are numerous and quite demanding. Thus, the book "Economic Policy," by Prof. Dragana Gnjatović, PhD and Prof. Vladimir Grbić, PhD, comes at just the right moment, with its studious exposition of Serbia's economic policy and its unbreakable connection with the economic policy of the European Union. The book is used as compulsory literature in undergraduate and master's programs at Megatrend University, being of great significance to our country's future young leaders, as it introduces them to the way in which the contemporary economy functions.

This monograph contains 295 pages and through its nine chapters presents readers with the theoretical basis, analysis and concrete application of the most important instruments of economic policy. Its numerous supplements, 53 tables and 11 figures illustrate quantitative economic data to students and other readers alike, so that they may gain the best possible understanding of the functioning of economic mechanisms and of movements in the economy. In both scope and content, the book represents an exceptional contribution to economic sciences and a valuable work that encompasses the entire system of international economic relations.

In the first chapter, written by Prof. Vladimir Grbić, the concept of economic policy is defined, along with the basic goals of economic policy, both short-term and long-term. After giving a detailed description of the goals, the author acquaints us with the instruments of economic policy, which actually represent variables for the realization of its goals. As a conclusion, in a very clearly pre-

* E-mail: ajovancai@megatrend.edu.rs

sented table, the author links the goals with instruments for their most efficient possible achievement.

In the second chapter, Prof. Dragana Gnjatović introduces us to the state's regulatory function in the economy. The Great Depression of 1929-1933 was overcome precisely thanks to state intervention, which subsequently became a permanent factor of the functioning of capitalist economies and led to the development of the state's economic function. After giving an overview of the economic systems that functioned in Europe after World War II and analyzing them, the author goes on to define an active and neutral economic policy, along with the periods within the economic cycle when they are applied.

In order to gain a clear picture of the state's economic function, as well as economic policy as a whole, it is necessary to see what preceded the creation of this macroeconomic discipline. Thus, at the beginning of the third chapter, Prof. Dragana Gnjatović presents in detail the causes and consequences of the Great Depression, which quite clearly exposed the shortcomings of the market mechanism, for which it had been thought that it could push the economy out of recession in any situation. The crisis was overcome thanks to the state, which took on the role of initiator of overall demand on the market, thus proving that reasonable state intervention into economic flows makes up an integral part of the functioning of the capitalist system.

Once it was established after the Great Depression that state intervention is necessary, various theories justifying different ways and measures of state intervention gradually developed, and the last part of the third chapter deals with these various views on the role of the state in economic development. After a comparison of the neoliberal and the interventionist concepts, we are introduced to the concept of the welfare state, i.e. the modern welfare state, by which the state is responsible for the individual welfare of each citizen. Through the theory of public choice, the author explains that each economic decision is in the first place backed by the voters who elected the economic policy makers, and only secondarily by the politicians responsible for executing the made decisions. This theory in fact deals with the real possibilities for an efficient functioning of economic policy, which the author illustrates and brings closer to the reader with numerous examples.

Following the Great Depression, the governments of capitalist countries needed as many quantitative indicators as possible to be able to make timely interventions when needed. In the fourth chapter, Prof. Gnjatović writes about the onset and importance of state statistics, with a very interesting look at Serbia's state statistics, which appeared in their original form at the beginning of the 19th century. Statistical departments have the task of measuring the growth of the national economy, by measuring the growth of the gross domestic product (GDP). The author then goes on to deal with the methodological basis of calculating the GDP and the current position of the Republic of Serbia in groups

formed by the International Bank for Reconstruction and Development, which are supposed to indicate countries' levels of development.

The fifth chapter was written by both authors, and represents the core of the book. It answers the question of how stabilizational economic policy is actually implemented. After clearly defining the implementation and effects of monetary and fiscal policy in the preceding chapters, at the beginning of this chapter the authors provide a historical overview of the development of monetary integration, so that students and readers may understand its present-day functioning. There follow separate analyses of the way in which monetary policy is conducted in countries of the European Union and in Serbia, with a special accent on the conduct of foreign exchange policy. Serbia's relations with the International Monetary Fund over the years are also examined. Serbia's banking system, which is a very important topic of public discussion, is also analyzed. In the post-2001 period, 37 joint-stock banks have established operations in Serbia, of which 22 are foreign-owned, and this is one of the rare textbooks that presents, compactly and in one place, each bank's ownership structure, number of employees and working capital. Fiscal policy is treated in the second part of the chapter. We are presented with an insight into the forms of tax policy in the European Union, as well as the necessity of tax harmonization in order to remove barriers to the formation of a single market.

On the other side, the author acquaints the reader with Serbia's tax and budget system. It is needless to describe the importance of comparing economic policy-making in the European Union and in Serbia, especially as Serbia has spent an entire decade clearing its path toward EU integration.

The significance of competition for maximizing the welfare of the entire society is analyzed by Prof. Grbić in the sixth chapter, entitled "Allocative Economic Policy." In order to clarify the dilemma imposed by proponents of different approaches to market regulation, the author provides a broader elaboration of the market and activist approach, and its two aspects: the theory of market intervention and the theory of structural economic policy. This is followed by a treatment of competition policy in the European Union. Thanks to a number of examples of companies that violated rules on limiting competition or abused their dominant position, we gain an insight into the importance of the free movement of goods, people and services as one of the basic economic postulates of the Union, from its founding to the present. After examining the situation in the European Union, the chapter analyzes the concentration of supply in Serbia, which points to the presence of a very high level of concentration of supply in Serbia's industry. The author gives a brief historical overview of the subject of the relevant law in Serbia, from the beginning of the 19th century, when it was first recorded, to the present, concluding that, in comparison to European law, the questions of state aid the limitation, control and repeal of various forms of subsidies, have yet to be regulated here.

According to recent research, the Republic of Serbia has the biggest regional differences of any state in Europe. We can read about this problem, which affects the European Union to such an extent that it earmarks one third of its budget for its resolution, in the seventh chapter. Prof. Grbić first examines theoretical views regarding the influences of economic integration on resolving regional balances. This is followed by a review of the most important goals of EU regional policy, as well as the reasons for their implementation, and analyzes the methods of measuring and statistically encompassing regional problems in the EU. Finally, the author examines all the regional economic policies used by the European Union, including funds that financially support their implementation, and presents the plans of EU regional policy for the period between 2007 and 2013. In the same way, the author analyzes Serbia's regional economic policy, more precisely its goals and the dimension of regional disproportions.

The eighth chapter deals with the basic characteristics of the EU's foreign trade policy as well as Serbia's foreign trade policy. A more detailed analysis is given regarding Serbia's efforts to liberalize its foreign trade regime in the period of economic transition since 2000, as the EU is Serbia's most important trade partner.

In the ninth chapter, the authors deal with an extremely important, although insufficiently examined phenomenon – financial crises. The concept of financial crisis is very concisely explained, followed by an analysis of the connection of financial crises with the liberalization of capital movements. The authors make a very competent attempt to identify the causes of financial crises, as well as to examine their consequences. Finally, in the manner of experienced and skilled economic professionals, the authors aptly round out the story on financial crises by proposing economic measures that may aid in preventing future crises.

The large number of bibliographic entries at the end and numerous cited Internet sources add to the usefulness of this textbook. The textbook is comprehensive in content and structure and contains world-leading definitions, theories, models and practices, as well as a valuable contribution in the form of opinions and viewpoints of two capable professors, Dragana Gnjatović and Vladimir Grbić. Due to its easy style and numerous supplements, this book is very easily understandable even to readers without economic knowledge. It represents an exceptional scholarly contribution to the successful implementation of economic policy and is, at this moment, of extreme value to our scholarly circles and economic policy makers, as an exemplary model.

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