Vol. 6 (1) 2009 • UDK 33 • ISSN 1820-4570

megatrend review

The international review of applied economics

Contents

Megatrend University, Belgrade

Megatrend Review

The international review of applied economics

Vol. 6 (1) 2009.

Megatrend University, Belgrade

Megatrend Review

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Vol. 6 (1) 2009.

Published by:
Megatrend University

ISSN 1820-4570

UDK 33

The review is published twice a year in Serbian and twice a year in English language.

All papers have been reviewed.

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EDITORIAL

On the Occasion of Publishing "Megatrend Review", Vol. 6, No 1, 2009

This issue of "Megatrend Review" is a result of long term strategy of its Editorial Board aiming to open the 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 businesses in present crisis period.

We would particularly like to stress that this issue of "Megatrend Review" is the first one in the series that will be devoted to certain states – in this case to Italy and complex aspects of its present economic situation. The authors of contributions are distinguished scientists and professors mainly on *Libera Università Mediterranea 'Jean Monnet'* from Bari, Italy. Such concept is a result of very successful cooperation between our two universities.

Our guest editor, professor Dominick Salvatore, whom we have the honour to introduce to our readers, has appointed the authors of contributions from Italy. Professor Salvatore teaches Economics at LUM and Fordham Universities. He is also Honorary Professor at Shanghai Finance University and Hunan University, Visiting Professor at Universities of Rome, Vienna, Cairo, Krems, Pretoria, and Trieste. Professor Salvatore is Fellow of the New York Academy of Sciences and past Chairman of its Economics Section. He is Past President of North American Economic and Finance Association and of the International Trade and Finance Association. He is Consultant to the United Nations, World Bank, International Monetary Fund, Economic Policy Institute, and various Central Banks and Multinationals. Professor Salvatore published extensively in economic journals in the area of international economics. Among the volumes published are: *Income Distribution* (Oxford University Press, 2006); *Protectionism and World Welfare* (Cambridge University Press, 1993); *Microeconomics: Theory and Applications* (5th ed., Oxford Univ. Press, 2009); *International Economics* (10th ed., Wiley, 2009).

We are very grateful to Professor Salvatore 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 Italy and Serbia for their excellent contributions.

Professor Mića Jovanović, PhD
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Original scientific paper
Received: March 30th, 2009

UDC 316.3/.4
ID 158242572

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NEW SOCIAL MOVEMENTS AGAINST NEO-LIBERAL GLOBALIZATION: A SOCIOLOGICAL APPROACH

Abstract: *The essay focuses on the case of "No Global" movement, which struggled against neo-liberal models of international economic integration. Theoretical frames of the 1970s Social Movements and their opposition to "Old Left" political parties are analyzed. Also, brief history of "Seattle movement" is described, in order to face an endless question: is the latter revolutionary of "only" social-democratic? The essay has been divided in tree parts. The first part starts with the premise that every position one takes on the desirability and effectiveness of collective action is a political position. In the second part, five components of collective action are analyzed. The third part is devoted to discussion on collective action outside nation-state boundaries. To the nation-state, supra-national governmental levels have become increasingly important, especially in the course of European integration. It is also the case that the neo-liberal policies of the 1990s that favoured the free market over social intervention have reduced the capacity of political reaction with respect to social inequality.*

Key words: *collective action, social movements globalization, neo-liberalism*
JEL classification: *F02, A14*

1. Premise

It has been said by someone[1] that the analysis of collective action is a risky adventure. For one thing, there are too many experts around, as it happens about other issues (food, football or sex!). Moreover, the students of collective actions run the risk of urging hypotheses which common sense contradicts.

[1] C. Tilly, *From Mobilization to Revolution*, Random House, New York, 1978

It is inevitably: collective action concerns about power and politics; it raises questions of right and wrong, justice and injustice; hope and hopelessness. As the reader could guess, in some sense, every position one takes on the desirability and effectiveness of collective action is a *political* position. The tone of later discussions in this work is generally hostile to the collective action of governments and favourable to the collective action of ordinary people (organized in groups/associations or not). At the same time, we give no importance to right-hand social movements, stressing only the ones which have a revolutionary task. Or a liberal aim, at least. Behind this apparently subjective choice, it stands a functional reason: it is hard following the development mechanism of a conservative lobby or group. We mean that it is difficult focusing on well-defined right-hand groups, while analysing conservative collective actions, because of their links with obscure lobbies, both inner and external to State apparatus.

This essay focuses on the case of "No Global" movement, which struggled against models of neoliberal models of international economic integration. To do so, we summarize the theoretical frames of the 1970s Social Movements and their opposition to "Old Left" political parties, then we describe the brief history of "Seattle movement", in order to face an endless question: is the latter revolutionary of "only" social-democratic? We mean: are its main features actually anti-systemic or does it aim at limiting the "very excess" of bourgeois Democracy?

As a starting point, there is the evidence that collective action straddles a divide, which ordinarily separates one major kind of social analysis from another. That is the divide between *causal* and *purposive* explanation. We may choose to consider the action of an individual or of a group as the resultant of forces external to the individual or group: those external forces supposedly *cause* the behaviour. In this case, we are likely to think we have a good explanation when a careful look at the actor's situation permits us to deduce more or less accurately how the actor will behave.

On the other hand, we may consider the individual or group to be making choices according to some set of rules (implicit or explicit); that approach is *purposive*. Then we think we have a sound explanation when we can impute to the actor a rule, which leads logically to most or all the choices we observe the actor making.

To sell the truth, in the realm of collective action, it is hard both to build causal models which give serious attention to the interests, grievances and aspirations of the actors, and to build purposive models which specify the constraints limiting the pursuit of interests, grievances and aspirations. For that reason, theoretical synthesis would have to combine causal models of constraints with purposive models of choices among available courses of action. In order to draw both models together, we start from the description of five main components of collective action: interest, organization, mobilization, opportunity and collective action itself.

2. The components of collective action

The *interests* are the gains and losses resulting from a group's interaction with other groups. Obviously, the social researcher worries about what constitutes a relevant group and how to identify a real and durable interest.

The *organization* concerns that aspect of a group's structure which most directly affects its capacity to act on its interests. Clearly one of the problems is to determine which features of organization do make a difference.

Mobilization is the process by which a group acquires collective control over the resources needed for action. These resources may be labour power, goods, weapons, votes and any number of other things, just so long as they are usable in acting on shared interests. Sometimes a group as a community has a complex internal structure, but few pooled resources. Sometimes it is rich in resources, but the resources are all under individual control. The analysis of mobilization deals with the ways that groups acquire resources and make them available for collective action.

Opportunity concerns the relationship between a group and the world around it. Changes in relationship sometimes threaten the group's interests, providing new chances to act on those interests. The trouble with studying opportunity is that it is hard to reconstruct the opportunities realistically available to the group at the time. Knowledge of later outcomes makes it too easy to second-guess a group's action, or inaction. We can minimize that disadvantage by looking only a contemporary collective action or by concentrating on situations in which the opportunities are rigorously defined and strictly limited. But then we risk loosing our ability to follow large-scale changes over considerable periods of time.

Collective action consists of people's acting together in pursuit of common interests. Collective action results from changing mixture of interests, organization, mobilization and opportunity. The most frequent problems faced by the researcher in analysing collective action is its lack of sharp edges: people vary continuously from intensive involvement to passive compliance, interests vary from quite individual to nearly universal.

To sum up, our subject (non-conventional participation) matters in the overlaps of several intersecting areas. Sometimes we are interested in a particular **population** in its own terms: for example, we want to know what was happening to poor people living in Russia under the Czar before 1917 Revolution.

Sometimes we are chiefly interested in a set of **beliefs**: we want to follow the rise and development of the theories about the struggle against the world poverty. Sometimes, on the contrary, certain kinds of **action** attract our attention: we might want to understand the conditions by which people claim their issues in each different countries. We can take **groups** as our basic units of the study of collective action: by this way, we start from a population, though adding a common structure and shared beliefs. We can also take **events** as our starting

point, beginning with a particular revolution, ceremony or confrontation. We can even begin with a **class of events**: attacks on poorhouses, demonstrations against unemployment, strikes organized by trade unions.

The study of collective action ordinarily requires the researcher to deal with at least two of these areas at once. Among the above-mentioned combinations, the notion of "social movement" is one of the more complicated.

We have to make a preliminary statement: the concept of "social movement" inheres the so-called *contentious politics*.[2] In its more general sense, the term "contentious politics" is used to include all situations in which actors make collective claims on other actors, claims that, if realized, would affect the actors' interests, when some government is somehow party to the claims. In these terms, wars, revolutions, rebellions, (most) social movements, industrial conflict, feuds, riots, banditry, shaming ceremonies and many more forms of collective struggle usually qualify as contentious politics. While some of these forms clearly escape the rules of the polity, others cross the boundary between institutional and non-institutional politics.

According to a reasonable theory[3], social movements belong to "anti-systemic movement" category, coined in the 1970s in order to have a formulation that would group together what had, historically and analytically, been two distinct and in many ways rival kinds of popular movement – those that went under the name "social", and those that were "national". Social movements were conceived primarily as socialist parties and trade unions; they sought to further the class struggle within each State against the bourgeoisie or the employers. National movements were those, which fought for the creation of a national State, either by combining separate political units that were considered to be part of one nation or by seceding from State considered imperial and oppressive by the nationality in question – colonies in Africa and Asia, for example.

Both types of movement emerged as significant bureaucratic structures in the second half of the XIX century and grew stronger over time. Both tended to accord their objectives priority over any other kind of political goal – and, specifically, over the goals of their national or social rival. This frequently resulted in severe mutual denunciations. The two types seldom cooperated politically and, if the did so, tended to see cooperation as a temporary tactic, not a basic alliance. Nonetheless, the history of these movements between 1850 and 1970 reveals a series of shared features:

1) Most socialist and nationalist movements repeatedly proclaimed themselves to be "revolutionary", that is, to stand for fundamental transfor-

[2] S. Tarrow, '"The Very Excess of Democracy": State Building and Contentious Politics in America', in A.N. Costain and A.S. McFarland (eds.), *Social Movements and American Political Institutions*, Rowman & Littlefield Publishers Inc, Lanham, Boulder, New York, Oxford, 1998, pp. 20-38

[3] I. Wallerstein, "New Revolts Against the System", in T. Mertes (ed.), *A Movement of Movements. Is Another World Really Possible?* Verso, London – New York, 2004, pp. 262-274

mations in social relations. It is true that both types usually had a wing, sometimes located in a separate organization that argued for a more gradualist approach and therefore eschewed revolutionary rhetoric. But generally speaking, initially – and often for many decades – those in power regarded all these movements, even the milder versions, as threats to their stability, or even to the very survival of their political structures.

2) Secondly, at the outset, both variants were politically quite weak and had to fight an uphill battle merely to exist. They were repressed or outlawed by their governments, their leader was arrested and their members often subjected to systematic violence by the State or by private forces. Many early versions of these movements were totally destroyed.
3) Thirdly, over the last three decades of the XIX century, both types of movements went through a parallel series of great debates over strategy that ranged those whose perspectives were "state-oriented" against those who saw the State as an intrinsic enemy and pushed instead for an emphasis on individual transformation. For the social movement, this was the debate between the Marxists and the anarchists; for the national movement, that between political and cultural nationalists.
4) The fourth similarity concerns what happened historically in these debates: those holding the "state-oriented" position won out. The decisive argument in each case was located in the State apparatus and that any attempt to ignore its political centrality was doomed to failure, since the State would successfully suppress any thrust towards anarchism and cultural nationalism. In the late XIX century, these groups enunciated a so-called "two-step strategy": first gain power within the State structure, then transform the world. This was true for both the social and the national movements.
5) As the fifth common feature, socialist movements often included nationalist rhetoric in their arguments, while nationalist discourse often had a social component. The result was a greater blurring of the two positions than their proponents ever acknowledged. It has frequently been remarked that socialist movements in Europe often functioned more effectively as a force for social integration than either conservatives or the State itself; while the Communist parties that came to power in China, Vietnam and Cuba were clearly serving as movements of national liberation. There are two reasons for this: firstly, the process of mobilization forced both groups to try to draw increasingly broad sectors of the population into their camps, and widening the scope of their rhetoric was helpful in this regard. Secondly, the leaders of both movements often recognized subconsciously that they had a shared enemy in the existing system – and that they therefore had more in common with each other than their public pronouncements allowed.

6) The processes of popular mobilization deployed by the two kinds of movements were basically quite similar. Both types started out, in most countries, as small groups, often composed of a handful of intellectuals plus a few militants drawn from other strata. Those that succeeded did so because they were able, by dint of long campaign of education and organization, to secure popular bases in concentric circle of militants, sympathizers and passive supporters.
7) The seventh common feature is that both these movements struggled with the tension between "revolution" and "reform" as prime modes of transformation. Endless discourse has revolved around this debate in both movements. Revolutionaries were not in practice very revolutionary, and reformists not always reformist. Certainly, the difference between the two approaches became more and more unclear as the movements pursued their political trajectories. Revolutionaries had to make many concessions in order to survive. Reformists learned that hypothetical legal paths to change were often firmly blocked in practice and that it required force, or at least the threat of force, to break into the barriers. The so-called revolutionary movements usually came to power as a consequence of the wartime destruction of the existing authorities rather than through their own insurrectional capacities.
8) Finally, both movements had the problem of implementing the two-step strategy. Once "stage one" was completed, and they had come to power, their followers expected them to fulfil the promise of stage two: transforming the world. What they discovered, if they did not know before, was that State power was more limited than they had thought. Each State was constrained by being part of an interstate system, in which no one nation's sovereignty was absolute.

3. Collective action outside nation-state boundaries

We need to deepen this topic: collective action has been always linked to national boundaries, so that someone said, "an unexpected result of the creation of the nation-state was the emergence of modern social movements".[4] Indeed, people protested before the advent of the nation-state, but it was only with its advent that organized social movements addressing the central political system came into being. Pressure from these movements, often mediated through political parties, has contributed to the development of citizen rights (and thus individual freedom), political rights (above all the right of the active and passive

[4] D. Della Porta, "Social movements and Europeanization", in G. Bettin Lattes and E. Recchi (eds.), *Comparing European Societies Towards a Sociology of the EU*, Monduzzi, Florence, 2004, p.261

electorate) and social rights (some level of access to well-being). In a way, the concept of citizenship, including social citizenship, has taken on a central role in the legitimisation of the state as a guarantor of positive rights.

Today, however, social movements must adapt to neo-liberal challenges to the "mid-century compromise" between the welfare state and capitalism, a compromise that has characterised European democracy since the Second World War. Also, the nation-state is no longer the exclusive point of reference for these movements. To the nation-state, other sub- and supra-national governmental levels have been added that have become increasingly important, especially in the course of European integration. It is also the case that the neo-liberal policies of the 1990s that favoured the free market over social intervention have reduced the capacity of political reaction with respect to social inequality. Finally, the coming together of Europe has also strengthened this tendency, with its emphasis on the "negative" integration of market liberalisation.

The relevance of these changes for collective actors mobilizing in the different members states of the European Union is clearly great. Yet research into the effect of the construction of European institutions on social movements is still in its infancy.

On the other hand, some surveys have revealed the role of new social movements in the building of the forthcoming European public sphere.[5] Since the first half of the 1990s, a new collective actor imposed itself into the world political sphere. For its complex articulation and the capability to spread out, it was soon labelled "Movement of Movements" or "No Global", on account of its opposition to dynamics of economic globalization.

The originality of this movement is its transnational dimension that makes it a critical subject and, at the same time, a product of the world society. It is the consequence of those processes of individualization and reflexivity typical of our late modern era, where the subject, achieving complete freedom, has become entangled in the unforeseen consequences of decision made without restraints. The danger of endless war, the climate global warming and the increasing number of situations of exploitation partially determined by the dynamics of neoliberal globalization, have given birth to solid relations and to new forms of collective behaviour.

The engagement of the actors of the so-called "world civil society" is the outcome of these processes. Thus, ecological associations (Greenpeace, WWF, Friends of the Earth), pacifist movements and many non-governmental organizations active throughout the world have decided to come together in a single social movement operating in the global dimension, singling out neo-liberalism and the unbridled market as its enemy. "No Global" movement was considered anti-globalization as it opposed free trade in goods and capital, whose media focus were WTO meetings and the annual Davos World Economic Forum.

[5] Fabio De Nardis, "The Political Change in the Practice of the Anti-globalist Movement" in *Il dubbio*, n. 1, 2004, pp. 7-17

The WTO summit in Seattle (1999) was a key moment of the protest, as large contingents of trade unions, Old Left activists and anarchist groups organized significant protests, which actually disrupted the proceedings of the meeting.

Following Seattle, the continuing series of demonstrations around the world against intergovernmental meetings inspired by the neoliberal agenda led, in turn, to the construction of the World Social Forum, whose initial meetings have been held in Porto Alegre. The characteristics of this new claimant for the role of anti-systemic movement are rather different from those of earlier attempts. First of all, the WSF seeks to bring together all the previous types – Old Left, new movements, human-rights bodies, and others not easily falling into these categories – and includes groups organized in a strictly local, regional, national and transnational fashion.

The basis of participation is a common objective – struggle against the social ills consequent on neo-liberalism – and a common respect for each other's immediate priorities. Importantly, the WSF seeks to bring together movements from the North and the South within a single framework. The only slogan, as yet, is "Another World is Possible". Even more strangely, the WSF seeks to do this without creating an overall superstructure. At the moment (eight years after the first counter-meetings), it has only an international coordinating committee, representing a variety of movements and geographic locations.

As a conclusion, "No Global" activists share the same statement about the so-called "Old Left" with 1970s movements: they ceased to believe that communist parties would bring about a glorious future or a more egalitarian world, and no longer give them their legitimacy. This did not mean that large sections of the population would no longer vote for such parties in elections, but it had become a defensive vote, "for lesser evils", not an affirmation of ideology or expectations. On the contrary, they seek for political performances able to guarantee the employment, to eliminate alienating wage labour, to diminish inequalities, to expand real democratic participation. Finally, they condemned Old Left parties as being "not part of the solution but part of the problem"!

However, it is widely recognized that the high degree of "No Global" movement's success has been based on a negative rejection of neo-liberalism, as the ideology and the praxis responsible for the present structural crisis. Many have argued that it is essential for "No Global" movement to move towards advocating a clearer, more positive programme. Whether it can do so, and still maintain the level of unity and absence of an overall (inevitably hierarchical) structure, is the big question of the next decade.

In the meantime, there is still a long way to go.

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Original scientific paper
Received: February 15th, 2009

UDC 336.143.232(1-775)
ID 158243340

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STRUCTURAL IMBLANCES & TWIN DEFICITS IN THE G-7 COUNTRIES

Abstract: *The article discusses the relationship between the budget deficits and the current account deficits in G-7 countries. After presenting theoretical discussion, this relationship has been tested indirectly, focusing on each of the intermediate links between the budget deficit and the current account deficit. The analysis shows that there is strong empirical evidence that a direct relationship exists between the budget and the current account deficits for all the seven largest and most important industrial countries (the United States, Japan, Germany, United Kingdom, France, Italy, and Canada), but the relationship is a lagged one, with budget deficits leading to current account deficits by one or more years.*

Key words: *budget deficit, current account deficit, G-7 countries*
JEL classification: F40, H21, F32,

1. Introduction

In recent years there has been a revival of interest in the relationship between the budget deficit and the current account deficit, or "twin deficits".[1] In the United States, this interest has been fueled by the reappearance of huge budget and trade deficits since the turn of the century. The term "twin deficits" itself was coined to

[1] M. Bordo, "Globalization and Imbalances in Historical Perspective", *Federal Reserve Bank of Cleveland Working Paper* No. 13, 2006; C. C. Coughlin, M. R. Pakko, and W. Poole, "How Dangerous Is the U.S. Current Account Deficit?", *The Regional Economist*, St. Louis Fed, April 2006, pp. 5-9; C. L. Mann, "The U.S. Current Account Deficit and Sustainability", *Journal of Economic Perspectives,* Vol. 16, No. 3, 2002, pp. 131-152; M. Obstfeld, K. Rogoff, "The Unsustainable Current Account Position Revisited", *NBER Working Paper* No. 10869, October 2004; M. Obstfeld, K. Rogoff, "Global Current Account Imbalances and Exchange Rate Adjustments", *Brookings Papers on Economic Activity*, No. 1, 2005, pp. 67-146; OECD, "Channels for Narrowing the U.S. Current Account Deficit and Implications for Other Economies", *Working Paper* No. 390, 2004; Sinai, A., "Deficits, Expected Deficits, Financial Markets, and the Economy", *North American Journal of Economics and Finance*, March 2006, pp. 79-101

describe the relationship between the budget and current account deficits in the United States during the early 1980s.[2] In a nutshell, the theoretical relationship links casually an increase in the budget deficit to an increase in domestic interest rates, to an inflow of foreign capital, to the appreciation of the domestic currency, which then results in a current account deficit. Section II of this paper reviews and extends the analysis of the chain in this theoretical relationship.

There are two ways of testing empirically the relationship between budget and current account deficits. One test relies on examining the relationship between them directly, without examining each of the intermediate steps that links them together. The other test is **indirect** and focuses specifically on each of the intermediate links between the budget deficit and the current account deficit. That is, it focuses on the link between the budget deficit and domestic interest rates, between the latter and exchange rates, and finally between exchange rates and the current account. In examining the empirical evidence, I will concentrate on the direct relationship between the budget deficit and the current account deficit. This is done in Section III of the paper. Long chains of theoretical reasoning, as in the indirect test between the budget and current account deficits, are notoriously dangerous in economics and can simulations using large-scale, detailed general-equilibrium models of the entire economy do best.

The theoretical discussion in Section II is broad and general and is applicable to any open market economy. The direct empirical evidence examined in Sections III refers to the G-7 countries and covers the flexible exchange rate period from 1973 to the present. Only by focusing on such a sample of important countries over a relatively long period of time can we hope to detect some general empirical regularity. Not only are country-specific experiences during short periods of time (say, a few years) almost useless from a general theoretical point of view but also they cannot even be interpreted correctly, except within a broader context that includes the most important nations over a period of many years. Furthermore, the dichotomy often made in the literature between the national accounting framework or saving-investment approach and the balance of payments accounting framework or elasticity approach to the analysis of the twin deficits is inappropriate. The latter is simply one of the links in the former. Specifically, the relationship between the exchange rate (and relative growth rates),

[2] J. D. Abell, "Twin Deficits During the 1980s: An Empirical Investigation", *Journal of Macroeconomics*, Winter 1990, pp. 81-96; R. J. Gordon, R.J., "U.S. Fiscal Deficits and the World Imbalance of Payments", *Hitotsubashi Journal of Economics*, October 1986, pp. 7-41; L. O. Laney, "The Strong Dollar, the Current Account, a Federal Deficits: Cause and Effect", *Economic Review*, Federal Reserve Bank of Dallas, January 1984, pp. 1-14; R. I. McKinnon, "Exchange Rate Instability, Trade Balances, and Monetary Policies in Japan, Europe, and the United States", in: P. Oppenheimer, ed., *Issues in International Economics,* Boston: Oriel Press, 1980, pp. 225-250; R. I. McKinnon, "The Exchange Rate and the Trade Balance", *Open Economies Review*, Spring 1990, pp. 17-38; S. M. Miller, F. S. Russek, "Are the Twin Deficits Really Related?", *Contemporary Policy Issues,* October 1989, 91-115

on the one hand, and the current account, on the other, is the last link in the chain of reasoning that runs from budget deficits to interest rates, from interest rates to exchange rates, and from exchange rates changes to the current account. To consider these as conflicting alternatives of examining the twin deficits is at best misleading.

2. The relationship between budget and current account deficits: the theory

We begin our examination of the relationship between budget deficits and current account deficits by reviewing the national accounting framework or savings-investment approach and then examining the causal chain of events that links budget deficits to current account deficits.

2.1. The National Accounting Framework of the Analysis

In order to examine the theoretical relationship between government budget deficits and current account deficits in the balance of payments for an open economy, we begin with the familiar national accounting identity:

$$C + I + G + (X-M) - R = C + SD + T \quad (1),$$

where
C = private consumption expenditures
I = private domestic investments
G = government expenditures
X = exports
M = imports
R = net transfers to abroad
SD = private domestic savings
T = government tax receipts

Identity (1) is true in nominal and in real terms, but our future discussion will generally be in real terms. Rearranging identity (1) to highlight the relationship between budget deficits and current account deficits, we get:

$$(G-T) = (SD-I) + (M+R-X) \quad (2)$$

Relationship (2) postulates that the government budget deficit, or expenditures less taxes (G-T), must equal to or be financed by the excess of domestic savings over domestic investment (SD-I) plus the current account deficit (M+R-X).

The current account deficit is equal to a nation's expenditures on foreign goods and services or imports (M) plus net transfers (R), minus foreign expenditures on the nation's goods and services or exports (X). This current account deficit must be financed by an equal net foreign capital inflow or net foreign savings (SF). Thus, we can rewrite relationship (2) as:

$$(G-T) = (SD-I) + SF \tag{3}$$

From relationship (3) we can see that an exogenous increase in the budget deficit (G-T) can only be financed by an increase in net domestic savings (SD-I) and/or net foreign savings (SF). In terms of flow of funds terminology, we can rewrite relationship (3) as:

$$(G-T) + I = SD + SF \tag{4}$$

This postulates that for equilibrium, the sum of the budget deficit and domestic investments, which represent the total domestic demand or uses of savings (D), must equal the sum of gross domestic savings and net foreign savings, which represent the total sources or supply of savings (S) to the economy.

In order to trace the economic chain of causation from a budget deficit to a current account deficit for an open economy under a flexible exchange rate system, we rewrite relationship (3) in functional form and substitute net foreign saving (SF) by its current-account deficit or net import-balance counterpart (NM):

$$(G-T) = SD(r) - I(r) + NM(e),\ SDr>0,\ Ir<0,\ \text{and}\ NMe>0 \tag{5},$$

where real domestic saving (SD) is postulated to be directly related to the real interest rate (r), real domestic investment (I) is inversely related to the real interest rate (r), and net imports (NM) are inversely related to the real exchange rate (e), defined as the foreign currency price of a unit of the domestic currency, adjusted for the differential rate of inflation in the home and foreign countries (so that an increase in the real exchange rate represents a real appreciation of the domestic currency). Thus, an exogenous increase in the budget deficit can only be financed by an increase in domestic savings, a reduction in domestic investment (both of which are functions of the real interest rate), and/or an increase in the nation net trade deficit or inflow of net foreign saving (which is a function of the real exchange rate).

Several points must be made before we go on to examine in detail the chain of causation between budget and current account deficits. **First**, all the variables in relationship (5) should be expressed in real terms so as to eliminate the inflationary impact common to them all. **Second**, a budget deficit of a given size represents a declining relative burden when GNP rises. Thus, we concentrate on

the ratio of budget deficits to GNP, rather than on the absolute levels of budget deficits. **Third**, we should examine **structural** rather than actual budget deficits. A structural, full- or high-employment, or cyclically adjusted budget deficit is the budget deficit that would prevail if the economy were operating at full or high employment (which in the United States now means about 5 percent unemployment). The difference between the actual and the structural deficit arises because both government revenues and expenditures respond in a systematic manner over the business cycle. Specifically, with given tax rates, government revenues rise with a cyclical increase in GNP, while government **expenditures** increase with a cyclical decline in GNP (because of higher unemployment benefits paid out). The problem, in using structural rather than actual deficits in the empirical analysis is that data on structural deficits are not available for the earlier part of the period under analysis, and even the data that are available are somewhat controversial.

2.2. The Effect of a Budget Deficit on Interest Rates, Exchange Rates and the Current Account

We now go on to examine the dynamic short-term effects of an exogenous increase in the budget deficit on interest rates, exchange rates, and the current account in an open economy operating under a flexible exchange rate system. An exogenous increase in a budget deficit is one that affects **directly** neither private domestic savings and investment nor the current account. We adapt the well-known loanable fund and Mundell-Fleming models, which are usually used for other purposes, to analyze and summarize the relationship between the budget and the current account deficits.

In Figure 1, D represents the initial total domestic demand or uses of loanable funds (savings), while S refers to the initial total short-run supply or sources of loanable funds or savings, as in relationship (4) above. Thus, S represents the sum of gross private domestic savings plus net foreign savings flowing into the economy for a **given current account deficit**. The economy is initially in equilibrium at point E, with real interest rate of r and quantity demanded and supplied of funds of F.

An increase in the budget deficit shifts D out to D'. At the unchanged interest rate of r, there is now an excess demand for funds. This leads to an increase in the real interest rate to r', at which the quantity demanded of loanable funds equals the quantity supplied at the higher level of F' (equilibrium point E'). Interest rate pressure is more likely to be averted the larger is the slack or rate of unemployment in the economy and the larger is the increase in real GNP resulting from the fiscal stimulus. As the economy approaches full employment, however, the pressure on interest rates to raise increases. This stimulates private domestic savings, discourages private domestic investment, and encourages net capital inflows from abroad.

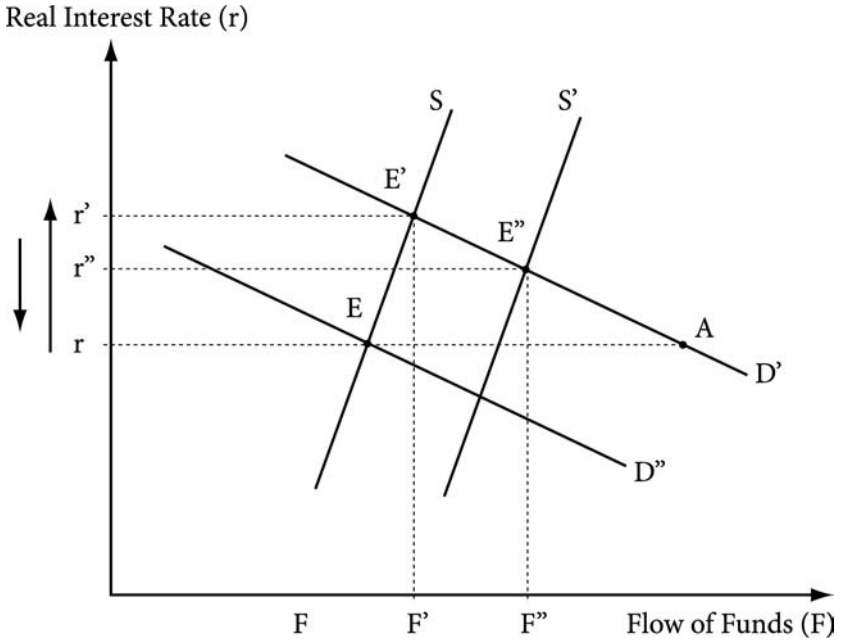

Figure 1: *Relationship between Budget and Current Account Deficits*

As investors switch from foreign to domestic assets to take advantage of higher interest rates in the nation and purchase the domestic currency with foreign currencies to affect the switch, the real exchange rate rises (i.e., the domestic currency appreciates). The rise in the real exchange rate or real appreciation of the domestic currency results in a **gradual** increase in the current account deficit or net imports (NM). This is the mechanism that allows foreign savings to supplement domestic savings in financing the domestic budget deficit and domestic investments. In Figure 1, this is shown by a gradual shift of S to the right to S' and results in equilibrium point E", at which the real interest rate is r" and the equilibrium level of loanable funds is F". Thus, as foreign funds flow in to take advantage of higher real interest rates in the nation, the original increase in the real interest rate to r' falls back toward the lower world level, and the initial appreciation of the domestic currency and deterioration in the current account balance fall toward the long-run level.

Several things must be noted with respect to the above adjustment process to an exogenous increase in the budget deficit in an open economy under flexible exchange rates. **First**, the sluggish current account response to the initial appreciation of the domestic currency is primarily responsible for the initial overshooting of domestic real interest rates and appreciation of real exchange rates above

their long-run equilibrium level.[3] **Second**, the same general pattern of adjustment described above for an exogenous increase in the budget deficit would result from any other policy, such as a reduction in business taxes that increase the after-tax returns on domestic investments without necessarily increasing the budget deficit. If the increase in the domestic demand for investment occurred at the same time as the exogenous increase in the budget deficit, domestic real interest and exchange rates would tend initially to rise even more before eventually falling back toward their long-run equilibrium levels.

Third, for a closed economy or for a given foreign account deficit or net foreign capital inflow (savings), the Barro-Ricardo equivalence theorem (BRET) postulates that an exogenous increase in the budget deficit (decline in public savings) will lead to an instantaneous equal increase in private savings.[4] That is, according to the BRET, economic agents fully perceive that an increase in the budget deficit implies an equal present value of future taxes, and thus it has no net effect on aggregate demand and GNP. As it is well known, there are many theoretical objections to the BRET, such as lack of information, imperfect capital markets, and especially the fact that bequests may be involuntary, and there is little empirical support for this extreme proposition. In any event, an exogenous increase in the budget deficit in an open economy operating under a flexible exchange rate system is likely to lead to some increase in domestic private savings as well as to an increase in net foreign savings (capital inflows) without much or any crowding out of private domestic investments. This does not mean that the budget deficit invariably leads to current account deficits. For example, during a recession a budget deficit tends to rise but **net** private domestic savings typically increase even more because of the depressed demand for private domestic investments. Furthermore, the changes in taxes and expenditures underlying the change in the budget deficit may directly affect private domestic savings and investments. These effects must be assessed before the effect of a budget deficit on the current account can properly be evaluated. Different national rates of trade protection also affect the response of current account balances to budget deficits.[5] In short, there is no mechanical relationship between the two.

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3 See R. Dornbusch, "Expectations and Exchange Rate Dynamics", *Journal of Political Economy*, December 1976, pp. 1161-1176

4 R. J. Barro,„"Are Government Bonds Net Wealth?", *Journal of Political Economy*, November/December 1974, pp. 1095-1117

5 D. Salvatore, "A Model of Dumping and Protectionism in the United States", *Weltwirtschaftiliches Archiv*, Heft 4, 1989, pp. 763-781; D. Salvatore, "Europe's Structural and Competitiveness Problems and the Euro", *The World Economy*, March 1998, pp. 189-205; D. Salvatore, "Import Penetration, Exchange Rate and Protectionism", *Journal of Policy Modeling*, Spring 1997, pp. 125-141; D. Salvatore, ed., *The New Protectionist Threat to World Welfare*, Amsterdam and New York, North-Holland, 1987; D. Salvatore, "Trade Protection and Foreign Investments", *Annals of the American Academy of Social Sciences,* January 1991

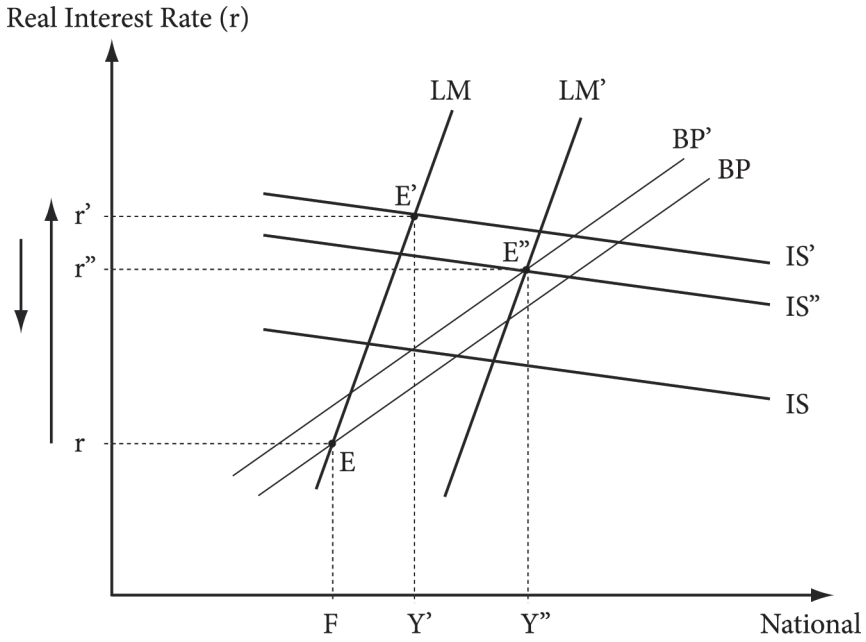

Figure 2: *Budget and Current Account Deficits with the Mundell-Fleming Model*

2.3. Analysis of Budget and Current Account Deficits with the Mundell-Fleming Model

The Mundell-Fleming model can be used to analyze more explicitly the short-run dynamic relationship between budget and current account deficits for an open economy operating under a flexible exchange rate system.[6] This is shown in Figure 2.

The IS curve shows the various combinations of interest rates (r) and national incomes (Y) at which the real goods market is in equilibrium. The negative slope of the IS curve indicates that lower interest rates lead to higher investment levels and are thus associated with higher levels of national income through the familiar multiplier process. The LM curve shows equilibrium in the money market. The rising slope of the LM curve indicates that higher interest rates reduces the speculative demand form money requiring a higher level of national income and transaction demand for money to absorb the entire fixed supply of money. The BP curve shows the various combinations of r and Y at which the nation's balance of payments is in equilibrium **at a given exchange rate**. The balance of payments is in equilibrium when a

[6] R. A. Mundell, "The International Disequilibrium System", *Kyklos*, Fasc. 2, 1960a; R. A. Mundell, "The Monetary Dynamics of International Adjustment Under Fixed and Flexible Rates", *Quarterly Journal of Economics*, May 1960b, pp. 227-257; J. Frenkel, A. Razin, "The Mundell-Fleming Model a Quarter of a Century Later", *IMF Staff Papers*, December 1987, pp. 567-620

trade deficit is matched by an equal capital inflow. The BP curve is positively sloped because higher interest rates lead to greater capital inflows (or smaller outflows) and must be balanced with higher levels of national income and imports for the balance of payments to remain in equilibrium. The more responsive are international capital flows to positive interest differentials the flatter will be the BP curve. To the left of the BP curve, the nation has a balance of payments surplus and to the right a balance of payments deficit. A devaluation or depreciation of the nation's currency shifts the BP curve down since the nation's trade balance improves, and so a lower interest rate and smaller capital inflows (or greater capital outflows) are required to keep the balance of payments in equilibrium. On the other hand, a revaluation or appreciation of the nation's currency shifts the BP curve upward.

Figure 2 shows that initially the nation is simultaneously in equilibrium in the goods market, in the money market, and in the balance of payments at point E, where the IS, LM, and BP curves intersect. Suppose that the equilibrium level of national income (Y) at point E is below full employment and the nation uses expansionary fiscal policy to reduce unemployment. Expansionary fiscal policy (which leads to a budget deficit or to an increase in the budget deficit for the nation) shifts the IS curve to the right to IS' so at to intersect the LM curve at point E', resulting in the higher level of income (Y') and interest rate (r'). Since point E' is above the BP curve, the nation faces an external surplus because of the net inflow of foreign capital induced by the increase in the interest rate. This causes an appreciation of the domestic currency, which shifts the BP curve up to BP'. The appreciation of the domestic currency worsens the nation's current account balance causing the IS' curve to shift back part of the way to IS". The appreciation of the domestic currency also reduces the domestic-currency price of imports and the general price level in the nation. With lower domestic prices and a fixed money supply, the LM curve shifts to the right, say, to LM' (i.e., it is equivalent to an increase in the nominal money supply). The final equilibrium might be indicated by a point such as E", at which IS", LM', and BP' cross, thus defining the equilibrium interest rate of r" and the equilibrium level of national income of Y".

Note that the interest rate in the nation first increases from r to r' and then falls back part of the way to r". This leads to a similar overshooting and appreciation of the nation's currency (as r increases to r'), followed by a depreciation that eliminates part, but not all, of the original appreciation as r' falls back part of the way to r". Figure 2 also shows the final **net** appreciation of the domestic currency. Thus, the larger budget deficit is associated with a larger capital inflow and a current account deficit than originally, establishing a direct link between the budget deficit and the current account deficit. This final outcome depends, however, on the assumption of a fairly elastic or gently rising BP curve (or, in any event, on the BP curve being flatter than the LM curve). This is realistic for the real world of today. Thus, the dynamic progression from budget deficits to higher interest rates, to appreciation of the domestic currency and, finally, to current account deficits seems to be based on sound theoret-

ical analysis. There are, of course, situations (which can be shown with the Mundell-Fleming model) where this progression is interrupted and different results can be obtained, but under normal conditions we expect the above results to hold.

3. The relationship between budget and current account deficits: the evidence

We now examine the empirical evidence for the relationship between budget deficits and current account deficits. I will first present briefly the descriptive evidence, such as it is, in the form of simple correlations to get a feeling for the data and the lag structure involved (if any). After all, it is such a simple graphic and correlation information that is often introduced either in support for or against the relationship between budget and the current account balances. Then, I will present more analytically rigorous and conclusive evidence with regression analysis.

3.1. Descriptive Evidence on the Relationship between Budget and Current Account Deficits

Table 1 shows simple correlations between the current account and the budget account balances (both expressed as a percentage of GNP), unlagged and lagged by one, two, and three years, as well as leading by one, two, and three years the current account for the 1973-2005 period. The general rather than central government budget balances are used because the latter are available for a shorter period of time and are generally highly correlated with the former.

Table 1: *Correlations between Current Account and Budget Balances*

	t – 3	t – 2	T – 1	t	t + 1	t + 2	t + 3
CUS with BUS	0.065	-0.021	-0.117	-0.047	0.015	0.100	**0.148**
CJA with BJA	0.163	0.243	**0.259**	0.111	0.056	0.022	-0.014
CGE with BGE	0.166	0.247	0.269	**0.292**	0.289	0.277	0.181
CUK with BUK	-0.347	-0.412	**-0.456**	-0.382	-0.195	0.113	0.385
CFR with BFR	-0.525	**-0.603**	-0.576	-0.339	0.130	0.419	0.489
CIT with BIT	0.011	0.117	0.296	0.391	0.522	**0.563**	0.555
CCA with BCA	0.383	0.442	0.514	0.440	0.490	0.519	**0.527**

The correlations in Table 1 do not seem to support the theory that budget balances are directly related to current account balances (i.e., that budget **deficits** are positively related and lead current account **deficits**, and budget surpluses are associated with and lead current account surpluses). The theory seem to hold only for Japan, where budget deficits lead current account deficits by one year

(but the correlation is small). For Germany budget and current account balances are directly related but contemporaneous. For the United Kingdom and France budget deficits lead current account deficits by one and two years, respectively, but the correlations are negative or inverse (i.e., budget **deficits** seem to be associated with and lead current account **surpluses** rather than being associated with and leading current account deficits), which completely contradicts the theory. For the United States, Italy and Canada the correlation between changes in budget and current account balances are positive, but the latter seem to lead in time by two or three years the former, rather than vice-versa as postulated by theory. It is true that even if changes in budget balances cause changes in current account balances, changes in the latter will have feed back effects on the former. But for theory to be confirmed, changes in budget balances must lead and cause changes in current account balances, rather than the other way around. The figures for the United States, Italy and Canada do not show this and, as such, go counter theoretical expectations. The general conclusion that can be reached by these simple correlations is that the theory that budget deficits lead to current account deficits does not seem to hold. Simple correlations, however, is a superficial and unrigorous method of analyzing data and, in complex situations such as the one at hand, can be very misleading. Thus, we turn to regression analysis.

3.2. Regression Analysis Evidence

The theory presented in Section II postulates that a nation's current account balance is directly related to the government budget balance; that is, larger budget deficits are supposed to lead to higher current account deficits. The link or chain of causation, we remember, is from a budget deficit to higher domestic real interest rate, to appreciation of the domestic currency, and finally to a deterioration of the nation's current account balance (which paves the way for foreign capital inflows). Since it takes time for this chain of events to unfold and fully work itself out, we can expect a nation's current account balance to be related to both contemporaneous and lagged values of the budget balance. Since it is also well known that the current account responds sluggishly over the course of several years to exchange rate changes, a change in the budget balance in a given year may affect the current account balance over the course of the next two, or even three years. This means that current account balances are a function of or depend on current as well as lagged (by one, two, or even three years) budget balances.

In fact, a nation's current account may first **improve** as a result of the appreciation of its currency (following the budget deficit) before eventually worsening (the so-called inverse J-curve effect.[7] Thus, a current account **surplus** may first be associated with a contemporaneous budget **deficit** before the direct relation-

[7] See C. L. Mann, C.L., "Prices, Profit Margins, and Exchange Rates", *Federal Reserve Bulletin*, June 1986, pp. 1-17

ship between the current account **deficit** and the budget **deficit** becomes evident over the course of the subsequent two or three years. A nation's current account balance depends also on the rate of growth in the nation as well as in the rest of the world. Higher domestic rates of growth spill into increased imports of goods and services (a deterioration in the nation's current account balance), while higher growth abroad stimulates the nation's exports of goods and services (an improvement in the nation's current account balance). Thus, we can postulate the following functional relationship for estimation:

$$C_t = a_0 + a_1B_t + a_2B_{t-1} + a_3B_{t-2}, + a_4B_{t-3} + a_5G_t + a_6GR_t \quad (6),$$

where:
C = Current account balance as a percentage of GNP
B = General government budget balance (surplus=+, deficit=-) as a percentage of GNP
G = Growth of real GNP in the nation
GR = Growth of real GNP in the rest of the world
t = Current year

According to theory, a_2, a_3, a_4, $a_6 > 0$, $a_5 < 0$, while the sign of a_1 is ambiguous.

An econometric problem arises in estimating equation (6), however, because the lagged values of the budget balance are highly intercorrelated. As a result, the regression may provide relatively high coefficients of multiple correlation (R^2), but statistically insignificant estimated coefficients for the various lagged values of the budget balance (so that we are unable to confirm or reject the expected positive relationship between current account and budget deficits). Indeed, this is confirmed by estimating equation (6). To be noted is that the problem here is econometric, not theoretical. An adequate econometric solution is possible, however. This involves the assumption that the current account balance is a function of the **expected value** of the budget balance. That is, if it is assumed that the current account balance in year t is a function of the expected value of the budget balance and that these expectations are generally formed on the basis of a distributed lag of the current and past values of the budget balance, we can then postulate a general distributed lag model which states that the current account balance in year t is partly determined by its own value in the previous period and partly by the contemporaneous budget balance and the other exogenous variables in the model (in our case, mostly the former). Since distributed lag models lead to a first order autoregressive disturbance term (and thus violates two basic assumptions of OLS), they have to be estimated by generalized least square methods rather than by ordinary least squares.

Thus, we can reformulate equation (6) as:

$$C_t = b_0 + b_1B_t + b_2G_t + b_3GR_t + b_4C_{t-1} \quad (7),$$

where, C_{t-1} is the current account balance lagged one year. We expect coefficient b_1 to remain ambiguous in sign, b_3 to be negative, and b_2 and b_4 to be positive. Since C_{t-1} reflects entirely or for the most part the lagged values of the budget deficit (it also allows different nations to have different lag structures), the test of a direct causal relationship running from the budget balance to the current account balance requires a positive and statistically significant b_4 coefficient.

The econometric results are presented in Table 2. From Table 2, we see that coefficients (b_2, b_3, and b_4) of the G_t, GR_t, and C_{t-1} variables have the correct sign, with more than half of these coefficients being statistically significant at better than the 5 or 10 percent levels. This is remarkable in view of the great complexity of the relationship postulated by equation (7), the diversity of the nations examined, and the economic turmoil of the past three decades. The results for b_2 and b_3 indicate that higher domestic growth worsens while higher foreign growth improves the nation's current account balance, as predicted by theory. Particularly important are the b_4 results for the lagged dependent variable since all 7 estimated slope coefficients have the predicted positive sign and all of them are statistically significant at better than the 0.01 level. This means that lagged budget deficits result in current account deficits, as predicted by the theory of Section II. While the lag structure may differ for different countries, lagged budget deficits seem to be the single most important determinant of current account deficits. This confirms the results of simulations of large macro econometric models (reviewed in Congressional Budget Office, 1989), which indicate that from 2/5 to 2/3 of U.S. current account deficits are due to current and past U. S. budget deficits.

Turning to the b_1 coefficients in Table 2, we see that for the United Kingdom and France current account deficits are **inversely** and significantly associated with **concurrent** budget **deficits** (very likely because of the inverse J-curve effect mentioned above). For the United States, Japan, Germany, Italy, and Canada current budget balances do not seem to affect contemporaneous current account balances.

The coefficient of multiple determination (R^2) ranges from 0.43 for Japan to 0.89 for the United States, for a simple average of 0.62 for all seven countries. Thus, a respectable 62 percent of the variation in the current account balances of the G-7 countries over the past three decades was explained, on the average, by the model. Finally, Table 2 shows that the D-W statistic indicates no remaining serial correlation of the error term. The overall conclusion that we can reach,

therefore, is that current account balances in the G-7 countries seem to respond to budget deficits (but with a lag) as postulated by theory.

To be noted is that re-estimating equation (7) for each of the G-7 countries using a dummy variable which assumes a value of 0 for the 1970-1980 period and the value of 1 for the 1981-2005 period (to assess the structural response of each of the G-7 countries to the petroleum shock and resulting double digit inflation in the 1970s) does not change the conclusions. That is, all of the estimated dummy coefficients are statistically insignificant and the sign, size, and statistical significance of all the other explanatory variables remain practically the same as those reported in Table 2. We expected D to be positive and statistically significant for Japan and Germany and negative for the other countries because Japan and Germany were able to adjust to the structural problems much better than the other countries. But the results of re-estimating equation 7 with the dummy variable did not show this.

Table 2: *Econometric Test of the Relationship between Current Account and Budget Balances*

NATION	CONST.	Bt	Gt	GRt	Ct-1	R2	SEE	D-W
U.S.	0.062 (0.16)	0.014 (0.23)	-0.100 (-0.97)	-0.014 (-0.08)	0.958** (11.89)	0.89	12.28	1.82
JAPAN	1.024* (1.74)	0.489 (0.64)	-0.304** (-2.07)	0.355 (1.59)	0.479** (2.93)	0.43	36.91	1.96
GERMANY	0.579 (0.74)	0.230 (1.32)	-0.622** (-4.24)	0.464** (2.38)	0.976** (9.80)	0.77	29.75	2.09
U.K.	-0.390 (-0.68)	-0.125 (-1.64)	-0.240* (-1.72)	0.106 (0.52)	0.800** (7.22)	0.65	30.52	1.74
FRANCE	-1.554 (-1.61)	-0.427** (-2.07)	-0.152 (-0.54)	0.219 (0.91)	0.572** (3.60)	0.54	43.01	1.81
ITALY	-0.883 (-1.09)	-0.100 (-1.21)	-0.544** (-3.54)	0.399* (1.78)	0.750** (3.65)	0.57	40.06	1.73
CANADA	-0.059 (-0.08)	0.140 (1.37)	-0.147 (-0.69)	0.213 (0.66)	0.636** (3.90)	0.52	72.68	2.07

* = Statistically significant at the 0.1 level.

** = Statistically significant at the 0.05 level.

4. Summary

According to open-economy macroeconomics, a government budget deficit leads to a current account deficit. The link is as follows: a budget deficit leads to an increase in the real domestic interest rate; this attracts foreign capital and results in an appreciation of the domestic currency, which leads to a current account (imports plus net transfers abroad, minus exports) deficit. Thus, the entire current account deficit and part of the budget deficit is financed by a net capital inflow.

There is strong empirical evidence that a direct relationship exists between the budget and the current account deficits for all the seven largest and most important industrial countries (the United States, Japan, Germany, United Kingdom, France, Italy, and Canada), but the relationship is a lagged one, with budget deficits leading to current account deficits by one or more years.

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Scientific review paper
Received: November 12th, 2008

UDC 339.5/.9
ID 158244108

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GEO-ECONOMICS – REALITY & SCIENCE*

Abstract: *The article analyzes theoretical and empirical aspects of geo-economics. Different theoretical attitudes toward mastering of world economic space are studied, starting from attitudes of American scientists who are known as founders of geo-economics to the opinions of Italian, French, Russian, Ukrainian and Indian geo-economists. Empirical analysis aims to explain geo-economics as geo-economic policy of developed states and large companies. Those geo-economic policy makers are put in the context of competition and rivalry on the world market.*

Key words: *geo-economics, world market, competition, rivalry*
JEL classification: F02, P16

1. Working hypothesis

Geo-economics is "over-border political economy"[1] based on "unfair competition".

2. Founders of geo-economics

American scientist George T. Renner used the term "geo-economics" for the first time in 1942.[2] Another American scientist, Romanian by origin, Edward Luttwak was the first one who tried to explain theoretically the term geo-economics in his article: *From geo-politics to geo-economics: the logic of conflict, grammar of commerce,* that was published in 1990.[3] He is known as godfather of geo-economics as

* English language translation: Professor Dragana Gnjatović.

1 The term "political economy" has been used by geo-economists to mark "state management", which means both economic and development policy.

2 George T. Renner: *Human Geography in the Air Age,* New York, Macmillan, 1942

3 Edward Luttwak: "From geo-politics to geo-economics: the logic of conflict, grammar of commerce", *The National Interest,* summer, 1990, pp. 17-23

a separate scientific discipline.[4] This term has been further elaborated in his book: *Turbo capitalism: winners and loosers in the global economy,* published in 1999.[5]

The snowball that Luttwak has let grow aside did not turn into avalanche. Until today, relatively small number of works on geo-economics has been published. The first important one is *Geoeconomics, Mastering of Economic Space*, edited and co-authored by Paolo Savona and Carlo Jean, that was published in 1994.[6] Important credit for the development of geo-economics in Russia goes to Ernest Georgievitc Kocetov. His major work is *Geoeconomics, Mastering of World Economic Space*, published in 1999 and 2006.[7] In France, the most important work is *Introduction to Geo-economics*, edited and co-authored by Pascal Lorot, published in 1999.[8] French journal *Revue française de géoéconomie* that was started in 1997 with the purpose of studying international economic strategies and power has given large contribution to dissemination of the term "geo-economics" in science and public.[9] Among well-known geo-economists are also two Indian writers: Jagdish Shet and Rajendra Sisodia, co-authors of a book: *Techtonic Shift – the Geo-Economic Realignment of Globalizing Markets*, published in 2006.[10]

3. The Meaning of geo-economics

3.1. Understanding of Edward Luttwak

3.1.1 Entering the time of geo-economics

Neologism "geo-economics" marks the amalgamation of the logic of conflicts by methods of trade, as Karl Clausewitz said: "the logic of war in the grammar of trade."[11] During the Cold War, trade conflicts between the USA, Europe and Japan had been easily overcome. "It was not allowed for the trade conflicts to

4 That is how he was called by Aleksandar Neklessa: *Концептуальные основы геоэкономики*, Internet http://www.archipelag.ru/geoeconomics, 18 X 2007, p. 1

5 Edward Luttwak, *Turbo capitalism: winners and loosers in the global economy,* Harper and Collins Publishers, New York, 1999

6 Paolo Savona, Carlo Jean, *Geoeconomia. Dominio dello spazio economico*, Editore Franco Agneli, 2-a edizione, 1997

7 Э. Г. Кочетов, *Геоэкономика: освоение мирового экономического пространства,* Норма, Москва, 2006

8 Pascal Lorot, "Introduction – Pourquoi la géoéconomie", in: Pascal Lorot (Sous la direction de), *Introduction á la Géoéconomie*, Economica, Paris, 1999, p. 6

9 *Ibid*

10 Jagdish N. Shet, Rajendra S. Sisodia, *Techtonic Shift – the Geo-Economic Realignment of Globalizing Markets*, Response Books, A division of Sage Publication, New Delhi/ Thousand Oaks/London, 2006

11 Luttwak, "From Geopolitics…", op. cit., p. 19

harm political relations that would jeopardize allies' solidarity in front of threatening Soviet Union".[12] Between the USA, Western Europe and Japan "the war has become almost unimaginable…military power and classic diplomacy had lost their ancestor importance in their mutual deeds, staying in use only against those who provoke disorder on the periphery…"[13]

In return, the solidarity between allies forced by common external threat is disappearing. Economic issues are coming to the edge. Economic rivalries are strengthening. Numerous conflicts are arising concerning the rules of international trade and leadership in industries with high technology that are considered as "strategic" ones. "Trading methods are forcing out military methods".[14] "We entered the era of geo-economics".[15]

In another words, geo-economics is a game between the states that has eliminated the inter-wars. On the main field of world politics where Americans, Europeans and Japanese cooperate and compete, rivalry attitudes can be expressed only with help of economic means.[16] At times of geo-economics, both reasons and means of rivalry are economic ones.[17]

Thus, rivalry among the states has not disappeared with the end of strategic opposition of superpowers but it moves continuously from military-strategic to economic sphere. The hierarchy of the states and their influence on international scene is determined more and more by economic reasons. The rulers of the states, seeking for keep or strengthen their position, make efforts to "gain geo-economic substitution for declining geo-political role."[18] Geo-economics has been continuously taking place from geo-politics.

3.1.2. New means of warfare: geo-economics

Geo-economics is a new edition of old rivalry between the states. "Within such rivalry, capital for investing in industry provided or directed by the state is an equivalent to fire weapons; product development supported with government subventions is an equivalent to weapon improvements; and market penetration with the help of the state takes place from military bases and army on foreign soil as well as diplomatic influence."[19]

Even if military power had disappeared totally from international scene and only economic business units would have remained on it, the logic of trade would

12 Luttwak, *Turbo-capitalism*, op. cit., p. 139

13 *Ibid,* pp. 127-8

14 Luttwak, "From Geopolics ...", op. cit., p. 17

15 Luttwak, *Turbo-capitalism*, p. 127

16 Ibid. p. 128

17 Ibid. p. 141

18 Luttwak, "From Geopolitics…", op. cit., p. 19

19 Luttwak, Turbo-capitalism, pp. 128-9

lead to fierce competition or to the creation of alignment. In both cases, i.e. in case of competition as well as in case of alignment between economic business units "action on all sides would take place regardless the state borders."[20]

The reality is not that simple, yet. The military power has not disappeared. The international scene has been taken primarily by the states and the states alignments. As territorial units, the states are determined by space rather than by function. Thus they cannot follow economic logic that would neglect their own borders. The question is raised: What logic they follow?[21]

All states have their economic goals. Each of them seeks for the greatest possible benefits. Each of them regulates its economy, seeks to reach economic optimum in its own state borders, and encourages technological innovations in order to maximize the benefits within its own borders. In all three mentioned cases, the state acts regardless the consequences for other states. So, in all three cases the logic of conflict appears.

Thus, the reality is such that *world politics* is still not ready to give its place to *world economy*, i.e. to free trade that is governed only by its non-territorial logic.[22] "… Geo-economic goal is not to acquire the highest possible living standard but rather to conquer or keep desired role in the world economy."[23] Although the war between the USA, Europe and Japan is excluded, "yet, each of those states has the state structure still organized as for war rivalry and they are all tempted to follow war goals with geo-economic means."[24]

In geo-economic rivalry, the law of force as in war divides the roles. The winners take highly profitable and leading roles for themselves while losers end up with the processing lines if their internal market is wide enough.[25]

3.1.3. Credits and limits

Edward Luttwak got the reputation of the founder of geo-economics as separate discipline. His merits are numerous. First, by separating geo-economics from geo-politics he turned the attention to growing importance of economic matters in international relations, and not only for commercial reasons. Second, he tried to prove that geo-economics has it own subject and method and to separate it in that way from geo-politics.[26] Third, he made effort to keep geo-economics far from mercantilism and economic war at the same time.

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20 Luttwak, "From Geopolitics…", op. cit., pp. 17-18

21 Ibid.

22 Ibid., p. 18

23 Luttwak, *Turbo-capitalism*, p. 133

24 Ibid., p. 129

25 Ibid., p. 133

26 Rudolf Kjellen used the term geo-politics for the first time at the beginning of the 20th century. German scientist Karl Haushofer had founded the journal called *Zeitschrift für*

The shortcomings of Luttwak's considerations are the following. First, they are not methodologically clear enough. Luttwak did not argue on the subject or method of geo-economics as a branch of science. Second, he bases his understanding of geo-economics on economic and strategic reality of the end of the 20th century.[27] Thus, his approach is not basically analytical but normative one: how to overcome economic conflicts between the allies who are left without common external enemy.

3.2. The perceptions of Italian geo-economists

Italian geo-economists Savona and Jean take a stand that geo-economics has emerged from geo-politics. This new discipline intends to put economic choices of a state in the framework of the strategy aimed for enlarging its capabilities in word competition. Geo-economics is "a discipline that studies politics and strategies used for enlarging the competitiveness abilities of the states, which remain key elements of international system in new conditions." Military power has lost its traditional role that determined the hierarchy of the states and was a major instrument of geo-politics. After disappearance of two-poles world it plays its remaining role while geo-economics becomes basic parameter of international order.[28]

The purpose of geo-economics is not to determine the measures for suppress individual entrepreneurship with help of strategic schemes designed by the state nor it is a synonym for mercantilism or protectionism or economic war. The purpose of geo-economics is to contribute to the creation of enlarging rivalry capabilities of national economies in new international economic competition. Economic rivalry has been enforced with the end of the cold war and divisions and political-strategic rivalry that was limiting it. In another words, geo-economics reveals itself in an endeavor for shaping economic engineering that uploads institutional engineering.[29] This implies that the task of geo-economics is building a strategy for the state actions towards providing maximum competitive advantages to domestic enterprises and economy as a whole in comparison with foreign enterprises and economies.[30]

Geopilitik in 1923, which became a tool of propaganda of Natzi Germany, so the term geopolitics got bad connotation. That was probably the reason why Luttwak created term geoeconomics. More on Kjellen's attitudes in: Stepić, M., Srećković: "Stanovništvo i država - aktuelnost učewa Rudolfa Kjelena", *Glasnik,* vol. LXXXVII, no. 2, Serbian Geographic Society, Belgrade, pp. 79-92.

27 Pascal Lorot, "La nouvelle grammaire des rivalités internationales", in: Pascal Lorot (Sous la direction de), *Introduction á la Géoéconomie*, op. cit., p. 15

28 Карло Жан, Паоло Савона, *Выводы: геоекономика как инструмент геополитики,* Internet, http://www.archipelag.ru/geoekonomika, 17 X 2007, p. 4

29 Ibid.

30 Марк Урнов, *Преисловие к сборнику "Геоекономика",* Internet, http://www.archipelag.ru/geoekonomika, 18 X 2007

3.3. The perceptions of French geo-economists

Lorot, following Luttwak, begins with the belief that after the end of cold war military power of developed nations is no more the leading source of their strength on international scene. Times of military conflicts between them are gone. "In fact, economic health of a state is the standard for measuring its power." Economic interests of the states are taking a lead over political interests. Thus a new era emerges, an ear of geo-economics.[31] In another words, Lorot is following Luttwak's hypothesis that relations between developed states are marked with economic rivalry instead of military conflicts.

According to Lorot, "geo-economics analyses economic strategies - especially trade strategy - that are adopted by the states in certain political conditions for the protection of their economies or their exactly determined segments, as to help their enterprises to acquire technologies or penetrate certain segments of world market for certain production or commercialization of some product. Holding or controlling such segment of the world market provides certain unit - enterprise or state - with an element of power and international influence and it helps enlarging its economic and social power."[32]

Geo-economics does not mean the end of politics of power. It means only new estimation of relative importance of different elements that it is made from. It is characterized with diminishing importance of military-strategic factors and growing importance of economic ones, as well as seeking economic power as key strategic goal of Western and developed states. Economics gains certain primacy in international framework.

Geo-economics appears also as a method of analysis of international actions of key powers, primarily Western ones. In the world in which the powers are seeking for new fields of maneuver, geo-economic approach is necessary for evaluation f international relations.[33]

Geo-economics deals with the relations between power and space, whose borders change all the time, where the space has fictitious meaning, being without territorial ad physical constraints that are inherent to geo-politics. Compatible with this definition is the nature of means used by geo-economics. Those are the means on disposal to the state, which could be used for the achievement of the above-mentioned goals.

With respect to spatial limitations of the implementation of geo-economics, French geo-economists differ somewhat from Luttwak. According to them, geo-economics is a planetary phenomenon today. It represents new field of competition between developed market economies, not only Western ones. They take a stand too that geo-economic strategies are most frequently the characteristic of develo-

[31] Lorot, "La nouvelle grammaire...", op. cit., pp. 11-12

[32] Ibid.

[33] Ibid.

ped states, but they say that in the case of need industrialized countries that are not members of "Western club" in classical sense could also initiate those strategies.[34]

3.4. The perceptions of Russian geo-economists

Since recently, many writers have been interested for geo-economics in Russia. That is understandable taking into account crucial changes in geo-political and go-economic surrounding of Russia and its position in international relations after dismantling of the USSR. In Russian geo-economics, two distinctive approaches could be traced:

a) Geo-economics as policy and strategy of enlarging competitive strength of a state in new international environment. This pattern has been founded by Kocetov, the founder of Russian school of geo-economics.[35]
b) Geo-economics as hexagonal scheme of world geo-economic space. Aleksandar Ivanovič Neklessa has founded this pattern.

3.4.1. Neo-economic pattern

The perception of geo-economics of Kocetov is fundamentally different from Luttwak's. It could be even said that those two perceptions of geo-economics are in contradiction.

a) According to Lutwak, geo-economics deals with the rivalry of economic interests of Western states after the end of cold war and the ways of overcoming those conflicts with help of peaceful actions and means since among these states the implementation of power is not possible. On the contrary, Kocetov does not connect the emergence of geo-economics with the end of the cold war. He considers it as an outcome of globalization. Geo-economics is one of scientific fields that make globalistics – "science on general laws on global transition".[36]
b) Luttwak limits geo-economics to the West. According to Kocetov, geo-economics is a new phase in world development. "At the beginning of 21st century geo-economics emerged as a new field of scientific knowledge that studies world economic space as unique synthesis of very important fields of human actions in the conditions of global transition."[37] The motto of his major book: *Geo-economics - mastering the world economic space,* speaks for itself about that: "The world of the 21st century is geo-economic world: that is life, flourishing, success!"[38]

[34] Ibid.

[35] В. Кузнецов, "Вступиетлная статья", in: Кочетов, *Геоекономика* ..., op. cit., p. XI

[36] Э. Г. Кочетов, *Глобалистика: теория, методология и практика*, Москва, Норма, 2002.

[37] Кочетов, *Геоэкономика* ..., op. cit., p. 6

[38] Ibid, p. XIII

In the Introduction to the mentioned book of Kocetov, academician Viceslav Kuznecov says: "Real and rational action of men - geo-economics … is the essence of globalization and it determines overall historical steps of the human kind in new era, smooth turnover from the 20th century *homo economicus* to the 21st century *homo geo-economicus*."[39]

c) Luttwak understands geo-economics as applied discipline - the method of prevailing economic conflicts between the states of the West. Kocetov understands geo-economics as both theoretical and applied science.

From general point of view, at the beginning of the 21st century geo-economics has come to the surface, taking place from geo-politics and building geo-strategic (military-strategic) attributes in geo-economic systems.[40] The main reasoning behind geo-economics is "searching for the pattern of geo-economic system of the world founded on the balance of strategic interests and really emerging zones of geo-economic influences, devotion to the search for the patterns of civilized growth that would enable avoiding very dangerous clashes of technogenous patterns with other civilization paradigms of development."[41]

From practical point of view, "geo-economics might be understood as a study on the technique of national actions in geo-economic space aiming for modern decomposition of powers for acquiring the most favorable conditions for education and redistribution of world income."[42]

The position of national economy in modern economic world is determined by interactions of three strategic components: conditions in international sphere; conditions in national interests and priorities; conditions in national economy.[43]

Such understanding of geo-economics comes from the circumstances in which Russia found itself after dismantling of the USSR. Kocetov says that "Russia is gradually getting out from political and economic rigidities, throwing away old structures and strategic attitudes." In the course of events, Russia us faced with the necessity to undertake fundamental economic and political reconstruction in the country and to build new strategy for the relations with the world.[44]

3.4.2. Hexagonal scheme

Neklessa bases his pattern of geo-economics on the fusion of politics and economics in the modern world. In this respect, Neklessa's pattern differs from Kocetov's perceptions because he stipulates that decisive factor in the world

39 Ibid, p. XI

40 Ibid, p. 2

41 According to: *Геоэкономика*, Internet, http://www.archipelag.ru/geoeconomics, 18 X 2007

42 Кочетов, *Геоэкономика* ..., op. cit., p. 6

43 Ibid, p. 3

44 Ibid., p. 3

is not the hierarchy of states but the hierarchy of "geo-economic entities", i.e. industries, financial and legal structures, high technologies, raw materials production etc that are linked to some group of countries or to some geographical area. In line with this approach, following matrix has been shaped in the world economic order:

a) Four geographically defined areas:
- North-Atlantic West, with the production of goods and services has been developed on high technologies;
- Industrialized New East within Large Pacific Ocean Ring;
- Raw materials South that is mostly situated in the area of Indian Ocean Arch:
- Geo-economically the least determined area of "land ocean" (сухопутний) of North Euro-Asia.

b) Two geographical areas that are not clearly defined:
- Transnational Quasi-North that derives from North Atlantic area being linked with legal and financial management of the world economy;
- The archipelago of Deep South – "world underground", destructive economy based on grasping exploitation of natural resources.

Decisive position in geo-economic world nowadays has "headquarters economy" of New North, based on strategic compliance of North Atlantic and transnational blocks regarding ways and methods for redistribution of world income and collection of "quasi-rent."

Geo-economic tools for reaching those goals are world financial and legal technologies such as world reserve currency, international debt, programs of structural adjustments and financial stabilization, "Washington consensus", system of managing national and regional risk and in the future - world issue-tax system.[45]

3.5. The perceptions of Ukrainian geo-economists

Ukrainian scientists see geo-economics as modern geo-politics that is pursued by new means shaped under the effect of the elements of globalization and regionalization. One of the leading scientists in this field in Ukraine is Vladimir Aleksandrovich Dergecev. In his book *Geo-economics* he determines this branch of science as "new organizational system of the world economy", "mechanism and strategy of winning the world economic space" and at the same time as "science on state development strategy, achieving regional or world power primarily with help of economic means."[46]

[45] Геоэкономика, Internet, http://www.archipelag.ru/geoeconomics, 18. X 2007

[46] В. А. Дергачев, Геоэкономика, 2000.
Internet: http://www.archipelag.ru/geoeconomics, 18. X 2007

3.6. The perceptions of Indian economists

3.6.1. Triple structure of the world economy

Indian writers Shet and Sisodia are bothered with the destiny of less developed countries in geo-economic structuring of the world. According to them, developed and underdeveloped countries depend on each other. Developed states have low rates of economic growth and high well being. As long as they trade among themselves they will not have chances fir fast economic growth. Their population is aging quickly so their well being is inevitably going to decrease. Less developed countries need investments and technology to reach the well being with their young population.

Community of North and South will be achieved with help of their integration by means of trade blocks. Until 2025, almost all countries will be integrated in one of the three following blocks: North American, Euro-African or Asian. European Union will be integrated with East Europe and Russia. Then, Europe will lean on Africa and Middle East and incorporate them. The Free Trade Area of the Americas (FTAA) is going to be constituted of North, Central and South America. India will soon tie to the USA and become one of key members of FTAA.[47] The third pillar of emerging triads is China, Japan, South Korea and ten ASEAN states.[48]

How is integration between North and South developing? The states with mature economies are linking to the states with emerging economies.- Germany to Russia, the USA to India, Japan to China. Since the members of "powerful triplet" search necessary for partners on the South, in the long run this triplet will become a factor of overall economic stability.[49]

3.6.2. Factors of geo-economic restructuring

All three blocks are going to be marked with the integration of North and South. Many factors are indicating to such direction: common geography, common heritage, and compatibility of their economies and rivalry of other blocks.[50]

Emergence of triads is not going to be caused only by market forces. The states must adhere to strategic planning so this vision could come true. Thus term "state-corporation" will emerge to bi embodied in the tissue of blocks.

In one-polar world - as it is today - aspiration for one-sided action creates resistance, induces rebellion and terrorism. In bipolar world, with two matching rivals there is a threat of devastating competition - both economic and military.

47 Shtet, Sisodia, op. cit., p. 128

48 Ibid., op. cit., p. 169

49 Ibid., p. 53

50 Ibid., p. 87

Three-polar world offers high level of stability. "Stability and equilibrium are inherent to triangle."[51] If one block would become arrogant, the other two would make an alignment against him to control him. So three polls would prevent economic adventurism.[52]

Thus, world restructuring to three almost equally powerful blocks instead of Orwell "war of the worlds" will lead to the creation of "one world" of peace and well being.

3.6.3. A look ahead

Indian writers, heredities of long lasting civilization are not lost in debates on what gender are angels. They do not involve in debates if geo-economics is science. They are interested in the powers that shape the world economy. Instead of "geo-economic cold war" that is already taking place in North they offer a vision of geo-economic world peace. Triple geo-economic integration should lead to more equal world development.[53]

The perception of geo-economics of Indian writers is an innocent version of the synthesis of Ricardian belief in "free trade" and Gandian belief in the power of nonviolence.

4. Geo-economic makers

One of key questions of geo-economics as a science is: who are geo-economic decision makers?

4.1. The state

Majority of writers thinks that the state is key geo-economic decision maker.

Luttwak stresses that the states are built as spatial units that determine jealously their territory in order to execute the power. The state has been destined to fight for exclusive power over events on its territory as well as for relative advantage over remaining similar units on international scene, even with help of nonmilitary means only.[54]

Italian writers stress that today international competition and hierarchy depends more and more on economics. While European countries intended to increase in all possible ways their military power in the 16th and 17th centuries,

[51] Ibid., p. 54

[52] Ibid., p. 33

[53] Ibid., p. 318

[54] Luttwak, "From Geopolitics…", op. cit., p. 19

in our tomes the states try to improve the level of their competencies in international economic competition.[55] That is natural because geo-economics was derived from geo-politics. Politics and economics are always closely linked. Politics always took economics into account. At the same time, economics had always provided financial, technological and industrial resources to politics. Besides, politics used economics as a weapon for economic blockades and embargos.[56]

Thus, according to Italian writers, regardless all changes in the world, the state not only is not condemned to disappear but on the contrary it is strengthening. After ending conflicts between different ideologies, the states must conform to the new realities. They remain major subject of international relations, factor of stability between individual freedom and social solidarity, and the centers where political interest and goals could be met.[57]

In another words, 'geo-economics is geo-politics that…took primarily place from military geo-politics from the past. … So its studying gains first class importance for the reform of modern state. That is not simply economic science but discipline whose part is "socio-legal engineering". Being so, it makes deep influence on political science.'[58]

Two theses of Italian writers are particularly underlined.

a) Geo-economic issues deserve the highest possible attention of governments. Without taking into account geo-economic factors in its internal and foreign policy economically week country cannot stand on its own feet.
b) In present conditions the protection from foreign competition condemns domestic economy to defeat. In order to keep national economy in severe international rivalry, it is necessary that it is not only protected but also ready to participate the battle. To win, there is no need for unwise isolation but clever openness, not the protection of weak producers but support for powerful and perspective ones.[59] For that purpose, reasonable long-term overall geo-economic strategy and capable state apparatus to implements such strategy are needed.[60]

Italian writers are of the opinion that parliamentary republic is less favorable for geo-economic rivalry than presidential one. For successful implementation

55 Карло Жан, Раоло Савона, *Предисловие к русскому изданию сборника "Геоэкономика"*, Internet, http://www.archipelag.ru , 18. XI 2007, p. 1

56 Ibid.

57 Ibid.

58 Ibid., p. 2

59 According to: Урнов, ibid.

60 Ibid., p. 3

of geo-economic endeavors the state needs strong, technocratic executive power, free from the pressure of politicized parliamentary.[61]

Lorot stresses that it is not true, as some ideologists say, that the state is interference for the success of an enterprise. On the contrary, the state plays a leading role in penetrating foreign markets and achieving technological supremacy.[62] The role of the state is of key importance in each geo-economic strategy.

4.2. Business units

Even large enterprises could have geo-economic strategies just as the states have them. That is why the states have competitors in the world arena. They encompass almost all world political space but just a segment of economic space. The state as well as many business units on the world market could exist simultaneously without mutual interferences.

Yet, there is another side of the coin – large enterprises need the support from the state in the world arena. In that way, interdependence emerges between business firms and the states. The states could have interests to give directions to large enterprises turning them to their "chosen instruments". The enterprises can also use the states as their instruments in international economic strategies. The third solution also exists: for the states and large companies to consider one another as their instruments.[63] "Yet, in most cases, the acts of state and in accordance with acts of the company - one is helping and stimulating the other – completely aware of each other's strategic imperatives."[64]

Neklessa thinks that in geo-economics the decisive role is not played by hierarchy of the states but by "economic entities".[65]

4.3. Domination of the state

Yet, most writers both on the West and East and South see the key pillar of geo-economics in the state. Thus, the overwhelming opinion is that geo-economic is scientific discipline, which studies world economic rivalry whose main pillars are the states.[66]

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61 Ibid.

62 Lorot, "La nouvelle grammaire...", op. cit., p. 16

63 Luttwak, "From Geoeconomic …", op. cit., p. 22

64 Lorot, "La nouvelle grammaire …", op. cit., p. 15

65 Геоэкономика, Internet, http://www.archipelag.ru/geoeconomics, 18. X 2007

66 Урнов, ibid.

5. World economic rivalry

In this respect three issues are of particular importance: globalization of the world economy; peculiarities connected to the position of "economic polls"; regionalization and disintegration.

5.1. Globalization of the world economy

After the disappearance of division of the world on two conflicting polls the competition between the states had moved from military-strategic to economic grounds. With technological and scientific development, especially informatics in communications and transportation, mutual interdependence of the states is growing in overall world. But the streams of globalization do not lead to the creation of McLuhan's "world village"[67] or to Fukuyama's "end of history"[68] that emerged from the victory of democracy and free market.[69]

According to Jean and Savona, globalization reveals itself in diminution of economic importance of territorial boundaries of the states thanks to deterritorialization and dematerialization of wealth. At the same time, liberalization of the world trade, alleviating trade barriers and easing capital movements had taken a share of power from national-territorial states to control economy that is a share of sovereignty in economic field.[70] Now, companies can transfer their businesses more easily to the areas where business conditions are most favorable for them.

Protectionism and autocracy are loosing sense. Freedom of movement of goods and capital deprives "theory of product life cycle" from any sense. Developed countries, thanks to the freedom of movement of goods and capital do not have, as before, monopoly position in the highest production technologies. It is not needed any more for new technologies to achieve moral obsoleteness to be transferred to less developed countries. Information revolution has enabled for the goods of minor quality to be produced in less developed countries too, and they are capable today to compete with developed ones. Moreover, newly industrialized countries, thanks to lower price of labor force, lower costs of environment protection and security at working place are undermining the position of developed countries on the world market, as well as the level of well being of their citizens.[71]

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67 Herbert Marshall McLuhan, *The Gutenberg Galaxy: Their Making of Typographic Man*, Toronto University Press, 1962

68 Francis Fukuyama, *The End of History and the Last Man*, Free Press, 1992

69 Карло Жан, Савона, *Выводы: геоекономика как инструмент геополитики*, http://www.archipelag.ru/geoeconomics, 17. X 2007, p. 1

70 Жан, Савона, *Выводы..., op. cit.*, p. 1

71 Ibid., p. 1.

In any case, new division of labor is emerging. The process is developing too quickly so it does not give room for pursuing adequate structural reforms. In this process those countries that are not capable of building effective strategies are hurt.[72] Important novelty is that business cycles of less developed countries depend less and less on business cycles of developed states. Thus less developed countries become ever more dangerous competitors to developed states, especially in attracting foreign capital.[73]

5.2. Economic polls

The stream of globalization does not flow easily. Main obstacles are:

a) Creation of regional blocks that encompass already large portion of the world;
b) Disintegration of many states, which is still on the agenda today. This phenomenon exists both in the states on the East of Europe that are ethnically and religiously different, and in the countries of Western Europe that are ethnically and religiously similar. In West European countries there is "rebellion of riches" to which the states do not oppose as they do in the case of the "rebellion of poor".

Jean and Savona have an interesting explanation here. In these countries disappearing of boarder-line protectionist obstacles, cuts in state acquisitions, globalization of the market and the presence of national and supra national power weakened the position of the state in respect to rich areas. At the same time, poor areas and social groups encourage the state in order to provide social solidarity through the state that can initiate the redistribution of income. These regional polls oppose to large blocks. They transfer labor-intensive industries to less developed areas with cheep labor force. In such way they enlarge their own competitive strength and widen their own markets.

Competition growth on the world market forces the states to enlarge their own competitive strength within regional polls or blocks in which they are positioned. That is the consequence of dying protectionism and changes in spatial and time characteristics of the economy.

New discipline - geo-economic has exactly emerged from the need to answer to temptations that derived from such development of events and force the states to build corresponding technique, strategy and policy. The notion of geo-economics points to set of measures that are undertaken by the states in order to enlarge competitive strength of domestic economy on the world market.[74]

[72] Ibid.

[73] Ibid., p. 2

[74] Ibid., p. 3

5.3. Disintegration

In line with globalization and regional integrations the process of disintegration is developing that threatens the survival of national states due to growth of localisms and rebellions of rich areas against the poor ones. Yet, national states still exist as major stake for meeting national interests and policies and at the same time preserving the equilibrium between freedom and solidarity. "Economic development depends on freedom; social cohesion depends on solidarity."[75]

The state has passed through significant changes before playing this role.

During the 19th and at the beginning of the 20th centuries the state has provided the industry with the ultimate space for doing business, public order, tariff protection at the state borders, immediate assistance and state supplies. In return, a share of wealth that was produced by industry had been spilled over to the benefit of the poorest parts of the country and to the poorest segments of population.

After the World War II, the states that inclined to mercantilism and autarchy, made great efforts to prevent military conflicts. For that reason they turned to the welfare states. In that course of action, there was also a need to prevent the affinities toward socialism among population.

Those intentions ceased to exist after the end of cold war. At the same time international economic rivalry started.[76] The consequence of disappearance of two polls in the world was loosening of internal unity of the states. Usually such loosening is explained by ethnical clashes. However, new economic structures affected it also.

Jean and Savona, taking into consideration intentions such as separation of rich North of Italy from the South, turn our attention to an inclination toward the separation of rich parts of the states in separate centers of power, i.e. the emergence of city-states and area-states instead of nation-states, that seams to represent an archipelago of riches in the ocean if not of misery then in the last instance the negligence compared to the centers of immediate decision making.

In essence that is a scenario of economic "balkanization" that assumes political-economic structure of the middle ages type, where parallel to "wholly Roman empires" (GATT type) which provide general coordination in order to escape total anarchy of the system, there exist also local centers of power that make independent decisions. In that way the incentive for shaping structures on the principle "center – periphery" emerges.[77]

The state found itself in front of a difficult question: how to maintain the expansion of wealth in order to provide legitimacy in front of richest regions and social segments and to justify the sacrifice they make in the name of national solidarity.

[75] Ibid., p. 3

[76] Ibid., p. 4

[77] Ibid., p. 4

The conclusion of Jean and Savona is that reconsidering the role of the state is a prerequisite for avoiding dissolution and "balkanization" of the world system. "Exactly that task has been given to geo-economics."[78]

6. Geo-economics as geo-economic policy

From the point of view of geo-economics, the state is a country-system that competes with other country-systems. Such competition occurs of the world level according to determined rules. Those rules are objective, emerging from economic laws, but also subjective, derived from free trade international agreements. Those rules could not be disobeyed without sanctions because otherwise strong reaction would follow from other states in the system.[79]

6.1. Methods of geo-economics

Geo-economics does not stick to traditional methods of political economy - monetary and fiscal policy, income policy and labor market - but it also uses other methods that Jean and Savona put in two groups.

6.1.1. Methods of Colbertism[80] of high technologies

According to Italian geo-economists, these methods encompass the measures aimed at enlarging competitive abilities of national economy with help of both structural measures (for geo-economic competition those are institutional mechanisms and intelligence work; for attracting foreign investments with help of tax relieves those are services, infrastructure, scientific research) and investments in human factor for his adaptation to new market conditions, in order to provide employment to local population with highest value added and higher level of wages. That is a necessary precondition for providing well being that could not be provided with protectionist measures on the state borders.

6.1.2. Methods of economic war

Italian geo-economists consider the methods of economic war in narrow sense. Those are methods that use the niche of economic freedom inherent in the system of rules of the world market, and those rules are broken *de facto,* although not formally, for example, by non-tariff barriers; by formally legal but in fact ille-

78 Ibid., p. 4

79 Ibid., p. 5

80 According to French finance minister Jean-Baptiste Colbert who is considered as the founder of industry in France.

gal support of own exports; by technology controls; by official development subsidies but in fact for expansion and protection of own economy by use of international strategic embargoes, in order to provide benefits for own companies.

Geo-economic is not a new form of protectionism or mercantilism because it differs fundamentally from them. Those two last mentioned forms of protectionism use the measures of protectionism at the state borders. In new conditions of porous state borders defense strategy is not applicable especially statistical protectionism is not possible. "The time of performance has come. Modern world economic competition is coupled with the 'cult of performance' similar to those that determined European military-strategic conceptions in the eve of the World War I."[81]

Performance and defense could not exist separately. They are inevitable segments of any geo-economic strategy. Specific side of that strategy is protection from enemy usurpations that could turn mutual dependence in dependence; protection of industrial sectors of own technological base from industrial espionage and enemy usurpations.

However, in principle, strategic orientation is performance because an alternative would be burdened with the peril of recession. It turns out that the meaning of economic war has changed 180 degrees.[82]

In the past, at times of mercantilism or in modern era "economic weapons" were used against Soviet block as subsidiary instrument for accomplishing strategic and political goals. In present times, at times of competition between industrialize countries political means are used for achieving geo-economic goals. "For that purpose crucial changes occur in international law. That is about the appearance of right-obligation of interfering in not one's own businesses for humanitarian purposes, that weakens formal sovereignty of the states prescribed by the UN Charter." International system aimed for the protection of peace and security, adapts more and more to the needs of geo-economics.

6.2. Logics, strategy and methods of geo-economics

The logic of international geo-economic competition assumes the existence of world oligopoly nucleus. Large companies and banks have first class importance for long-term strategy. At times, market penetration was major company goal while today it is managing with securities.

Chronologically speaking, the first reason for the existence of states is protection from external enemies. Well known phenomenon is present: to instrument the states by economic interest groups that intend to misuse the state for the achievement of their goals, frequently asking that the state should take hostile attitude toward other states. Not one field of state performance is exempted from such misuses: fiscal policy could be implemented in a manner that imports would

[81] Жан, Савона, *Выводы...,* ibid., p. 5

[82] Ibid., p. 6

not pay off; laws, subsidies, services and infrastructure could be adjusted to favor domestic interests; and, what is understandable, providing state funds for domestic technological development by its nature is directed against foreign competitors which do not get government subsidies. It is important that "the states intend to act geo-economically simply because they are what they are: spatially determined units constituted as to push back one another on the world arena."[83]

7. The limits of geo-economics

7.1. Geo-economics and geo-politics

Dynamic relationship exists between geo-economics and geo-politics. That relationship is not given once for ever. It changes with the changes of international circumstances.

Geo-economics is a purpose and means of geo-politics as practice at the same time. Political power has been ever used for the achievement of economic goals. Both world wars have been conducted for the redistribution of economic power. Even today the wars are conducted for the same reasons. At the same time, economic means are used for the achievement of geo-economic goals: embargos, blockades, limitations to access market with help of tariffs and non-tariff barriers, subsidies of domestic companies for preponderance on the world market etc.

Common denominator of geo-economics and geo-politics is the fact that they both of them are methods of analysis and interpretation of power relations on the international level.

What differs geo-economics from geo-politics?

a) Goals. – Geo-politics is scientific discipline that studies rivalry behind which is a desire to master political space, i.e. territories and population that lives on those territories. Geo-economics studies rivalry behind which is a desire to master economic space. The goal of geo-economics is not to get power over certain territory but to make trade and technological dominance.
b) Methods. – Geo-politics leans on the use of force including military one. Geo-economics leans on economic means. It excludes violence both military and economic such as blockade and embargo.
c) Outcome. - The outcome of political conflicts is zero sums one. Trade conflicts are not necessary of such outcome. That could be difference between geo-politics and geo-economics.

[83] Luttwak, "From Geoeconmics …", ibid., p. 19

d) Makers. - Geo - economic makers are the states and large companies that adhere to world strategies. That is not the case with geo-politics. Here, the makers could be not only states and large companies but also groups of people gathered politically or not. Leaning on historical data, they take part in strategies for mastering territories.
e) Space. - Luttwak has primarily started from the thesis that geo-economics is a method for overcoming economic conflicts among Western countries where the use of weapon is unthinkable. According to Lorot, "Today, notion of geo-economic is a lot more comprehensive than the founder of this neologism had in mind; it encompasses really planetary dimension that cannot be reduced only to Western countries."[84] Russian geo-economists are of the same opinion.
f) Reach. - Luttwak underlines that the role of geo-economics in the development of world economy is smaller than the role of geo-politics in overall world politics. The states are less sure to act geo-economically tan to act geo-politically.[85] Lorot also thinks that geo-economics does not mean the end of conflicts and territorial pretensions. Geo-politics loses on importance in Western countries only because conflicts considering territories are over between them. Thus geo-economics is overwhelming among Western countries.[86] Kocetov thinks that the whole world is a field of both geo-politics and geo-economics. Their amalgamation is what he calls "geo-economic war".[87]

7.2. Geo-economics and mercantilism

The question is: does geo-economics mean going back to mercantilism? Is the notion of geo-economics thus obsolete? Luttwak thinks that it is not. he makes clear distinction between mercantilism and geo-economics.

The purpose of mercantilism was enlarging the supplies of gold. The purpose of geo-economics is to provide the best possible occupations for the majority of population. In the past the trade conflicts had easily turned to political ones, they led easily to military conflicts and those to wars. Mercantilism was subordinated modality of relations meaning that there is always possibility for a loss in international trade to start recourse to the "grammar of war."

Geo-economics, on the contrary, emerges in a world where there are no superior modalities of relations. The fact that violence in trade has lost the role it

84 Lorot, "La nouvelle grammaire …", ibid., p. 15

85 Luttwak, "From Geopolitiks...", loc. cit.

86 Lorot, "La nouvelle grammaire …", op. cit., p. 18

87 Кочетов, *Геоекономика* …, op. cit., стр. 312-318

played at times of mercantilism, as approved auxiliary means of economic competition is evident enough.[88]

The methods of mercantilism were always determined by the methods of war, and "in new geo-economic era not only causes but also means of conflicts must be economic ones."[89] The means that replaced weapons are: more or less disguised restrictions on exports, more or less disguised export subsidies, financing of competitive technological projects, support for chosen type of education, provisions of competitive infrastructure etc.[90]

7.3. Geo-economics and economic war

What is the relation between geo-economics and economic war? Is geo-economics a simple replacement, more modern term for economic war?

Rivalry between partners with respect to penetration of market share or to acquiring technology is common to geo-economics and economic war. However, that is a spot were the resemblance between these two notions ends. Major differences exist between them:

a) Participants. - Companies or non-governmental interest groups (organizations of consumers, ecological organizations, different lobbies etc) could pursue their own economic wars, on the level of domestic market or on the world level. On the contrary, geo-economic practice could be performed only by the states. The initiative could come from the heads of the states or in connection with the companies that are considered as strategic ones.[91]
b) Means. - Geo-economic is free from any war way of thinking of Clausewitz type including economic war. The truth is, geo-economics could use certain tolls of economic war such as: classical practice of competition prevention, discriminatory use of physical contingents, tariffs or non-tariff barriers, reservations of public works to domestic firms and some activities with the monopolies that are classical examples of industrial espionage. Yet, geo-economics does not lean on most aggressive weapon such as introducing one-sided embargo or organized boycott.[92]
c) Higher interest. - As the states are deprived from a share of their sovereignty because of globalization, bureaucracy leans on geo-economics for providing its own influence.[93]

88 Luttwak, "From Geoeconomic …", op. cit., p. 21
89 Ibid.
90 Ibid.
91 Lorot, "La nouvelle grammaire…", op. cit., p. 16
92 Ibid., p. 16
93 Ibid., p. 17

7.4. Geo-economics and political economy

What are the differences between geo-economics and political economy?

a) Methods. - Political economy uses only traditional methods for governing an economy - monetary and fiscal policy as well as income policy and labor market - and development policies. Geo-economics, besides those methods, uses others that political economy excludes.
b) Cause. - The company goals are always commercial but the state goals are not. "Private companies are doing daily exactly the same things - investments, research and development and actions to penetrate markets - for pure commercial reasons. However, when the state interfere, encourage, help or direct those same activities, that is not only pure economics at work but geo-economics." [94] In another words, everyday destiny of private companies is to invest, research, develop products and seek for new markets for commercial reasons only. That is "pure economics". And when the state helps and directs those same activities that are not "pure economics" any more but geo-economics because the goals are not only commercial any more. Thus, main difference between political economy and geo-economics is in nature of the role of the state.
c) Business rules. - Political economy considers that the role of the state is to prescribe economic rules and to protect them. Those rules are the same for all economic participants o domestic economic space. Majority of EU regulations refer to prescription of common business rules on common European market. If the state prescribes certain subsidies it will offer them to all participants who are ready and capable to follow chosen goals.

In another words, the aim of political economy is competition on domestic market. Deviation from these rules is considered as felony that has to be punished. All states with market economy have anti-monopoly laws. Large numbers of verdicts of European Court are namely punishments of monopolistic behavior of companies and banks as the worst form of breaking rules of "free competition".

It is different with geo-economics. Along with competition within domestic market, there is rivalry on the world market.[95] The ideal of the state is to provide monopolistic position of domestic business units and domestic economy on the world market. The actions that are considered as violation of rules of "fair game" on domestic market are considered desirable on the world market. Benefits for

[94] Luttwak, *Turbo-capitalism*, op. cit., p. 128-9

[95] On English language, in which loans from old Greek and Latin language suffer equally, there is only one term to denote rivalry market behavior that is "competition". In Russian, French or Italian languages, for example, there are different terms: *соревнование – соперничество; concurrence – competition; concorrenza – competizione*. Luttwak saw these limitations, so he uses term rivalry in is book *Turbo-capitalism* to denote the difference between the conducts of competitors and opponents.

strengthening rivalry position on the world market are offered only to domestic business units.

In short, from the point of view of economic science, geo-economics is "over-border political economy" based on „unfair competition".

8. Dispute

As soon as it "learned to walk", as Urkov says, geo-economics became an issue of vivid dispute. The dispute is on two issues:

a) Is there geo-economics as a separate field of study at all?
b) Is it justifiable to consider geo-economics as science?

8.1. Is there geo-economics as a separate field of study at all?

The place and role of geo-economic rivalry in overall international competition is the essence of this dispute. In that respect, two attitudes are shaped:

a) In modern world geo-economic rivalry is a key element of the battle between national economies on the world market. Effective use of geo-economic means is an important condition for the success in that battle.
b) Newly created science, geo-economics, exaggerates the importance of geo-economic side of the rivalry between the states. According to Urkov, it plays very modest role.

The question is what is behind this dispute?

By all means, behind this dispute are the differences in evaluating competitive abilities of the economies on the world market.

Opponents of geo-economics consider, as a rule, heir national economy strong enough to dope with international competition, without adhering to massive state support. The proponents of geo-economics, on the contrary, doubt competitive abilities of their national economies and consider that it cannot successfully compete with other economies without systematic assistance of its own state.

"In another words, here as anywhere, the powerful are inclined to preach liberalism, and the weak to call for government assistance."[96]

[96] Урнов, op. cit.

8.2. Is it justifiable to consider geo-economics as science?

Kocetov considers geo-economics as new branch of science that has its own subject and method. Geo-economics is a field of science that incorporates new specific spheres of economic knowledge.[97]

According to Kocetov, the subject of geo-economics is "a) economic dimension of global world, key promoter of world development; b) synthesis of different fields of man's activities (economic, political, social, ecological, military) and his spiritual and moral condition (cultural, ethno-national, ethical, moral) in unified model of rational behavior and living. In that sense geo-economics appears to be new paradigm (system of understanding) of the world development in the 21st century.[98]

The method is also explained in line with the way the subject has been determined. The key issue here is the way of understanding of geo-economic space. "At the beginning of the 21st century it has taken prevailing role on hierarchical scale of strategic actions in the world system. Geo-economic space enters in complex mutual relations and actions with other spaces, before all with geo-political and military-strategic ones."[99] For those reasons, geo-economics is multi-sided, supra disciplinary new scientific discipline.[100]

The trouble with Kocetov's understanding of the subject and method of geo-economics is in the fact that he does not draw a line between geo-economics as scientific discipline and geo-economics as its application. That is clear from his understanding of the cause of geo-economics. According to him, "geo-economics is a part of scientific development strategy. It gives strategic landmarks for the development of national economies, determines the character and contents of national doctrines and concepts of mutual actions with outer world."[101]

8.2.2. Geo-economics – emerging science

Baumard and Lorot think, "Geo-economics is not still a science but emerging scientific discipline (*discipline naissante*)."[102] They do not give also clear determinants of the subject and method of geo-economics.

It is not questionable that geo-economics studies particular field of international relations. It describes and prescribes the relations of power and space without borders, contrary to geo-politics, which deals with the relation of power and space divided in the states. Geo-economics neglects state borders. In another

97 Кочетов, op. cit., p. 2 and 7

98 Ibid., p. XIII

99 Ibid., p. XIV

100 Ibid., p. 7

101 Ibid., p. 7

102 Philippe Baumard, Pascal Lorot, "Le champ geoeconomique: une approche epistemologique", in: Lorot, *Introduction á la Géoéconomie,* op. cit., p. 214

words, as majority of writers who study thus field, French writers under geo-economics assume both science and its application. Thus, geo-economics is "today stretched between describing and making, between explaining and acting."[103] Mainly, from the works of French writers it derives that subject and method of geo-economics are made from loans from other sciences – economics, geography, history, and geo-politics.

In short, subject and method of geo-economics are not still clearly defined nor there exists separate geo-economic theory. Thus geo-economics as science is yet to be formed.

8.2.3. Geo-economics – science or ideology

Neither geo-economics nor geo-politics are clearly defined. The question is if there are two separate sciences or two sides of the same ideology. By book, science is a collection of theses that could be tested and ideology is a collection of normative judgments. In the case of geo-economics and geo-politics it seams there is an amalgamation of science and ideology.

There is no doubt that there is reality that requires scientific analysis. There is also no doubt that behind geo-economics and geo-politics there are normative judgments, i.e. "conditioned mind", i.e. mind determined by the interests of the states.

What is behind geo-economics? In essence, behind it there is a hidden postulate: geo-economics is applied among Western countries because there is no room for geo-politics between them. Why? Geo-politics is applied with violence and there is no room for violence among Western countries. Geo-politics is, thus, a collection of means, methods and actions for mastering political space out of West. Thus, geo-economics does not apply to the space out of West because in those areas the use of force as means of mastering territories and population is "allowed". That is the reason why Luttwak approves the race in armament.

Luttwak's reasoning of the role of geo-economics is a continuation of the understanding of international law in Western Europe in the 19th century. According to that understanding, international law is relevant only for the space considered as Europe. In Europe, only sovereign states can exist but not colonies. Out of that space international law does not count because other areas are "free hunting zone", fit for colonizing.[104]

French geo-economists differ from Luttwak in this matter. The truth is, according to them, also, geo-economics is applied among the countries that excluded the threat of wars between them. Yet, they ask themselves if it was justi-

[103] Ibid., p. 228

[104] That is another side of dispute on the issue if Balkans are in Europe. Balkan states were persistantly trying to prove that if they were Europe, they would not be coloniyed, but metropolies made efforts to exclude Balkans from Europe in order to preserve some "free hunting zone" for them. Dragoljub Živojinović: *Evropa danas,* Beograd, 1985

fiable to limit the application of geo-economics only to West. Many countries of Latin America and Asia have emerged on the world market with geo-economic strategies. They achieved that by means of their own economic and military power – enlarging the application of geo-economics in that way.

All states that are capable of such actions, try to develop the most powerful weapons to escape from geo-political "free hunting zone" and become actors of geo-economics. That is one of the paradoxes of modern world: the more nuclear states the wider field for geo-economics. For, the more devastating is the power of weapon it is less usable.

8.2.4. Geo-economics and geo-economic policy

Epistemological disorder leads to confusion in understanding the phenomenon that really exists and in the way of its explanation.

The notion of geo-economics is ambiguous. Geo-economists on the West and on the East use the same notion (*Geo-Economics*, Геоэкономика, Géoéconomie, Geoeconomia) to denote both geo-economic theory and its application. Thus it is often not clear if the issue is geo-economics as a scientific discipline or over-border economic policy of the states. That is the reason why it is often not clear what is the issue of dispute.

The confusion comes from mechanical separation of geo-economics from geo-politics. Luttwak, who was the first to try it, did not understand geo-economics as separate scientific discipline, but as separate international practice.

The dispute could be overcome with the analogy to economic science and its application: economics as theory and economic policy as its application. In line with that model, one could differentiate geo-economics and geo-economic policy. In analogy with economic policy, geo-economic policy could be determined as a field of science that studies means, methods and actions for mastering economic space.

The separation of two terms: geo-economics and geo-economic policy would not terminate the dispute because it would be necessary to determine in advance if there is geo-economic theory and what are its subject and method.

8.2.5. Geo-economics: reality and understanding

To consider it as a science, geo-economics must have its own theory its own subject and its own method. If geo-economics fulfills these conditions it is still disputable.

However, it is out of question that reality exists on which the destiny of the world depends: conflict of economic interests of planetary dimensions. In that conflict, directly or indirectly, all states in the world are involved. All methods and means, violent and non-violent are used in that conflict.

It is clear that so complex reality cannot be encompassed by any separate discipline. That is the reason why geo-economics is a field of research whose subject and method are made of loans from various sciences: economics, geography, demography, political sciences and others.

Thus, geo-economic practice exists inevitably, but economic theory is yet to be developed.

In short, the disputes on geo-economics remind us on well-known case with giraffe: it is difficult to be described but who ever see it, he knows that is her.

9. Conclusion

1) Geo-economics is a science in development. From the point of view of economic science, geo-economics as applied science is "over-border political economy" based on "unfair competition."
2) It is questionable if geo-economics has its own theory, subject and method that are necessary conditions for recognizing it as a science. The meaning of neologism geo-economics is also questionable by itself. But there is no question if there is reality that cannot be explained by any recognized field of science: conflict of economic interests of planetary dimensions.
3) Separation of geo-economics from geo-politics has been made for ideological reasons with far-reaching goals. Geo-economics has been understood as mastering economic space without the use of violence and geo-politics as mastering political space with the use of violence including military and economic means - blockade and embargo.
4) That kind understanding of geo-economics is a basis for differences in respect to the fields of its implementation.
5) At first, on the West geo-economics has been understood as a method for overcoming the conflict of economic interests only among Western countries because between those countries the use of weapon is not possible. The rest of the world stayed in the filed of geo-politics where the use of weapons is possible.
6) Geo-economists out of the West see the conflicts of economic interests as planetary phenomenon so according to them the whole world is a field of geo-economics. Since more and more countries are included in the battle for overcoming division on the West and the rest of the world by means of their economic and military power, the field of the application of geo-economics is widening proportionally. Many
7) geo-economists on the West take this fact into account today.
8) Stable growth of producing power of the world on one hand and exploitation of energy sources and mineral raw materials on the other is a con-

tradiction that is in the essence of the world crisis. The danger of turning economic wars into geo-economic war is growing steadily.

9) Each state, no matter its geographical, demographic or economic proportions, must build the strategy for facing geo-economic reality.

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Expert article
Received: March 21st, 2009

UDC 332.145/.146; 502.131.1
ID 158245132

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COMMUNICATION & SOCIAL STRATEGIES: SUSTAINABILITY REPORTS & THE GLOBAL REPORTING INITIATIVE GUIDELINES*

Abstract: *Modern business performance calls for standardization of sustainability reports capable of fostering an articulated and continuous flow of information with respect to stakeholders. Those reports should enable that the flow of information be centered on the sustainability of the firm's process of growth and development and broken-down in terms of economic, social and environmental aspects. The article studies evolution of social and sustainability reporting systems and the Global Reporting Initiative (GRI) principles in the social and sustainability reporting standardization process.*

Key words: *corporate communication, social strategies, sustainability reports, GRI reporting principles*

JEL classification: L15, M41, K33

1. Corporate communication and social strategies

Communication of the ways enterprises interact with the context of reference is relevant in terms of both information flows within a business organization and its relations with the outside world, where the communication of the ethical values at the basis of a company's actions must be interconnected with the other forms of communication (whether imposed by law or not) that the company uses in respect of its stakeholders.

* This paper is the result of two authors' common reflections on the subject. Nevertheless, so as to correctly identify the contribution made by them, section 1 was edited by Giovanni Maria Garegnani while sections 2, 3, 4, 5 and 6 were edited by Filippo Vitolla.

The ever increasing diffusion of the concept of accountability, encapsulating responsibility and the need to give due account, show how the principles of transparency and honesty continue to be more widely perceived as the cornerstone underlying the stability of an organization that intends to pursue its institutional objectives over the long term.

Transparency and honesty are, moreover, two indissolubly entwined principles: an organization that operates according to the principles of legality and ethical rigor will not find it hard to act transparently and openly in respect of its stakeholders. On the other hand, the tendency towards wide-ranging reporting processes, screened by control systems whose effectiveness is under ever increasing scrutiny, helps to reduce the establishment of dishonest practices (and, over the long-term, dishonest behavior) within the fabric of an organization.

The fallout from the positive combination of transparent disclosure and upright management is evident also in terms of strategic effectiveness, which is, by definition, such if it can be communicated, shared and adopted by a business organization.[1] According to the institutionalist economics model,[2] moreover, the difference between the ethical approach and the strategic approach to handling relations with stakeholders and, consequently, communications, is greatly reduced.[3] The ethical approach basically tends to identify a set of values and codes of conduct considered morally positive both within and outside an organization, that are intended to inspire its management and communications; whereas the strategic approach considers management and relations with stakeholders in terms of the criticality of social consensus and the importance of their contribution to the pursuit of financial/economic results.

In this scenario, financial statements continue to be of prime importance. The recent serious events that have also affected major Italian firms show, *a contrariis*, how misleading financial statement disclosures can firstly prove destructive for the fabric of the organization involved, not only by concealing areas of inefficiency, but also by giving rise to policies that would otherwise be hard to justify.

Transparent disclosure and upright management are thus the fundamental ethical values that must permeate both the processes for the preparation and control, of year-end accounts, in the well-known terms of the truthfulness, neutrality, accuracy, validity and completeness of their supporting documents, and the processes of analysis of the existence and consistency of the events being disclosed.

1 V. Coda, "Trasparenza informativa e correttezza gestionale: contenuti ed informazioni di contesto", in *Scritti di economia aziendale in memoria di Raffaele d'Oriano*, CEDAM, Padova, 1997

2 A. Beretta Zanoni, "Le relazioni con gli stakeholder e gli obiettivi istituzionali d'impresa. Un approccio strategico", in (edited by) Rusconi G., Dorigatti M., *Teoria degli stakeholder*, FrancoAngeli, Milan, 2007

3 R. Ferraris Franceschi R., "Etica ed economicità", in (edited by) Cavalieri E., *Economia ed etica aziendale*, Giappichelli, Turin, 2002

Reference to the principles of legality, as the necessary basis of any correct corporate disclosure process, thus appears unavoidable.[4]

Furthermore, the complete satisfaction of stakeholders' expectations in disclosure terms cannot be confined to the – albeit fundamental – knowledge to be gained from financial statement; nor can overcrowding year-end accounts with superfluous information be considered a valid solution.

In this regard, it has been a known fact for some time that disclosures of a purely financial/economic nature offer just a partial view of the dynamics of a business; changes of conditions in the context of reference (an unstable and erratic scenario, increasingly powerful competitive dynamics, competitive advantages linked to intangible resources) have made the limitations of such a practice even more evident, especially with regard to the inability to grasp the implications of strategic decisions in advance and for an organization to monitor the assessment of intangible resources (such as its image, its organizational context, the skills its staff possess) whose criticality assumes prime value.

Furthermore, over-concentrating on just financial/economic information can accentuate the phenomenon of "managerial myopia", tending to prefer focusing on short-term performance levels rather than the wider-ranging long-term picture. What are thus becoming increasingly more important – combined with the tendency towards an increasingly higher degree of the reliability of financial/economic information, which is often compulsory and pursued also by strengthening control mechanisms – are voluntary disclosure tools, which are not explicitly required by law or regulations, but used to enable stakeholders to better appreciate an organization's capacity to generate wealth and maintain over time the competitive advantages intrinsic to it and ensuing from the intent of its strategy. Of course, the whole point of this is to arouse consensus and trust around a company.

This prompts the search for tools capable of fostering an articulated and continuous flow of information with respect to stakeholders, centered on the sustainability of the firm's process of growth and development and broken-down in terms of:

- economic aspects (with particular reference to significant indicators in terms of appreciation of growth and development strategies);
- social aspects (and thus intended to highlight the results achieved in terms of initiatives designed to stimulate consensus and trust);
- environmental aspects (in which the initiatives taken to optimize the environmental impact of the organization's operations are analyzed).

For obvious reasons of spatio-temporal comparability, the need to provide this information has, in turn, prompted the need for organization and stand-

[4] A. Matacena, *L'accountability nelle imprese lucrative e sociali. Verso una possibile convergenza*, in Economia Aziendale 2000 web, no. 4/2005

ardization in terms of the measurement, representation and control of the information supplied, in respect of which, in the absence of regulatory prescriptions, relevance is assumed by the recommendations contained in doctrine and Italian and international best practices, the most relevant of which amongst the report preparation models are the GRI and GBS standards and, amongst the models intended to define the procedural rules for the accountability process, the AA1000 and Progress standards.

Correct accountability requires, in the first place, the identification of strategically relevant stakeholders, on the basis of the interest they hold in the company and their influence over its long-term stability, and the establishment with them of a continuous and articulated two-way flow of information. To that end, it is obviously necessary to identify the contents of the information to be communicated and accordingly set up a system for gathering the qualitative and quantitative data needed for such purpose. Lastly, provision has to be made for apposite mechanisms for preparing, auditing and circulating the flows of information in question.

Social reports, provide a concise picture of an organization's social operations and performance levels during the period covered by the report, which is, moreover, not focused on just financial/economic aspects, but on the various economic, social and environmental factors involved.[5] They are documents not compulsory under Italian law and often differ in terms of their format, structure and even the name they are given. Furthermore, over the last ten years there has been a strong leaning towards the standardization of social and sustainability reporting.[6] The fundamental objectives of standardization are the creation of best practices and the achievement of spatio-temporally comparable documents, in a way analogous to what happens in the case of financial reporting documents. Standardization also means that the auditing process is facilitated and the self-certification risk, which is unfortunately very high in connection with socio-environmental reporting, is reduced.

Standardization processes are, however, not without risk. Sustainability reporting has developed in relatively recent times and therefore the techniques, methodologies and structures it utilizes are still far from being fully complete. It is true that the creation of models facilitates the diffusion of methodologies and techniques, but it is equally true that homologation can have a reductive effect in terms of the inclination for innovation that is certainly necessary to improve social reporting processes.[7]

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5 J. Elkington, *Cannibals with forks. The triple bottom line of 21st century business*, Capstone Publishing, Oxford, 1997

6 L. Hinna, "Come gestire la responsabilità sociale dell'impresa", *Il Sole 24 Ore*, Milan, 2005

7 Op. cit.

2. The evolution of social and sustainability reporting

The evolution of social reporting has not been spatio-temporally homogenous, because of the diversity of the contexts in which business organizations operate. This notwithstanding, and albeit at different speeds and in different ways, the evolution of doctrine and best practices is leading towards reporting models with increasingly convergent characteristics and objectives.

Generally speaking, it is possible to identify five separate periods in this evolution process:[8]

- *the 1940s – 1970s*, during which the early documents of a social nature were prepared in the United States. The objective of social reporting was to meet the growing need for information of political movements, consumer associations and environmental associations. Socio-environmental reports, which were developed on a voluntary basis, represented a way for companies to justify their actions in a certain area rather than a tool for increasing stakeholder involvement in company management;
- *the 1970s*, in which the basic accounting and socio-environmental reporting techniques were defined, despite still being somewhat unsophisticated, and during which there was a modest diffusion of disclosures of a social nature (especially in the United States, Germany, France and Great Britain). In 1973 a vain attempt to make reporting of a social nature compulsory was made in Great Britain. Thanks to this attempted reform stakeholders' interest in obtaining additional information, besides to traditional accounting data, increased and it was created a favorable situation to social disclosure. In 1977 it became compulsory in France for large firms to draw up a social report containing information on its employees (their salaries, additional benefits, health and safety conditions, training, industrial relations);
- *the 1980s – mid-1990s*, when the evolution of social reporting basically came to a halt, due to a reduction in the interest displayed by companies in ethical-social problems. The early 1980s mark the first initiatives launched by the Institutions of the European Community: in 1980 a proposal for a directive on the harmonization of information on workers was submitted to the European Parliament but never approved. Said proposal was heavily influenced by the French model, tending to combine the concept of social relevance with that of the relationship between a company and its staff. A few years later, in 1983, during the Ninth Strasbourg Congress organized by the Professional Associations, a set of guidelines was drafted on the representation of the social dimension of business organizations (which bears the imprint of the German *Sozialbilanz-Praxis*). The

[8] G. Rusconi, *Il bilancio sociale*, Ediesse, Rome, 2006

Strasbourg document was followed by numerous other parliamentary bills; however, only some of them led to the actual adoption of measures. The EMAS Regulation was issued in 1993, allowing voluntary participation by organizations in a Community eco-management and audit scheme. This Regulation was of particular significance because it was indicative of the intent of EC institutional bodies to make the reporting process not compulsory and not standardized;

- *the late 1990s*, during which true and proper social reporting systems were developed within accountability processes. The reasons for this development lie in a number of contextual factors stemming from a higher degree of public awareness of ethical and environmental issues, which led to companies having to give account not only of their conduct having an immediate effect in financial terms, but also of their actions of a social nature. Furthermore, the growing strategic importance of relations with stakeholders determined the need of their greater involvement in corporate management and made it increasingly evident that a structured dialogue had to be established. Another not negligible factor in this evolution process was the diffusion of standardized socio-environmental and sustainability reporting guidelines, which fostered the development of structured communications tools;
- *the 2000s*, a period characterized by the internationalization of reporting, improved and increasingly widely distributed socio-environmental reporting guidelines and interventions on the part of the European Union. The publication in 2001, by the European Commission, of the Green Paper that, for the first time, provided a systematic definition of the concept of corporate social responsibility (CSR) was of particular significance. In that document, emphasis was placed on the "internal dimension" of corporate social responsibility (*i.e.*, on employees), without failing, however, to highlight the social role of companies in respect of out-house stakeholders (business partners and suppliers, customers, public authorities, local communities, etc.). The Green Paper was of great importance from a reporting perspective, since it contained a whole chapter on "Social responsibility reporting and auditing". In 2002 the European Commission published the White Paper outlining the strategy, broken down into six points, for the promotion of CSR. In so far as concerns reporting, the White Paper stressed the need for greater convergence and standardization in accounting, reporting and audit methodologies pertaining to the social aspects of corporate operations, revealing a change of direction with respect to the past. Generally speaking, the expansion of social disclosure over the last ten years has underlined a process of convergence between the standards and systems adopted in different countries that is linked, above all, to the effect of globalization (this harmonization is, for

obvious reasons, even more apparent among EU Member States). What does emerge is a process of concrete evolution towards standardized and structured sustainability reporting systems.

3. The GRI's role in the standardization of sustainability reports

The *Global Reporting Initiative* (hereinafter, the GRI) plays an undoubtedly important role in the social and sustainability reporting standardization process; the latest version of its guidelines (G3), published in October 2006, represents an important reference tool at international level.[9]

The GRI was set up in Boston in 1997, at the initiative of the U.S. NGO called CERES (*Coalition for Environmentally Responsible Economies*), with the objective of creating a reference model for environmental reports. The UNEP (*United Nations Environment Program*) was a key partner in that project, which saw the active involvement of companies, workers' associations, research institutes, universities, rating firms, auditing firms, consulting firms and associations of accounting experts. The GRI's frame of reference was subsequently broadened, adding economic and social aspects to its initial environmental dimension.

The GRI's mission is to achieve transparency on the financial, social and environmental aspects of corporate management, improving the quality and the usefulness of reports by identifying report preparation standards that enable the full and complete representation of the dynamics of organizations. By identifying drafting principles and specific contents, the GRI Reporting Framework outlines a reporting model designed to provide a balanced and reasonable picture of sustainability performance levels, by, in particular:

- Facilitating the creation of effective and efficient sustainability reporting systems;
- Advocating benchmarking and the assessment of performance levels against codes, performance standards and strategic objectives;
- Facilitating the spatio-temporal comparison of data and information;
- Improving dialogue with stakeholders and stakeholder engagement mechanisms in general.

[9] S. Cantele, "I modelli della rendicontazione sociale", in (edited by) Campedelli B., *Reporting aziendale e sostenibilità*, FrancoAngeli, Milan, 2005; Bartolomeo M., "Il framework di reporting Global Reporting Initiative (GRI). Origini, caratteristiche, critiche", in (edited by) Rusconi G., Dorigatti M., *Modelli di rendicontazione etico-sociale e applicazioni pratiche*, FrancoAngeli, Milan, 2005; Fazio V., "Lo Standard AccountAbility (AA) 1000. Punti di convergenza con le Guide Lines della Global Reporting Initiative (GRI) ed il modello Gruppo Bilancio Sociale Italiano (GBS)", in (edited by) Rusconi G., Dorigatti M., *Modelli di rendicontazione etico-sociale e applicazioni pratiche*, FrancoAngeli, Milan, 2005; Manetti G., *Il triple bottom line reporting*, FrancoAngeli, Milan, 2006

The GRI Reporting Framework is broken down into:

1) Guidelines, which define the basic sustainability reporting model and explain the Principles guiding the preparation and the contents of Standard Disclosures;
2) Technical protocols, which regard specific aspects of the reporting process and supplement, from a technical perspective, the guidelines on significant issues. Eight technical protocols are currently in place: six Indicator Protocols (one for each performance category), dealing with the measurement and recording of performance levels; the Application Level, which outlines the different ways in which the guidelines can be applied (in order to overcome any inflexibility, especially longitudinal inflexibility, associated with the evolution over time of social relations and the field of reference); the Boundary Protocol, which identifies the ways in which the reporting boundary is defined;
3) Sector supplements, which deal with specific problems connected with sustainability reporting and constitute the GRI's response to the risk of transversal inflexibility in the standardization process. To date, seven such documents have been published in their final versions (financial sector; logistics and transport; mining and metalworking; public sector; tour operators; telecommunications; motor industry) and two have been published in draft form (textiles/clothing/footwear; electricity).

The latest version of the guidelines (G3), published in 2006, contains a number of improvements with respect to previous versions and can be noted for:

- The emphasis it places on drafting principles and stakeholders' expectations;
- Its simplification, achieved by grouping the drafting principles in just two clusters (principles defining report content and principles to ensure report quality);
- Its introduction of a series of self-assessment tests to verify correct application of the principles;
- The relevance of its descriptive part and of the information of a qualitative nature and on strategic analysis (as well as the reduction of the number of performance indicators);
- Its broadening of the area of accountability (with the inclusion of upstream and downstream entities) and the determination of the guidelines for defining the reporting boundary;
- The responsibility it places on organizations to ensure the completeness of data and information.

Three levels of the application of the guidelines are also envisaged, depending on the report's content. The level applied is self-declared by report preparers,

who may also obtain certification of compliance issued by an external organization or by the GRI itself (when external assurance is provided, a "plus" is added to each level). This makes it possible for the reporting process to be flexible in relation to different contextual situations and also enables report readers to identify the reporting model used by an organization.

4. GRI reporting principles

The reporting principles constitute the general frame of reference for the preparation of sustainability reports according to the GRI model. They are supposed to be a consistent source of inspiration for report preparers, especially in those cases where there is a margin of discretion in how technical provisions can be construed and methodologies, processes and tools for the measurement, recording and communication of corporate performance levels can be applied and used.

Generally speaking, the effect of report preparation models is standardization by means of the identification of reporting principles, combined with the determination of specific techniques and contents; moreover, each model privileges one of these two aspects. Compared to its previous version, the G3 focuses more on report preparation principles than on assessment and recording techniques and methodologies; the principle-based model, towards which the GRI guidelines seem to tend, does, in fact, reconcile standardization and flexibility requirements, thereby reducing the risks of inflexibility of both a (temporal) longitudinal and a (spatial) transversal nature.

The fundamental report preparation principle laid down by the G3, overriding all other principles, is that of transparency on the social, economic and environmental impacts of corporate management, and it breaks down into the principles, instrumental to such end, for **defining report content** and **assuring report quality**.

The former establish the criteria to be applied in determining the information to be included in reports so as to provide a true picture of the organization and its sustainability performance levels. These criteria consist in:

- **Materiality**. Reports must include information implying a significant social, environmental and economic impact, capable of substantively influencing the decisions of stakeholders (relevance); relevance/materiality is considered to be a minimum threshold of meaningfulness (for the definition of which it is necessary to consider also the qualitative aspects of the information). As stated in the guidelines, the meaningfulness of a piece of information depends on a combination of internal and external factors, including those such as the organization's overall mission and competitive strategy, the concerns expressed by stakeholders, the social

expectations of players in the competitive system and the indications of international ethical-social standards;

- **Stakeholder inclusiveness**. This principle responds to the need to involve stakeholders in the determination of the information to be included in reports, since it is the satisfaction of their disclosure requirements that is the fundamental objective of sustainability reporting. Understanding the expectations, interests and disclosure requirements of report readers is an essential qualification for adequately discharging the informative function that sustainability reports are supposed to perform;
- **Sustainability context**. The definition of report content requires an assessment of the economic, social and environmental context in which the organization operates;
- **Completeness**. The report must cover all information needed to fully reflect the economic, social and environmental impacts that may affect stakeholder assessment and decision-making processes. Completeness encompasses three dimensions: topics covered (in terms of the specificity of each sustainability context); reporting boundary (in terms of the range of entities to be included in the report); time (referring to the period covered by the report).

The principles for assuring report quality seek, instead, to ensure that the information contained in a report is capable, from a qualitative viewpoint, of providing an honest picture of the sustainability of an organization's operations, and consist in the following individual requirements:

- **Balance.** The guidelines construe this principle as being a requirement for the inclusion of both positive and negative aspects of the reporting organization's operations, in neutral terms. The report should provide an unbiased picture, avoiding inclusions, omissions, selections of information and the presentation of formats with the only aim of meeting the approval of one or more stakeholders;
- **Comparability**. Data should be selected, compiled and reported in a manner that enables spatio-temporal comparison, meeting both transparency requisites and stakeholders' disclosure requirements;
- **Accuracy**. This principle refers to the "validity" of reported information, in terms of its lack of errors and significant manipulation. Indeed, the existence of serious errors could compromise the correct assessment of economic, social and environmental impacts. The data-gathering stage and the presentation of such data are crucial to the accuracy of qualitative information, whereas the accuracy of quantitative data must extend to all data compilation and measurement operations;
- **Timeliness**. This principle expresses the capacity of the accounting and reporting system to provide information in time for stakeholders

to assess sustainability performance levels at the right moment. The G3 refers above all to the frequency and regularity of information and passes over the capacity of the disclosure system to significantly reduce accounting and reporting cycle timelines (involving data gathering, compilation, presentation and publication);

- **Clarity**. Reports must be comprehensible to report readers. Clarity is of more crucial importance in sustainability reports than it is in economic/financial reports, since, in view of stakeholders' varied backgrounds, it is harder to prepare reports whose content reconciles the need for disclosures of a general nature (to all stakeholders) and those of a specialized and detailed type (pertinent to stakeholder groups interested in knowing about specific aspects in more detail). The conflict between completeness and clarity requirements represents a serious problem in sustainability reporting (to an undoubtedly greater extent than it is in the case of reports on individual aspects of an economic, social or environmental nature). Nevertheless, this difficulty cannot be considered grounds for reducing the informative effectiveness of a sustainability report, given its capacity to present an overall and long-term picture of an organization's situation, which, due to their nature, other models do not possess. It is from this perspective that the role played by organizations engaged in the preparation of standard reporting models in seeking innovative solutions for the preparation of quality reports is particularly important;
- **Reliability**. This principle regards the ability to check the data and information contained in a report. According to the G3, data is reliable if it can be verified (using internal control systems or by third parties).

An important novelty in the G3 is the introduction of a series of assessment tests to verify the correct application of each principle. These tests are self-diagnosis tools that, albeit not explicitly portrayed as information intended for stakeholders, constitute a reference point for illustrating the decisions taken on the application of the principles, if they are included in a report.

5. Structure and content of the GRI guidelines

A sustainability report prepared according to the G3 guidelines is made up of five sections:

- Strategy and analysis;
- Organizational profile;
- Report parameters;
- Governance, commitments and stakeholder engagement;
- Management approach and performance indicators.

The **strategy and analysis** section should present the reporting organization's overall vision and strategy in terms of sustainability and also contain a statement from the CEO on strategic priorities for the short and long term with regard to sustainability, taking account of the macro-economic context and the evolution of the variables (of an economic, competitive, social and environmental nature) that most closely affect the organization. This section also requires a SWOT (*Strengths, Weaknesses, Opportunities and Threats*) Analysis, making it possible to put the internal and external variables affecting the organization into relation and thus understand its strengths, weaknesses and opportunities, as well as the threats it faces, in connection with sustainability.

The **organizational profile** section should provide an overall view of the reporting organization from the following perspectives: institutional (nature of ownership and legal form), competitive (products/services provided, markets served), organizational (group structure, organizational structure, level of decentralized production, number of employees) and economic/financial (net turnover, total assets, allocation of costs and revenues by geographical area).

The **report parameters** section provides information on the report profile (reporting period, date of publication, reporting cycle), on the processes for defining report content and the entities included, on the data measurement techniques used and on significant changes from previous reporting periods in the scope, boundary or measurement methods applied in the report.

The **governance, commitments and stakeholder engagement** section outlines the institutional structure of the reporting organization, its governance mechanisms and, above all, describes the stakeholder engagement process (the stakeholders involved, the basis for identification and selection of stakeholders with whom to engage, the kind of engagement undertaken and frequency thereof, the concerns raised and responses thereto).

The fifth section, **management approach and performance indicators**, identifies performance levels in respect of each sustainability dimension: economic, social and environmental. Specific performance aspects (to which one or more indicators of a quantitative or qualitative nature correspond) are indicated for each such dimension. An important novelty, introduced in the G3, is a qualitative description of the specific management policies pertaining to each aspect (or category) in order to set the corporate and environmental context in which the indicator is placed.

In so far as concerns just the social dimension, the aspects are further categorized by specific performance areas (labor, human rights, society and product responsibility)[10].

[10] A problematic aspect of this model is the lack of a clear explanation of the relationships between the different dimensions and their various aspects. The identification of such links on the lines of a balanced scorecard model would enable report readers to verify the impact of a change in any one indicator on another.

The G3 identifies three types of performance indicator:

- Core indicators. These are assumed to be material indicators for all business organizations. Their inclusion in the report is compulsory;
- Additional indicators. These represent emerging best practices that are important for the presentation of the sustainability performance levels of just some organizations. Their inclusion in the report is not compulsory;
- Sector-specific indicators. These are key indicators only for organizations operating in those sectors for which the GRI has published supplements. Their inclusion is compulsory only for organizations in the sectors regulated by supplementary guidelines (financial sector; logistics and transport; mining and metalworking; public sector; tour operators; telecommunications; motor industry).

On careful analysis, the distinction between core and additional indicators does not appear consistent with a principle-based model. The determination of indicators of absolute importance also clashes with the principle of sustainability context intended to ensure the flexibility of reports and meet specific disclosure requirements on the part of stakeholders.

6. Conclusions

The multi-stakeholder approach[11] to strategic corporate management makes it necessary to re-examine the communication process; the achievement of stakeholder consensus and trust, at the basis of an organization's medium and long-term success, is based on accountability-driven communication (turning a duty into a strategic opportunity). The accountability process presuppose the engagement of stakeholders in corporate management and is realized in the assessment of social outcomes, the preparation of summary reports and verification of reported information.

However, focusing on just one dimension of management means that it is not possible to make an overall assessment of sustainability, understood as being the capacity of an organization to endure in time and develop. Sustainability is of fundamental importance to all stakeholders, because the satisfaction of their interests depends on an organization's capacity to create wealth and continue performing its function of producing goods and services over time.

The strategic/management approach taken by sustainable organizations inevitably influences the reporting process, transforming it from bottom line reporting into triple bottom line reporting, by integrating the economic dimension, the social dimension and the environmental dimension.

[11] R. E. Freeman, *Strategic management: a stakeholder approach*, Pitman, Boston, 1984

Sustainability reporting (just like social reporting and environmental reporting) is not compulsory. The absence of any legislative reference has been offset by the preparation of a large number of standard reporting models, chief among which are the GRI guidelines, which have been adopted by approximately 2,200 organizations worldwide. This prevalently principle-based model makes it possible to reconcile both standardization and flexibility requirements, thereby reducing the risks of longitudinal and transversal inflexibility associated with models that over-privilege the definition of content.

However, in its attempt to reconcile the determination of report preparation principles with the definition of report content, the latest version of the guidelines reveals some inconsistencies. For example, the focus on comparability does appear to veer the model towards an excessive degree of standardization, reducing the margins of flexibility allowed to report preparers (which should be preserved in a principle-based model). Furthermore, from the same perspective, the *a priori* distinction between core and additional indicators does not appear to adhere to the principle of sustainability context (which underpins the flexibility of the model).

Clearly, a problematic aspect of the GRI model (and of all sustainability reporting models) is the trade-off between clarity and completeness that is more pronounced than in one-dimensional models. Nevertheless, this problem cannot be considered grounds for reducing the informative effectiveness of a sustainability report, given its capacity to present an overall and long-term picture of a company's situation, which, due to their nature, other models do not possess.

Notwithstanding these limitations, the GRI guidelines prove to be a reasonably flexible reporting standard, tending to privilege the addressee of information rather than a uniformity of content. A possible positive development could see this inclination becoming more pronounced, with the ensuing revision of the guidelines more in terms of best practices than of a model designed for the harmonization of information and the comparison of data. The model could thereby be made more accessible to small and medium-sized enterprises, which still seem far from such reporting systems despite very often being quite well aware of the strategic cruciality and the importance of sustainable management.

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Original scientific paper
Received: February 13th, 2009

UDC 340.134(4-672EU)
ID 158245388

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THE MISSED CONSTITUTION: WHAT THE EUROPEAN CITIZEN HAS LOST

"Aber man wird nicht sagen:
Die Zaiten waren finster
Sondern: Warum haben ihre Dichter geschwiegen?"*

Bertolt Brecht

Abstract: *Fundamental values of the European legal system are presented in this article. The first part of the article gives a brief outline on the different European legal systems. The second part of the article analyses developments in the European legal systems that are caused by the overcoming of the pure "Limited Government". The Project of a Constitution for Europe is studied in the third part of the article. The following six parts of the article analyse particular legal issues as presented in the "European Constitution": the requalification of business and market; law and justice; the principles of proportionality, subsidiarity and conferral; the right to a good administration and the effectiveness of the EU justice-jurisdiction; the principle of precaution and the EU citizenship.*

Key words: *European legal system, European constitution, European citizen*
JEL classification: K10, K33, I31, H83

1. An outline of the different European legal systems

In order to make some juridical considerations on the project of the "European Constitution" (2003/C 169/01) we have to compare the different EU legal systems and, in particular, the Civil law and the Common law systems.

The first ones usually give a central position to the statute law as an effect of French revolution: in fact, in August 1789 the law, for the first time, freed people from the feudalism and we had the first Charter of Human and Citizen Rights. The National Assembly and the Parisian legislator, begun to mythicize the law; in fact

* However, one will not say: / Those times were dark / But: Why did their poets keep quiet?

the new law, or better, the new legislator had performed the miracle to set all men free and equal.

The State law will be used to define the Sovereign power, the executive power and at last that of Public Administration. This arrives because in Western Continental Europe the Public Administration assures the public interest through the power to which the citizen is submitted, but the laws provide suitable guarantees and protections generating a "Limited government".

In England, on the contrary, we have a tradition of juridical and jurisprudential rules that will be the external limit imposed by the Sovereign State. The Magna Charta Libertatum, swore on the 5th of June 1215 by John Lackland, even if it had an elitish nature (in fact it was the revenge of barons, clergy and upper middle class), is historically the first limit to the Sovereign power in the Anglo-Saxon system.

After many years from French revolution, we will have other Citizens' Charters and the "Parliament supremacy" will be definitively established thanks to the dynastic change, to the 1688 "glorious revolution" and to the 1689 Rights' declaration, that submitted the sovereign to the State-Parliament will, and that foreseen the control of the two Chambers over the government according to the principle that people (and its representatives) had the real sovereignty.

In Continental Europe, during the Magna Charta period, thanks to Italian city-states we have the birth of the "city economy", "the first example of the merchant capitalism". In fact, the state-cities aimed at obtaining the juridical and political recognition of their autonomy that came from a private association as, at the beginning, was the "commune"[1] and this was an important example of the feudal and imperial power limitation. But, this kind of sovereign power limitation is destined to become different from the Anglo-Saxon one, as in the European continent we will have the Absolute Government, emblematically theorized by Machiavelli as regards the political aspects and by Bodin as regards the juridical ones[2].

[1] But this movement was an elitish one: see R. VILLARI; *Mille anni di storia*, Roma-Bari 200 (52 ss): "the age of the Italian city-states is generally a period in which we have the assertion of a *democratic* political system. The sense of this definition is different from the today's sense. The city-state democracy substitutes the feudal bonds of dependence of the principle of association among equal individuals and of representation; so, in this way the government was exercised on behalf of the community and controlled by it. But not all the citizens have the right to be represented by legislative organisms and to participate, directly or indirectly to the government: normally a lot of citizens were not involved in the government of the City-state". But this did not avoid that the Assemblies, the Citizens' councils were the basis of the *popular* will during the consular regime and even during the regime of the podestà. In this way we did have the first kind of *democracy* where the podestà was the *expert between laws and politics*" (G. GALASSO, *Storia d'Europa, Antichità e Medioevo*, I, Roma-Bari, 1996, 292).

[2] In *Six livres de la République* (1576) where we have the relationship between sovereignty and laws, between absolute power and subjects' rights. Nevertheless, the law is only the "King command" and it is only "announced by the judges" (J. BODIN, *I sei libri dello Stato*, Vol. II, Turin, 1988, 174ss.)

So, in Europe, we have the comparison between the two legal systems of the western civilization: from one side the Anglo-Saxon system that is characterized by external limits imposed to the State, that, by then, are become a juridical tradition, from the other side, the continental Civil law systems in which it is the State that limits itself through its laws[3].

The first one is based on the traditions of freedom, equality, meant as equal dignity between Citizen and State, that is even the essence of a democratic society: the juridical instruments adopted in the relationship between Citizen and State are those of the laws (the Common Law administered by judges) that regulates the relations among citizens[4] which are guaranteed by the rule of law.

On the contrary, the continental system is traditionally characterized by the authority of the State and by its power, and only in the nineteenth century the citizen has conquered, thanks to the "limited Government", the right to exist when the power of the state is exercised in an unlawful way. But the juridical rules that regulate the relations between Citizen and State are different from those that regulate the relations among citizens, as the State has a supremacy position and it is regulated by Administrative law.

It's a long time that the "methodological rift"[5] between Common and Civil Law is getting narrower and the two systems are passing a deep revision phase. In the English law we have had some institutional reforms that have been influenced by the juridical positivism and we become to have a contraposition between public and private law[6], things that are completely extraneous to the Common Law tradition. In the continental law we become to have an equal dignity between citizens and public authorities, the administration uses more and more rules that belong to private relationship, in addition the "fair trial" is now ensured, even at the highest level of the jurisdiction.

2. From the pure "limited government" to the welfare state

Then, in the European legal systems we have developments that are caused by the overcoming of the pure "Limited Government". We have realized that the guarantee of freedom rights is no more sufficient, but it must become effective through a network of utilities that the State has to give to the citizen in order to free him at

[3] This difference is well explained by N. Picardi, "Il sistema giudiziario inglese tra continuità ed innovazione", in: *Il giusto processo civile*, 2007, 631 s.

[4] But it is even true that, recently, English *Common Law* has been strongly influenced by the *Civil Law* and this has sapped the foundations of the different structure of the British laws (U. MATTEI, *Common Law*, Torino, 1992, 118), and this is arrived even because of the England entry in the European Community, where we have mostly Countries with *Civil Law* systems.

[5] M. Rheinstein, *Common Law-Equity,* Enciclopedia del diritto, VII, 924

[6] U. Mattei, *Common Law,* cit., 117 s.

least of the basic necessities, so that, through the "Welfare State", the citizen can really become free.

The European Community gathers these needs under the principle of the "universal service": that is, all European citizens must have primary services at prices suitable for everybody. In fact, in order to identify from a juridical point of view the public service, the EU legal system inserts the concept of the universal service, according to which "some services must be used by consumers at an established qualitative level, apart from their geographical belonging, and, considering even the specific national circumstances, at a reasonable price", but on condition that this kind of service foresees an "universal service *obligation*"[7].

In fact, the obligations of public service identify from a juridical point of view the EU public service[8] giving it the juridical feature of the "Function" (activity which has a public interest)[9] and providing its effectiveness: offering the service at a reasonable price, with the requirements of continuity and quality[10], with the possibility of more specific additional obligations, with the juridical consequences as regards the resources (as we can easily understand from the Report of the European Council of Barcelona (15-16 March 2002), according to which the public service obligation corresponds to the "mission" and is lawful even if it can be interpreted as a Government aid[11]).

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7 See the "Green book on services of general economic interests" (Com/2003/0270), 3.1., even as regards some aspects of the universal service such as dynamism, flexibility and compatibility with the principle of subsidiarity, the consumer protection, and even the risks for the effectiveness ("there is the risk that these rights which are provided by EU laws are only at a theoretical level, even if they are acknowledged by national legislation").

8 The obligations imposed to an enterprise which is in charge of the service must be specified in an act of the Public Authority or in a contract signed with it; see the Relation of the European Council Commission of laeken (December 2001) on the "Services of general interests" (but even the Regulations 1191/69 and 1893/91 on the "obligations for the Public service", on the systems of obligations and offsets, on the necessity for a separated accounting, etc.).

9 Even if the same juridical means can pursue private interests and even public interests, the EU legal system provides for particular precautions as regards the cancellation of public service obligations (art. 14, par. 4 and 5, reg. 1893/91 and art. 4, Reg. 1191/96) because the interests are public. So, if we use the same juridical means, we could have a public function even when we have a private autonomy.

10 See again the Green Book, 3. As regards the rules for these specific fields, see G. V. JORDANA, *Il concetto di servizio universale nella normativa comunitaria,* in *Rass. Giur. Energia Elett.,* 1998, 63 ss. As regards the quality aspects, even for resources, see I. Sanderson, *Valutazione, apprendimento ed efficacia dei servizi pubblici,* in *Problemi di Amm. Pubbl.,* 1997, 517 ss.

11 But on condition that the aid will remunerate the supplementary costs caused by the enlargement of the enterprise work in the management of a service of general economic interest, and that this aid is necessary to let the enterprise respect the obligations coming from the management of a public service in case of economic equilibrium. See the following judgements: EU Court of Justice, 27 November 2003 (Judgement nr. C-34/01 and others); EU Court of Justice 24 July 2003 (Judgement C.280/00).

So, besides the Europe of the market and of the competition we must speak even of the Europe of the rights of freedom and equality, the Europe of the "universal service", the Europe of security and justice, the Europe of social protection and solidarity and thanks to all these things EU has begun its way towards the Treaty establishing a Constitution for Europe.

3. The project of a constitution for Europe: The Fundamental Rights

The project of the Treaty establishing a Constitution for Europe is a strong reinforcement of the European integration, mostly thanks to the Human and fundamental rights' Charter that has been included in the Constitution and that asserts the dignity of the citizen.

The insertion of these kind of rights within the fundamental rules of the Community legal system will bring even an increase of the guarantees for the citizen as these rights will not only be recognized and safeguarded by the Human rights' Court (the Court of Strasbourg) but even by the Luxembourg Court, by the Court of justice that, in this way, will ensure their fulfilment in the EU and even in all Member states[12].

Moreover, the influence of the jurisprudence of Strasbourg Court for Human rights has been extremely important to understand the European course. In fact, the Luxembourg Court of Justice has based its decisions considering the human rights as they were general principles of the EU law (drawing its inspiration from the constitutional traditions of the Member states)[13]. Without the part on human rights and on fundamental principles[14], the project of Constitution would be a pure collection of treaties and rules.

In fact, the Treaty for the Constitution strongly poses again the fundamental principles of the EU jurisdiction: the principle of jurisdiction, that of subsidiarity and that of proportionality, but mostly those principles which are considered as "European Union values": the respect of human dignity, freedom, democracy, equality and so on.

The fundamental rights guaranteed by the European Covenant to protect Human rights and fundamental freedoms are considered by the EU Law as "general principles" (article 7/I), but they are even a indispensible condition for the following adhesions to

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12 Y. Mény, *Tra utopia e realtà. Una Costituzione per l'Europa,* Firenze, 2000

13 See C. Zanghi', "Comunità europea", in: *Enciclopedia del diritto,* IV aggiornamento, Milano, 2000, and in particolar, 302 ss.

14 Moreover, the idea that the foundation of a juridical society must be the human rights ("that must be *politically* neutral"), the rights and the fundamental freedoms, pervades Europe from a long time; and they are followed by the "measures that ensure to all citizens the means to give real effectiveness to their use of freedom"(S. Veca, *Prefazione,* a I. Kant, *Per la pace perpetua* (1795), Milano, 1997, 34).

the treaty: only the European state that respects the principle of freedom and democracy and the fundamental freedoms can ask to join the EU.

Moreover, the European Union (the Council) can intervene to ascertain and to sanction a serious violation of the EU values, now foreseen in the article 2/I of the project of the constitution, among which, we have human rights and fundamental freedoms but even the permanency of the democracy. And the sanction can be even the suspension for the Member state of certain rights coming from the Constitution, even the voting rights (art. 58/I).

The conditions to join the EU are stated in this way, but even the conditions for which a state can remain in the EU with all its rights, so we can have a first juridical scenario for the future of the United Europe: the possible intervention on the real contents of the fundamental rights and even on the real contents of the democratic nature of each Member state[15]. If we connect it to the constant evolution of the democracy linked to the *values* of the democracy in itself, and even to the way to make laws, we can notice a progressive possibility that the EU can intervene to let respect human rights and fundamental freedoms, but even the substantive democracy. It's enough to remember the example for which the European law, as provided by art 3/I, 2° par., of the Project of Constitution, must be justified, so it becomes really a prescriptive act[16].

It is clear that with the European Constitution we will have important scenarios on the effectiveness of fundamental rights, on their contents and the obligations for the EU to ensure them, considering that, in this way, we will pose again the EU objectives through which the Union wants to offer to its citizens "a space of freedom, security and justice without internal borders", before offering an "internal market where competition is free and not forged".

The urgency to insert in the European Constitution principles, objectives, fundamental rights, values comes from the need to search new identities for law and democracy: first of all, the democracy cannot be a pure technique or method, but it must re-establish values, it must re-establish an ethic of the democracy[17]. This ethic will even force us to pay a renewed attention to enterprises and to the market.

15 In the EU we observe even the value of the local democracy: "the EU gives legitimacy to the Member states and to citizens", even as regards the real democratic relationship between the elected person and the voter that we must have not only in the EU but even inside the Member states (recommendation approved by the European Chamber of the local authorities, CPLRE, 113 (2002), and as regards the relations among citizens, local assemblies and executive organism when we speak of local democracy, Strasbourg 10.06.2002. A recommendation which has been discussed and approved by the Local Authorities' Chamber the % June 2002 and adopted by the permanent Commission of the Congress the 6 June 2002.

16 In Italy the legislation is a "function" (art. 70 of Italian Constitution), but the legislator must not justify the way in which it corresponds to the institutional duty to satisfy the public interest (a duty that belongs to the activity-function). If in Italy we would have the obligation to justify the juridical acts: such as laws and regulations we surely will have an evolution as regards the democracy.

17 R. Ruffilli, *Motivazioni etiche alle origini della democrazia moderna: il caso europeo continentale,* and E. Berti, *Momenti della rifondazione etica della democrazia,* in *Valori morali*

4. The requalification of business and market

Some times ago, Giuliano Amato pointed out the decay of a market where the top managements of the economic technocracies misuse in an abominable way the work inside their enterprises: the entrepreneurial organizations must have an ethic even as regards the reasonable economic difference between subordinates and high management[18].

From Adam Smith[19] to Amartya Sen[20] the need to know the limits of the capitalistic system goes through the ethic and the studies of the economic sociology are as necessary as the economics itself. An ethic that involves even the politics, if it is true, as stated by Adam Smith, that "the world of business corrupts the politics just as the politics corrupts the world of business".

Moreover, in Italy the history of democracy is characterized by the government intervention on economy, not only on state controlled enterprises, but mostly on public utilities, those utilities that the Giolitti Government started to offer to its citizens with prices that did not pay the real costs of their products. So we arrived to have a multi-class State in which the citizens were free from charges for basic services that, in that period, were unbearable.

So, we shift the reflection on the supportability of these services from the European citizens and, then, on the "universal service" in Europe that must be the complementary aspect of the competition and the market[21]. In short, capitalism against real democracy: what Colin Crouch calls post democracy (the declining phase of the democracy) but that is even said by other Authors[22].

The problem of values in connection with a scientific (and juridical) positivism that supports a science that is neutral as regards the values seen as paradigm of the rationality, still troubles the science and the legal systems. For example, to this idea we can clash the new lessons on J. Maritain on the value on the possible existence of the judgements of value, in contrast with Nietzsche and (partly) with Weber. If "the sleep of the reason produces monsters" we can even say that the calamity of the man is still that to believe to know (M. de Montaigne).

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e democrazia, edited by G. Galeazzi, Milano, 1986, and in particular, 37 e 114.

18 G. Amato, *Quei confusi confini fra etica e impresa,* La Repubblica, 27 ottobre 2003 (that is the Annual Report of Ucld of 17 October 2003).

19 We have to remember that Adam Smith has written *An Inquiry Into the Nature and Causes of the Wealth of Nations* but even the *the Theory of Modern sentiments* (translated in Italian in 1995) where the juridical system comes from the principles of the natural ethics.

20 A. Sen, *Globalizzazione e libertà,* Milano, 2002, 17 s.; *La democrazia degli altri,* Milano, 2004.

21 Otherwise, we could assert what J. Maritain says, that is "the tragedy of the modern democracies is that we are not still be able to realize a true democracy" *(La tragedia delle democrazie* –1943-, Roma, 1990 – pag. 35)

22 Charles Lindblom *(Politics and Markets)* and Kevin PHILLIS *(Wealth and Democracy).* the C. CROUCH thought can be read in *Postdemocrazia,* Roma-Bari, 2003.

5. Law and justice

The project of the Constitution faces even the problem of justice and we think that this question would need further specifications, even if any attributive that we can add to the word justice will play down its importance. Anyway, we are used to speak about the justice of judges, the social one, that of redistribution of incomes and solidarity, even among generations, and so on. Among the EU objectives we find the offer to the citizens of freedom and security, but even of justice (beginning from the Preamble of the Treaty and from the "Values of EU" in the article 2/I).

Even as regards this aspect, the insertion of the concept of human rights and fundamental freedoms in the Project of the Constitution increases the level of protection of rights and freedoms in the EU. On this matter, we have only to remind the rule (art. 54/II) on the prohibition of abuse of right that forbids any interpretation of the Fundamental Charter which aims at the destruction of any of the rights and freedoms recognised by this Charter or at their limitation to a greater extent than is provided for the Constitution.

So, as regards the prohibition of abuse of right we can have really interesting interpretative problems, as this rule becomes a hermeneutic rule through which we can even interpret the same right imputed by EU law.

Moreover, even the project of Constitution aims to insert some principles in the legal system; these principles correspond to the needs of justice, democracy and values, so they become part of the European legal systems. In this way, through these principles, we will have the introduction of a countertendency as regards the usual lack of evaluation in the law and as regard the really common phenomenon of the delegitimized organization, which is unglued from the objectives: the technocracies that prevalently are inclined to protect themselves[23].

In the same time the law has a particular complexity that is typical of the post-modernity[24], as it combines values and multi-disciplinarity that highlight new foundations and new needs for the law.

6. The principles of proportionality, subsidiarity and conferral

The principle of proportionality (art. 9/I, but even art. 54/II on the prohibition of abuse of right) clearly imposes itself in the EU legal system and is asserting itself even in the Member states legal systems.

[23] We can remember the considerations of J. K. Galbraith (*American Capitalism,* Boston, 1952) as regards the importance of the "techno-structure" of US System: the State is not only the upper middle class business committee, but "the business committee of the techno-structure" (J. K. Galbraith, *Il capitalismo americano,* Milano, 1978, Introduction of V. Valli).

[24] See J. Chevallier, *Vers un droit post-moderne? Les transformations de la régulation juiridique,* in *Revue du droit public,* 1998, 659

The content and the form of the EU action cannot go over the achievement of the objectives that the Constitution imposes to EU.

This principle is asserting itself even as a principle of no-invasiveness of the juridical and economic sphere of the private citizens from the Public authorities: the pursuit and the achievement of public interests cannot and must not be an unjustified detriment of the private interests. The action of the Public authorities in the public interest must be limited as it must not damage the rights and the interests of the private citizen more than it is necessary.

The principle of subsidiarity is clearly imposing itself beyond the EU legal system and becomes a principle even for all Member states' legal systems.

The subsidiarity asserts itself as a principle through which the citizen can choose the nearest institution that will take care of the interests of its community (the Italian commune can be considered the most ancient association of citizens in the continental Europe). Only the inadequacy of the local institutions allows and confirms the intervention of upper institutions: subsidiarity and adequacy guarantee a system that takes care in a democratic way of the public interest. Democratically means that we have citizens that legitimate with their votes their administrators and that the local administrators must have the power to ensure effectively the public interests of the communities that have voted them[25].

The European Union is even aware that this result cannot be reached without allowing citizens to participate freely to the care of interests that are higher then their particular sphere. So, the principle of subsidiarity evolves a a the principle that effectively enable the citizens to be involved in the general interests, or in the interests of their communities and then to take care of these interests together with the Public institutions[26].

These are principles that the Italian Constitution of 1948 already known, in fact in the art. 4, paragraph 2 it provided the duty for everybody to make, beyond his own job, an activity that can contribute to the development of the society. These are principles that are provided even in the new Italian constitution of 2001 and in particular in art. 118 of Title V, re-written by the constitutional law nr. 3 of 2001.

Moreover, the project of the European Constitution reaffirms the principle according to which the conferrals which are not expressly ascribed to the EU are ascribed to the Member states.

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[25] The European Charter on the Local Autonomy, voted by the Council of Europe in Strasbourg on 15 October 1985, begins with the "reflections" on the right for citizens to participate to the management of the Public affairs as a democratic basic principle which is realized completely at a local level and with the "awareness" that the "defence and the strengthening of the local autonomy in the Member countries is an important contribution to the construction of an Europe which is based on the principles of democracy and of powers' decentralization"

[26] In Italy we can remind the art. 2 of the law 3 August 1999, nr. 265 that for the first time speaks about this principle and in particular about the functions of the Municipalities and the provinces can be done even through the activities "that can be adequately carried out by the citizens and by their social associations" (we find this rule even in the paragraph 5 of the Local Authorities consolidated act: Leg. Decree 18 August 2000, nr. 267).

The principle of conferral has become a principle of reference to assign the competence between EU and Member states, but even inside the Member states, and between the Government and the Regions (or federal Governments). The residual (or general) conferral, even the legislative one, belongs to the confederate states and to the regions (now even in Italy after the 2001 Constitution), while the conferrals of the States are identified in details by the fundamental Charters (as provided by art. 117 of our Constitution).

After all, it is a corollary of the principle of subsidiarity that could be futile if the residual or general conferrals were at a European or a government level.

All these principles are developing even in the Member states' legal systems, as they are becoming internal principles of the member states and not only European ones.

7. The right to good administration and the effectiveness of the justice-jurisdiction

To this idea of osmosis between the internal legal system and that of the EU, we can add even the right to have a good administration (art. 41/II) that thanks to the EU Constitution would become an essential part for the European citizenship. The procedures through which EU "institutions", "bodies and offices" publicize their wills become a rule, and we can find it even in the member states' legal systems (in Italy is foreseen by art. 1 of the law on the administrative procedures n. 241 of 1990). And, there are even the rules that oblige the Public Authority to justify its acts and that on the compensation for each citizen if he is damaged by public authorities or by their subordinates.

So, the Constitution reproduces a tested system of justice in which we have to highlight the effectiveness[27]. The interpretations of the Treaties by the Court of Justice and those of the human and fundamental rights by the Court of the human rights are indispensable reference rules for the judges and for the administrations of all Member states[28].

[27] The EU law and its uniform interpretation are guaranteed by the principle of effectiveness. We can remember the judgements of the European Court of Justice: Kühne & Heitz of 2004 (on the obligation for the Public authority to deliberate again even if there was a judgment in the case of violation of community rules in order to protect itself), Köbler of 2003 and Traghetti del Mediterraneo SpA of 2006 (on the obligation for the judges to pay compensations to the citizen when a EU rule violation causes damages to him and when there is a damage for a citizen that has been caused by a judgment of a member state court of finale resort that violates the EU law)

[28] For example we can remind the Human Rights' Court guidance that, from 1986, with the Lithgow judgement, has inserted in the principle of legality the principle of proportionality, and even the Scordino Judgement of 2006 and in Italy the judgment of the Constitutional Court of 24 October 2007, nr. 348.

8. The principle of precaution

Then we have to pay a particular attention to the principle of precaution (art. 129/III). This principle has been foreseen for the environment, but the Court of Justice seems to give it a particular enlarged *vis*, so it has become a real principle, that is producing a real risk law.

Moreover, this is in line with the foundations of the EU that are reaffirmed in the project of the Constitution: one of the objectives of the EU is that to "offer its citizens an area of freedom, security and justice…" (art. 3/I); we read in the preamble of the part II of the constitution that the Union places the individual at the heart of its activities, and so on.

Consequently every time there is a doubt if the outcomes of the scientific and/or technological development can have a risk for the people, the principle of precaution establishes that the human and the environmental protection must prevail: the cultivation or the commerce must be stopped, we have to do everything is necessary to protect the human being[29].

It is a principle that is already consolidated in Europe even because of its ethical aspects. We can remind the example of the Genetically Modified Organisms (or even Micro-organisms). The respect of the ethical aspects is considered "particularly important" when these principles are acknowledged in a Member state (nine "statement" of the Directive 2001/18/CE of the European Parliament or of the Council of 12.03.2001), whenever these GMO are deliberately traded.

Moreover, the nine "statement" of the Directive of 2001 on MGO foresees that the citizen must be listened by the Commission or by Member states during the formulations of the "measures" and that he must even be informed on the "measures" adopted during the fulfilment of this directive (tenth statement). The ethical aspects are foreseen even in the "statement" 57 in order to underline the jurisdiction of the member states on the ethical matters even when the European Group of the Commission for ethic in sciences and new technologies has been consulted (this can arrive even upon request of a Member state, art. 29 of the Directive of 2001), in order to obtain an advice on the general ethical problems as regards the wilful issue or sale of MGO[30].

[29] The EU law clears up the superiority of the right to health, to security to environment on the economic interests (See, for example, the judgment of the EC Trial Court of 26 November 2002, nr. 74).

[30] On the EU rules on GMO see *Gli organismi geneticamente modificati. Sicurezza alimentare e tutela dell'ambiente,* edited by Rosario Ferrara and Ignazio Maria Marino, Padova, 2003

9. The EU citizenship

In this way we can hope that in the EU law we will have, even through the Constitution, the union between the social and the individual values, as the lack of this union has brought fractures in the individual and in the social rights.

We can identify this first union when we deal with the evolution of the right as regards the right to be well cured. The Project of the Constitution confirms that the freedom of the enterprises, as provided by the EU Law and by National laws, must always respect an "high level of human health protection" (art. 35/I) and a "high level of environmental protection and improvement of its quality" that "must be part of the Union policies and must be guaranteed by the principle of the sustainable development" (art. 37/II).

We can identify the second union when we deal with the concept of citizenship. In fact in this concept there are many unitary aspects and pluralistic needs, individualism and solidarity, human rights and fundamental freedom, and so on.

Moreover, the citizenship has made rapid progresses from the Council of Dublin in 1984, in which we have had the recognition of the political and social rights to the EU citizens, up to the Maastricht (1992) and Amsterdam (1997) Agreements, with the articles (from 17 up to 22) of the Treaty of the Community on the EU citizenship, and with the Charter of the EU fundamental rights of Nice (December 2000).

If we consider that at the beginning we were concerned about the sovereignty of the State and about the few attention that was given to the popular sovereignty, the evolution we've had till now in the EU legal system is almost astonishing. In the EU, thanks to subsidiarity and proportionality principles, we have had an important growth towards the popular sovereignty in order to ensure to Member states principles, information, effectiveness of the rights and of the justice (even as regards the time of the judgements), guarantees of democracy. We can even say that the Project of the Constitution has the same trend. The relapse on the Member states has been really efficacious and in order to confirm it we can remember our constitutional modification of 2001 (art. 118 – the principle of subsidiarity). So, we can foreseen that with the European Constitution the incisiveness of the European legal system will grow more and more, mostly in favour of the European citizen.

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Scientific review paper
Received: March 5th, 2009

UDC 339.92(4-672EU:497.11); 341.217.02(4-672EU:497.11)
ID 158246156

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EU–SERBIA RELATIONS

Abstract: *This article considers the architecture of relations between the European Union and Serbia in the light of The Stabilization and Association Agreement. It examines the normative foundations of the established system of institutional interaction between the Parties and analyses the outline of the relations in major fields.*

Key words: *EU enlargement, Stabilization and Association Agreement, Serbia*
JEL classification: F15, K33

1. Introduction

Over the last years, the European Union's role in the western Balkan arena has become stronger. A short historical overview sheds light on the relations between EU and these countries. Afterwards, as regards the difficult situation in ex-Yugoslavia (1991), the EU has showed an increasing and expanding presence. Since then, the relations with these countries have significantly developed and they are considered as part of Europe. Consequently, their expectations towards cooperation with EU are rising and new contractual relationships are devised and are called the Stabilization and Association Agreement (SAA). These agreements become a part of the Stabilization and Association process (Sap), which offers a prospect for EU membership to all western Balkans countries[1]. In addition, the EU grants special trade advantages to these countries: goods from that region have full and free access to the European market and even a support for preparing countries to SAA (i.e. reconstruction of destroyed cities, return of refugees and reconciliation of ethnicities) [2].

[1] The EU and western Balkans countries formally agreed the SAp on 24 November 2000, in Zagreb. See, in particular, J. Becker, *The European Union and the Western Balkans*, in *South East Europe Review*, 2008, p. 7 ff.; V. Gligorov, *European Partnership with Balkans*, in *Monthly Report-The Vienna Institute*, 2004, p. 8 ff.; F. Petiteville, *Exporting "Values"? EU External Co-operation as a "Soft Diplomacy"*, in *Understanding the European Union's External Relations* (Edited by M. Knodt, S. Princen), 2003, p. 127 ff.; W. Tiede, *Croatia and Serbia on their Road to EU Accession: Halfway there?*, in *South East Europe Review*, 2007, p. 7 ff.

[2] See: D. Fink-Hafner, *Europeanization and Party System Mechanics: Comparing Croatia, Serbia and Montenegro*, in *Europeanization and Party Politics in the Territory of Former Yugoslavia*

The SAA are negotiated separately, on the basis of Article 310 of the Treaty on European Union, with each country. It provides for the gradual adoption of the *acquis communautarie* and for the expansion of the four freedoms of Treaty on European Union to the contracting parties.

By Regulation 1085/2006 (17 July 2006) the European institutions establish an Instrument for Pre-accession Assistance (IPA) which renews the framework for financial assistance to pre-accession countries[3].

Nevertheless, the relations don't develop smoothly. In fact, any State must fulfil a certain set of criteria before it can join EU. Article 49 of the Treaty on European Union explicitly states "Any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union". According to Article 6, paragraph 1, the values of democracy, the rule of law, the respect for human and minority rights, solidarity and a market economy, constitute the very foundations of the European Union.

It must be noticed in general that as the EU enlarges further, there is a need for consistent and uniform standards of internal and external protection of human rights. In the context of the democratisation process in the Central and Eastern European countries and dissolution of the Soviet Union, the European institutions initiated a "minority talk" and in the light of ethnic conflicts in these countries, the EU membership requires the respect and protection of minorities. Yet, protection of minorities in single Member States largely depends on states' political will; therefore, a strategy is needed, not to create a new layer of rules on the EU level but to influence the implementation performance of existing rules, because they are complete and homogeneous.

In this outline, Serbia may be considered as one of the most difficult cases in the EU enlargement process during the last two decades[4]. It is important to remember that Serbia is also included in the Sap and that in 2004 the EU con-

(Edited by D. Fink-Hafner and R. Ladrech), *Journal of Southern Europe and the Balkans*, 2008, p.167 ff.; P. G. Lewis, *Changes in the Party Politics of the New EU Member States in Central Europe: Patterns of Europeanization and Democratization*, *ibidem*, p.151 ff.; S. Orlović, *Parties and the Party System of Serbia and European Integrations*, ibidem, p. 205 ff.

[3] The strategic planning of assistance under the Instrument for Pre-Accession Assistance (IPA) for the period 2007-2009 amounts in € 3,961 billion. For Albania, Bosnia and Herzegovina, Montenegro and Serbia (572,4 million €), assistance will focus on improving governance and the rule of law, supporting economic and social development and helping these countries adopt laws in line with those of the EU and building their capacity to make the laws work out on the ground. In Kosovo, EU assistance will support the implementation of the future status settlement provisions and will focus particularly on the development of a stable, modern, democratic and multi-ethnic society based on the respect of the rule of law. It will foster Kosovo's social and economic development for the benefit of all communities.

[4] See: K. Friis, *The Referendum in Montenegro: the EU's "Postmodern Diplomacy"* in *European Foreign Affairs Review*, 2007, p. 67 ff.; M. Knodt, S. Princen, *European External Relations Fields-The Multi-Pillar Issue of Economic Sanctions against Serbia*, in *Understanding the European Union's External Relations* (Edited by M. Knodt, S. Princen), 2003, p. 92 ff.; J.

cluded a European Partnership with Serbia and Montenegro[5], which was reaffirmed in 2006. After Montenegro declared its independence on June 3, 2006[6], Serbia declared itself the independent sovereign successor to the Union of Serbia and Montenegro on June 5, 2006. Since that time the EU continued its relationship with both country separately[7].

On April 28, 2008, a SAA and an Interim Agreement with Serbia has been signed. Yet, from that moment the relations have been developing slowly, because Serbian authorities were not cooperating sufficiently with the International Criminal Tribunal for the former Yugoslavia (ICTY). In fact, articles 2, 4 and 133 of the SAA and articles 1 and 54 of the Interim Agreement require full collaboration with the ICTY, including all possible efforts to arrest and transfer suspects. Thus, the Council and the Commission regularly monitor that Serbia continues this cooperation and the EU and its Member States assist Serbia in this respect[8]. Finally, an important step on path to EU accession has been made, on September 9, 2008, when Serbian Parliament ratified the SAA[9]. The agreement now awaits ratification by all 27 EU-member States, but Netherlands and Belgium indicated that they might block EU efforts to speed up Serbia's accession until Belgrade will demonstrate full cooperation with the ICTY[10] .

This article considers the architecture of relations between the EU and Serbia in the light of SAA. It examines the normative foundations of the established system of institutional interaction between the Parties and analyses the outline of the relations in major fields.

Minić, *Reforms, Democratization and European Integration of Serbia*, in *International Issues & Slovak Foreign Policy Affairs*, 2007, p. 75 ff.

5 Communication from the Commission on the preparedness of Serbia and Montenegro to negotiate a Stabilization and Association Agreement with the European Union, COM, 2005, 476 final

6 See: A. Elbasani, *EU Enlargement in the Western Balkans: Strategies of Borrowing and Inventing*, in *Journal of Southern Europe and the Balkans,* 2008, p. 293 ff.; C. Rault, R. Sova, A.M. Sova, *The Role of Association Agreements within European Union Enlargement to Central and Eastern European Countries,* in *Aussenwirtschaft,* 2008, p. 309 ff.; Z. Vujović, O. Komar, *Impact of the Europeanization Process on the Transformation of the Party System of Montenegro*, in *Journal of Southern Europe and the Balkans,* 2008, p. 223 ff.

7 Communication from the Commission to the European Parliament and he Council, Enlargement Strategy and Main Challenges 2006-2007 including annexed special report on the EU's capacity to integrate new members, COM, 2006, p. 649.

8 On this point see: P. Dragisic, *Serbia and the European Union: a View from Brussels*, in *L'Europe en formation*, 2008, p. 147 ff.; A.Wieser, V. Dzihic, *The Crisis of Expectations - Europeanisation as "acquis démocratique" and its Limits. The Case of Bosnia-Herzegovina and Serbia*, ibidem, p. 81 ff

9 The Balkan nation hopes to achieve membership in the 27-nation bloc by 2014.

10 See: E. Abazi, *A New Power Play in the Balkans: Kosovo's Independence*, in *Insight Turkey,* 2008, p. 67 ff.; S. Orlović, *Parties and the Party System of Serbia and European Integrations*, in *Journal of Southern Europe and the Balkans,* 2008, p. 205 ff.

2. The stabilization and association agreement: principles and institutional aspects

The worth of the SAA is double: it has put an end to a period of uncertainty around the future developments of the process of Serbia's integration and, as far as it matters, it has sufficiently prepared a coherent picture for the creation of an area stabilized by the political point of view (*stabilization*) and fully integrated with the EU through an area of free exchange (*association*). The objective expressly declared is to help Serbia in the attainment of the partner economic standards with those of the EU[11]. In fact, the SAA confirms rules and principles of the Treaty on European Union, firstly necessary for the establishment of the free area and, then, to join EU.

It consists of a Preamble and ten Titles[12]: (I) General Principles, (II) Political Dialogue, (III) Regional Cooperation, (IV) Free Movement of Goods, (V) Movement of Workers, Establishment, Supply of Service, Capital, (VI) Approximation of Laws, Law Enforcement and Competition Rules, (VII) Justice Freedom and Security, (VIII) Cooperation Policies, (IX) Financial Cooperation, and (X) Institutional, General and Final Provisions.

The Agreement starts by noting the strong links and the importance of the SAA for the stability within South-Eastern Europe. Then it sets out various principles and objectives to which the Parties are committed. These include democracy, development of civil society, political and economic freedoms, free market economy, fight against organised crime and terrorism[13].

Afterwards, the SAA begins with the formal establishment of an Association between the Community and its Member States and the Republic of Serbia and, subsequently, its aims are spelt out in Article 1, paragraph 2[14].

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11 D. Phinnemore, *Stabilization and Association Agreement: Europe Agreements for the Western Balkans?*, in *European Foreign Affairs Review*, 2003, p. 77 ff.

12 http://www.europa.org.yu/code/navigate.php?Id=398

13 "There are certainly strong *prima facie* reasons for suggesting that European integration and democratization are processes that are likely to advance together so far as Central Europe is concerned. Firstly, the extension and consolidation of existing levels of democratic development were a primary leitmotiv in the whole enlargement process. Secondly, evidence from Eurobarometer surveys has consistently shown that Central Europeans do not rate levels of national democratic achievement at all highly and are significantly more impressed by the democratic credentials of the EU. This pattern is, thirdly, the inverse of that seen in the established EU member states, where grater satisfaction is seen with national levels of democratic operation, so this sense a linkage may be anticipated in terms of democratization and continuing Europeanization": P.G. Lewis, *Changes in the Party Politics of the New EU Member States in Central Europe: Patterns of Europeanization and Democratization,* in *Journal of Southern Europe and the Balkans,* 2008, p. 151 ff.

14 Article 1, paragraph 2, declares: The aims of this Association are: (a) to support the efforts of Serbia to strengthen democracy and the rule of law; (b) to contribute to political, economic and institutional stability in Serbia, as well as to the stabilisation of the region; (c)

The emphasis on the SAA contributing to respect for human rights is well reflected in the general principles. These confirm the protection as proclaimed in the Universal Declaration of Human Rights and as defined in the Convention for the Protection of Human Rights and Fundamental Freedoms, in the Helsinki Final Act and the Charter of Paris for a New Europe. Moreover, respect of international law, development of good neighbourly relations, countering the proliferation of weapons of mass destruction and regional cooperation are considered really important assumptions.

Having expressed the general principles of the association being established, the SAA sets out the purpose and mechanisms for political dialogue. Significantly, political dialogue promotes "full integration of Serbia into the community of democratic nations and gradual rapprochement with the European Union" (Article 10, paragraph 2).

The importance of regional cooperation is evident in the mechanisms for political dialogue[15]: here, the SAA explicitly refers to regional cooperation and good neighbourly relations. This is reinforced – in line with exiting EU policy to the region – by the reference to the Community assistance programmes may support projects having a regional or cross-border dimension through its technical assistance programmes.

On the other hand, Serbia must work in this direction too; it "shall start negotiations with the countries which have already signed a Stabilisation and Association Agreement with a view to concluding bilateral conventions on regional cooperation, the aim of which shall be to enhance the scope of cooperation between the countries concerned" (Article 15). This can be said also in respect of negotiations that Serbia shall start with Turkey, which the central element is a free trade area establishing in accordance with Article XXIV of the GATT. It is obvious that such cooperation shall be compatible with the principles and objectives of the SAA.

Moreover, the EU is prescriptive with regard to the content of the required conventions[16] and Serbia is obliged to engage in regional cooperation with other

to provide an appropriate framework for political dialogue, allowing the development of close political relations between the Parties; (d) to support the efforts of Serbia to develop its economic and international cooperation, including through the approximation of its legislation to that of the Community; (e) to support the efforts of Serbia to complete the transition into a functioning market economy; (f) to promote harmonious economic relations and gradually develop a free trade area between the Community and Serbia; (g) to foster regional cooperation in all the fields covered by this Agreement.

15 See: P. Blass, *Regional Parliamentary Cooperation and Ownership*, in *The Balkan Prism*, edited by J. Deimed and W. van Meurs, Munich, Verlag Otto Sanger, 2007, p. 307 ff; A. Rotta, *Promoting Regional Cooperation: the EU in South Eastern Europe*, in *The International Spectator,* 2008, p. 57 ff.

16 In according to the Article 15: The main elements of these conventions shall be: (a) political dialogue; (b) the establishment of free trade areas, consistent with relevant WTO provisions; (c) mutual concessions concerning the movement of workers, establishment, supply of services, current payments and movement of capital as well as other policies related

countries, which have already signed a SAA. It may also foster cooperation with countries involved in the EU Stabilization and Association Process and, finally, with candidate countries for EU membership.

In order to implement these aims, precise powers and attributions have been identified and established by the interaction of several institutions[17]. First of all, the Stabilization and Association Council that shall supervise the application and implementation of the SAA and shall meet at an appropriate level at regular intervals and when circumstances require to examine any major issues arising within the framework of this Agreement and any other bilateral or international issues of mutual interest. According to Article 120, the Council is composed of the members of the Council of the European Union and members of the European Commission, on the one hand, and the members of the Government of Serbia, on the other. It shall be chaired in turn by a representative of Serbia and a representative of the Community, implying that the Commission could assume the role. While this may be welcomed by supports of a more coordinated and consistent EC position in relations with associates, it does reduce the political impetus, which might derive from EU Member State chairing meetings.

The Stabilization and Association Council plays a relevant role in the political dialogue. Various points must be emphasized of this interchange: full integration of Serbia into the community of democratic nations; convergence of on international issues, including Common Foreign and Security Policy issues[18]; cooperation with neighbours; common views on security and stability in Europe. Therefore, within the Stabilization and Association Council, the involved Parties can work on different areas to adopt specific strategies and measures preparing partners for gradually obtaining a stake in the EU Internal Market and, overall, to create absolute legal certainty.

Additionally, a Stabilization and Association Committee, having the same composition, assist the Council. It may create subcommittees, especially for the migration issues.

If we also consider the other special committees and bodies that can assist the Stabilization and Association Council in carrying out its duties and the Stabilization and Association Parliamentary Committee – a forum for Members of the Parliament of Serbia and of the European Parliament to meet and exchange views – the institutional mechanism appears complete.

In essence, these joint bodies are destined to assure the correct management of the agreement and a framework of consultation among the Parties.

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to movement of persons at an equivalent level to that of this Agreement; (d) provisions on cooperation in other fields whether or not covered by this Agreement, and notably the field of Justice, Freedom and Security.

17 See the Articles 119-125, Title X, of the SAA.

18 That is primarily because western Balkans is often the object of Common Foreign and Security Policy discussions.

One must also remember that, in the case of dispute between the Parties, the Stabilization and Association Council settles it by binding decision. In the light of Protocol 7, in order to arrive at mutually acceptable solutions, the disputes may be referred to an arbitration panel.

3. Subject matter of agreement

Of particular interest for the purposes of the present paper is a in-depth analysis of the fourth Title of the SAA since its provisions set out a timetable for the establishment of the free trade area. It is scheduled to be completed within six years from the entry into force of the Agreement.

To this end, customs duties and charges "having equivalent effect to customs duties include any duty or charge of any kind imposed in connection with the importation or exportation of a good, including any form of surtax or surcharge in connection with such importation or exportation". Thus, Article 18 that the effect deriving from the abolition of the customs duties can be limited through the imposition of tax that, although answering to several denominations and the most various techniques of imposition, they had the same effects of customs duties: to increase the cost of the imported (or exported) goods and to render them less favourable regarding the national goods that do not cross the frontier. To the same end, both Parties provide that quantitative restriction and measures having equivalent effect shall be abolished[19].

Nevertheless, the free trade area is restricted to industrial goods with special arrangements, applying to agricultural and fishery products, wine and spirit drinks (see too Annexe 1, 3-5). And, if the importation of products originating in one party causes serious disturbance to the markets or to their domestic regulatory mechanisms, both Parties shall immediately enter into consultations to find an appropriate solution.

Besides new customs duties or charges having equivalent effect, new quantitative restriction or measures having equivalent effect cannot be introduced from the date of entry into force the Agreement. Finally, any measures or practice of an internal fiscal nature shall refrain from imposing new measure and abolish the existing one; as well as Serbia shall progressively adjust any state monopolies of commercial character.

With regard to movement of workers, establishment and supply of service the key principle is non-discriminatory treatment based on nationality and the coordination of social security system. The discipline concerns all the activities, independ-

[19] As a matter of fact, it is clearly evident, for instance, with regard to the free movement of goods and services sought to be realised that different national legal conceptions as to permissible and non-permissible commercial activity substantially threaten a uniform internal market.

ently from their nature (subordinated or less) and from the established or occasional character of their exercise and it also involves the spouse and the children.

Although, the liberalization of supply is progressively allowed, according to Article 59, "the Parties shall permit the temporary movement of natural person providing the service or who are employed by the service provider". Hence, any measures or actions shall not be taken by the Parties, which render the conditions for the supply of services more restrictive as compared to the situation existing on the day preceding the date of entry into force of the Agreement.

Furthermore, the provisions in the SAA are clearly meant to ensure the free movement of capital relating: to direct investments made in companies formed in accordance with the laws of the host country; to credits related to commercial transactions or to the provision of service in which a resident of one of the Parties is participating, and to financial loans and credits. In addition, Serbia shall authorise, by making full and expedient use of its existing procedures, the acquisition of real estate.

For the importance that competition rules have in the process of integration, the SAA expressly provides the obligation for Serbia to eliminate the existing divergence between national and EU legislation, whereas such difference hampers the application of the agreement and, in general, the functioning of the market. In other words, the harmonization of the legislations in the field of competition is considered an essential step in sight of the amplest objective of the approximation of the political antitrust and, therefore, to join EU.

The SAA endorses the adoption of national rules analogous to those in force in EU, as well as the transposition of the *acquis communautaire*. In fact, according to Article 72, the agreement comprise the approximation of Serbian and Community laws to the extent required for the functioning of the market because different regulations constitute a prime obstacle to market access.

Among the specific provisions a central position is occupied by the prohibitions of all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Parties and which have as their object or effect the prevention, restriction or distortion of competition.

Besides it is held incompatible with the good functioning market any abuse by one or more undertakings of a dominant position in the Community or Serbian territories as a whole or in a substantial part; as well as any measure or State aid which distorts or threatens to distort competition by favouring certain undertakings or certain products.

The rules on the protection and enforcement of intellectual, industrial and commercial property rights and those on the opening-up of the award of public contracts on the basis of non-discrimination and reciprocity, following the WTO rules, have reinforced this approach.

Although the protection of free competition is not isolated in comparison to other values altogether expressed by the considered agreement, it is set entirely

rather in a complementary position in comparison to them. The competent Serbian authorities and the Commission may be cooperating and exchanging significant information in this field[20].

The SAA also includes a contribution to the strengthening of consumer protection. This is reflected in the fact that a high level of consumer protection is to be taken as a base for the Article 78: "The Parties shall cooperate in order to align the standards of consumer protection in Serbia to those of the Community. Effective consumer protection is necessary in order to ensure the proper functioning of the market economy, and this protection will depend on the development of an administrative infrastructure in order to ensure market surveillance and law enforcement in this field".

There are, then, several areas in which the agreement promotes cooperation. These are spread across Title VII dedicated to Justice, Freedom and Security, Title VIII entitled Cooperation Policies and Title IX on Financial cooperation. In the named areas, the Parties establish close cooperation aimed at contributing to the development and potential growth of the associate and strengthening existing economic links on the widest possible foundation. As in the EU, prominence is given to ensuring that environmental considerations are taken into account in all policies and measures.

As for the remainder of the agreement, the provisions – governing the fulfilment of obligations, duration, application, deposit, definitions, languages, ratification and an interim agreement – are simple and don't raise problems. Finally, the SAA do, however, contain an extra provision committing the Parties to consult promptly to discuss matters concerning the interpretation and implementation of the agreement and other relevant aspects of relations.

4. Conclusion

It is clear that there are almost two reasons why the SAA should enter into force and Serbia should enter into the accession phase: firstly, the need to help consolidating the international and regional positions of the Republic of Serbia. Secondly, it is important not to loose sight of the interfaces between the various components of the enhanced administrative capacities and to maintain the standards of the EU financial and technical assistance at the same level with other potential candidates in the western Balkans.

[20] It is important take into account that on 28 November 2008 the two Parties have signed the Memorandum of Understanding formalising Serbia's entry in the EU Entrepreneurship and Innovation Programme (EIP). Part of the EU Competitiveness and Innovation Framework Programme (CIP), the EIP, promotes innovation, entrepreneurship and growth in small and medium-sized enterprises (SMEs). Serbia is the sixth country of the group of candidate and potential candidate countries to join the EIP following Croatia, the former Yugoslav Republic of Macedonia in 2007, and Turkey, Montenegro and Albania earlier in 2008.

Serbia has become an inspiring precedent showing that the perspective of membership is a reality, the fuzzy commitment has often been perceived as a lingering journey of neither total exclusion nor rapid inclusion. However, having in mind that the membership is conditioned by the cooperation with The Hague Tribunal and that in other fields a sufficient level of cooperation for signing the agreement is achieved, the elapse of time can increase the list of conditions and further impede progress in relations with the EU. In the circumstances of widespread support for EU membership, it is in the interest of Parties not to run against the stream, but in harmony with the prevailing climate of thought.

If this is true, and we believe so, the next step depends just on the commitments of the Parties embodied in the agreement, mostly because in the implementation of the agreement it is necessary that Serbia's peculiarities are taken in account.

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Scientific review paper
Received: March 13th, 2009

UDK 342.9(4-672EU:450)
ID 158246924

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PUBLIC ADMINISTRATION IN THE RISK SOCIETY*

Abstract: *The principle of precaution is the basic principle of the action of public powers in cases of scientific uncertainty. The essay analyses the constituent features of the precautionary principle, and wants to underline its "procedural" character. This "procedural" character is strictly linked with the concept of "reflexive" administration. The research has been done through the analysis of the Community law of European Union. Moreover, inside the "Administrative Community law", an attempt is made to point out the main relapses of the European Administrative law on the Italian Administrative law system.*

Key words: *risk society, "reflexive" administration, EU Community law*
JEL classification: H83, K33

1. The risks from "scientific uncertainty"

The theorization of the "risk society" is based on the relationship firm - concurrence- market - production of risks for the health and for the environment, shifting the attention from the choice of the firm to the creation of "social situation of exposure to risks"[1]. To the enterprise risk, in which comes into play the techno-economical choice[2], is correlated, in an indissoluble way, the unaware exposure to new risks, accidentally assumed by citizens and consumers[3].

* This essay revises some methodological aspects and topics of I.M. Marino and A. Barone work on *The precautionary principle and the "reflexive" Administration*, European Group of Public Administration Conference, Milan 2006.

1 See U. Beck, *Risikogesellshaft. Auf dem Wegin eine andere Moderne*, Franfkfurt 1986

2 U. Beck, *From Industrial Society to the Risk Society: Questions of Survival, Social structure and Ecological Enlightment*, in M. Featherstone (e.b.), *Cultural Theory and Cultural Change*, London 1992, 98, underlines as "risk presume industrial, that is, techno-economic decisions and considerations of utility".

3 Beck does not make a net distinction of the concepts of "danger" and of "risk", as is made by other important sociological scholars: N. Luhmann, *Soziologie des Risikos*, Berlin 1991. Even the juridical doctrine has a particular attention to the distinction between risk and

These risks, often called "glocals" and "from technological unknown", concern men, animals, plants, health and even the status and the equilibrium of the environment, setting aside the sole borders of the State but in the same time they often show local relapses[4]. Moreover they are risks of modernization, produced by an industrial system, which is strongly based on the applied scientific research[5].

Science tends to loose its autonomy, confounding with technique[6], and in the meantime fails in giving "certainties" on the way to face and to neutralize the risks caused by itself (more or less directly)[7]. This means that the ways to calculate risks, as they are till now determined by science and by legal systems, collapse[8]. The risk of incident, in the modern complex techno-industrial systems, cannot only be eliminated but even can become "normal"[9].

Air and electromagnetic pollution, water safeguard, waste management, industrial activities with relevant risks, Genetically Modified Organisms, and Genetically Modified Micro-Organisms, food safeguard, drugs for human use, are only some hypothesis which illustrate the nowadays contrasts between the demands of economic production and the need to guarantee safety and freedom of individuals and communities[10].

danger, even if with not always converging reasons: J. Esteve Pardo, *Privileged Domain in risk treatment: Risk and Health*, in Revue Europeenne de Droit Public, Vol. 15, n. 1, 2003, 110; M. Brenner, A. Nehrig, *Public Law and Risk in Germany*, in Revue Europeenne de Droit Public, Vol. 15, n. 1, 2003, 306-309; M. Brenner, *The risk in Administrative Law*, Annual Meeting of the "San Giustino" Association, European Research Doctorate in Administrative Law, Catania 24/6/2005. In the awareness of the plurality of distinctions between risk and danger, in this essay the two terms are sometimes used as synonyms.

4 On the relation between the global dimension and the local one, see R. Robertson, *Globalization: Social Theory and Global Culture*, Sage, London, 1992

5 M. Cini, *Un paradiso perduto. Dall'universo delle leggi naturali al mondo dei processi evolutivi*, Milano 1994, 265. For a juridical consideration see F. Salvia, *Considerazioni su tecnica e interessi*, in Diritto Pubblico, 2002, 603-605.

Moreover, the risks from scientific uncertainty can even concern the economic freedom practices. The economic freedom, in fact, is not exclusively characterized by a "positive" freedom (freedom "of"), but has even some typical aspects of the "negative" freedoms and so, of the freedoms "from". For example, the freedom to make biological or conventional agriculture foresees even the freedom to make transgenic agriculture (GMO) that can contaminate and destroy the characteristics of the biological or conventional cultivations.

6 S. Amsterdamski, Scienza, in Enciclopedia Einaudi, Vol. 12, Torino, 1981, 550-551; M. Cini, *Un paradiso perduto*, 265.

7 F. Fukuyama, *Our Posthuman Future*, 2002.

8 On these aspects see P.L. Bernstein, *Plus forts que les Dieux – La remarquable histoire du risque*, Flammarion, 1998.

9 Perrow, *Normal Accidents*, Princeton, 1993.

10 Some examples of the wide varieties of the examined phenomena can come from the following works: C. Hood, H. Rothstein, R. Baldwin, *The Government of risk. Understanding Risk Regulation Regimes*, Oxford 2001; AA.VV., *Lessons from early warnings: the precautionary principle 1896-2000*, Environmental issue report no. 22, European Environmental

In this context, the European juridical doctrine begins to analyse the new dangers for society, putting beside the traditional reflection on the risks linked to natural phenomena (for example, seismic risk) or characterized by their willingly taking (contractual risk, enterprise risk), the study of the risks which even come from the market system: risks unwillingly taken by man and by the citizen-consumer[11].

The principle of precaution is the basic principle of the action of public powers in cases of scientific uncertainty[12]. The essay analyses the constituent features

Agency, Copenhagen 2001; D. Lupton, *Risk*, London 1999. It is still true that they are risks for human health and for the environment, that are added to other risks which are typical of the contemporary era. The "globalizated" economy, in fact, suffers "financialization" processes, redrawing itself as a great zone of transfer of risks, if it is true that "the main aspect of finance is the management of risk": see R.J Shiller, *The new financial order*, Princeton 2003; I.M. Marino, *Diritto amministrativo e globalizzazione*, in Diritto dell'Economia, 2005, 25 et seq.

[11] The Revue Europeenne de Droit Public devoted its Vol. 15, n. 1, 2003, to the theme Droit Publique e risque, with sages of M. Franc, H.H. Trute, J. Esteve Pardo, G. Sioutis, A. Bianchi, J.B. Auby, M. Stelzer, A. Hauer-C. Raschhofer, C. Thiebaut, M. Gøtze-J.E. Rytter, P. Gonod, M. Brenner-A. Nehrig, C.A. Pétrou, T.J. O'Dowd, A. Travi, T. Zwart-F. Goudappel, C. Amdo Gomes-A.M. Guerra Martins, L. Moral Soriano, G. Edelstam, G. Anthony, G. Dellis, E. Fisher. The 2005 "Rapport public" of the French Conseil d'État is entitled "Responsabilité et socialisation du risque"; it also contains the notes of J.B. Auby, F. Ewald, D. Fairgrieve, O. Godard (http://www.conseil-etat.fr/ce/rappor/index_ra_li0502.shtml). For the Italian juridical doctrine, see R. Ferrara, I.M. Marino, *Gli organismi geneticamente modificati. Sicurezza alimentare e tutela dell'ambiente*, Padova 2003; A. Barone, *Il diritto del rischio*, II ed., Milano 2006; F. De Leonardis, *Il principio di precauzione nell'amministrazione di rischio*, Milano 2005; A. Fioritto, *L'amministrazione dell'emergenza tra autorità e garanzie*, Bologna, 2008.

Face of the "recent" interest of the European juridical doctrine on the theme of the risk from technological unknown, the US legal system has been one of the first systems to consider the consequences of the economic development. From years '60 of the last century, when the industrial capitalism has become ripe, the North American experience has been characterized by the adoption of original and innovatory solutions as far as security, public health and environment are concerned. On these aspects see D. Vogel, *The politics of Risk regulation in Europe and the United States*, in http://faculty.haas.berkeley.edu/vogel/uk%20oct.pdf; C.R. Sunstein, *Risk and Reason: Safety, Law and the Environment*, Cambridge University Press 2004; Id., *Laws of fear*, New York, Cambridge University Press, 2005.

[12] German juridical doctrine has had a fundamental part in the study of this principle. Among the others, see T. Darnstädt, *Gefahrenabwehr und Gefahrenvorsorge: eine Untersuchung über Struktur und Bedeutung der Prognosetatbestände im Recht der öffentlichen Sicherheit und Ordnung*, Frankfurt 1983; H.W. Rengeling, *Der Stand der Technik bei der Genehmigung umweltgefährdender Anlagen*, Köln 1985; A. Reich, *Gefahr, Risiko, Restrisiko: das Vorsorgeprinzip am Beispiel des Immissionsschutzrechts*, Düsseldorf 1989; E. Rehbinder, *Vorsorgeprinzip im Umweltrecht und präventive Umweltpolitik*, in U.E. Simonis (e.b.), *Präventive Umweltpolitik*, Frankfurt am Main – New York 1988, 129 et seq. E. Rehbinder, *Prinzipien des Umweltrechts in der Rechtsprechung des Bundesverwaltungsgerichts: das Vorsorgeprinzip als Beispiel*, in *Festschrift für Horst*

of the precautionary principle, and wants to underline its "procedural" character. This "procedural" character is strictly linked with the concept of "reflexive" Administration. The research will be done through the analysis of the Community law. Moreover, inside the "Administrative Community law"[13], I will try to point out the main relapses of the European Administrative law on the Italian Administrative law system.

2. The "reserve of administration"

In front of the tumultuous evolution of the techno-scientific knowledge, it has been asserted the need to put beside the various methods of scientific evaluation of risk, the consideration of the values expressed by the society[14]. This kind of interpretation gets confirmation in the Community law that, regulating the fields of biotechnologies and of food safeguard, draws expressly the need to take into consideration even the ethical aspects[15].

Sendler, München 1991, 269 et seq.; K.H. Ladeur, *Das Umweltrecht der Wissensgesellschaft: von der Gefahrenabwehr zum Risikomanagement*, Berlin 1995; C. Callies, *Rechtsstaat und Umweltstaat*, Tübingen, 2001.

For French doctrine see N. De Sadeleer, *Les principes du polleur-payeur, de prévention et de précaution*, Paris 1999; G. Cans, *Le principe de précaution, nouvel élément du côntrole de légalité*, in RFD adm. 1999, 750 et seq.; K. Foucher, *Principe de précaution et risque sanitaire : recherche sur l'encadrement juridique de l'incertitude scientifique*, Paris 2002 ; C. Noiville, *Du bon gouvernement des risques. Le droit et la question du "risque accettable"*, Paris 2003; A. Gossement, *Le principe de précaution: essai sur l'incidence de l'incertitude scientifique sur la décision et la responsabilité publique*, Paris 2003; F. Ewald, C. Collier, N. De Sadeleer, *Le principe de précaution*, Paris, 2003.

As regards Anglo-Saxon doctrine see T. O'Riordan, J. Cameron (e.b.), *Interpreting the Precautionary Principle*, London 1994; T. O'Riordan, J. Cameron, A. Jordan (e.b.), *Reinterpreting the Precautionary Principle*, London 2001; E. Fisher, *Risk regulation and Administrative Constitutionalism,* Hart Publishing 2007.

13 This definition is of J. Schwarze, *European Administrative Law*, London 1992, 3 et seq. According to M.P. Chiti, *Monismo o dualismo in diritto amministrativo: vero o falso dilemma?*, in Rivista Italiana di Diritto Pubblico Comunitario 2001, 301 et seq., the Community law is "mainly administrative law".

14 Cfr. E. Fisher, *Drowning by Numbers: standard Setting in risk Regulation and the Pursuit of Accountable Public Administration*, in Oxford Journal of Legal Studies, Vol. 20, n. 1 (2000), 123-124 e 129-130.

15 As regards the "whereas" nr. 9 of the EC Directive 2001/08, as far as wilful emission in the environment of Genetically Modified Organisms, "Respect for ethical principles recognised in a Member State is particularly important. Member States may take into consideration ethical aspects when GMOs are deliberately released or placed on the market as or in products".

According the "whereas" n. 19 of EC Regulation n. 178/2002 (laying down the general principles and requirements of food law, establishing the European Food Safety Authority and laying down procedures in matters of food safety): "It is recognised that scientific risk assessment alone cannot, in some cases, provide all the information on which a risk management

Moreover, Community legal system stresses the importance of juridical values (human security, health, environment) and principles (precaution, subsidiarity, proportionality, preventive actions, "polluter-pays", good faith, etc.) beyond precise legislative provisions that would reproduce the typical model of continental legal system (Administrative law systems). This affects even the centrality of the role of the law in the continental legal systems. This centrality moves backwards in parallel with the increase of importance of values and principles. These values and principles are recognised by Constitutional rules and Community laws[16]; they nowadays come to a more real fulfilment through the action of all social actors[17].

The crisis of the traditional principle of lawfulness, sharpened by the continuous obsolescence of legal rules because of the techno-scientific evolution, increases the need of a "reserve of Public Administration"[18].

The administrative activity, in particular, contributes in a primary way to the formation of the "risk law", rendering effective values and principles through the comparison of private and public interests inside the administrative procedures[19].

decision should be based, and that other factors relevant to the matter under consideration should legitimately be taken into account including societal, economic, traditional, ethical and environmental factors and the feasibility of controls".

16 The principles must really develop in the action of public and private subjects and must be confirmed through judicial interpretation: see I.M. Marino, A. Barone, *The responsible governace of risk in the European Union*, IIAS Conference, Public Administration and Private Enterprise Co-operation and Regulation, Berlin, 20-23 September 2005. The matter of the relationship between judges and science presents several profiles of interest and deserves a widening that lies outside the investigations made in this essay. On this matter, referring to the American experience, see. S. Jasanoff, *Science at the bar: law, science, and technology in America*, 1995.

17 As regards the effect of the precautionary principle on the enterprises actions, see infra par. 6. On these matters, in general, see K.H. Ladeur, *The changing role of the Private in Public Governance. The erosion of Hierarchy and the rise of a New Administrative Law of Cooperation. A comparative Approach*, European University Institute, Working Paper, LAW, n. 2002/9, www.iue.it; Id., *The theory of Autopoiesis as an Approach to a Better Understanding of Postmodern Law. From the Hierarchy of Norms to the Heterarchy of Changing Patterns of Legal Inter-relationships*, European University Institute, Department of Law, Working paper n. 99/3, www.iue.it.

18 In the Italian juridical doctrine, the crisis of the traditional result of the principle of lawfulness is pointed out by : F.G. Scoca, *Attività amministrativa*, in *Enciclopedia del Diritto, Aggiornamento*, Vol. VI, Milano 2002, 82-85; I.M. Marino, *Profili interpretativi dell'autonomia comunale*, in Nuove Autonomie 2000, 891 et seq.; Id., *Giurisdizione esclusiva e Costituzione*, in V. Parisio, A. Perini (a cura di), *Le nuove frontiere della giurisdizione esclusiva. Una riflessione a più voci*, Milano 2002, 15. E. García de Enterría, *Justicia y seguridad jurídica en un mundo de leyes desbocadas*, Civitas Ediciones, Madrid 1999 points out the crisis of the principle of lawfulness, even underlining its relevant importance.

19 On the relationship between law and administration in "risk law", see H.H. Trute, *From Past to Future Risk – From Private to Public Law*, in Revue Europeenne de Droit Public, Vol. 15, n. 1, 2003, 98-101.

This "reserve of administration" is not only one of the way followed by the legal system to adapt in a more easy way the juridical datum to the techno-scientific evolution, but, in the same time, determines a new democracy of the administrative behaviour, open even to the proceeding contributions of private persons, in fields which are traditionally counted to the dominium of technique[20].

The "reserve of administration", moreover, is the most appropriate way to let become effective the "case by case" approach to the risks coming from scientific uncertainty; this kind of approach is, according to Community law, the mainstay of the precautionary strategies[21].

The Community law gives a central position to the administrative function in the government of the new risks coming from scientific uncertainty. This central position is realized through the different models of European administrative integration such as, for example, the "indirect execution" and the "co-administration"[22]. The Community regulations on the risks from technological unknown, in particular, outline (besides) administrative procedures of authorizing type, focused on a "case by case" approach. This approach allows to shape the content of the authorizing administrative provision not only according to the specific peculiarities of each industrial activity and of the related risks, but mostly as regards the evolution of the "best available technologies" or the possible acquisition of "new scientific information".

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20 The sociological literature has pointed out the importance of public participation in the public decision making with an high technical complexity; see A. Irwin, *Citizen Science. A Study of People, Expertise and Sustainable Development*, London, 1995.

21 For example, according to art 4, 3° par. of Directive 2001/18/EC, on the wilful issue in the environment of GMO, "Member States and where appropriate the Commission shall ensure that potential adverse effects on human health and the environment, which may occur directly or indirectly through gene transfer from GMOs to other organisms, are accurately assessed on a case-by-case basis".

22 As regards the "indirect fulfilment", the "faithful cooperation" foreseen by art 10 of EC Treaty, forces Member states even to adopt all the suitable administrative measures to allow the fulfilment of Community rules. The "co-administration", unlikely by the indirect fulfilment, is characterized by the attribution of the "legal ownership" of the function on two different levels, community and national, that are strictly linked together. The Community and national authorities, in fact, work strictly together (as there is a sole function) and according to a "necessity" relationship (as the activity of one subject is necessary for the activities of the other ones). In this way, the co-administration is made through procedures that have national and Community phases, allowing to each subject which is in title of the function the chance to evaluate all the interests in stake. On these aspects, see E. Chiti, C. Franchini, *L'integrazione amministrativa europea*, Bologna 2003. Moreover, as we have already highlighted, the difference between the different way to fulfil the community law must not extremely underlined, as even when the fulfilment arrives by national authorities, they are deeply conditioned by community law and they seem as "common organisms" of European Legal system. See M.P. Chiti, *Diritto Amministrativo Europeo*, Milano, 1999, 176-177.

3. The constituent features of the precautionary principle and its "procedural" character

Art. 174, par. 2 of EC Treaty, identifies as criteria of Community environmental policy the principles of precaution, preventive action, the principle "that environmental damage should as a priority be rectified at source", and even the "polluter pays" principle.

The principle of precaution, whose genesis could be the environmental international law[23], is only stated in EC Treaty. Its definition is still given by the Euro-

[23] The first acknowledgement of the precautionary principle in the international law dates back to the beginning of years '80ies (World declaration of the Nature adopted by General Assembly of U.N. in 1982). This concept has been revised by other international documents on environmental safeguard; among them, in particular, we speak about the Ministerial declaration of the second international conference on the safeguard of North Sea (1987). Moreover, the precautionary principle is sanctioned in the principle n. 15 of Rio Declaration (Conference of Rio on environment and development – Rio de Janeiro 1992). At least, even the U.N. Agreement on the climatic changes and the Preamble of the Convention on bio-diversity (adopted in the Rio Conference) speak clearly of precautionary principle. Moreover, this principle, is expressly foreseen by art. 10, par. 6 of the Protocol of Cartagena on prevention of biotechnological risks, concerning the safety transfer, the manipulation and the use of modified living organisms coming form modern biotechnology. In doctrine see R. Churchill, D. Freestone (e.b.), *International Law and Global Climate Change*, London 1991; P. Sands, *Principles of International Environmental Law*, Manchester 1995; D. Freestone, E. Hey, *The Precautionary Principle and International Law*, The Hague, 1996; C. Leben, J. Verhoeven, *Le principe de precaution: aspects de droit intenational et communautaire*, Paris 2002; P.M. Bidou, *Le principe de précaution en droit international de l'environnement*, in Revue général de droit international public 1999, 632 et seq. For Italian doctrine see L. Marini, *Il principio di precauzione nel diritto internazionale e comunitario*, Padova, 2004.

Even World Trade Organization has foreseen the need to safeguard environment and human, animal and plant health. We speak, in particular, of art. 5.7 of the agreement on sanitary and phyto-sanitary measures (SPS) foreseen by World Trade Organization. See G. Majone, *What Price of Safety? The Precautionary Principle and its Policy Implications*, in Majone G. (e.b.), *Risk Regulation in the European Union: Between Enlargement and Internationalization*, European University Institute, Robert Schumann Centre for Advanced Studies, Firenze, 2004, 33-51; G. de Burca, J. Scott, *The impact of the WTO on EU Decision-Making*, Harvard Jean Monnet Working Paper, n. 6/2000, www.jeanmonnetprogram.org; C. Joerges, *Law, Science and the Management of risks to Health at the National, European and International Level: Stories on Baby Dummies, Mad Cows and Hormones in Beef*, in Columbia Journal of European Law, 2001, vol. 7, 1-19; J. Scott, E. Vos, *The Juridification of Uncertainty: Observations on the ambivalence of the Precautionary Principle within the EU and the WTO*, in R. Dehousse, C. Joerges (e.b.), *Good governance in an Integrated Marke*t, Oxford 2001; D. Bevilacqua, *I limiti della scienza e le ragioni della discrezionalità: il principio di precauzione nel diritto globale*, in G. Della Cananea (e.b.), *I principi dell'azione amministrativa nello spazio giuridico globale*, Napoli 2007; S. Battini, *Amministrazioni nazionali e controversie globali*, Milano 2007.

pean Court of Justice[24]. This criterion has been acknowledged by Italian legal system; in fact it is recognized at legislative and jurisprudential level.

The precautionary principle has an effectiveness sphere that is wider than the environmental matter. According to the European Commission, in particular, it "finds its application in all the cases in which a preliminary scientific objective evaluation shows that there are reasonable grounds to fear that the possible injurious effects on the environment and on the health of human beings, of animals and of plants can be incompatible with the high level of protection chosen by the Community"[25]. According to this aspect, the European Court of Justice and the European Court of First Instance case law identified the "constitutional" basis of the precautionary principle in the art. 3, 6, 152, 153 and 174 of EC Treaty[26].

The Community law organizes the precautionary approach in three elements: evaluation of risk, management of risk and communication of risk[27].

The principle of precaution is characterized by the separation between the scientific evaluation of risk, made only by experts, and the management of risk, committed to political decision.

The need of scientific evaluation of risk can be associated to the spread, at a Community level, of the system of Committees and of Agencies. In particular, the European Agencies (for example the European Environmental Agency, the European Medicines Agency and the European Food Safety Authority) are (moreover) "Techno-scientific fora", that gathers representatives of the equivalent National organisms. These agencies, moreover, interface themselves with the National authorities, which act in the same field on the basis of cooperative "net-relationships"[28].

The main moment of the precautionary approach is made by the management of risk, oriented to the examination of the choices of intervention (through the consultation of the interested parts), taking into account the issues of the evaluation of risks

[24] We can even remember European Court of Justice: case C - 331/88 (judgement of 13 November 1990); case C - 405/92 (judgement of 24 November 1993); case C-435/92 (judgement of 19 January 1994); case C-180/96 (judgement of 5 May 1998); case C – 179/95 (judgement of 5 October 1999); case C – 6/99 (judgement of 21 March 2000); case C – 316/01 (judgement of 12 June 2003); case C – 236/01 (judgement of 9 September 2003). As regards the case-law of the European Court of First Instance: case T – 199/96 (judgement of 16 July 1998, upheld by European Court of Justice, 4 July 2000, case C – 352/98 P); case T – 13/99 (ord. 30 June 1999, upheld by European Court of Justice). All these decisions can be seen on web site www.curia.eu.int.

[25] European Commission, *Communication on the precautionary principle* – COM (2000)1, 2 February 2000 (www.europa.eu.int), 3 of the summary.

[26] European Court of First Instance, case T-74/00, T-76/00, from T-83/00 to T-85/00, T-132/00, T-137/00 e T-141/00, judgement of 26 November 2002, www.curia.eu.int, par. 183-184.

[27] See for example art. 3, par. 10-13, of the EC Regulation n. 178/2002

[28] On these matters see. S. Cassese, *Lo spazio giuridico globale*, Roma-Bari 2003; E. Chiti, *Le Agenzie Europee. Unità e decentramento nelle amministrazioni comunitarie*, Padova, 2002.

and, mostly, "of other legitimate factors"[29]. These last factors impose to consider further aspects as far as the scientific data or the economic ones are concerned. They are aspects of, for example, ethical or cultural nature, that are introduced in the decision making process through the participation of citizens, social groups and communities to the administrative proceedings directed towards the management of risk[30].

In fact, if from one side the precautionary measures must be based on a test of the potential benefits and charges coming from the action or the inaction, from the other side, this test cannot be reduced to an economic costs/benefits analysis. On the contrary we must enlarge the evaluation to other variables, such as the acceptability of the measure from the interested people. "In fact, it is possible that a society is ready to pay an higher cost in order to guarantee an interest, such as the environment or the health, recognised to be really important"[31].

According to the Community case law, moreover, "the needs which are linked to the protection of the public health must have in an incontestable way a prevailing characteristic as regards the economical consideration"[32].

The communication of risk supplements the precautionary strategy[33], emphasizing in the juridical reflection the central importance of the processes of communicative interaction among all the public and private actors of the governance of risk. The public communication mainly aims to give effectiveness to the participation of citizens (individuals or associated) and of their communities to administrative proceedings oriented to the risk management. This arrives through the decryption of the techno-scientific datum that must be comprehensible to non-expert people. Parallely, the spread of information on the dangers for people and environment has a autonomous stress. They are information that Public authorities are obliged to spread independently by the development of the single proceedings.

In this way, the concept of precaution is strictly linked to those of risk: a "potential" risk, whose real importance cannot be demonstrated because of the lack and of the uncertainty of the scientific data[34]. According to some scholars,

29 Art. 3, n. 12, of the EC Regulation n. 178/2002.

30 The Aarhus Convention obliges the adhering State to warrant the effective participation of the "interested public" to environmental proceedings, included those that regards the wilful emission in the environment of GMO (art. 6); see infra, par. 4.

31 European Commission, *Communication on the precautionary principle*, 20-21.

32 European Court of First Instance, case T-70/99 (judgement of 30 June 1999), www.curia.eu.int.

33 For example, the EC Regulation n. 178/2002, points out the "communication of the risk" (art. 3 n. 13) as: "the interactive exchange of information and opinions throughout the risk analysis process as regards hazards and risks, risk-related factors and risk perceptions, among risk assessors, risk managers, consumers, feed and food businesses, the academic community and other interested parties, including the explanation of risk assessment findings and the basis of risk management decisions".

34 European Commission, *Communication on the precautionary principle*, 14 and 17-18. Art. 3, n. 9, of the EC Regulation n. 178/2002, defines the risk as "function of the chance of a

precaution is different from prevention, that, on the contrary, is the guideline in case of danger, which is characterized by an adequate degree of scientific certainty[35]. Nevertheless it is important to oppose to the rigid distinction between the equation risk-uncertainty-precaution and danger-certainty-prevention a reading in which precaution is a "development and specification" of the preventive action[36]. In fact, prevention and precaution aims to modify at the origin the damages caused to the environment (and not only those), finding a real fulfilment even through administrative authorizations.

Moreover, the principle of precaution can be interpreted in various ways that swing from an extreme way, that wants at all costs to reach the "zero risk", forbidding consequently all the potentially dangerous activities, and a weak way, that is related only to those risks that can provoke serious and irreversible consequences[37].

Both these ways have been criticized. Referring to the radical concept, it has been underlined the perverse consequences of the creation of "laws of fear" on the scientific research field and even on the economic development one[38]. Parallely, it is obvious that the weak concept of precaution removes every character of "originality" of the principle as regards the traditional prevention of the dangers[39].

harmful effect for the health, coming from a danger".

35 S. Grassi, A. Gragnani, *Appunti per la relazione sul principio di precauzione nella giurisprudenza costituzionale*, rapport in the meeting on Biotechnologies and environmental safeguard, Caserta 6-7 June 2002, www.unina2.it, 3 of the paper, highlight that 'the precautionary principle, Vorsorgeprinzip, or, according to a terminological variant, Risikovorsorge, legitimates in this way to use some precautions in a moment that is former to a moment in which, according to a preventive logic, must be done interventions to safeguard from the danger, according to the "Gefahrenabwehrprinzip" or "Schutzprinzip", (where the term danger, "Gefahr", is used as requirement of a causal process that, except for external interferences, is surely fit to produce a harmful event)'.

36 R. Ferrara, *I principi comunitari di tutela dell'ambiente*, in Diritto Amministrativo 2005, 530-531; P. Dell'Anno, *Principi del diritto ambientale europeo e nazi*onale, Milano 2004; L. Kramer, *Manuale di diritto comunitario per l'ambiente*, Milano, 2000, 83.

37 In order to reconstruct the different theoretical formulations of the precautionary principle see P. Kourilsky, G. Viney, *Le principe de précaution. Rapport au Premier Ministre*, Paris, 2000, 139 et seq.; P. Bechmann, V. Mansuy, *Le principe de précaution, Environnement, santé et sécurité alimentaire*, Paris, 2002.

38 C.R. Sunstein, *Laws of fear*, 13-63.

39 In the anciéen regime societies there were a regulation open to the dangers of non-technological nature. For example, we can speak about the measures of prophylaxis against the epidemics (plague: cfr. P. Preto, *Epidemie, paure e politica nell'Italia moderna*, Roma-Bari 1987) as the "lazaretto" placed extra moenia or the closing of the town with walls; or better the food-rationing law (flat prices, privileged food supplies) in order to grant the food to urban people in order to avoid famine. As regards the liberal age, we can speak of the "funzione di polizia" exerted by the Italian Government to prevent different kind of dangers: fires, natural disasters, public health, epidemics, diseases. On these aspects see V. Ottaviano, *Cittadino e amministrazione nella concezione liberale*, in *Scritti Giuridici*,

Authoritative doctrine has pointed out the chance of a third interpretation linked to the concepts of "best available technology" and "margin of safety"[40]. Scientific uncertainty, in particular, cannot bar the adoption of risk management "proportioned" measures that aim to maintain the economic activities whose danger is under the suitably identified margin of safety, with the possibility to revise the adopted prescription when there are new technological knowledge[41].

So, it seems misleading to retrace this principle only to the exercise of *extra ordinem* powers from the Administration. We can say that, even if we are aware of the crisis of the traditional result of the lawfulness principle, precaution is not necessarily a moment of breach of lawfulness principle[42].

The juridical result of the precautionary principle can be better appreciated in relation to a strategy of approach to risk, linked to share procedures rather than through the reference to the limits of the *extra ordinem* ordinance power. This kind of interpretation is linked to a "procedural" reading of the precautionary principle[43], that is the main aspect of the centrality of the administrative activity in "risk law".

I., Milano 1992, 33-52; M.S. Giannini, *L'Amministrazione pubblica dello Stato contemporaneo*, in *Trattato di diritto amministrativo*, e.b. G. Santaniello, I, Padova 1988, 41-47. Anyway, even the liberal State had to deal with the risks for the community coming from a industrial system which was still immature. Among the first examples of reply of the legal system to technological challenge right we have the Prussian law of 3rd November 1838 on the damages coming from the railway activity.

40 R.B. Stewart, *Environmental regulatory decision-making under uncertainty*, in Research in Law and Economics, vol. n. 20, Timothy Swanson ed. 2002., 71-78.

41 From a juridical point of view, the precautionary principle affects even legislation. Even if is limited to the need to grant specific administrative reserves , in fact it, this principle foresees more and more "typical, ordinary and articulated powers" of risk management. In nowadays society of the risk, consequently, the precaution badly resigns itself, at a legislative level, with the general prohibitions devoid of any scientific elements. On this subject we have the laws adopted by several Italian regions that, in lack of a scientific evaluation of the risk, has limited or even forbidden the use of GMO in their territories: see A. Barone, *Il diritto del rischio*, 104-139.

42 Underlines the difficulty to link the precautionary principle only with the exertion of *extra ordinem* powers from the Administrations, G.D. Comporti, *Amministrazioni e giudici sull'onda dell'elettrosmog*, comment to TAR Toscana, sez. I, 26 luglio 2001, n. 1266, in Foro Amministrativo TAR 2001, 2472-2475; Id., *Contenuto e limiti del governo amministrativo dell'inquinamento elettromagnetico alla luce del principio precauzionale*, in Rivista Giuridica dell'Ambiente, 2005, 215-252.

43 S. Bartolommei, *Sul principio di precauzione: norma assoluta o regola procedurale?*, in Bioetica, 2001, 321-332.

4. Risk management between European administrative law and Italian administrative law

The "procedural" value of the principle of precaution has a first exemplification in the concept of risk management, that must be based on a plural approach to the problems linked to risks from technological unknown; this approach is able to integrate different knowledge and languages[44]. This integration comes true through a procedural dialectic that cannot be limited to the relations between the main "parts" of the administrative procedure (firm that asks for the authorization and cognizant authorities)[45].

The Community regulations on environment, biotechnologies and food safeguard improve the role of public and private subjects that can be "third parties" in the proceedings.

The EC Directive 2001/18, on the wilful emission of GMO, foresees hypothesis of participation and information of the public[46]. Similarly, European laws on food safety allows the "public" to submit remarks in proceedings of authorization to commerce genetically modified foods [47].

The generic reference to the possible participation of the "public", foreseen even in the former form of the 96/61 EC Directive (on the prevention and reduction of the pollution) is mitigated by the Aarhus Convention. This Convention, in fact, obliges the signatory States to guarantee the real participation of the "interested public" to the environmental proceedings, even in those on the GMO wilful emission in the environment (art. 6).

According to art 2, par. 5, of the Aarhus Convention, 'with the words "interested public", we speak about one or more natural or juridical persons, their associations, organizations or groups that could be interested to the potential changes of environmental quality, or that have some interests in the decision making process, and even environmental protection non-governmental organizations according to national laws'.

44 See S. Jasanoff, *Designs on Nature: Science and democracy in Europe and the United States*, Princeton NJ, 2005.

45 R. Ferrara, *Il procedimento amministrativo visto dal "terzo"*, in Diritto Processuale Amministrativo, 2003, 1024-1074. As regards the peculiarities of the Community administrative procedures see A. Weber, *Il diritto amministrativo procedimentale nell'ordinamento della comunità europea*, in Rivista Italiana di Diritto Pubblico Comunitario, 1992, 293 et seq.; E. Picozza, *Il regime giuridico del procedimento amministrativo comunitario*, in Rivista Italiana di Diritto Pubblico Comunitario, 1994, 321 et seq.; G. Della Cananea, *I procedimenti amministrativi della Comunità europea*, in G. Greco, M.P. Chiti (e.b.), *Trattato di Diritto Amministrativo Europeo*, I, Milano 1997, 225 et seq.; F. Bignami, S. Cassese, *Il procedimento amministrativo nel diritto europeo*, Quaderno n. 1 of the Rivista Trimestrale di Diritto Pubblico, Milano, 2004.

46 See, whereas n. 9 and art. 9 and 24 of EC Directive 2001/18

47 Art. 6, par. 7, of EC Regulation 1829/03 of 22nd September 2003, on genetically modified foods and feedstuffs

This concept has been substantially acknowledged by EC Directive 2003/05, that has (even) modified EC Directive 96/61 in order to allow the "interested public" to "participate in a timely and effective way" to the procedure for the issue of the supplemented environmental authorization. According to third whereas of the EC Directive 2003/35: 'effective public participation in the taking of decisions enables the public to express, and the decision-maker to take account of, opinions and concerns which may be relevant to those decisions, thereby increasing the accountability and transparency of the decision-making process and contributing to public awareness of environmental issues and support for the decisions taken'.

Then, the participation can be linked to the risk management, and this lets to a difference between the management and the scientific evaluation of risk[48].

As regards the Italian legal system, we can point out as the concept of "interested public" adopted by the Aarhus Convention widen the number of the "third parties" in proceedings as to the provisions of the Law 7 August 1990, nr. 241[49]. But, this kind of widening jars with the restraint to the "justiciability" of the participation claims of the interested public in accordance to art. 21 *octies*, paragraph n. 2, of the Law 7 August 1990, nr. 241, as introduced by Law 11 February 2005, nr. 15[50].

This provision, in fact, foresees two different hypothesis of non-annullability (from the administrative judge) of the provision adopted in violation (besides) of the rules on proceedings participation[51]. The hypothesis that regards even the dis-

[48] Moreover, according to current Community regulation on food safety, that ensures the public participation, the risk management must consider the results of the risk evaluation, "and even other aspects, if pertaining" (art. 6 of EC Regulation n. 178/2002). European Commission, when issues, modifies, suspends or withdraws the authorization to commerce foods with GMO, must consider the scientific advice of the Food safety Authority, without being bind to it, and even "other factors, which are pertaining to the examined matter" (art. 7, par. 1 and art. 10 of EC regulation n. 1829/2003).

[49] In particular, art. 7 and 9 of the Law 7 August 1990 n. 241 See R. Montanaro, *L'ambiente e i nuovi istituti della partecipazione*, in A. Crosetti, F. Fracchia (edited by), *Procedimento amministrativo e partecipazione. Problemi, prospettive ed esperienz*e, Milano 2002, 124. Most recently on these matters see M. Occhiena, *Situazioni giuridiche soggettive e procedimento amministrativo*, Torino 2002, 392-415. We have to highlight that the Italian legal system has recently acknowledged the concept of interested public as regards the Integrated Pollution Prevention and Control: see art. 2, letter r) of legislative decree 18 February, 2005. n. 59.

[50] Cfr. F. Fracchia, M. Occhiena, *Teoria dell'invalidità dell'atto amministrativo e art. 21 octies, l. 241/1990: quando il legislatore non può e non deve*, www.giustamm.it, 38-40 of the paper.

[51] According to art. 21 *octies*, par. 2, of the law 7 August 1990, n. 241, and to the law 11 February 2005 n. 15, it cannot be repealed the administrative provision which has been adopted in violation of rules on the procedures or on the form of the acts, when, as regards the bounded nature of the provisions, is clear that its content could not be different from that which has been really adopted. The administrative provision cannot anyway be repealed if there has not been the communication of the beginning of the procedure when the administration proves in a trial that the content could not be different from the adopted one.

cretionary provisions, in particular, jars with the Directive 2003/35 EC and with Aarhus Convention, that expressly acknowledge to the "interested public" the chance of jurisdictional safeguard against public decisions unlawful for substantive or procedural reasons (for example, adopted in breach of the participation claims)[52].

The non-involvement of "third" parties in the administrative procedure since from the beginning of the decisional process removes any integration between different learning and languages, reducing the possibility to consider non-scientific evaluation elements in the precautionary choice. The participation of the interested public, in fact, is an element, which is structural and indispensable for the management of risk; this element is linked to the "procedural" character of the precautionary principle[53].

In scientific uncertainty situation, in the light of the above-mentioned European and international laws provisions and considering the "procedural" character of the precautionary principle, art. 21 *octies*, par. 2, violates art. 117, par. 1, of the Italian Constitution[54], and anyway must not be applied as it is an internal law incompatible with the Community law[55].

5. The "reflexive" administration

The precautionary approach to risk does not suppress the chance of a re-examination of the measures of risk management in the light of the evolution of the scientific datum[56]. This arrives according to procedures of re-examina-

[52] See in particular art. 9 of Aarhus Agreement and art. 15 bis of Directive 96/61 EC, and the art 4 of Directive 2003/35 EC

[53] Risks from technological unknown, moreover, increase the difficulties for the Administration to prove in a trial that the content of the administrative act cannot be different from the adopted one; these difficulties are well explained in E. Picozza, *La nuova legge sull'azione e sul procedimento amministrativo. Considerazioni generali. I principi di diritto comunitario e nazionale*, in Consiglio di Stato 2005, II, 1419 et seq. Moreover, the theory to transfer in a different and not suitable place (the trial) the dialectic confrontation (which aims to find the real public interest), that has its "natural place" in the administrative procedure, cannot be shared. As regards differences between trial inquest and administrative procedure inquest see I.M. Marino, *Giudice amministrativo, motivazione degli atti e "potere" dell'Amministrazione*, in Foro Amministrativo TAR, 2003, 346-353.

[54] According to art. 117, first par., of the Italian Constitution, modified by constitutional law n. 3 of 2001, the legislative power is exercised by the State and by the regions in respect of the Constitution, and even of the obligations coming from the Community laws and from the international obligations.

[55] F. Fracchia, M. Occhiena, *Teoria dell'invalidità dell'atto*, 39. On the pre-eminence of the Community law on the internal one see M.P. Chiti, *Diritto Amministrativo Europeo*, 69-104.

[56] Highlights this aspect R. Ferrara, *La protezione dell'ambiente e il procedimento amministrativo nella "società del rischio"*, in D. De Carolis, E. Ferrari, A. Police (edited by), *Ambiente, attività amministrativa e codificazione*, Milano, 2005, 763.

tion (of the adopted authorization provisions) that pass one after the others in accordance with a *continuum* that escapes to the traditional differences between proceedings of first and second degree.

Consequently, a further aspect of the "procedural" character of the precautionary principle regards the renewal and the re-examination of authorization provisions.

The precautionary measures, in fact, are provisional[57] and are subjected to review in front of the acquisition of "new scientific information" or of the evolution of the "best available technologies"[58].

These profiles can be esteemed both in the co-administration provisions and in the hypothesis of "indirect" execution of Community law. In both cases, the evolution of the techno-scientific datum throws the attention of the interpreter on the moment, which follows the end of the administrative proceeding and the implementation of the authorization provision.

As regards the co-administration, after the grant of an authorization, new information on the dangers for human health and for environment can bring to the establishment of a complex plot of relationship among the actors of risk management. This complex plot has its final synthesis in the decision by European Commission. This happens in the hypothesis of request from a member State to re-examine an authorization provision having effectiveness at Community level[59], and even in case of adoption of "safeguard" national measures.

According to this last aspect, for example, art. 23 of the EC Directive 2001/18, on the "commerce of GMO or of products containing GMO" allows, according to art. 95, par. 10, of EC Treaty, the adoption of national provisions to forbid or to limit temporarily the use or the sale of a particular genetically modified product on the national territory[60]. This arrives when: "A Member state, according to new or further information available after the date of authorization on the evaluation of environmental risks or on a new evaluation of the existing information based on new or additional scientific knowledge, has well-grounded reasons to think that a GMO

[57] Restricting to some examples, the authorization to commerce of a medicine for human use lasts 5 years (art. 24 of EC Directive 2001/83), the authorization to commerce GMOs (even if are part of products) or GM foods cannot last more than 10 years (respectively art. 15, par. 4, of EC Directive 2001/81 and art. 7, par. 5 of EC Regulation n. 1829/03). The Italian legislative decree 4 August 1999 n. 372, which enforces the EC Directive 96/61, says that the temporal effectiveness of the Integrated Pollution Prevention and Control is of 5 years (art. 7). This last option is confirmed by the recent legislative decree18 February 2005 n. 59 (art. 9) which repeals the legislative decree 4 August 1999, n. 372.

[58] European Commission, *Communication on the precautionary principle*, 21-22.

[59] For example, EC Directive 2001/83, "containing a community code for the medicines for human use", allows every Member state to put in action a procedure to modify, suspend or withdraw the "decentralized" authorization to commerce a medicine.

[60] Safeguard provisions are foreseen even as regards pharmaceutical products: see art. 18 of the EC Regulation n. 2309/93 and art. 36, par. 2, of EC Directive 2001/83

(alone or contained in a product that has been notified and authorized according to the current directive) is a risk for human health and for environment"[61].

Moreover, in case of "hard risk" the Member State can suspend or let stop the commerce, informing the public[62]. Once adopted the precautionary measure according to the safeguard clause, the Member State informs the Commission and the other States, justifying its decision and giving a new evaluation judgment on the environmental risks. The decision to maintain or to withdraw the national precautionary measure will be taken at a Community level, thanks to an special "committee procedure"[63].

The new scientific information on the risks for health and for environment are the necessary requirement to open procedures of re-examination and even to adopt national safeguard provisions. These information determine a duty of evaluation on the European Administration; this duty is justiciable through the procedure provided for by art. 232 of EC Treaty.[64]

As regards the indirect execution of the Community law, art. 8 of EC Directive 2001/18, forces the competent administration to evaluate the new information on new or wider risks for human, animal health or for the environment. Parallely, Directive 96/61 EC forces the Administration to re-examine the environmental authorization according to the evolution of the better technologies. The Administration must know this evolution[65].

Moreover, this statement is typical of the EC Directive 2004/35, on prevention and reparation of the environmental damage. In particular, art. 12 of the

61 Art. 23, par. 1, of EC Directive 2001/18

62 Art. 23, par. 1, of EC Directive 2001/18

63 Art. 23, par. 2, of EC Directive 2001/18 The European Court of Justice case-law has progressively elaborated the requirement of admissibility for national provisions of precaution. The Court of Justice, in a recent sentence on food safety, has stated, "The measure of safeguard taken in force of the safeguard clause cannot be validly alleged only with a hypothetical approach to the risk, based on simple suppositions which are not yet scientifically verified." The examined precautionary provisions, in fact, suggest "that the evaluation of the risks at the disposal of national authorities has specific evidences that, without excluding the scientific uncertainty, allow them to reasonably conclude, according to the available scientific data that are more reliable and of the most recent results of the international research, that the fulfilment of these measures is necessary to avoid to commerce new foods which are potentially dangerous for human health". See European Court of Justice, case C-236/01 (judgment of 9 September 2003) in Foro italiano 2003, V, 245-251, with critical remarks of A. Barone (*Organismi geneticamente modificati, e precauzione: il "rischio" alimentare tra diritto comunitario e diritto interno*). On these matters see even C. MacMaoláin, *Using the precautionary principle to protect human health: Pzifer v Council*, in European Law Review, 2003, 723 et seq.; P. Dąbrowska, *Risk, precaution and the internal market: Who won the Day in the recent Monsanto judgement of European Court of Justice on GM foods?*, in German Law Journal, 2003, www.germanlawjournal.com.

64 M.P. Chiti, *Diritto Amministrativo Europeo*, 387-390.

65 Art. 11 and art. 13 of the Directive 96/61 CE

Directive imputes to several subject the right to "ask for an action" (even) in front of a "environmental damage menace". This request obliges the competent Administrations to evaluate the received data, and, in case, to take the necessary precautionary measures.

Nevertheless, as regards the Italian law, the link between the duty of evaluation and the information coming from the "third" subjects (public or private) who take part in the already ended administrative proceedings, clashes with a consolidated restrictive trend of the *Consiglio di Stato* case-law. In fact, it denies, in lack of specific provisions, the existence of an obligation of the public powers to pronounce on the request of re-examination of administrative provisions.

This kind of interpretation has its *ratio* in the rule of the incontestability of provisions, once expired the terms for the jurisdictional claim[66]. In the Italian legal system, besides, the temporary unfitness of the administrative determinations fulfils, traditionally, through the exertion of the discretionary powers of administrative "autotutela"[67]; powers that can be started up only *ex officio* and (tendentially) never through the initiative of other parties.

The Community law renews the Italian juridical legal system even as regards the obligation to evaluate the new scientific information [68]; obligation that is today justiciable through the new proceeding against the "silence" of the Administration[69].

In the European administrative integration process, the re-examination of the public decision, adopted in scientific uncertainty situations, lets better emerge the peculiar aspect of the administrative function seen as permanent correspondence to the public interest (in case of human and environmental safety). This correspondence does not allow to fossilize the administrative duty in the issue of the single administrative provision (for example, the authorization), showing even the need to reconsider the principle of continuity: from a prevalently organization moment to a prevalently functional one.

66 For a critical analysis of this case-law see M. Immordino, *Revoca degli atti amministrativi e tutela dell'affidamento*, Torino, 1999, 173-179.

67 See for example, Consiglio di Stato, sezione VI, 1/4/1992, n. 201, in Foro Amministartivo 1992, I, 798; Consiglio di Stato, sezione IV, 6/10/2001, n. 5307, in Foro Amministrativo 2001, 2718; TAR Emilia Romagna, Bologna, sezione I, 27/11/1998, n. 401, in Foro Amministrativo, 1999, 1855.

68 The impact of European Administrative law on the Italian legal system goes beyond the acknowledgment of the Community rules. See in particular: art. 11 of legislative decree 8 July 2003, n. 224 (which acknowledges art. 8 of the EC Directive 2001/18); art. 9 of the legislative Decree 18 February 2005 n. 59 (which acknowledges art. 11 and 13 of the EC Directive 96/61); art. 309 of the Legislative Decree 3 April 2006, n. 152 (which acknowledges art. 12 of the EC Directive 2004/35)

69 Not by chance, the art. 310 of the Italian legislative decree 3 April 2006, n. 152, expressively call as "silenzio-inadempimento" the inertia of the Minister of the Environment and of the Territory Safeguard in front of a "claim for a State intervention". According to art. 2, 4th par., of the law n. 241 of 1990, as modified by law n. 80 of 2005, the administrative judge, in a trial on the silence of the authority, can know the merits of the case.

The authorization for an industrial activity that can potentially cause risks for health and for environment causes an administrative relationship, which is *ab origine* "unstable". The relationship with the Administration has even after the authorization a "procedural" character, which is characterized by a permanent modification of the administrative function. In the risk logic, so, not the single procedure but all the procedures of issue, renewal and re-examination, which cannot be separated in a strict way, have the shape of an administrative function that progressively and permanently creates the features of the same administrative relationship[70].

This arrives according to a *continuum* that seems not to allow distinctions between procedures of "first" and "second degree".

In this way even the risk management cannot be fossilized in the single authorization procedure. The participation to the risk management sets aside from the single administrative procedure and performs its numerous potentialities before, during and after the carrying out of the procedures of renewal and of re-examination of the authorizations. Moreover, Aarhus Convention and EC Directive 2003/35, expressly bestow the participation of the public which is interested to the renewal, or to the updating of the authorization (in the environmental field)[71]. This shows the indissoluble link between the two distinctive profiles of the "procedural" character of the precautionary principle: the democratic participation to the processes of risk management and the continuous temporary unfitness of the decisions based on precaution.

Precaution, as principle of the administrative action, would start a kind of duty of evaluation that enhances or exasperates, so to say, the duty to pursue the public interest. In "risk law" public authorities action cannot exhaust itself in the single administrative provision. The global relevancy of the administrative function finds its expression through the continuous re-examination of the decisions taken in the light of the evolution of the techno-scientific datum. It is mostly with this duty to evaluate and to re-examine the scientific datum that the sociological concept of "reflexive" Administration becomes juridically real[72].

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[70] These argumentations are based on the study of F. Benvenuti, *Funzione amministrativa, procedimento, processo*, in Rivista Trimestrale di Diritto Pubblico 1952, 118 et seq.

[71] See art. 6, par. 10 of Aarhus Convention. Art. 4 of the EC Directive 2003/35, modifies art. 15, par. 1, of EC Directive 96/61, on Integrated Pollution Prevention and Control, in the following way: "Member states must give to the interested public timely and effective chances to partecipate to procedures on: the issue of an authorization for new plants, the issue of an authorization for important changes in the plant functioning, the updating of an authorization or of the requirements for an authorization according to art. 13, paragraph 2, first hyphen. For this kind of procedure we must use what is foreseen by enclosure V".

[72] "Reflexivity" as awareness of the nature of expert knowledge and of the chance that the decision based on them could be revised and rectified: A. Giddens, *Modernity and Self-Identity*, Cambridge 1991, 20; U. Beck, A. Giddens, S. Lash, *Reflexive Modernization*, 1994.

6. A new concept of the legal certainty principle?

The "reflexivity" of public administrations, obliged to continuously review their provisions, cannot be considered prejudicial to the principle of legal certainty and to the principle of the protection of legitimate expectations. The enterprises, on the contrary, are obliged from the risk law to put the principle of precaution at the basis of their activity and, then, must evaluate in advance the predictability of the precautionary measures adopted by public authorities.

In fact, the recent judgement of European Court of First Instance stated that the careful and wary economic operator cannot appeal to the principle of the protection of legitimate expectations when he is able to foresee the adoption of a Community precautionary provision fit to be prejudicial to its own interests, especially in the case of the review of the already give licences[73].

Moreover, the Community laws on the risk "from technological unknown" oblige the economical operators to behaviours that deeply affect the firm activity. These obligations impose to private subjects, in situation of risk for health and environment, fit interventions *ex ante*, that must, at times, anticipate and spur the decision of public administrations.

The precautionary principle expands its effects even in the continuance in the time of the requirements and of the requisites thanks to those; for example, the firm has obtained the authorisation. We are used to say that the relativeness and the suppleness of the processes of risk management are even for the firms, which are obliged to verify constantly the security of the activities that potentially produce risks for health and environment.

In this way, art. 11, 4° paragraph of EC Directive 96/82 obliges the operator to review and update the internal emergency plan at least every three years, considering (even) the technical progresses and the new knowledge as far as the measures to be adopted in case of relevant accident are concerned.

Similarly, the EC Directive 2001/18 charges the economic operator of various behaviour duties in case of modification of the deliberate release of a GMO already authorized (or in case of non intentional change of the same emission),

[73] EC Court of First Instance, case T-13/99, par. 492 (judgement of 11 september 2002); EC Court of First Instance, case T-70/99, par. 370-383 (judgement of 11 september 2002), www.curia.eu.int. According to the European Court of First Instance, case T-74/00, T-76/00, from T-83/00 to T-85/00, T-132/00, T-137/00 e T-141/00, par. 177 (judgement of 26 november 2002), "In particular, in view of the precedence thereby accorded to the protection of public health, where, on the basis of the progress of scientific knowledge and new data collected in particular in the context of pharmacovigilance, the competent authority proves to the requisite legal standard that a medicinal product no longer meets one of the criteria set out in Article 11 of the directive, the holder of the marketing authorisation of that medicinal product, which is valid for five years and renewable for five-year periods pursuant to Article 10 of Directive 65/65, may not claim that he is entitled, by virtue of the principle of legal certainty, to specific protection of his interests during the period of the authorisation's validity".

with possible consequences on the risks for the human, animal and environmental health, or better in case in which are available new scientific information. In these hypothesis, in particular, the firm must: make a new evaluation of the risk; examine again the measures defined in the authorisation; adopt anyway the urgent measures which are necessary to safeguard human, animal and environmental health; inform the competent public authorities[74]. Similar forms of responsibleness are foreseen by food security Community law.[75].

The missed respect of the obligations of preventive and precautionary action leads the economic operator to have sanctions (penal or administrative), whose assessment is referred by Community law to the Member states legal systems[76]. These sanctions, on the other hand, can coexist with civil sanctions.

According to this profile, EC Directive 2004/35, sets that "Where environmental damage has not yet occurred but there is an imminent threat of such damage occurring, the operator shall, without delay, take the necessary preventive measures"[77]. It is a particular important provision that moves the requirement of the juridical safeguard from the real damage to the "dangerous" behaviours. In this way, the meaning of "polluter-pays" principle will be enlarged to prevention actions (*ex ante*), beyond the reparative ones (*ex post*), with a whole evaluation of the firm role.

Therefore, it seems possible to point out a general trend of the Community law to let fall the preventive and precautionary actions even on the private enterprises. The risk for human and environmental safety obliges the private economic subjects to adopt all the necessary measures to avoid the change of the risk in damage.

According to this aspect, to the "reflexivity" of the public powers coincides symmetrically the "reflexivity" of the firms. In fact, the feature of the continuous

74 Art. 8 and art. 20 of EC Directive 2001/18

75 See as example, art. 19 of EC Regulation n. 178/2002

76 As regards the Italian legal system, see articles 34 e 35 of the Legislative Decree 8 July 2003, n. 224, of acknowledgement of EC Directive 2001/18, and even the art. 27 of Legislative Decree 17 August 1999, n. 334, of fulfilment of EC Directive 96/82.

77 Art. 5, 1° par. of EC directive 2004/35. The quoted article foresees moreover that: "2. Member States shall provide that, where appropriate, and in any case whenever an imminent threat of environmental damage is not dispelled despite the preventive measures taken by the operator, operators are to inform the competent authority of all relevant aspects of the situation, as soon as possible. 3. The competent authority may, at any time: (a) require the operator to provide information on any imminent threat of environmental damage or in suspected cases of such an imminent threat; (b) require the operator to take the necessary preventive measures; (c) give instructions to the operator to be followed on the necessary preventive measures to be taken; or (d) itself take the necessary preventive measures. 4. The competent authority shall require that the operator takes the preventive measures. If the operator fails to comply with the obligations laid down in paragraph 1 or 3(b) or (c), cannot be identified or is not required to bear the costs under this Directive, the competent authority may take these measures itself."

temporary unfitness regards the precautionary measures *tout court*, included those which have to be adopted also by private subjects[78].

In the "risk law", therefore, the legal certainty can be connected to the "certainty of the action"[79], seen as a duty to adopt preventive and precautionary measures and as duty to evaluate and to intervene in case of new scientific information. This certainty of the action involves public authorities and firms. It aids even to have a better comprehension of the precautionary principle but, in the meanwhile, is the qualifying element of the "responsible governance of risk"[80].

[78] On the correlation between reflexive law and risk cfr. J. Esteve Pardo, *Privileged Domain in risk treatment.,* 113-115. The processing of the concept of "reflexive" law is due to G. Teubner. Among Teubner's works we have to remember: *Substantive and reflexive elements in modern law*, in Law and society review 1983, 239 et seq.; Id. (e.b.), *Dilemmas of law in the welfare state*, Berlin, 1986.

[79] F. Lopez de Oñate, *La certezza del diritto*, Milano 1968, 160. The quoted volume collects even the essays of P. Calamandrei, F. Carnelutti, P. Fedele, G. Capograssi e M. Corsale.

[80] On the concept of "responsabile governance" of risk see I.M. Marino, A. Barone, *The responsible governace of risk in the European Union*.

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Original scientific paper
Received: March 10th, 2009

UDC 347.921.6(4-672EU:450)
ID 158247436

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DIFFERENCES IN THE PROCEDURES & SPEEDING UP OF THE PROCESS: THE SIMPLIFIED MODEL OF EU LAWS*

Abstract: *The article studies differences in the procedures and speeding up of legal process, presenting the simplified model of EU laws. The first part of the study gives the research background. The European order for payment procedure, considering the main features and elements to simplify this procedure is studied in the second part of the article. Then, the impact and relapses on the national laws are discussed. The analysis of the European small claims procedure, taking into account main features and elements to simplify the procedure follows. Finally, the simplified model of the EC legal system, considering the effects on the Italian procedural law is analysed.*

Key words: *EU law, payment procedure, Italian procedural law*
JEL classification: K40, K33

1. Research background

In the XX century we have the decline of the illuminist idea according to which we must have only one kind of process for every legal case: the ordinary process.

The development of the processes with a special procedure has progressively supported the ordinary process knocking its central role. We can explain this phenomenon with many reasons, not always coincident, that have brought techniques and ways of the processes each differentiated.

1.1. Especially from the 70ies the idea that it was necessary a different judicial protection for some categories of individuals and for particular kinds of litigations, was growing more and more.

* The text of this article, which has a first bibliographic description, has been used in the study meeting about "brainstorm of civil trial", organized, by the Italian Consiglio Superiore della Magistratura, in Rome (November, 10th – 12nd, 2008).

For this reason we become to have full cognizance special actions, but which have different procedures.

For example, we can remind the labour trials and the extension of its procedures to litigations on matters such as tenancy and accommodate of immovable properties, lease of business, or even to agrarian litigations. As we know, a more rapid and short process has substituted the ordinary procedure in order to protect the "weaker" party (the worker, the tenant, the lessee, the bailee of urban immovable properties) which is in contraposition with the stronger party (the employer, the lessor, the licensor, the bailor) – according to a typical *a priori* evaluation. In pursuance of the principle of equality, this different procedure had to compensate the imbalance between the parties: the "strong" one able to resist to the judicial proceedings of the other one for a long time; and the "weak" party, which, on the contrary, needs a privileged protection as regards the modes and the times of the process.

We can even say that the law of 21 February 2006, nr. 102, comes up to the same *ratio*, in fact it provides the (apparently) "full" execution of the procedural laws for the labour trials even to the causes for compensation for damages, for death or injuries coming from road accidents (art. 3). This extension of the labour trial has been done according to a way that has not been adequately weighed and that can be even questionable; for this reason it has caused several problems as regards its interpretation and enforceability. Maybe it will have a very short life if its abrogation – provided by the decree of reform of the lawsuit, approved by the Chamber of Deputies – will be confirmed even in the final law. Moreover, it answers to an old idea of important civil procedure scholars to have full cognizance special actions in the so-called industrial injury litigations in order to protect the "weaker" party.

During these last years, the new company trial is become an integral part of the full cognizance special actions with different procedures (Leg. Decree 5/2003). Some scholars think that this comes from the increased awareness of the correlations of the judicial system with the political and social systems, but even with the economic one; so they assert that if the trial course is faster, the economic system becomes more competitive.

Prosaically, the real reason could be that the lawmaker wants to anticipate the outline of the procedure of the new ordinary process; but today, luckily (as several scholars say), it seems that this idea has been dropped out.

1.2. Then, the main purpose to have a rapid judicial protection is the foundation to predispose typical kinds of non-provisional summary protection, where the court makes a "reduced" cognizance that anyhow leads to a judgement (or to a *pro iudicato* foreclosure).

To these kinds belong the traditional "optional" summary processes and not the (ordinary or special) full cognizance actions – such as the order and the notice to quit – whose legitimacy (even as provided by the Constitution) is base on the fact that the law allows the counterpart to transform the summary process in a cognizance action so to guarantee completely the right to counsel (art, 24 of the Italian Constitution).

Maybe, to this kind belongs even the new summary cognizance action provided by the decree of reform of the lawsuit, already approved by the Chamber of Deputies and now under consideration of the Senate (art. 32 of the decree n. 1082/S that foresees the insertion in the Code of civil procedure of articles 702 *bis, ter and quarter*).

1.3. During these last years, in the more and more troubled research of procedures to reduce the excessive length of the processes, we have had an increase in the use of the summary technique of the judicial protection of the rights that has brought to have summary cognizance actions that cannot be optional as regards the ordinary or special cognizance actions and even that cannot be transformed in these kinds of action (in this case we would have an inadmissibility or a demurrer of the claim when we have had the non-fulfilment of the prescribed procedure).

As everybody knows, the most important and recurring technique on this matter is that to use the outlines provided for by the proceedings before chambers with some adjustments and integrations.

The typical case in which we use the proceedings before chambers in order to protect the rights of the individuals is provided for by the law nr. 89/2001 on the fair compensation for damages caused by the unreasonable length of a process. Then, we can remind even the processes before chambers in case of the discriminatory behaviours against nationality, race or ethnic group belonging, or a particular disability of an individual, that provide for just compensations (art. 44 Leg. decree 25 July 1998, n. 286; art. 4 leg. decree 9 July 2003, n. 215; art. 3 l. 1 march 2006, n. 67).

Even if there is a heated debate as regards its compliance to the fair trial Constitutional rules – refused by those who say that there is a necessary correlation between the ordinary cognizance and the judgment on the rights – the use of the chamber proceedings seems to be lawful – as provided for by the jurisprudence as regards the constitutionality (see, Spec. Cost Court, judgement nr. 543 and 573 of 1989) and the legitimacy (see spec. Cass. Sez. U. n. 5629/1996) but on conditions that during this proceeding the court shall guarantee the public discussion and then successively we must have a control of legitimacy from Cassation Court, through the extraordinary appeal (ex. Art. 117, 7° paragraph., const).

In this way, the process before chambers is used more and more and is almost becoming a new model of process, which is alternative to the ordinary cognizance action.

1.4. Always in order to meet the common and increasing need of a real judicial protection that must be even effective, the summary of the judicial protection has, however, turned towards simplified proceedings, which are released from the judgement.

First of all, as regards the protection of merits, the lawmakers have foreseen summary cognizance actions or sub-actions that issue a judicial writ of execution, which is not suitable for the judgement. We can remind briefly that the forerunner of these actions was the procedure to punish the anti-union behaviour (art. 28 of the

Workers' statute of rights). This is a procedure that has an executive efficacy that overstay till the probable fulfilment of the final judgement; if the judgement will not arrive, this procedure does not lose its executive efficacy and its effects can still have some stability.

On the other hand, we have to remind the summary measure provided for by the Art. 19 of the Leg. Decree 5/2003. In case of special conditions of admissibility and at the end of a summary cognizance action, we can have an order that, if it is not impugned, cannot produce a binding assessment under art. 2909 c.c., even if it gives to the creditor a judicial writ of execution that has an almost stable executive effectiveness.

Another procedure is that of the precautionary protection which allows the formation of anticipating measures, which are essentially executive as the precautionary measures, but that are not necessarily instrumental to the trial on merits and are even not suitable for the judgement, but that can produce their open-ended effects if we will not have the trial on merits.

So we have a new kind of a provisional protection of merits (that can be precautionary or not precautionary) characterized by the fact that the measures coming from summary proceedings, even if they are not suitable to deliver a judgment, have an enforceability and their effects go over the limits marked by the same proceeding (ultra-activity), moreover they had even some stability that comes from the *rebus sic stantibus* clause.

In fact, we speak about a new model of lawsuit and about the presence, in the Italian judicial system, of a "double line": one with a really slow speed so the judgment arrives in very long times and that has its archetype in the ordinary cognizance action; the other, with a really high speed, as it is a highly de-formalized proceeding, with a summary cognizance, which aims to settle the litigation through provisional measures, released from the judgement, but that immediately produce effects and so they are suitable to guarantee a juridical structure to the interests in hand.

1.5. Beyond these different reasons that we have tried, even synthetically, to highlight, it is undeniable that the phenomenon of the diversification of the procedures has its basis in the length and the too high costs of the ordinary cognizance action.

In fact today's the phenomenon of the special procedures' proliferation has reached really excessive sizes, as if the civil justice diseases has been all caused by the inadequacy and the excessive length of the ordinary cognizance action.

We know that the real knotty problem is that of the dramatic absence of instruments and resources. First of all, there is a shortage of judges (about 11% as we can know). This shortage seems even to be really higher if we consider the (absolute) need to have as many judges as the number of lawsuits. We have even to consider the insufficient judicial staff and mostly the high imbalance of the internal assignment of this staff, so some offices are over measured and others have really high staff shortage. We have even to add the infrastructural and technological inadequacy of the offices.

So, we can say that the worrying proliferation of the special processes is the result of an uncritical and preconceived trust (which has an Enlightenment style) in the ability that the legislation on forms and protection measures has to solve the serious problems of the civil justice.

In fact, in several cases, the diversification of the procedures has not even been able to solve the problem of the excessive length of the processes.

We could consider emblematic the chamber proceeding for the fair compensation of the damages coming from the excessive length of the processes. Today's Italy has begun to be condemned by the Strasbourg European Court (15 times in only one day – 22 July 2008) because our Government late pays compensations of the damages caused by the excessive length of the processes and even because these compensations are too low as regards the international standards. So, we have an Italian paradox – that has even been supposed by the first annotator of the Pinto Law – according to which the processes for the compensation of the damages caused by the violation of the fair length (art. 6 European Conv. of the Human rights) have an unreasonable length and so they cause further damages to the citizens.

Further more we have to talk about the labor trial: in some judicial offices because of the staff shortage in the labour branch, the processes last sometimes more than the ordinary cognizance ones that are pending in the same Courts.

The above mentioned phenomenon of the provisional protection of merits (which is even ultra-active) certainly meets the necessity of the modern society, projected to guarantee a timely settlement of all litigations that we have. But, this settlement is based on the probability, and not on the truth and the certainty. In fact, we must not to forget that – as we have already highlighted – "any process is not really closed if the judgment does not correspond to the truth".

On the other part, we have correctly said that the proliferation of the processes causes problems of selection and compatibility, and even, "weaving" among the different kind of processes and this compromises the effectiveness and the economy of the "machine of justice" itself.

Maybe, the road to follow is that one to recover the centrality of the ordinary cognizance action, which needs a substantial acceleration. Naturally, we have to do it according with a *de iure condendo* outlook, even if we must not ignore the *de iure condition* one, through the elaboration of praxis and virtuous interpretations that, if possible, must be able to give functionality and efficiency to the ordinary procedure.

But we must be aware that this solution is not really adequate to remove the civil justice diseases; even if this solution seems to be the most serious one compared with the proliferation of processes with special procedures as we have today.

1.6. We can insert in this situation the today's trend of the EU laws – which we can find especially in the second generation European rules – to have uniform procedure laws that must simplify and speed up the processes on certain features of litigations.

In particular, I speak about the most recent laws: the (EC) Regulation nr. 1896/2006 of the European Parliament and of the Council of 12 December 2006, creating a European order for payment procedure; the (EC) Regulation nr. 861/2007 of the European Parliament and of the Council of the 11 July 2007 establishing a European Small Claims Procedure.

The impact of these regulations on our legal system has to be evaluated from a double point of view. In fact, as they establish new sectorial special proceedings it is necessary, from one hand, to evaluate the problems of enforcement and of coordination that we have as regard the existing procedural law. From the other hand, considering that these regulations' purpose is to speed up and to simplify the processes we must evaluate the possibility to elaborate a new simplified process model as foreseen by the EU laws. But this model must provide useful indications – even as regards the interpretative praxis – in view of the already mentioned purpose to speed up and to simplify the ordinary processes.

2. The European orders for payment procedure: the main features and elements to simplify this procedure

This kind of procedure - that, for the moment is optional and in alternative to the National law procedures (art. 1, 2° par. Reg. 1896/2006) - has been established for civil and commercial matters in cross-border cases (art. 2 Reg. 1896/2006); or rather for those cases in which at least one of the parties is domiciled in a Member State other than the Member State of the court seized (art. 3 reg. 1896/2006).

This procedure is applied to uncontested pecuniary claims that can be exacted at the date of request presentation. But, this new procedure shall not be applied to all the matters that are expressly excluded by art. 2 of the Reg. 1896/2006. It is not applied even to the claims arising from non-contractual obligations (usually the illiquid ones), unless they have been the subject of an agreement between the parties or there has been an admission of debt or they relate to liquidated debts arising from joint ownership of property (art. 2 of the same Reg.).

Its jurisdiction is governed by the EC Reg. 44/2001 on the jurisdiction and the execution of the judgments on civil and commercial matters; provided that when there is an order towards the consumers the request must be done before the courts in the Member State in which they are domiciled (art. 6, par. 2 of the Reg.).

On the contrary, the internal jurisdiction is governed by the ordinary criteria, even in pursuance of the principle according to which all procedural issues not specifically dealt with in that Regulation shall be governed by national law (art. 26 of the Reg.) In particular the vertical jurisdiction between the justice of the peace and the court is provided for by the ordinary criteria of the value and the matter.

The purpose of this Regulation is to simplify, speed up and reduce the costs of litigations concerning the recovery of those claims by creating a uniform and

harmonized procedure that is a European order for payment able to circulate in all Member states without *exequatur* intermediate proceedings.

This kind of special procedure is necessary for the small and medium size enterprises, as it wants to remedy to the phenomenon of delay in the payments and it aims to overcome the different procedures among the different Member states that create impediments to access to efficient justice in cross-border cases and even a distortion of competition within the internal market (see in the preamble items 6,7,8,9).

So, we can have a special procedure whose *ratio* does not come from the protection of the "weak" party, but from the necessity to have a better and more correct functioning of the EC market.

The simplifying and speeding up function is indicted according to different aspects, moreover respecting the basic principle of the cross-examination and the right to counsel.

a) The claimant and the defendant can even personally appear before the court without the presence of technicians (art. 7, 6° par. And art. 16 5° par. of the Reg.). The choice to appear personally before the court, mostly for the claimant is encouraged by the provision according to which the court fees shall comprise fees and charges to be paid to the court (art. 25, 2° par. of the Reg.) (for example the united fee), and there are not included for example lawyers' fees (see item 26 of the preamble).

b) Even considering the above-mentioned principle, to the regulation is annexed an application form for the statement of opposition to the court, so to simplify and to abridge the work of the parties and of the court.

c) So, the regulation provides a summary process with a superficial cognizance according to the features of the so-called pure process of warning.

As we know, we have two forms for the injunction: the "pure" warning process and the "documentary" one. In the first one the application is based on facts that are simply asserted and not proved; the issued *inaudita altera parte* judgement has no enforceability; this judgement becomes enforceable only after the expiry date for the opposition if it is not submitted. In the second case, (the "documentary" warning) the application is based on proved documents; the issued *inaudita altera parte* judgment can have enforceability by law or by court order; the debtor opposition allowing produces the ineffectiveness of the judgment (and so it conditions it in a resolute way).

The European order of payment belongs to the first case. The application shall state the amount of the claim and the description of the circumstances invoked as the basis of the claim and only a description of evidence supporting the claim (without enclosing documentary evidences) (art. 7 of the Reg.).

The European order of payment is issued according with a real superficial cognizance of the court as regard the request. We must not be deceived by the art. 8

of the Regulation. This article states that first of all the court shall examine if the application form meets the requirement set out in the Regulation (for example if it is a civil or commercial case as provided for art. 2; if it is a cross-border one; if it is a cash and receivable claim; if exists a clear jurisdiction, etc.). I would add even the evaluation of the other trial requirements provided for the national laws that can be surveyed ex officio (for example the jurisdiction on matter, value or territory). Then, art. 8 states that the court must evaluate if the claim appears to be founded. Moreover, the art. 11 of this regulation states that the application must be rejected only if the claim is clearly unfounded, while art. 12, par. 4°, item a) states that in this order, the defendant shall be even informed that "the order was issued solely on the basis of the information which was provided by the claimant and was not verified by the court". In this way the existence of the claim must be evaluated *prima facie*, to see if it is unfounded, according to the information given by the claimant, that in case could be supplemented upon court request (art. 9).

The judgment has its enforceability only after a statement of the court if we have not had an opposition from the defendant in the time limit provided for the art. 16 (within 30 days of service of the order).

So, it shall be recognized and enforced in the other Member States without the need for a declaration of enforceability and without any possibility of opposing its recognition (art. 19).

Because of the return to the national laws (art. 26) we can think that in Italy the European order of payment shall have, because of the lack of opposition, a stability that can be comparable to that of the injunction with no opposition. We cannot even object that this kind of procedure is a "pure" warning one, as no one doubts that this stability will act in our legal system even in the (few) cases of pure warning (for example an injunction to recover the lawyer professional fees).

d) In order to simplify the procedures the Regulation sets an important value to the non-opposition of a claim from the defendant. On the contrary the main purpose of this procedure is that to have the certainty and then the claim recovery through the non-opposition of the defendant (that is linked to the lack of opposition within the law time limit).

As it is foreseen by the application F (IV annex of the Regulation) it is sufficient that the defendant states its opposition even in a generic way. If it arrives, the European order of payment has reached its purpose.

Exactly for this reason, the Regulation states that the claimant – right in the moment of the submission of the application form and even successively (but before that the order is issued – shall ask with a suitable appendix that can terminate if there is an opposition. Moreover the appendix is not acquainted by the defendant (art. 12, 2° par. "It shall not comprise the information provided by the claimant in Appendices 1 and 2 to form A") in lack of this application the opposition procedure follows the ordinary law of the Member state.

e) In order to balance the basic meaning given to the "non opposition" as it is the "exclusive" justification in merits of the enforceability of the European order of payment we have two correctives, that shall protect the defendant right of counsel.

In the first place, the court shall ensure that the order is served on the defendant in accordance with national law by a method that shall meet the minimum standards (art. 12, 5° par.). These rules favour, from the one side, the personal service attested by an acknowledgement of receipt by the defendant (art. 13). From the other side, among the several types of service in the different national laws where the order can be served on a person other than the defendant, the regulation admits only those in which, even in a supposed way, the document could really have reached the defendant (art. 14). For example, in Italy, we cannot accept the personal service at the defendant's personal address on persons who are living in the same household as the defendant or on the concierge; the service in the manner provided for by art. 140 C.C.P.; and so on.

In the second place, beyond what is provided for by the national laws, we have the possibility to review the European order of payment before the competent court in the Member State of origin when the time limit for opposition is expired. This can arrive only in particular cases: a) when the service has been effected without proof of receipt by the defendant (art. 14) and not in sufficient time to enable him to arrange for his defence b) When the defendant even if the personal service has been received directly by himself (art. 13), is prevented from objecting to the claim by reason of force majeure or due to extraordinary circumstances without any fault on his part. c) When the order for payment has been clearly wrongly issued, having regard to the requirements laid down in this Regulation, or due to other exceptional circumstances. (art. 20, par. 1° and 2°). If the court rejects the defendant's application the European order for payment shall remain in force; on the contrary it shall be null and void (art. 20, par. 3°).

3. Impact and relapses on the national laws: first brief remarks

As I've already said, the simplify and speed up function of the order – that is based on the inertia and the non-opposition of the defendant – terminates when he lodges the statement of opposition, using a standard form (F as set out in Annex VI) with which he contests the claim, without having to specify the reasons for this (art. 16).

Vice versa, in the case when a statement of opposition is lodged, the process "continues" before the competent courts of the Member state of origin and it is "regulated by the ordinary civil procedure laws" (provided that the claimant has not preventively asked the redemption in case of opposition). More generally, the regulation states that all procedural issues not specifically dealt with in this Regulation shall be governed by national law (art. 26).

a) It is a real complication, which, in fact, is connected to the transmutation of the procedure that must follow the Member State law of the court of origin, with all the problems that are linked to this passage.

The matter is limited to the change of the procedure and does not involve, on the whole, problems of jurisdiction. In effect, even in this kind of procedure we have to affirm the functional and imperative jurisdiction of the court that has issued the order of payment; a jurisdiction that, even it happens for the European order, has the same problems that afflict the jurisprudence as regards the injunctions for *lis abili pendens*, consolidation of actions, excess of compensation, counterclaim, etc.

But even this matter is not easy to solve. We must consider that it is possible, and sometimes probable, that the parties must appear before the court personally. But, further to the opposition, it is compulsory the advocacy in court. On the other hand, the application for a European order for payment shall be made using standard form A – that could be supplemented (in the limits of the *emendation libelli*); while the opposition of the defendant – that, as a rule, could be a pure objection (using form F) – must be advanced again mostly as regards the original application that he has done with form A, but even with reference to a subsequent and possible emendation. Naturally we have always to consider that the adverse has the substantial status of claimant, while the objectant has that of defendant.

On the other hand, the change must be done according to the, sometimes special, procedure that must be applied before the competent court. So, if the object of the European order of payment is a privileged debt or the payments for tenancy of urban immovable properties, the change of the procedure seems to be the one that is provided for by art. 426 of C.c.p. The court must issue an order to determine the date of the hearing giving to the parties a time limit for supplements, respecting the above mentioned needs: a first time limit for the adverse to supplement the application and to submit all the preliminary investigations, according to art. 414 of C.C.P.; a second time limit for the objectant considering even its substantial status of defendant, according to art. 416 C.C.P.

The order of change of the procedure must be transmitted to the addresses of the parties as stated in the form A and F, according to the methods provided for article 13 and 15 of the Regulation. This must be done in order to give final dates to the parties. Then, the exchange of supplementary acts shall be done through the appearance before the court of the defender and the deposit in the clerk's office (art. 414, 416 and 426 C.C.P.).

When the European order of payment has been issued for a litigation subjected to the ordinary cognizance action I could exclude solutions such as the reinstatement of action with an act that is serviced from one party to the other, and I would think that even in this case we could adopt the solution of the change of procedure with an order of the court in charge of the cause. The solution could arrive thanks to the enforcement by analogy of the last two paragraph of art. 164 C.C.P.. Essentially, the Court must give the adverse a final date to supplement the application already

submitted with the Form A (always within the limits of the emendation), with a content that must be similar to a writ of summons according to art. 163 C.C.P.; must determine the date of the hearing considering the terms for the appearance according to art. 163 bis; must give to the objectant the time limit of twenty days before the hearing to deposit his supplemental answer to the opposition, in pursuance of art. 167 C.C.P. Even in this case, the order must be transmitted to the parties with the above mentioned methods of service.

I think that the complications and the subsequent slowing down of the process that come from the statement of opposition and the need to change the procedure are sufficiently clear.

b) Another problematic outline as regards the coordination between the regulations and the national rules is given by the enforceability of the European order of payment. Art. 18, 1° par. of the Regulation declares the European order for payment enforceable (with the consequent possibility to circulate easily within Europe in pursuance of art. 19) when the opposition is not submitted according to the law. The second paragraph states that, "without prejudice to paragraph 1", the formal requirements for enforceability shall be governed by the law of the Member State of origin.

This means that the European order of payment can be directly enforceable, with a consequent chance of circulation without *exequatur* (art. 19) only if there is no opposition, that is only in the case in which the claim has not be contested. This even means, I think, that once we have the statement of opposition and there is a change of the procedure (in the case in which the claimant has not preventively required the redemption) if the judgment of opposition comes to an end the injunction would be enforceable according to art. 653 C.C.P., but as it is an order of a national court subjected to the circulation in pursuance of the Regulation nr. 44/2001, and not if it is a European order of payment.

On the other hand, the laws of the Member State of origin regulate the formal issues to the enforceability. If I'm not mistaken, as regards Italy, the provisions of art. 647, 2° par. C.C.P. fall within these issues; according to this article the court before stating the enforceability for lack of opposition must order that the service must be renewed "as it is or is probable that the objectant does not know the order". With regard to this, we must even consider that, according to last paragraph of art. 12 of the regulation, the court shall ensure that the order is served on the defendant in accordance with national law by a method that shall meet the minimum standards laid down in Articles 13, 14 and 15, these standards must have a certainty and a high degree likelihood as regards the receipt of the order by the receiver. It comes out that, when one of these standards has not been correctly applied, we have the hypothesis provided for art. 647 C.C.P. and the court has to issue a new service.

c) At last, I make a short outline as regards the instrument of the review of the order as provided for art. 20 of the Regulation.

Our laws provide for the remedy: it is the tardy opposition regulated by art. 650 C.C.P.. Moreover, as regards the cross-border cases and the European order of payment the enforcement of this provision becomes larger.

On the one hand, in this case, the tardy opposition can be done even if there is a clear mistake of the requirement of admissibility provided for by the regulation (for example, a clear national cause, lack of jurisdiction, etc.) and in certain exceptional circumstances (among which the item 25 of the preamble includes as an example a situation where the European order for payment is based on false information provided in the application form).

On the other hand, as regards the provision of art. 650 we think that when the service procedures have not a vice in the service, they cannot be considered a fortuitous or a force majeure event (and so the probable negligence of the bailiff that has prevented a timely acknowledgement of the act becomes irrelevant)

Having established this, the wording of art. 20 of the regulation seems to allow the statement of tardy opposition in the cross-border cases, mostly, when the service is not been done according to the minimum standards laid down in Articles 13, 14 and 15 (for example in case of service according to art. 140 C.C.P.; of delivery to the concierge, etc.). Moreover, these are cases in which the court shall issue a new service of the European order of payment before declaring its enforceability according to art. 647 C.C.P.. In the second place, when the service has been done according to the standards laid down in art. 14, art. 20 seems to allow the tardy opposition even when it is not been done in sufficient time to enable the defendant to arrange for his defence, without any fault on his part, including the hypothesis of negligence of the bailiff or other circumstances with regard to the service that cannot be a vice in the service itself.

d) Moreover, I think that these new laws could expand even outside the straight application of the European order of payment and could be able to produce immediate effects even on the procedure for the national order.

Drawing our attention on the last mentioned cases I cannot find sufficient reasons to look after the justice users when they are involved in a no-cross-border case in a different and worst way. The EC rules on services simplify this procedure and even represent a minimum standard of protection of the right to counsel that is constitutionally guaranteed.

So we can state that – even in order to respect the principle of equality provided for by art. 3 of Italian Constitution – art. 647 and 650 C.C.P. must be interpreted and applied even to the national procedure of the injunction using the same methods of the cross-border injunction proceedings.

4. The European small claims procedure: main features and elements to simplify the procedure

This kind of procedure - that, for the moment is optional and in alternative to the National law procedures (art. 1, 1° par. Regulation 861/2007) - has been established in civil and commercial matters of cross-border cases, where the value of a claim does not exceed EUR 2000 at the time when the claim form is received by the court or tribunal with jurisdiction, excluding all interest, expenses and disbursements. Moreover, this regulation is not applied to the cases that have been already excluded by the regulation 44/2001 (Bruxelles I); and even to those on employment law, on violations of privacy and of rights relating to personality and on tenancies of immovable property, with the exception of actions on monetary claims (art. 2 Reg. 861/2007). A cross-border case is one in which at least one of the parties is domiciled or habitually resident in a Member State other than the Member State of the court or tribunal seized (art. 3 Reg. 861/2007).

The jurisdiction is governed by EC Regulation 44/2001 on the jurisdiction and on the enforcement of the decision on civil and commercial matters.

On the contrary the National jurisdiction is governed by ordinary rules, even on pursuance of the principle according to which, except for the specific provisions of this regulation, the procedure shall be governed by the procedural law of the Member State in which the procedure is conducted (art. 19 of the Reg.). So we can say that this special action normally pertains to the justice of the peace, if it is within the above mentioned value; but it could even pertain to the court, especially as regards claims on tenancy relationships.

This regulation aims to have in all Member States (except Denmark) a uniform procedure to simplify and to speed up this kind of claims and to reduce the costs, so to facilitate the access to justice and to guarantee a level playing field for creditors and debtors throughout the European Union. This for the benefits of consumers but even of small and medium size enterprises. Its purpose is that to guarantee to the parties a speed and cheap judgment, that can be immediately enforced (art. 15), and that shall be recognized and enforced in another Member State without the need for a declaration of enforceability and without any possibility of opposing its recognition (art. 20).

Unlike the Regulation nr. 1896 of 2006, this purpose is prosecuted through a full cognizance action that is able to combine the needs to simplify and to speed up with the right to have a fair trial and a public discussion, really felt in this matters.

The main features of this new procedure are the result of a balancing between these two needs.

a) The claimant and the defendant can appear before the court personally and the rrepresentation by another legal professional shall not be mandatory (art. 10). The choice to appear before a court personally is even encouraged by the provision

according which the Member States shall ensure that the parties can receive practical assistance in filling in the forms (art. 11); and even by the provision according to which the court or tribunal shall not award costs to the successful party to the extent that they were unnecessarily incurred or are disproportionate to the claim (art. 16).

b) Even considering the above-mentioned principle, the regulation has annexed a standard application form for the objection of the claimant and to the court judgments, in order to simplify the parties and the court activities.

c) The action shall have a written procedure, and there is essentially a "cut and thrust" between the parties (art. 4 and 5).

The claimant commences the Procedure by filling in standard claim Form A as set out in Annex I, and lodging it with the court or tribunal, specifying the parties, the object and the reason of its claim (normally a simple description of the circumstances without any legal assessment of the claim: art. 12, 1° Par.). The claim form shall even include a description of evidence supporting the claim and be accompanied, where appropriate, by any relevant supporting documents. A copy of the claim form shall be served on the defendant by postal service attested by an acknowledgement of receipt including the date of receipt, or, if it is not possible according to the methods provided for in art. 13 and 14 of Reg. n. 805/2005 (European judicial writ of execution for uncontested claims), we have the same methods in the Reg. 1896/2006 on the European order of payment (see paragraph 3).

The defendant shall submit his response by filling the standard answer Form C (Annex III), and he has to specify if he accepts the claim and, if he does not accept it, which are the reasons of his dissent and the evidences of it. If he wants to submit a counterclaim he fill up the form A that then is served to the claimant together with some supporting documents. To the counterclaim the claimant shall reply using the form C.

d) The court or tribunal shall give a judgment even after the "cut and thrust" between the parties (art. 7, 1° par.). But it can give a judgment even before, that is after the submission of the claim from the claimant, when it is really unfounded or inadmissible, as it has some procedural flaws that can be pointed out *ex officio* (for example lack of jurisdiction).

In alternative, we can even have a public discussion before the court. It shall be a written one, in which the court demands further details concerning the claim from the parties within a specified period of time (art. 7, 1° par. Item a). Secondly, it shall summon the parties to an oral hearing, which can even be done through a video conference or other communication technology if the technical means are available (art. 7, 1° par, item c; art. 8). Moreover, even if a party requests it, the court may refuse to hold an oral hearing if it is obviously not necessary for the fair conduct of the proceedings (art. 5, 1° par.).

At last, the court can admit evidence but only the "necessary" ones for its judgment (art. 9, 1° par.). The probative inquest is normally governed by the procedural law of the Member State (art. 19). But, considering the cross-border characteristic and that they are small claims, we have some important derogations: in particular the possibility to have written statements of witnesses or in video conference. In fact, evidences such as expert evidences or even oral testimonies are not well accepted: the regulation specifies that these evidences can be taken only if they are necessary for giving the judgment and in making its decision, the court shall take costs into account, so to balance the costs and the real need to have this evidence (art. 9, 3° par.).

e) The parties and the court have very quick requirement times, in order to conclude the procedure as soon as possible. The time limits for the parties are not peremptory, as the court can extend them. Moreover the delay can be ordered only in exceptional circumstances if it is necessary to protect the rights of the parties. As regards the time limits the court or the tribunal must respect them and the regulation states that if it is not possible to respect them in "very exceptional circumstances" the court and the tribunal must adopt the necessary measures "as soon as possible".

f) The regulation states that the judgment shall be enforceable notwithstanding any possible appeal and apart from any contrary national laws (art. 15).

Anyway, in case of circumstances provided for by art. 23 it is possible to stay or limit the enforcement proceedings only to protective measures

5. The simplifies model of the EC legal system: effects on the Italian procedural law: some brief remarks

Even considering the particular field in which the EC laws must act and the special nature of the litigations that they govern, I think that the simplified model of the EC legal system is sufficiently clear and can give some useful suggestions with prompt relapses on our procedural law.

First of all, contrary to the last year Italian trends, the European law highlights that the way to improve the quality of the civil justice is not that to have too many summary processes, with superficial cognizance forms of safeguard, which are alternative to the full cognizance and to the formation of the judgment.

On the contrary, from this rules we have a model of full cognizance action that respects the public discussion and the right of action and of counsel but which even has the characteristics of speeding up, simplification and flexibility.

Speeding up, that is the cognizance occurs in closured times, compatibly with the need to protect the rights of the parties and with the possibility for the court or the tribunal to adopt the provision respecting the time limits (see art. 14 Reg. 861/2007).

Simplification, that is in an ordinary process we have to try to eliminate all repetitive activities, which cannot be useful for a fair conduct of the case.

Flexibility that is the procedural rule shall allow the adaptation of the process to the needs to have a fair conduct of the real case.

Approximately, it seems possible to enucleate some guidelines where we can find the above-mentioned model in order to evaluate its relapses, even from an interpretative point of view.

a) Pointlessness of the conduct of the cause when the application appears to be clearly unfounded or inadmissible

Art. 4, 4° par. of the Regulation 861/2007 provides the refusal of the application in *limite litis* – even without a public discussion – when it appears to be clearly unfounded or inadmissible (when it has irremediable procedural flaws that can be pointed out *ex officio*). Even more, the court has to give its judgment when the clear groundlessness or the inadmissibility (for irremediable procedural flaws) come from the defendant exceptions (for example the invalidity of the contract that has generated the claim; lack of jurisdiction, etc.). So, I think that in both cases the need to have a public discussion can suggest to hear the parties on this specific matter, asking them integrations or details according to art. 7, 1° paragraph, item a).

In any case, the European directive is really clear: when the cause has issues on the merits that could lead to a refusal or to procedural issues that can able the court to give its judgement, we can avoid a further conduct of the case and the court must give immediately its judgment. So, we can speak about a real right of the defendant to obtain a judgment on (refusal for) merits or on the proceeding without any delay, every time we can have a clear groundlessness or inadmissibility.

I think that this directive could be fulfilled even in the Italian ordinary cognizance action.

In case of preliminary issues on the proceeding or on the merits that can lead to a judgment, the remission according to art. 187 c.c.p. must be ordered in the first hearing; this can arrive when the parties ask to have a written procedure in pursuance of art. 183 c.c.p.

Moreover, this is (was) even provided for by art. 80 bis of the present law – a quite unused rule. And it cannot be an obstacle to the literal formulation of art. 183, 7° par., according to which the remission of the judgment or the taking of evidences admissibility are alternative options, as to mean that the first one can be issued only after that the preliminary estoppels have been completed (even after the court has given a time limit to submit written memorials).

The defendant shall have a quick judgment when he has been summoned before the court with an action that is really unfounded or vitiated as regards the trial requirements. On the other hand, the court can or must identify the easy solution cases from the difficult ones, and must deal with them in a different way.

If this is true, what is provided for by art. 187 c.c.p. the power of judgment remission has to be referred to the whole conduct of the case and not to a particular phase of it. So, it is a power that the court has to use in any moment of the conduct, even during the first hearing.

b) Pointlessness of the conduct of the cause when there is an admission, a non-objection and an absentia

In the European laws the behaviour of the defendant has a basic role as regards the simplification and the speeding up of the process.

In the European Small Claims Procedure the acceptance of the application from the defendant, expressively provided for by Form C (Annex III) allows the court to give an immediate judgment: in fact, this hypothesis is among those according to which the court shall give a judgment after the response of the defendant, without demanding further details (art. 7, 1° par. Reg. 861/2007).

The non-appearance before the court of the defendant has the same importance. According with art. 7, 3° par, if the court or the tribunal has not received an answer from the defendant party within the time limits laid down in the regulation, it shall give a judgment. The matters which are at the basis of the claim become incontestable if we have the defendant absentia. In fact, as we must have a judgment without allowing the taking of evidences (from the claimant) the European lawmaker implicitly but clearly exempts him from the onus, as the court cannot charged the claim matters because of the defendant inertia. The confirmation of what we have just said can be deduced by art. 18 of the regulation that – in any case – allows the court to review the judgment when there is an unintentional absentia of the defendant.

Moreover, the absentia of the defendant has a specific importance for the certification of the European judicial writ of execution for uncontested claims in pursuance of art. 3 of the EC regulation 21 April 2004 n. 805/2004. As we have already said, the defendant inertia coming from lack of opposition to the European order is crucial to give it a final enforceability.

After all, the defendant inertia and his absentia can be considered as *ficta confessio*, and so the court thinks that the claimant is right and it can give a quick judgement.

I think that the European law can have immediately relapses on the national procedural law. In the cross-border cases, when the defence of the defendant is more difficult, the absentia can exempt the claimant from the taking of evidence. This must be even worth in the national cases. In short, we have a different conduct in the cross-border case and in the national one that cannot be justified and reasonable; so it seems to be justifiable the doubt of constitutional legitimacy (because of the violation of articles 3 and 24 of Italian Constitution) of the code rules that govern the absentia as it is a *ficta contestation*. At the same time, in front of the

European lawmaker clear position on this matter, it is quite difficult to think that in Italy we can hide behind the procedural law tradition, as the Constitutional Court has done in the judgment of 12 October 2007, on the absentia rules in the company trial (art. 13, 2° par. Of the Leg. Decree 5/2007).

Beyond this above-mentioned doubt, I think that we have not to ignore what comes from the European law even as regards a different outline. If there is an absentia of the defendant the court has no reason to delay the judgment. Supposing that even the claimant has to prove in any case the reason of his claim since from the first hearing, there is no reason – in case of the absentia of the defendant – that he appears before the court without preparation. I think that this matter will strengthen the conviction according to which, in case of the defendant absentia, the time limit to have a written procedure in pursuance of art. 183 c.c.p cannot be given even if the claimant has asked it.

c) Defendant counterclaim burden

What we have already said, according to this model the defendant has to submit a counterclaim *in limine litis* to the claimant's reasons, which are at the basis of the claim.

According to the Italian procedural law we can state that this burden should subsist even in the ordinary procedure as it happens in the labour law cases. So we could waive the idea (that is quite common) according to which - as the simple silence of the defendant can be interpreted as he does not want to submit a counterclaim – the simple defences (that is the refusal of the claim facts) are always possible till the conclusions of the procedure.

d) Recovery of the court powers as regards the case.

The simplification and the speeding up of the case allow a full recovery of the court powers as regards the case. In fact the court or the tribunal decides which are the activities to be done to have a fair trial, according to the principle that every one has the right to have a fair trial and a public discussion.

We have to take note of it in a realistic way, without prejudices. According to our Constitution the court guarantees the democracy even towards the other powers of the State, in this way, I do not think that we can have a full recovery of the court powers and so a return to the authoritarianism that characterized the 1940 Code. On the other hand, according to my opinion, the quite short life of the company trial has showed that if the trial is characterized by the parties initiatives – even if they are limited to the summons – it is really complicated, uneconomic and devoid of a real functionality.

The real problem is that the court – in order to be able to have the guiding role coming from its simplification and speeding up function in pursuance of the European laws - must be able to know the terms of the litigation from the real beginning

of the claim. In real terms, this means that the working load must be suitable and must allow the full and immediate cognizance of the case.

But, now we have another problem: do we really want that the court will be able to carry out its task?

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Original scientific paper
Received: March 15th, 2009

UDC 340.15(37); 347.72
ID 158253324

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COMPANY MODELS & ENTERPRISE FIGURES BETWEEN ROMAN JURISPRUDENTIAL LAW AND CODE REGULATIONS*

Abstract: *The history of the company law shows us that the present and the future of this area of law must be marked by the contract. If this fact can be shared, then it is probable that the historians of Law have still something to say in the bewilderment of our hasty time. The article analyzes company models and enterprise figures between Roman Jurisprudental Law and Code regulations with help of some graphic schemes and some Latin texts which can be useful for better understanding. The values of Roman Law are analyzed as a "compass" to legal standardization of the company institutions in the European Law*

Key words: *company law, contract, Roman Jurisprudential Law, Code regulations*
JEL classification: K22, D86, N40

At first European jurists think of a company like a body provided of a legal status, in which single partners are not liable with their own properties for the obligations assumed by the company and vice versa.

This conceptual pattern regulated in the Codes as *società per azioni* or *società anonima* (joint-stock company), *società a responsabilità limitata* (limited company) or the like, seems the cultural reference pattern, though in European Civil Law there are also types of *società di persone* (partnership) in which there is

* This paper was published in the proceedings of the 21st Annual Conference of the Australia and New Zealand Law and History Society; see *Australian Journal of Legal History*, Vol. 9, 1, 2005, 119 ss.

I wish to thank the Australia and New Zealand Law and History Society. I was particularly honoured for the invitation to open its 21st Conference. Here I am publishing the paper developed on that occasion, deliberately keeping its conversational style and adding just some guideline notes. Some small changes in the text are due to my colleague and friend Andrew Buck's suggestions, of the Macquarie University, and to some critical comments made by Richard Bauman and by the other colleagues of the University of New South Wales, who I met to discuss these stimulating topics.

not a juridical "shield" protecting the partnership assets against the single partner's creditors'attacks. On the other hand in these cases also the partner's private assets are exposed to the company's creditors' executions.

Now the enterprise concentration in big groups, in many cases listed on the Stock Exchange and sometimes of transnational importance, leads as a result to a preponderance of joint-stock companies. In a delicate period of economical transformations such as the present one, their regulation often makes Codes insufficient and needs a continual legislative adaptation. In making this the UE countries are helped by the unitary normative policy imposed by the European Community.

But what is the position of the present European Law towards Roman tradition? And again we live in a period of cultural bewilderment to which Continental jurists are exposed, we are witnesses of the so-called "decline of codifications". So I ask myself in which terms Roman Law can help as a "compass" to orient the interpretation of the company institutions in a trend of a progressive legal standardization of the European Law? A Law, a set of rules, - I must add – whose adequacy to the changeable economical events of the western society is at a crisis point and in which the conformity of events to rules, Hans Kelsen's[1] '*Regelmäßigkeit des tatsächlichen Geschehens*', seems nearly a pure utopia.

I'll try to face these great questions of our time objectively, but I am aware that probably in no other matter as in the company matter we can find a confirmation of how history is not a geometrical figure, as Henry Block affirms. Just leaving positive jurists' conscious or unconscious '*esprit de geometrie*', I'll propose you a short visit to a 'Romanist's workshop', though the Romanist is a traveller like me. So I let the sources speak to try to analyse with you some aspects from a small observation angle 'pointed' on Roman private law[2] and particularly starting from the theme of this conference on the relation between companies and enterprise models in Roman legal system.

I'm taking the liberty of providing you with some graphic schemes and some Latin texts which can let you follow better what I'm going to say.

Roman partnership was a contract based on the agreement of two or more parties who cooperate to reach a common aim. This aim could consist in a single or in more results all coordinated among them. Partners contributed all their goods, money or labour to the company, or single goods or specific activities and they gained a profit from this, in proportions which could vary from a partner to another, according to the scheme described by Gaius:

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1 *Il problema della giustizia*. Ital. transl. edited by M. Losano, Torino, 1975, p. 73

2 On this perspective see S. Randazzo, *Roman Legal tradition and American Law. The Riccobono Seminar of Roman Law in Washington*, in *Roman Legal Tradition* 1, 2002, 123 ff. = *Tradizione romanistica e diritto statunitense: il Riccobono Seminar of Roman Law a Washington* (Italian translation), in *Bullettino dell'Istituto di Diritto Romano* 100, 1997. 684 ff. (on line in http://www.unipa.it/~dipstdir/portale/).

3.148: *Societatem coire solemus aut totorum bonorum aut unius negotii, veluti mancipiorum emendorum aut vendendorum.* (Partnership usually covers either all the partners' worldly wealth or else a single business, for instance, buying and selling slaves).

The share of profits and losses among partners is 'inside' the contract and it concerns the obligations among the partners themselves, regulated by the *actio pro socio*, a civil action based on *bona fides*. However the partnership was 'personale', that is among people, both in the sense that a partner could not convey his membership to other people without all the partners' consent – in that case a 'new' society would be risen, both substantially and legally - neither by a contract *inter vivos* (among living people) nor *mortis causa* (by hereditary succession), and in the sense that neither the partnership as a whole nor personally the other partners are liable for the obligations assumed by a single partner:

D. 17.2.82 (Papinianus 9 quaestionum): *Iure societatis per socium aere alieno socius non obligatur, nisi in communem arcam pecuniae versae sunt.* (By the law of partnership, a partner is not liable to incur debt through a co-partner unless the money was paid into the common fund).

And this according to a principle which appears reflected in a well-known Ulpian's passage:

D. 17.2.20 (Ulpianus 31 *ad edictum*): *Nam socii mei socius meus socius non est.* (For my partner's partner is not my partner).

This Ulpian's tongue twister says in only eight words what entire treatises tried to say, that is a partner is never liable for obligations deriving from the relations between another partner and a third person. Such a pattern differed from English partnership in that it did not necessarily aim at profit, but still more in the fact that while in Common Law partners are, within limits, agents for each other, and bind each other by dealings with third persons, this aspect of the matter did not appear in Roman Law in ordinary cases, since one man could not in general contract so as to affect another. Thus the law dealt almost entirely with the relations of the *socii*, *inter se*.

The doctrine which fathomed the different problematic outlines of Roman partnership is not univocal, but it oscillates between traditional theories and trends resorting to an actualising reconstruction of institutes. This is very often an attempt of identifying a Roman commercial law considered as independent towards the general Civil Law[3], with an analysis extending from partnership to

[3] Efforts (and failures) of such a research, both among Roman law scholars at least starting from L. Goldschmidt (*Handbuch des Handelsrechts*[3]. *Universalgeschichte des Handelsrechts* 1, Stuttgart, 1891) and among modern Commercial law scholars are outlined by Filippo Gallo, *Negotiatio e mutamenti giuridici nel mondo romano*, in *Imprenditorialità e diritto nell'esperienza storica. Atti del Convegno di Erice, 1988* (pubbl. Palermo, 1992) 133 ff.

enterprise and 'entrepreneurs'. This analysis wants to coordinate them but most of the times only superimposes and confounds their nature and their legal regulation[4]. Thus it doesn't seem easy to move in this context but adopting middle solutions. I must say, I don't like these kinds of solutions because they serve to offer reconstructions which may be 'academically correct' but that often run the risk of offering a low rate of scientific nature and therefore of 'truth'. Of course to deal with these particular outlines needs a prudent approach which moves away from a 'paleoromanistica di ritorno'[5] (that is a return to an ancient way of studying Roman Law) as Riccardo Orestano defines it, with the help of the other social sciences, the history of economics as first, in this delicate matter. But this approach must consider the problem with the traditional methodological instruments, and must be free from every dangerous and limited 'actualising' tendency.

Roman Law, as we said before, does not know joint stock companies and the doctrine has reasoned in different ways on the possibility of understanding figures which can be considered to a certain extent undeveloped hypotheses of liability limits. In the 'scientific psychology' of these attempts we can perhaps guess modern Roman Law scholars' trend of searching at any rate in Roman Law legal 'patterns' that they can consider as historical premises of modern institutes. In this context the research often worked taking into consideration as tightly interdependent concepts (and institutes) linked, respectively to partnership and enterprise so that it arrived to assume a 'limited liability enterprise' where we cannot identify a 'limited liability partnership', non-existent as such in Roman Law[6].

Now, if in modern codifications and in the analysis of the modern trade-law doctrine itself companies and enterprises appear at least to be studied in a tight connection[7], this is due to the great number of problems that the preponderance of joint stock companies, both national and transnational, present. These problems are essentially about the relations among the organizational structure of companies, the legal configuration of enterprise properties (micronized in shares whose

= *Opuscula selecta*, Padova, 1999, 823 ff. The transitory autonomy itself of the Italian commercial Codes of 1865 and 1882 towards the Civil Code of 1865, resulted in the code unification of 1942 is a faithful mirror of this fact. Finally P. Cerami e A. Petrucci, *Lezioni di diritto commerciale romano*, Torino, 2002, 5 ff. supported the conservative opinion of Commercial law speciality; see the cit. doctrine ib. in note 13.

4 I apologize for these statements, which I cannot prove in this seat, but I hope to come back soon on them.

5 R. Orestano, *Idea di progresso, esperienza giuridica romana e 'paleoromanistica'*, in *Alle origini della sociologia del diritto*, Milano, 1983, 15 ff. *Amplius* see S. Randazzo, *Le radici di un'incomprensione: Emile Durkheim e gli storici del diritto romano*, in *Index 28,* 2000, 53 ff. and note 11.

6 F. Serrao, *Impresa e responsabilità a Roma nell'età commerciale.* II. *L'impresa in Roma antica. Problemi e riflessioni*, Pisa, 1989, p. 27

7 Though 'impresa' and 'società' appear as distinctly considered by doctrine and, after all, by the Italian Civil Code itself, which regulates them separately.

value is determined by economical variables and complex policies, which are reflected in the movements of the Stock Exchange markets) and management.

This fact induced to focus 'enterprise' phenomena as an essential factor to understand the structure and the history of the ancient Roman *societas*. They were assumed into the Roman system above all through the praetor's work, which protected certain situations and gave them a juridical character. For example this happened when A, subjected to the paternal authority, conducted negotiations, while B, the *pater familias* was charged with the juridical effects, especially for A's liability – whether A is a *filius familias* or more often a slave – so that B could suffer (third) creditors' executions. Scheme 1 illustrates the case.

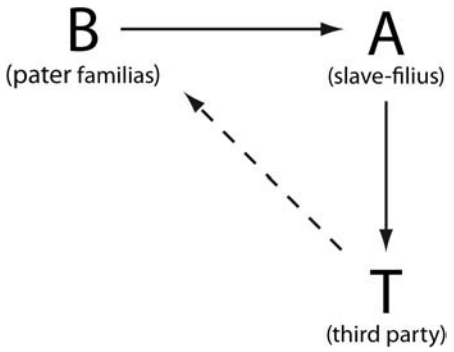

Figure 1.

As you can see an obligation is established between A (the slave or the *filius familias* subjected to paternal authority) and T, the third party. But B, the *pater familias*, is not involved in this relationship at all. He entrusted A with the business and economically benefits from it. According to the Roman *ius civile* in this situation the *pater familias* cannot be liable, because he does not have direct relations with the third party. But with Roman magistrates' decisions and the elaboration of particular actions, the so-called '*actiones adiecticiae qualitatis*', the third person is allowed to proceed against the *pater familias*. In this way he obtains with a particular trial *escamotage* that the sentence is passed against the *pater familias* himself, though it concerns a relation which was, *iure civili*, unconnected with him. So not only the benefits of the business fall on him but also its debts, as it is right.

Now even if in this hypothesis we could see a sort of split between A's management and the *pater*'s liability, we would move, however, in an elaborative context of a purely jurisprudential law, strictly connected with Roman magistrates' creative actions and in a context completely unrelated to company structures and profiles. But in cases like these misunderstanding is recurrent and not only in the Continental doctrine. You need only to think that also an eminent English Romanist like Buckland included the *adiecticiae qualitatis* actions, in particular the *actio institoria* and the *actio exercitoria*, respectively related to slaves' appointment in a trade activity and to the management of a merchant ship, inside *societas*, while these situations concern joint and several liability deriving from enterprise activities and not company ones[8].

[8] W.W. Buckland, *A Textbook of Roman Law from Augustus to Justinian*[2], Cambridge, 1950, p. 510

Actually in my opinion, the existence of, so to say, managerial figures in the praxis of Roman business relations cannot absolutely produce effects on the partnership matter, though it is admissible and in many cases proved by the sources. In spite of this fact sometimes the connection between enterprise phenomena and companies seems cultivated by doctrine, which hypothesized an alternative structure to *societas* for the situations in which someone made use of *servi communi*.[9] Now I think that if we want to analyse Roman partnership with a historical balance, we must keep absolutely separate the problems of juridical-economical configuration of partnership agreement from those concerning the management. In other words, to identify the first one we must concentrate our attention not on the persons but on the company 'assets', because to understand the nature of *societas* we must move from these common assets, from their historical origin, their juridical features, the relation between them and the partners.

But let's take a step backward, to the Archaic age and to the most ancient hypothesis of partnership, because certainly it is so the *consortium ercto non cito, 'legitima simul et naturalis societas'* as Gaius attests[10]. Actually Roman partnership comes from the most ancient civil institution of the *consortium ercto non cito* and this seems generally accepted in doctrine. This was an inseparable partnership[11], which was created among brothers when they inherited *mortis causa* a certain patrimony which they could not 'divide', originally and until the decemviral period (until the half of fifth century B.C.). They could but 'share' it, because they were *consortes*, (etymologically deriving from cum *sors*) that is bound, united, '*cum*', with the same '*sors*', destiny[12] of owners of a property which they had to maintain as a whole.

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9 A. Di Porto, *Impresa collettiva e 'schiavo manager' in Roma antica (II sec. a.C. – II sec. d.C.)*, Milano, 1984, on which see M. Talamanca in *Società*, in *Enciclopedia del Diritto* 42, 1990, 814 note 8.

10 Gai 3.154a: *Est autem aliud genus societatis proprium civium romanorum. Olim enim mortuo patre familias inter suos heredes quaedam erat legitima simul et naturalis societas quae appellabatur ercto non cito, id est dominio non diviso : erctum enim dominium est, unde erus dominus dicitur: ciere autem dividere est : unde caedere et secare [et dividere] dicimus.* There is, however, another kind of partnership peculiar to Roman citizens. For in former times on the death of the head of a family there arose among his immediate heirs a kind of partnership which was at the same time statutory and natural; it was called <ercto non cito>, that is <ownership undivided>; for <erctum> means ownership and hence <erus> is a word for <owner>; and <ciere> means <to divide> so that <caedere>, to strike, and <secare> to cut, are related words for division.

11 On this point see B. Albanese, "La successione ereditaria in diritto romano antico. Saggi", *Annali del Seminario giuridico della Università di Palermo* 20, 1949, 127 ff. and, finally, G. Aricò Anselmo, *'Societas inseparabilis' o dell'indissolubilità dell'antico consorzio fraterno*, in *Iuris Vincula. Studi in onore di M. Talamanca* I, Napoli, 2001, 149 ff. and ib. spec. bibl. in note 2.

12 Actually a *consors* is '*cui eadem contigit sors*': E. Forcellini, *Lexicon totius latinitatis*, Patavii 1940, p. 811. All the common dictionaries normally accept this etymological interpreta-

As you can easily notice the *consortes* are not the basis of this kind of relation, because they as such have a non-characterizing role in the institute, but the goods, the property in a 'comunione dinamica'[13], 'dynamical community' which has its own specifically 'real' normative characterization, given by its intangibility *pro parte* from the single co-owners. So the same relation between persons and property exists in the *consortium* and a secondary effect, so to say, towards the same property that is the bound patrimony. This is the reality of *consortium* because after all this is the reality of Roman Law. Ulpian – the great Roman jurist well-known to English scholars of Roman Law thanks to Tony Honoré's[14] excellent monograph on him – said that 'a complete *jus* (right) is either of acquiring or of keeping or of reducing; for the question is either how something may come to be somebody's or how a person may keep a thing or keep his *jus* or how he may alienate or lose it'[15]. This explains, as we will see later, the ideological unfitness, so to say, of Roman law – in its strong inclination towards the concept of "belonging" - to discipline, synthesizing Galgano's opinion, the partnership agreement to capitalist entrepreneurs' advantage[16] and the surreptitious utilization of differently configured enterprise mechanisms in the commercial praxis.

Now when *societas* joins the ancient juridical stock of *consortium*, this juridical (and cultural) structure in a certain way is transmitted to the new institute, and so the deriving connection of the *affectio societatis*[17] and of the *intuitus personae* with the consequent non-transferability of the quality of partner without other partners' agreement from the ancient *fraternitas*[18]. And in fact though the patrimony is a fruit not of a succession but of free contributions when it becomes the real partnership assets, it assumes the condition of 'comunione di diritti reali'[19],

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tion: see one for all, K.E. Georges - F. Calonghi, *Dizionario della lingua latina*, Torino, 1942, 580 f.

13 Because, apart from the inherited property, it is open to include, with real effects, also the purchases afterwards carried out by *consortes*: so A. Guarino, *Societas consensu contracta,* Napoli, 1972, p. 12 and M. Talamanca, "Società", *Enciclopedia del Diritto* 42, 1990, 815 f.

14 *Ulpian*, Oxford, 1982

15 D. 1.3.41 (Ulp. 2 *inst*.).

16 These discouraged remarks are of F. Galgano, *Storia del diritto commerciale*, Bologna 1976, 40 f.

17 D. 17.2.63 pr. (Ulpianus 31 ad edictum): *Verum est quod Sabino videtur, etiamsi non universorum bonorum socii sunt, sed unius rei, attamen in id quod facere possunt quodve dolo malo fecerint quo minus possint, condemnari oportere. hoc enim summam rationem habet, cum societas ius quodammodo fraternitatis in se habeat.* What Sabinus says is correct, that even where a partnership is not in all goods but in one item of property, the partners nonetheless may be condemned for the amount that they can pay or can by fraudulent means avoid paying. This is perfectly reasonable, since partnership implies, in a sense, a law of brotherhood.

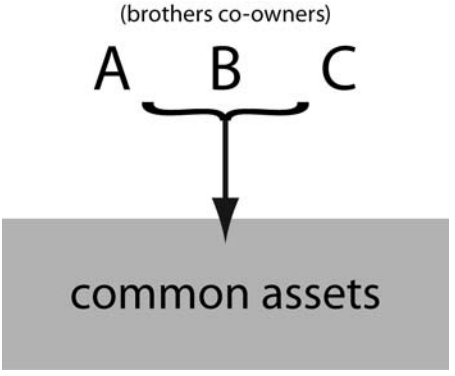
18 W.W. Buckland, *A Text-Book* cit. 507 ff. V. D. 17.2.63 pr. insists on it.

19 S. Riccobono jr., *Capacità manageriale e partecipazione agli utili nella 'societas' romana (Gai 3,148-149)*, in *Atti del Seminario sulla problematica contrattuale in diritto romano* I,

'community of real rights' and it holds its own independent configuration only towards persons, *socii*, who build it up, but it can be attacked by third creditors.

The partnership matter doesn't escape from this approach. In it the existence of 'correctives' for the absence of legal status does not affect the 'personal' characterization of contract. A typical example of a 'corrective' is the situation in which a partner received a mandate as a director of a specific sector of the partnership business from the other partners and the third persons who stipulated contracts with him could act to satisfy their credits against the other partners, but only because of the mandate and not of the company. This is the case of the *exercitores*' liability that appointed among them a *magister navis*. This liability originates from the charge and not certainly from the partnership[20].

Picture 2 shows graphically the structure of the *consortium ercto non cito*:



A well defined originally indissoluble area includes the goods object of community. As we can see it is an impermeable structure in which the connection between assets and outside activities is highlighted by active joint and several liability. So in case of purchases from a single co-owner the effects increase the common assets and for this reason, pro rata, the single assets which would be increased in case of dissolution and distribution of them.

On picture 3 we can see the scheme of the first hypothesis of partnership deriving from the *consortium* and with it probably coexisting[2121], at least in the Republic period: the *societas omnium bonorum*. It is a partnership having assets formed by *socii*'s all properties:

The assets seem an independent entity towards the *socii*'s activities with a strong 'real' connotation tightly linked to the community of goods[2222]. It is a consensual partnership certainly preceded by the admissibility of a *consortium* no more necessarily only among brothers but also among strangers in terms of

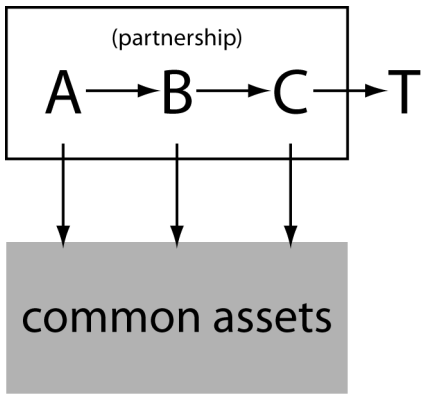
Milano, 1988, p. 230 note 12

20 *Infra*, note 24

21 On the evoluion of *consortium* towards *societas*, see M. Bretone, '*Consortium*' *e* '*communio*', in *Labeo* 6 (1960) 163 ff., M. Talamanca's synthesis in *Società* cit. 81 f. and G. Santucci, *Il socio d'opera in diritto romano. Conferimenti e responsabilità*, Padova, 1997, 1 ff.

22 As provided by the so-called *transitus legalis*: D. 17.2.1.1; eod. 2 and 3 pr. For a synthesis of the related problems see M. Talamanca, *Società* cit. 824 f.

a *societas re contracta*[2323]. Gaius himself points out terminological and conceptual links between the ancient *consortium* among brothers and the situation of those who '*… ad exemplum fratrum suorum societatem coierint*'[2424]. Moreover the name of *societas omnium bonorum* itself points out the characterizing role of the contributed goods, compared with the importance of profits which is evident in the denomination of *societas alicuius negotiationis*.



As we can see from the graph, the 'internal' contractual relations among the *socii* of the new partnership *consortium* are not important on the outside and so only if a partner received a precise mandate from the other partners to enter into a relationship with third persons, whether to carry out a specific agreement, or as permanently in charge of a financial activity, was there a juridical connection between the third party and the other partners, the mandators, which makes possible the third person's attack on single partners' assets. This was alien to the contractual pattern of partnership, but in the facts, the insertion of a mandate made the personal assets 'permeable' and we can presume that third persons would be more eager to assume credits towards such companies because they felt much more guaranteed. Out of the consequences deriving from these forms of mandate, the partnership produced its effects only inside the contractual relations among partners and their obligatory ties, but it did not have any independent legal status, which was outside significant.

An 'anomalous' hypothesis of partnership from the point of view of legal capacity would seem the so-called '*societas publicanorum*', that is a partnership in taxfarming, a tax collectors corporation[25]. Actually we move on a completely dif-

[23] In relation to the *societas consensu contracta* see T. Drosdowski, *Das Verhältnis von actio pro socio und actio communi dividundo im klassischen römischen Recht,* Berlin, 1998, 20 ff. and ib. bibl.

[24] Gai 3.154b, on which see M. G. Bianchini, *Studi sulla societas*, Milano, 1967, 9 ff.

[25] Similar but more articolate the situation of *societates argentariorum*, on which I cannot stop now. Another difficult question as regard its solution is the configuration of *venaliciaria societates*, whose problems are analogous to those of *argentarii* partnerships, while the problem concerning the so-called shipping company assumes its specificity. Ulpian D. 14.1.4 pr. refers to it. C. Sanfilippo's sharp exegesis (*Sulla irrilevanza del rapporto sociale nei confronti dei terzi*, in *IURA* 2, 1951, 159 ff.) which – starting from a small breach of V. Arangio-Ruiz (*La società in diritto romano*, Napoli, 1950, 90 notes 3 and 91) at the beginning also strongly supported by Arangio-Ruiz himself, as regards the lack of effects on partners' relationship towards the third persons who enter into a contract with the single partners — denies Ulpian's reference to a real *societas* among *exercitores navis*, both in the passage at issue and in D. 14.1.1.25, was harshly contested by F. Serrao (*Sulla rilevanza esterna del rapporto di società in diritto romano*, in *Impresa e responsabilità* cit. 79 ff.). He considers it only func-

ferent ground though some scholars' attempts to assimilate this figure to a partnership. The *societates publicanorum* work for their function as a matter of fact at a level basically of Public law. The evidences of the sources (only literary sources), which refer to them, present serious interpretative problems as they involve questions concerning associations in general. But they gravitate in a substantially different conceptual sphere, though some similarities with partnerships of Civil law. However, apart from the possibility of supposing in it a real 'legal status' which is a problem we cannot deal with here, the phenomenon assumes such specific outlines that it is rather risky to extend its characteristics to partnership in general[26].

So the two mentioned hypotheses constitute at the same time a justification and a limit to some recent approaches to the matter, which lead to an evaluation of this phenomenon as tightly connected to the enterprise one. In other words, according to this tendency of the doctrine, partnership evolves insofar as in it there is an enterprise structure. From here the attempts of identifying enterprise figures which would give a connotation to this ancient commercial experience and would really affect on the partnership phenomenon[27] within the widespread trend of proposing a general, but hypothetic, 'Roman Commercial law'[28].

Now in my opinion to understand this occurrence in terms which are adherent to sources and so far from mental and juridical intersections which in the modern concept of company leads to differentiate and coordinate company, enterprise, company legal ownership and management it needs to start from a clear vision: Roman partnership is not based on management but on contributed goods. Only starting from the goods relationship we will be able to understand the right nature of Roman *societas* and above all its complex evolution in the juridical and normative configuration with jurists' extreme difficulty in the formulation of a real partnership legal status, a persisting difficulty also of Middle Age and practically present at least until the XVI century.

As we can notice, the existence of 'deviations' from the consensual and personal nature of the partnership agreement does not affect the dogmatic struc-

tional to 'eliminare l'ostacolo' 'remove the obstacle' which the text would represent for the assertion of a 'certa rilevanza esterna del rapporto sociale' 'certain outer relevance of partner relationship' (*ib.* 79), but in this case *exercitores*' jointly and severally liability 'dipende dalla *praepositio*, non dal rapporto sociale': so M. Talamanca, *Società* cit. 829.

26 On *societates publicanorum* see M. R. Cimma, *Ricerche sulle società di publicani,* Milano 1981, on which M. Talamanca, *Società* cit. 831 ff. is rather critical and F. Bona, *Le 'societates publicanorum' e le società questuarie nella tarda repubblica*, in *Imprenditorialità e diritto* cit. 13 ff.

27 A. Di Porto, *Impresa collettiva e 'schiavo manager' in Roma antica (II sec. a.C. - II sec. d.C.)*, Milano, 1984

28 In this sense, Pietro Cerami and Aldo Petrucci, Lezioni cit., recently offer an articulate attempt *passim*. See also P. Cerami, *'Exercitio negotiationum'. Tipologia storico-giuridica della disciplina dei rapporti commerciali*, in *Iuris Vincula* cit. II, 147 ff.: the contribution, moreover, is published in the first chapter of *Lezioni* cit.

ture of the institute which keeps its Roman appearance, however, throughout the Roman juridical experience, still in medieval times and until the threshold of modern codifications.

You need only to think that still between the XVII and XVIII century the jurisconsult Baldo degli Ubaldi, certainly the great Bartolo da Sassoferrato[29]'s most genial disciple, needed to refer to mandate to make out administrators' powers and immunity from prosecution, though they were simple partners who carried out a business or a function *communi nomine*[30]. In the idea of the jurist himself, in his distinction between *societates collegiatae* or *collegiales* and *societates singulorum*[31] there is surely the effort of depicting the first ones as provided with legal status and of trying to consider the other ones as independent bodies acting under the insignia (*signum*) of partnership. There is above all also the change of the scientific point of view from partners' natural persons to capital, to that '*pecunia statuta*' which is '*ad usus societatis*'[32]. This fact could really lead the scientific analysis to the threshold of an extraordinarily important crossroads.

But Baldo's attention concerns mainly the partnership activity carried out by a single partner which can be considered no more as performed '*suo nomine*' but '*communi nomine*'. In this occasion Baldo's way of thinking is in contrast with his master's position. The way was open to the final step. Such activities can be considered as performed '*societatis nomine*'.

After Baldo the scientific analysis on these themes will become more and more modest and flat[33]. We need to wait Pothier's[34] formulation who at the end of XVII century will systematically develop the partnership matter and will consign to Code Napoléon an already mature discipline for this institute.

I'll stop here because I don't want to impose on your patience.

It may be answered now to the starting question about the role of the knowledge of Roman legal experience to jurists, not only to Continental jurists or jurists of Common Law, but to jurists 'tout court'.

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29 P. Stein, *Bartuls, the Conflict of Laws and the Roman Law*, in *Multum non Multa. Festschrift für Kurt Lipstein,* 1980, 254 ff. offers an outline of Bartul's contribution to a 'ius commune' which could face the imperial law.

30 *Consilia,* Venetiis, 1575, CXX, n. 3, f. 36 verso: *societas autem habet instar mandati: invicem enim sibi mandati videntur quod ea, quae fiunt negotiative, communi nomine fiant*; see also *In tres priores libros Codicis Commentaria,* Venetiis, 1599, *passim*.

31 *In secundam Codicis partem Commentaria,* Venetiis, 1599, *ad proemium C. pro socio* (C. 4.37), f. 104 verso.

32 *In secundam Codicis* cit., *ad C. Elius l. de non numer. Pecunia* (C. 4.31.9, n.5), f. 86 verso: … *compensatio non procedit quia corpus societatis agit, non ille tamquam singularis persona, et ideo quod debetur societati, non compensatur cum uno ex sociis. Item quia illa pecunia statuta est ad usus sociales.*

33 On this point G. Diurni, *Società. Diritto intermedio*, in *Novissimo Digesto Italiano* XVII, Torino, 1976, p. 531

34 *Traité du contrat de société* IV, Paris, 1890

The analysis made on Roman partnership shows that the discipline of the Roman contract of *societas* is in Civil Law and in the discipline of civil obligations. There is not a special Law as a 'commercial' Law and this fact explains the difficulty of modern scholars to consider institutes such as the enterprise and the entrepreneur inside the discipline of the partnership agreement. Roman jurists' linearity of construction prevent medieval annotators from giving shape to an independent commercial Law but 'forcing' the nature of Roman juridical relation. This historical forcing explains also how at the end of XIX century in Europe the attempts of creating independent trade Codes compared with Civil Codes fail and all the company matter is incorporated inside the Civil Codes themselves[35].

I spoke before about Roman Law as a sort of compass for modern jurists, to point out its precious function of orientation. I think that the case of company law clearly shows how we probably could not succeed in finding a methodological thread to have just an idea of what the history and the reality of 'company law' really is without the knowledge of Roman legal experience. So we could be exposed to a threefold failure: as historians of Roman Law, because we would interpret Roman Law according to an inexistent Roman commercial law; as historians of medieval law, because we would not understand entirely the difficulties of medieval jurists in giving shape to a company as a 'person' and also as historians of modern law, because we would investigate the reasons for the failure of the commercial Codes in external facts of legislative policy. Only thanks to a global point of view of the history of law, which must start from Roman Law, we can consider the contract as the real cradle of company law.

In the 70s Grant Gilmore, one of the most eminent American scholars of contract law, who is due the formulation of fundamental rules of the Uniform Commercial Code, wrote a book provocatively entitled The Death of Contract[36]. In this book he goes into the heart of the great cultural bewilderment between the doctrine of English Common Law and specific American connotations, in a complex and often contradictory context of judicial decisions. Well, he who has the patience to read this interesting book, will find a very surprising sentence, the last one of the volume, in which Gilmore writes: 'Contract is dead - but who knows what unlikely resurrection the Easter-tide may bring?'[37].

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35 In 1881 as first Switzerland will incorporate both civil and commercial rules in an only Code.

36 Columbus, 1974, *La morte del contratto*. Ital. transl, Milano, 1987

37 *La morte del contratto*, cit. 92. Maybe it is not a case that also the enterprise matter is more and more considered from a contractarian point of view and not only by jurists but also by economists: see in this regard M. Ricciardi, *La natura contrattuale dell'impresa*, in *Atti del Seminario sulla problematica contrattuale* cit. 333 ff. The expression 'natura contrattuale' 'contractual nature' is due to N.S.W. Cheung, *The Contractual Nature of the Firm*, in *The Journal of Law and Economics* 26, 1983, 1 ff. See also L.R. Cohen, *The Firm: a Revised Definition*, in *Southern Economic Journal,* 1979, 580 ff.

I think that as the history of the company law shows us – and we tried a verification of it also from our particular observation angle - the present and the future of this area of law must be marked by the contract. If this fact can be shared, then it is probable that we the historians of Law have still something to say in the bewilderment of our hasty time.

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Original scientific paper
Received: February 21st, 2009

UDC 347.734: 347.721(450.75); 336.71(450.75)
ID 158249996

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BANKS AND APULIAN SMEs: IS IT A QUALITY RELATION?

Abstract: *The relations between banks and SMEs in the South of Italy and Apulia are studied in this article. The empirical analysis of these relations is made with help of Scoring models for default risk measurement: discriminant analysis and z-score. The analysis has revealed that the revised z-score does not highlight a high probability of default, although the (median) values obtained fall inside the grey area, in which the model is unable to distinguish between good and bad firms.*

Key words: *default risk management, scoring models, SME, Apulia*
JEL classification: G21, M20, C25

1. Introduction*

The quality of the relationship between banks and enterprises in the South of Italy is influenced by the fragility of the economy in this area of the country, which negatively affects both access to credit and loan costs[1].

Banks should reposition their corporate and investment banking operations according to a more relational approach, also *vis-à-vis* small and medium enterprises (hereinafter SMEs), by offering innovatory services with a high added value, capable of completing conventional lending activity. A greater focus should be placed on the consistency between the lending characteristics of banks

* The article is the result of a joint effort and continuous exchange of ideas between the authors. The single paragraphs were written as follows: Paragraphs 1, 3.2, 4.1 and 5 by Claudio Giannotti; Paragraph 2 by Candida Bussoli; Paragraphs 3.1 and 4.2 by Mariateresa Cuoccio. The authors wish to thank Prof. Alessandro Carretta, Prof. Donato Michele Cifarelli and Prof. Paola Schwizer for the helpful suggestions they offered and Bureau Van Dijk for the data required for the analysis.

1 See Banca d'Italia: *Relazione Annuale sul 2007*, 31 maggio, 2008b.

and the financial needs of enterprises. An in-depth analysis and measurement of the default risk and a risk-based determination of loan pricing are important challenges on the credit market.

Recent surveys have revealed an increase in the quantitative and qualitative information required by lenders, in connection with loan applications and, in 2007, a drop in the proportion of credit granted to financially less solid firms[2]. These can be interpreted as signs of an increased focus, by banks, on their customers' risk profiles, also as a result of the implementation of the Basel 2 principles[3].

Enterprises are required to undergo a cultural transformation, first and foremost, leading to the development of a new outlook, in which banks are viewed as a medium-to-long-term financial partner. The information opacity of SMEs is particularly critical, because it heightens the difficulty of risk assessment and the efficient allocation of financial resources[4].

The aim of this article is to analyse the relationship between banks and Apulian SMEs, highlighting the relevant criticalities by evaluating the profitability, solvency and liquidity of the firms and measuring the related default risk.

Paragraph 2 features a review of the literature on the relations between banks and enterprises in the South of Italy in general, and Apulia in particular, and on the default risk measures, based on discriminant analysis and z-scoring. Paragraph 3 describes the survey population of Apulian SMEs, their segmentation into clusters and the two survey levels, namely, financial analysis and the revised z-score. Paragraph 4 contains an assessment of the results achieved and, lastly, paragraph 5 sets out the conclusions and research prospects.

2. Relations between banks and SMEs in the South of Italy and Apulia

At the beginning of the 1990s, relations between banks and enterprises in Italy featured a high level of bank borrowing and widespread reliance on multiple loans with multiple lenders, according to a typical risk spreading approach. These circumstances entailed serious problems for the quality and stability of the bank-SME relationship, characterized by inefficient credit allocation[5].

[2] See Bentivogli, C. – Cocozza, E. – Foglia, A. – Iannotti, S.: "I Rapporti Banca-Impresa dopo il Nuovo Accordo sul Capitale: un'Indagine Territoriale", *Questioni di Economia e Finanza*, n. 6, Banca d'Italia, Febbraio 2007; Banca d'Italia: *Relazione Annuale sul 2007*, 31 maggio, 2008b.

[3] See Banca d'Italia: *Nuove disposizioni di vigilanza prudenziale per le banche,* Circolare n. 263 del 27 dicembre e successivi aggiornamenti, 2006.

[4] See Bonaccorsi, Di Patti, E. – Dell'Ariccia, G.: "Bank competition and firm creation", *Temi di discussione*, n. 481, Banca d'Italia, June 2003.

[5] See, among others, Bisoni, C. – Landi, A. (a cura di): *Il finanziamento dello sviluppo delle piccole e medie imprese. Il caso delle imprese di Modena*, Bancaria Editrice, Roma, 1999; Szego, G. – Tontoranelli, N.: *La selezione della banca da parte delle imprese: un'indagine*

In around the mid-90s the bank system underwent a process of deep transformation, with significant regulatory and system changes, which led to the formation of large nationwide and even international banking groups[6].

In parallel to this process of concentration, deregulation, with respect to the opening of new branches, generated a considerable increase in the average number of banks per province, which rose from 29 in 1990 to 36 in 2005[7]. Increased competition gradually reduced fragmentation in bank relations, lending became less volatile and expensive and the number of financial intermediaries specializing in development lending increased[8]. The phenomenon of multiple loans with multiple banks, however, was downsized but did not entirely disappear. Italian SMEs have financial relation, on average, with at least 3 banks, and the higher the firm's indebtedness, corporate risk level and size the higher the number of banks firms do business with, rising to 5 or more in the case of firms with over 49 employees[9]. This is due to a number of reasons: a higher amount of credit that can be obtained as a result of risk spreading; encouraging competition among banks; the difficulty in finding the full range of services a firm needs at a single bank; the lack of uniformity in cash flow assessments by banks, which entails the search for a number of different counterparties with which to establish a balanced liability structure.

At the same time, between the 90s and the beginning of the 2000s, the Italian production system found itself tackling a series of challenges as a result of international competition, which led to the emergence of its vulnerability and the persistence of numerous weak points.

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sul campo, in Bancaria, n. 10, 1996; Ruozi (a cura di): *La gestione finanziaria delle piccole e medie imprese. Strumenti e politiche di gestione,* EGEA, Milano, 1996; Foglia, A. – Laviola, S. – Marullo Reedtz, P.: *Struttura delle relazioni di credito e rischiosità delle imprese,* Banca Impresa e Società, n. 2, 1998; Forestieri, G. – Rossignoli, B.: *Efficienza allocativa e criteri di valutazione dei fidi,* in Mottura, P. (a cura di): "La gestione della banca", Giuffrè, Milano, 1986; Giannotti, C.: *Evoluzione del rapporto tra banche e piccole-medie imprese italiane: inquadramento teorico ed evidenze empiriche,* Studi e Note di Economia, n. 2, 2001.

6 See Panetta: *Evoluzione del sistema bancario e finanziamento dell'economia nel Mezzogiorno,* Banca d'Italia, Temi di Discussione, 2003, n. 467; Nardozzi, G.: *I rapporti tra banca e impresa: ieri e oggi,* Seminario Cesifin "Banca e impresa. Nuovi scenari, nuove prospettive" Firenze, Palazzo Incontri, dicembre 2007; Tarantola, A. M.: *Banche e imprese: opportunità e sfide alla luce di Basilea II,* Seminario Cesifin "Banca e impresa. Nuovi scenari, nuove prospettive", Firenze, Palazzo Incontri, dicembre 2007; Bentivogli, C. – Cocozza, E. – Foglia, A. – Iannotti, S.: "I Rapporti Banca-Impresa dopo il Nuovo Accordo sul Capitale: un'Indagine Territoriale", *Questioni di Economia e Finanza*, n. 6, Banca d'Italia, Febbraio 2007.

7 See Banca d'Italia: *Segnalazioni di vigilanza*, Roma, 2005.

8 See Banca d'Italia: *Indagine sulle imprese industriali e dei servizi; anno di riferimento 2006,* Roma, 2007; Monferrà, S. (a cura di): *Il rapporto banca-impresa in Italia. Strategie, credito e strumenti innovativi,* Bancaria Editrice, Roma, 2007.

9 See Vulpes, G.: *Multiple Bank Lending Relationships in Italy: their Determinants and the Role of Firm's Governance features,* Unicredit Banca d'Impresa, Preliminary Draft, May 2005.

These included the significant weight of small firms with a highly centralized ownership structure, in which the financial function plays only a marginal role. The high degree of amalgamation between the firm's resources and the personal resources of the entrepreneur – as a result of a family-based ownership – inevitably increases the information opacity of SMEs and resistance to alternative forms of lending to bank lending.

These criticalities are also the result of a scarcely developed financial culture, of the costliness of the stock exchange listing process, and the desire to keep outsiders away from the management of the firm.

The important transformations in the domestic economic and financial system have had especially profound and incisive effects in the South of Italy. The difficulties resulting from the economic recession of the early 90s, combined with the discontinuation of the policies providing for extraordinary subsidies to enterprises, had heavy consequences on economic and banking activities. The bank sector, in particular, during the 90s, underwent a serious crisis, as a result of the heavy losses incurred due to the insolvency of enterprises.

To overcome these systemic crisis conditions, it was necessary to rely on public aid and, above all, consolidation operations, which led to the transfer of the ownership of the Southern Italian banks to the large banking groups based in the North. Following this process of consolidation, the number of South-based lenders was practically halved, determining the complete reorganization of the credit system and the return to conditions of improved capitalization and profitability[10].

As in the North, there was an increase of branches in the South too, rising from 3,900 in 1990 to about 7,000 in 2006.

In Apulia, the number of branches rose less dramatically, from 1,068 in 1996 to 1,425 in 2007, a dynamic that, moreover, was accompanied by an essential stability in the number of towns served: 233 in 1996 compared to 231 in 2007[11].

Loans to Southern-based enterprises featured a systematic growth in all the main industry sectors and for the various sized firms. The expansion was superior compared to the growth recorded for the Centre-Northern enterprises and concerned all the loans, included loans granted by the leasing and factoring companies. Between 2003 and 2007, the global data confirm the increase in the amount of loans to firms based in all the Southern regions: the growth rate, on average, was 10.7% a year, compared to 8.2% in the North[12]. The growth was due to both increased demand, driven by low loan costs, and supply, as a result of the banking consolidation processes.

Southern enterprises have benefitted from the large-scale availability of resources at progressively lower costs: the amount of loans granted in the South

[10] See Saccomanni, F.: *Indagine conoscitiva sulla situazione e le prospettive del sistema creditizio con particolare riferimento alle aree meridionali. Sistema creditizio ed attività economica del mezzogiorno,* Camera dei Deputati, 6° Commissione permanente (Finanze), 2007.

[11] See Banca d'Italia, public information database.

[12] See Banca d'Italia, Relazione Annuale (various years).

and the Islands is higher than the savings collected in the same regions, and the cost of loans to enterprises dropped gradually, also reducing the gap between the Southern and Central-Northern regions, which stood at 1.3 percentage points in 2007, compared to 2.5% in the mid-90s.

Despite these positive dynamics, there remains a certain disparity with other areas of the country. The amount of defaulting loans is consistently higher in the South compared to the North. The South features half the number of branches per inhabitant than the North (34 compared to 66 every 100,000 inhabitants)[13], less use of online banking services and of lending services in general, considering that four families out of ten do not have a bank deposit account.

Moreover, the trend, in the case of Southern firms is to bank with a lower number of lenders compared to those in the North. The role of the leading bank is predominant and accounts for 57% of all bank loans taken out, on average. The duration of relations with the leading bank, in the case of Apulian SMEs, is 7 years, on average, which is lower than in the Northern regions, such as Emilia Romagna, where it reaches 13 years[14] on average. This difference may be due to the smaller size and age of Southern SMEs, compared to the North, thus confirming the results found in literature[15].

One aspect that is especially worthy of attention is the low propensity to the dimensional growth of the small firms, due to the limited financial culture of the entrepreneurs and to a number of other reasons, such as the persistence of legal and fiscal disincentives, red tape, inadequate corporate governance[16], cultural backwardness[17], difficult relations between the production system and the financial system.

Enterprises based in Apulia and Basilicata may finance their growth primarily in one of two ways: by self-financing (which accounts for 45.5% of all funds) or by means of capital increases (which account for about a fourth of total funds)[18]. These circumstances highlight a situation in which the opportunities for growth may be grasped, by SMEs, only if there is a sufficient flow of internally produced resources: the banking system aids growth primarily in the case

13 See Saccomanni, ibidem.

14 See Bentivogli, C. – Cocozza, E. – Foglia, A. – Iannotti, S.: "I Rapporti Banca-Impresa dopo il Nuovo Accordo sul Capitale: un'Indagine Territoriale", *Questioni di Economia e Finanza*, n. 6, Banca d'Italia, Febbraio 2007.

15 See Farinha, L.: "Switching from single to multiple bank lending relationships: determinants and implications", *Journal of Financial Intermediation*, vol. 11, 2002, pp. 124-151; Ongena, S. – Smith, D. S.: "The duration of bank relationship", *Journal of Financial Economics*, vol. 61, 2001, pp. 449-475.

16 See Bianchi, M. – Bianco, M. – Giacomelli, S. – Pacces, A. M. – Trento, S.: *Proprietà e controllo delle imprese in Italia*, Il Mulino, Bologna, 2005.

17 See Accornero, A.: "Poter crescere e voler crescere: i piccoli imprenditori ex dipendenti", in: F. Traù (a cura di),", Il Mulino, Bologna. 1999.

18 See Banca d'Italia, API: *Indagine su Basilea 2 e lo sviluppo delle imprese*, 2006.

of firms that exceed certain minimum dimensions. Also in the case of the leading bank, the contribution to the growth process, in terms of a greater availability of credit, is limited and even more so are its advisory functions.

In ultimate analysis, among the factors affecting a small firm's decision to expand, those of a financial nature are particularly significant: the lack of adequate financial support represents the main reason for abandoning growth projects.

Despite the progress made, and the large-scale expansion of bank credit, the Southern banking system, therefore, needs to tackle further challenges. Bank lending maintains its competitive edge, over the years, which makes it a preferred option compared to other alternative systems: non interference by the bank in the company's management; possibility for enterprises to soften the impact of risk on loan prices, through the use of guarantees; a limited rationing policy by banks; speedy, simple and flexible loan procedures[19]. These aspects determine a reliance on bank loans, especially in the case of firms in financial distress and for smaller loan amounts, compared to which the need is felt for lasting relations. For this purpose, therefore, the focus should be on the renewed role of information, as a means for accurate credit risk assessment and the widespread diffusion of customer assistance facilities, characterized by a more simple organization, suited to developing and, indeed, enhancing the creation of relations with businesses.

3. Scoring models for default risk measurement: discriminant analysis and *z*-score

Scoring models are elaborate statistical instruments used to forecast borrower default[20]. The purpose of scoring models is to identity the factors on which to build a discriminant threshold for classifying firms. The result of this assessment is then summarized in a number (the score), which highlights the creditworthiness of a firm, classifying it as either good or bad.

The key scoring model categories are: linear discriminant analysis, regression models (linear, logit and probit); and heuristic-inductive models (neural networks and genetic algorithms).

Discriminant analysis is a statistical technique employed to classify or forecast cases in which dependant variables appear in a qualitative form, and is used to classify an observation and assign it to one of the predefined observation groups.

In the case of the assessment of the probability of default of a corporate borrower, the discriminant analysis aims at identifying the variables for distin-

[19] See Monferrà, S. (a cura di): *Il rapporto banca-impresa in Italia. Strategie, credito e strumenti innovativi,* Bancaria Editrice, Roma, 2007.

[20] See Beaver, W.: "Financial ratios as predictors of failures. Empirical research in accounting selected studies 1966", *Journal of Accounting Research, Supplement*, vol. 5, 1967, pp. 71-111; Altman, E. I.: "Financial Ratios, Discriminant Analysis and the Prediction of Corporate bankruptcy", *Journal of Finance*, vol. 23, n. 4, 1968, pp. 589-609.

guishing between financially healthy and distressed firms, i.e. between creditworthy and non-creditworthy companies that are thought to be defaulting, or whose debt is regarded as doubtful by the banking system, by assigning a score to each group determined by maximizing the variance of the variables among the firms included in the two groups, and minimizing the variance between the firms within the same group.

In short, the score of financially healthy firms must be similar and must differ from the score of defaulting firms.

Each enterprise receives a discriminant score based on the value of its independent variables. The score thus awarded is then compared with a threshold value used as a separation point between enterprises with low or high insolvency rates. This so-called 'cutoff score' represents the value below which an enterprise is considered non-creditworthy because too risky.

When applying scoring models it is often necessary to determine two, rather than one, cutoff points: enterprises featuring a score below the lower cutoff score are considered risky and unreliable; enterprises with a score above the higher cutoff score are considered creditworthy; enterprises with a score included between the two cutoff scores find themselves in a grey area, in respect of which the model is incapable of returning sufficiently reliable results.

The Altman z-score is the most widely known discriminant score applied to credit risk. The model was first formulated by Altman (1968) and later reviewed by Altman et al. (1977), when they extended the z-score approach to include seven variables. In the early 2000's, Altman (2000 and 2002b) turned out an upgraded version of the model for non-listed companies and 'Non-Manufacturers and Emerging Markets'.

The original version of the z-score – developed for US-based publicly listed corporations – was based on an initial sample of 66 companies divided into 2 groups: a group of 33 bankrupt firms and a group of an equal number of non-bankrupt active manufacturing companies. The companies were classified by industry and asset size, ranging between 1 and 25 million dollars. The data used for the initial test were drawn from the financial statements for the year before filing for bankruptcy.

The discriminant function is as follows:

$$Z = 1.2\,X1 + 1.4\,X2 + 3.3\,X3 + 0.6\,X4 + 1.0\,X5,$$

for which the cutoff score is 1.81: below this figure an enterprise is considered to be defaulting; the 'grey zone', inside which it cannot be accurately predicted whether the enterprise is creditworthy or at risk of default, is between 1.81 and 2.99; enterprises with a z-score value above 2.99 are considered creditworthy. The ratios included in the function are as follows:

X1: working capital/total assets (WC/TA). This ratio measures liquid assets in relation to the firm's size. Good firms generally feature a higher amount of liquid assets compared to distressed firms: this distinguishing element tends to increase as the distressed firm approached bankruptcy.

X2: retained earnings/total assets (RE/TA). This ratio provides information on the corporation's dividend policies, but it also implicitly measures the firm's age[21]; it implicitly also measures the weight of borrowing in the firm's management: firms with a high ratio value, in fact, have financed their investments through retained earnings and, therefore, have not found it necessary to borrow money. The ratio, therefore, also measures the employment of internally generated sources of financing for development purposes.

X3: earnings before interest and taxes/total assets (EBIT/TA). This is a measure of operating efficiency separated from any leverage and tax effects.

X4: market value of equity/total liabilities (MVE/TL). The value of equity is measured as the value of all equity; the liabilities include both short and long-term liabilities. The measure shows how the value of the assets can drop before the liabilities exceed the assets and the firm becomes insolvent.

X5: sales/total assets (S/TA). This is a financial measure that highlights the firm's capability of producing sales and, therefore, turnover with a certain amount of assets. It measure the management's capacity to manage the competitive edge of its market.

The model's accuracy can be either type I accuracy, with regard to the classification of firms approaching bankruptcy as good firms, and type II accuracy, with regard to the classification of good firms as bad. Total accuracy is the combination of the two types.

Type I accuracy is considered more important than type II, because classifying a failing firm as good determines rather high costs, for the firm's creditors, corresponding to the interest and the principal lost, as a result of the intervening default by the firm erroneously considered as creditworthy. Type II error produces lower costs, compared to the former, resulting from loss of income due to the failed granting of credit to a firm mistakenly classified as approaching bankruptcy. Altman's original model is capable of accurately classifying 95% of the total sample. Type I accuracy concerns only 6% of the cases, while type II accuracy only 3% of the cases.

The z-score model is custom-built for publicly listed corporations. To determine the z-score of unlisted corporations it is necessary to launch the discri-

[21] See Altman, E. I.: *Predicting Financial Distress of Companies: Revisiting the Z-Score and ZETA® Models,* Working Paper, New York University, July 2000; Altman, E. I.: "Revisiting credit scoring models in a Basel 2 environment", in: Ong, M., *Credit Rating: Methodologies, Rationale and Default Risk*, London Risk Books, 2002b.

minant analysis once again, replacing the market value with the book values of equity, when determining the X4 ratio. Such an operation entails changes to all the weight figures and the determination of a new cutoff score and grey area to distinguish between good and distressed firms.

The new model (revised z-score) may be represented as follows[22]:

$$Z' = 0.717(X1) + 0.847(X2) + 3.107(X3) + 0.420(X4) + 0.998(X5).$$

The equation has changed slightly compared to the model developed by Altman in 1968. The cutoff point of the model is 1.23 and the grey area is between 1.23 and 2.90, and is broader than the original grey area of the 1968 model: this means that the revised version is slightly less accurate than the previous version. Moreover, the percentage of type I accuracy is slightly lower in the revised model compared to the original formulation of the z-score (9.1%); while the type II accuracy is identical to the original model (3%).

The construction of scoring models features a large amount of subjective factors: subjectivity concerns the construction of a model, which is then used and applied to other firms in an objective manner, thus featuring a number of limitations.

A first limit is represented by the choice of the sample: samples must be balanced and include an equal number of good and defaulting firms. The firms included in the sample should be selected from the same industry, as far as is possible, because the single economic and financial indexes can feature significantly different average values from industry to industry and the same index may differently affect the determination of insolvency in the diverse industries.

A second limit is represented by the definition of insolvency. There are different degrees of insolvency, from simple delays in payment to bankruptcy. The definition of insolvency adopted to break down the sample will affect the outcome of the analysis. If the definition of insolvency is very broad then a large number of firms will be classified as insolvent and the probability of default (PD) will be higher[23].

The last critical factor consists of the independent ratios. In this case, the limit is represented by the fact that the survey of the independent ratios tends to change in time according to the structure of the markets or the economic cycle[24].

[22] See Altman, ibidem; Altman, E. I.: *Bankruptcy credit risk and high yield junk bonds,* Blackwell Publishing, 2002a.

[23] See Sironi, A. – Resti A.: *Rischio e valore nelle banche. Risk management e capital allocation,* EGEA, Milano, 2008.

[24] See Grice, J. S. – Ingramb, R. W.: "Tests of the generalizability of Altman's bankruptcy prediction model", *Journal of Business Research*, n. 54, 2001.

This aspect is particularly relevant in the case of the z-score model, the use of which by financial researchers and operators is very widespread[25], even in periods far from those in which Altman developed his original version. In particular, the degree of accuracy drops in time, as a result of the changing relationship between the financial indexes employed in the model and the economic situation, which is affected, *inter alia*, by the variability of interest and inflation rates and the availability of credit[26].

With regard to the z-score model in particular, besides the general considerations set out above, there are further criticalities.

The ratios used do not take into account events of a non-financial nature, which can nevertheless accelerate bankruptcy, such as legal actions or company problems[27].

The samples in the original model are rather small and non-representative of the actual proportion of population of defaulting companies, compared to financially healthy companies. The results of the oversampling of firms approaching bankruptcy determines the underestimation of the type I errors and an overestimation of the type II errors[28].

The estimate sample employed in the original studies included a small number of industries and the model is widely used also to evaluate firms operating in different sectors, compared to those included in the sample used to build the model[29].

In conclusion, the studies reviewed in the literature to test the z-score model suggest to interpret the results with a degree of caution.

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25 See Carcello, J. V. – Hermanson, D. R. – Huss, H. F.: "Temporal changes in bankruptcy related reporting", *A Journal of Practice and Theory*, vol. 14, n. 2, 1995, pp. 133-143; Berger, P. E. – Ofek, E. – Swary, I.: "Investor valuation of the abandonment option", *Journal of Financial Economics*, vol. 42, n. 2, 1996, pp. 257-287.

26 See Mensah, Y. M.: "An examination of the stationarity of multivariate bankruptcy prediction models: a methodological study", *Journal of Accounting Research*, n. 22, 1984, pp. 380-395; Grice and Ingramb, ibid.

27 See Grice and Ingramb, ibid.

28 See Altman, E. I. – Haldeman, R. – Narayanan, P.: "Zeta Analysis: A New Model to Identify bankruptcy Risk of Corporations", *Journal of Banking & Finance*, vol. 1, n. 11, 1977, pp. 29-54; Zmijewski, M. E.: "Methodological issues related to the estimation of financial distress prediction models", *Journal of Accounting Research*, Supplement, vol. 22, 1984, pp. 59-82.

29 See Begley, J. – Ming, J. – Watts, S.: "Bankruptcy classification errors in the 1980s: an empirical analysis of Altman's and Ohlson's models", *Review of Accounting Studies*, vol. 1, n. 4, 1996, pp. 267-284; Platt, H. D. – Platt, M. B.: "A note on the use of industry-relative ratios in bankruptcy prediction", *Journal of Banking and Finance*, vol. 15, n. 6, 1991, pp. 1183-1194.

4. Empirical analysis

4.1. Population

The examined population consists of 1,987 firms, namely, all the firms included in the Aida Bureau Van Dijk database (updated to April 2008), based in Apulia, either public or private ongoing limited companies (S.p.A., S.A.p.A., S.R.L. and single-member S.R.L.), with one or more employees, and with financial statements for 2004, 2005 and 2006.

The examined population was then segmented, based on the 2006 financial statement data, and on size, industry and province where the head office is based.

With regard to size, the firms were further broken down on the basis of their bank borrowings, selecting a threshold value of € 1,000,000, consistently with the definition of retail exposure adopted by Basel 2[30].

Two classes of firms were thus determined (see Table 1): those with bank debts below € 1,000,000 (retail) and those with bank debts in excess or equal to € 1,000,000 (corporate).

Table 1. *Dimensional segmentation of the population.*

SIZE	NUMBER OF FIRMS	PERCENTAGE
Retail firms	1,366	68.75%
Corporate firms	621	31.25%

With regard to the relevant industry, this is based on the Ateco 2002 codes and comprises Agriculture, Manufacturing and Services (Table2).

Table 2. *Industry breakdown of the population*

INDUSTRY BREAKDOWN	NUMBER OF FIRMS	PERCENTAGE
Agricultural sector	27	1.36%
Manufacturing sector	623	31.35%
Services sector	1,290	64.92%
Non-classified firms	47	2.37%

The following table shows the geographical breakdown of the population by province (Table 3).

[30] See Banca d'Italia: *Nuove disposizioni di vigilanza prudenziale per le banche,* Circolare n. 263 del 27 dicembre e successivi aggiornamenti, 2006.

Table 3. *Geographical breakdown of the population*

PROVINCE BREAKDOWN	NUMBER OF FIRMS	PERCENTAGE
Province of Bari	1,224	61.60%
Province of Brindisi	155	7.80%
Province of Foggia	256	12.88%
Province of Lecce	159	8.00%
Province of Taranto	193	9.71%

The breakdown of the population highlights a predominance of retail (68.75%), as compared to corporate (31.25%) firms; the most highly represented industry is the services sector (64.92%), followed by manufacturing (31.35%), while the majority of the Apulian firms included in the survey are based in the province of Bari (61.60%).

4.2. Methodology

The model of analysis of the profitability, solvency and liquidity and default risk of Apulian firms comprises two levels.

The first level of analysis concerns the financial statements of the firms, based on the reclassification of the balance sheet and income statement and the analysis by indexes and flows. The indicators taken into account (indexes, flows and ratios) are always the median of the values in the analyzed historical series, which is not influenced by extreme observations. The evaluation is made through a timing analysis in the three survey years.

There is a special focus on short-term liquidity and medium-to-long term solvency. This is consistent with the definition of default according to Basel 2[31].

The study of the financial balance requires an attentive analysis of the current ratio and of the acid test ratio, as well as the cash conversion cycle (hereinafter CCC), which is the lapse of time between receipts from customers and payments to suppliers, which provides important information on the borrowing requirement related to the working capital[32].

When the CCC is positive it enables the (obviously approximate) estimation of the short-term debt payable to the banks, which can be considered 'physiological', i.e. necessary to cover the short term borrowing requirement related to the working capital. The product of daily revenue and CCC can represent a proce-

[31] See Cannata, F. – Mancinelli, L.: *Il rischio di credito in Basilea 2: aspetti normativi comuni tra i metodi standardizzato e dei rating interni*, Bancaria, n. 4, 2007; Banca d'Italia: *Nuove disposizioni di vigilanza prudenziale per le banche,* Circolare n. 263 del 27 dicembre e successivi aggiornamenti, 2006.

[32] See Pavarani, E. (a cura di): *Analisi finanziaria. Valore, solvibilità e rapporti con i finanziatori,* McGraw-Hill, Milano, 2002.

dure for determining a measurement that can be used to identify the short-term bank borrowing for ensuring cash flexibility. This information is useful above all in respect of the firms whose working capital entails absorption of liquidity.

The analysis of short-term bank debts and, in particular, the ratio of the 'physiological' estimated level to the actual one is particularly useful, even more so in the Basel 2 framework. The determination of the risk exposure of banks, in fact, which takes into account the financial reporting value, the collaterals and the commitments, appears to be rather prudent[33].

Too low a level of bank borrowing, compared to short-term requirements, in fact, might lead firms to exceed the limits, with obvious effects not just on loan costs, but also on the default risk measures surveyed by means of the financial statement analysis and, above all, the performance analysis (Central Credit Register). Too high a level of bank borrowing, compared to the CCC, on the contrary, might entail a high capital requirement for the banks, with obvious effects on the cost of borrowing for firms; the credit conversion factors, in fact, in the standardized approach and the IRB foundation are identified by the supervisory authorities.

To assess equity balance it's necessary to consider the weight of borrowing compared to the equity and, in particular, the overall (financial and other) borrowing, the debts to shareholders, banks and other lenders. The models for determining the ratings are generally very sensitive to the firms' financial leverage.

A high level of lending from shareholders and the contextual under-capitalization of the firm might highlight a limited propensity by the shareholders to providing the company with a suitable amount of equity, preferring alternative and temporary solutions, which were also favored by the applicable regulations.

The sustainability of financial borrowing, in terms of income statement (ratio of interest to EBIT) and in terms of flow (the number of years in which it is theoretically possible to pay back the net financial borrowing through the EBITDA) provides some important information with respect to solvency and risk of default.

The firm's capacity to produce positive cash flows through its operating management is a key factor for evaluating its creditworthiness and, in particular, its financial balance.

The analysis of the operating cash flow makes it possible to highlight the role of the EBITDA (minus tax) and of the changes to the working capital, for the purpose of the production or absorption of liquidity by the operating managent. The annual operating cash flow makes it possible to evaluate the firm's self-financing capacity, while the EBITDA (minus tax) provides important information on medium-to-long term self-financing, given that the working capital, beyond the short term, tends to turn into liquidity.

The ratio of operating cash flow to the changes in short-term payables to banks highlights the tensions in the management of liquidity, analyzing the rel-

[33] See Resti, A.: *L'implementazione di Basilea 2: le nuove regole cambiano il gioco*, Bancaria n. 1, 2007.

ative contribution of self-financing and banks debts for achieving short-term financial balance.

A careful evaluation of the financial balances would undoubtedly require the integration of the analysis by indexes and flows with the results of the performance analysis (and, above all, the Central Credit Register)[34]. This enables, inter alia, the analysis of the degree of fractioning of the financial needs among the financial intermediaries; the ratio over time of loans granted to credit used, highlighting the relevant criticalities; the use of leasing, which, according to the current accounting principles, does not appear among the sources of financing of unlisted companies; the actual level of financial borrowing, which, at times, is masked in the financial statements, by expedient management policies.

With regard to the profitability analysis, it's possible to use the principal financial statement indicators, whose performance over the years provides information also on the volatility of the economic margins of the firms.

The return on equity (ROE) of small enterprises does not always adequately express the profitability of the shareholders, due to the undeclared revenues for tax purposes and the propensity of the owner/manager to prefer, in certain circumstances, the return in the form of manager's remuneration rather than dividend.

It appears important to break down the ROE to highlight the role of the three areas contributing to the net profitability of a firm[35]: the return on assets (ROA), the contribution of borrowing and the incidence of the extraordinary and fiscal management. In this way it is also possible to verify whether the development model implemented by the Apulian SMEs is primarily based on borrowing, rather than on the growth of the equity.

The return on investments (ROI) is explored through the efficiency of the firm and the incidence of operating costs (ROS) and the revenues produced by the firm for each capital unit invested (asset turnover).

The second level of analysis used in this research is represented by the calculation of a summary score capable of offering information on the default risk of firms, that is the revised z-score of Altman (2002b), applied to the 2006 financial statements, due to the absence of listed companies in the survey population.

The use of the revised z-score is consistent with the widespread diffusion of credit scoring techniques for assessing the creditworthiness of SMEs by banks. The information used descends primarily from the financial statements of the firms and the loan trends with the lender and the banking system as a whole (Central Credit Register)[36].

[34] See Carretta, A.: *Evoluzione dei modelli di intermediazione finanziaria, cambiamento della cultura bancaria e ruolo delle Centrali dei rischi*, Banca d'Italia "La Centrale dei rischi nella gestione del credito: esperienze e prospettive", Tematiche istituzionali, aprile 2002.

[35] See Pavarani, E. (a cura di): *Analisi finanziaria. Valore, solvibilità e rapporti con i finanziatori,* McGraw-Hill, Milano, 2002.

[36] See Albareto, G. – Benvenuti, M. – Mocetti, S. – Pagnini, M. – Rossi, P.: "L'organizzazione dell'attività creditizia e l'utilizzo di tecniche di scoring nel sistema bancario italiano: risul-

According to the revised z-score, the higher the value of z the lower the probability of default. In particular, firms with a value below 1.23 feature a high default risk, while above 2.90 there is a low default risk. The grey area, inside which the model is unable of forecasting whether the firm is good or bad, is limited between 1.23 and 2,90.

With regard to this aspect, the survey must attempt, in the future, to overcome certain limitations inherent in the use of Altman's revised z-score.

5. Results

The results are assessed – for reporting purposes – according to the two levels of survey (analysis of financial statements and z-score), distinguishing between the entire surveyed population and the customer segments[37].

5.1. Analysis of financial statements

Apulian SMEs feature an adequate and stable level of liquidity and their effective short-term indebtedness with banks is consistently lower than the 'physiological' one. Overall indebtedness is rather high, even though the amount payable to banks and other financial lenders is limited and presumably sustainable, in terms of principal repayment and interest payment capacity.

The firms have a good self-financing capacity, partially reduced by the absorption of liquidity due to the growth of the working capital.

Only 25% of firms use debts to shareholders. Short and medium-term payables to banks are equal to zero for about 30% and 60% of firms, respectively.

The ROE is rather limited (5.39% in 2006 and 4.65% in 2005) compared to the gross yield of annual treasury bills (BOT) (3.29% in 2006 and 2.23% in 2005)[38]. Overall indebtedness plays a rather significant role in the formation of the ROE.

Retail and corporate firms feature an adequate financial balance, even though the former have a higher degree of liquidity and a lower ratio of effective to so-called 'physiological' short-term bank debts.

While retail firms depend only to a limited extent on banks and other lenders, corporate firms feature a higher degree of financial leverage, which must be monitored in terms of sustainability. The percentage of firms that do not borrow money from banks is different: in the case of retail firms it is 40% (short term) and 75% (medium-to-long term), while in the case of corporate firms it is 4% (short term) and 25% (medium-to-long term).

tati di un'indagine campionaria", *Questioni di Economia e Finanza*, n. 12, Banca d'Italia, aprile 2008.

[37] Detailed results can be asked to the Authors.

[38] See Banca d'Italia: *Relazione Annuale sul 2007*, 31 maggio, 2008b, Appendix.

The self-financing capacity is good for retail and corporate firms, while the profitability of the former exceeds that of the latter, especially thanks to the ROI and the contribution of the overall indebtedness.

In all the sectors taken into account, the firms feature an adequate degree of liquidity and take out short-term loans with banks to a lesser extent than is considered 'physiological'. The overall indebtedness is high, even though the amount of bank borrowing is limited and sustainable. There is a good self-financing capacity. Approximately 25% of firms use loans from shareholders and about 30% do not take out short-term bank loans.

The ROE of manufacturing firms (4.4% in 2006 and 3.4% in 2005), which account for approximately 31% of the survey population, is below the industry average (8.5% in 2006 and 7.5% in 2005)[39].

The breakdown by province highlights no significant differences, with respect to liquidity and solvency, which appear to be adequate. The firms enjoy a good self-financing capacity. Neither are there significant differences with respect to profitabilit

5.2. Default risk analysis: z-scoring

The application of the revised z-score to the entire population of Apulian SMEs shows that, in 2006, only 17% of firms featured a low default risk, while 38% featured a very high risk. The median value in the three survey years is always inside the grey area (between 1.54 and 1.64).

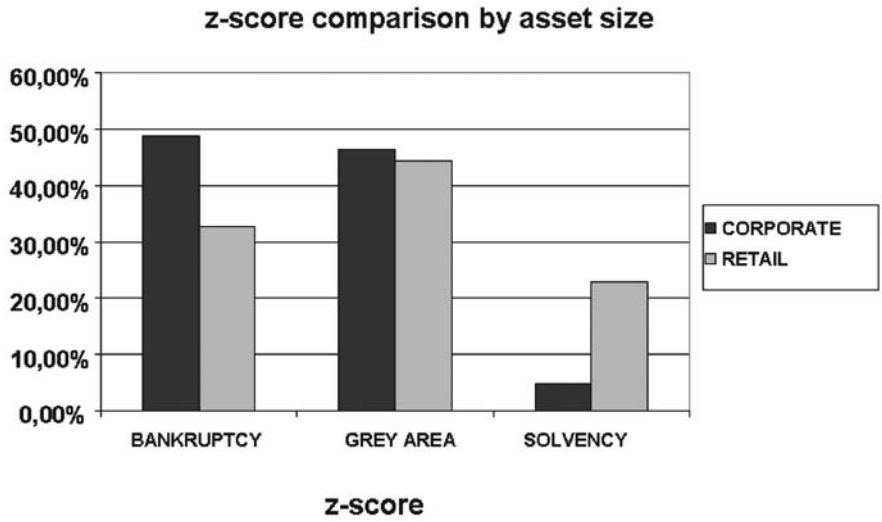

Figure 1. *Z-score of the survey population by asset size in 2006*

[39] See Prometeia: *Sintesi dei risultati del 72° Rapporto "Analisi dei settori industriali"*, realizzato in collaborazione con Intesa San Paolo, novembre 2007.

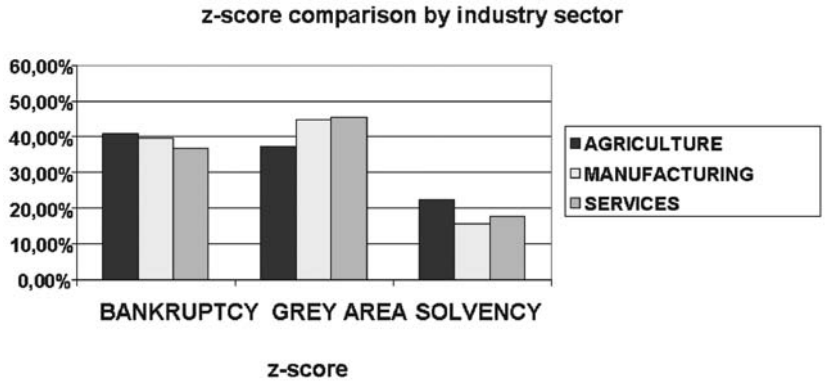

Figure 2. *Z-score of the survey population by industry sector in 2006*

In 2006, a larger number of corporate firms in default risk, compared to retail firms; 33% of retail and 49% of corporate firms, in fact, feature a high default risk. In the three years in question, the median value of corporate firms has been consistently below that of retail ones and approaches the lower threshold of the grey area (Fig.1).

The z-score analysis in 2006 highlights a lower propensity to default by service firms (37% in the services sector, compared to 40% in the manufacturing sector and 41% in the farming sector) (Fig. 2). The median values in the three survey years always fall inside the grey area and agricultural firms feature a higher default risk than the other sectors. However, it should be highlighted that there are only 27 agricultural firms in a survey population of 1,987 firms, which means that the indicators for the agricultural sector are rather weak.

The survey of the z-score by province in which the head office of the firm is located indicates that Foggia is the province with the highest propensity to bankruptcy in 2006 (45%; Fig.3).

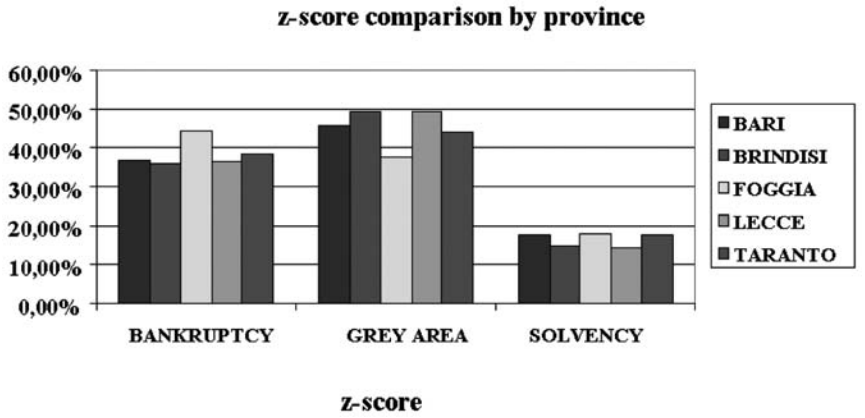

Figure 3. *Z-score of the survey population by province in 2006*

6. Conclusion

The profitability of Apulian SMEs is rather low. This may be consistent with the smaller dynamism of the GDP in recent years in the South of Italy (and the Islands), compared to the rest of the country[40] and with the reduced profitability of Apulian firms over the last decade[41]. However, a more in-depth judgment on the income balances would require further surveys and investigation. In particular, the question is how far the fiscal leverage is a competitive leverage for enterprises operating in Apulia, reducing the information transparency of the financial statements[42].

Apulian firms feature a good liquidity and a limited and sustainable debt to banks. The capacity to produce positive operating cash flows has improved in the survey period; self-financing seems to be the predominant form of financing for the growth[43]. The revised z-score does not highlight a high probability of default, although the (median) values obtained fall inside the grey area, in which the model is unable to distinguish between good and bad firms.

With regard to the comparison of firms classified by dimension, retail firms feature the best profitability, compared to corporate firms. In particular, all the management areas contributing to overall profitability feature the highest values among the small firms.

The financial structure differs significantly: the level of financial indebtedness to equity is about 15% in retail firms and about 190% in corporate firms. The firms with no short-term payables to banks account for about 40% of retail firms and about 4% of corporate firms. In the case of the larger firms, the sustainability of the financial indebtedness must be monitored. The result is a higher risk factor for corporate firms, with a revised z-score approaching the lower threshold of the grey area.

Apulian SMEs, and the segments taken into account, highlight an adequate degree of liquidity and rely on short-term bank loans to a lesser extent than is considered 'physiological'. This result may be in line with the growth of medium-to-long term indebtedness, as compared to short-term indebtedness, among Apulian SMEs in the survey period, entailing a better financial balance[44].

The assessment of the degree of reliance on banks and other financial lenders, however, requires further investigation. Recent analyses, in fact, have shown that, in 2006, the incidence of financial borrowing was rather high in small

40 See Gambacorta, L.: *Il credito bancario alle imprese nel Mezzogiorno*, Bancaria, n. 1, 2008.

41 See Banca d'Italia: *L'economia della Puglia nell'anno 2007*, Bari, 2008a.

42 See De Laurentis, G. – Caselli, S.: *Miti e verità di Basilea 2*, EGEA, Milano, 2006.

43 See Bentivogli, C. – Cocozza, E. – Foglia, A. – Iannotti, S.: "I Rapporti Banca-Impresa dopo il Nuovo Accordo sul Capitale: un'Indagine Territoriale", *Questioni di Economia e Finanza*, n. 6, Banca d'Italia, Febbraio 2007.

44 See Banca d'Italia: *Relazione Annuale sul 2007*, 31 maggio, 2008b.

firms and in the construction and services sectors, which represent a significant percentage of the examined population[45]. In 2004-2006, the growth of loans to Southern-based firms was higher than in the rest of the country; this increase does not seem to emerge from the financial statement figures of the Apulian SMEs[46]. The analysis of the Apulian economy shows the overall growth of loans in the various industry sectors and provinces, and a ratio of the net financial position of firms to the EBITDA (approximately 2.2) decidedly higher than for the population analyzed here (approximately 0.5)[47].

Further investigations are required. It is necessary to supplement the results with the data extracted from the Central Credit Register, to include in the analysis all the forms of funding that are not reported in the unlisted companies' balance sheets (leasing) and to confirm (or deny) the low degree of bank borrowing. The limited use of the financial leverage by retail firms, as compared to corporate firms, could confirm the theory of the greater degree of information opacity among small firms. This would result in increased difficulties in determining the quantity score, which, together with the performance and quality score, is the basis for calculating the rating by banks (counterparty risk and pool risk)[48].

Measuring the default risk by means of the revised z-score has revealed that the median values never highlight a high default risk, even if they always fall inside the grey area. By applying the revised z-score to failed Apulian firms in 2005, it was found that 23 firms out of 61 had been classified with a low probability of default.

In perspective, the research will consider a discriminant analysis observing the recently failed Apulian firms, to avoid using an algorithm that was obtained from the US market. Moreover, it shall be necessary to define a score for the various industry sectors in which the firms operate, which is an important requirement for a well-grounded discriminant analysis. Last but not least, the research will focus on the most sophisticated statistical methods to measure the default risk (logit and probit models; diagnosis of the state of default in a Bayesian context), compared to the z-score, which is unquestionably simple, but not exhaustive.

45 See Banca d'Italia, ibid.

46 See Gambacorta, L.: *Il credito bancario alle imprese nel Mezzogiorno*, Bancaria, n. 1, 2008 and the Bollettino Economico della Banca d'Italia for the survey period.

47 See Banca d'Italia, ibid.

48 See Albareto, G. – Benvenuti, M. – Mocetti, S. – Pagnini, M. – Rossi, P.: "L'organizzazione dell'attività creditizia e l'utilizzo di tecniche di scoring nel sistema bancario italiano: risultati di un'indagine campionaria", *Questioni di Economia e Finanza*, n. 12, Banca d'Italia, aprile 2008.

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Scientific review paper
Received: March 10th, 2009

UDC 657.92:347.72.4(450); 005.52
ID 158253580

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DUE DILIGENCE LIABILITY IN THE ITALIAN CIVIL LAW

Abstract: *Due diligence liability in the Italian civil law is studied in this article. The first part of the study discusses the notions of optional and mandatory due diligence. The second and the third parts of the study are devoted to different aspects of mandatory due diligence, while the fourth part of the study discusses optional due diligence with the obligatory publication of the results. The relevance of the debate over liability for due diligence is analyzed in the fifth part of the study. Sixth part deals with the nature of due diligence liability, and the following seventh and eighth parts discuss the protection of investors, company, partners and third parties from damage. Finally, in the last part of the study optional due diligences are analyzed.*

Key words: *due diligence liability, mandatory due diligence, optional due diligence*
JEL classification: K22, M42

1. Optional and mandatory due diligence

The regulations give us neither a definition nor a general discipline of due diligence[1], but it takes into consideration two notions of due diligence that is a

[1] About due diligence in the Italian Civil law you can see A. Stesuri, *Due diligence e investigation*, Milano, 2002; *Manuale di* due diligence, edited by D. Martinazzoli e G. Gagliardi, Milano, 2004; G. Giacoma – M. Sartori – A. Stesuri, Due diligence – *analisi contabile, fiscale e legale*, 3a ed., Vicenza, 2007; F. Ricci, *Due diligence e responsabilità*, Bari, 2008, p. 102 ss.. You can see also P. Mascaretti, "Due diligence"*: tipologie ed aspetti operativi*, in *Controllo soc. enti*, 1998, p. 499 ss.; M. Conte, *Responsabilità della società di revisione in caso di revisione volontaria nell'ambito di una* due diligence, in *Giur. comm.*, 2000, II, p. 439 ss.; A. Stesuri, *Aspetti fiscali della* "due diligence", in *Corr. trib.*, 2000, p. 2494 ss.; Id., *La* "due diligence" *nel processo di acquisizione delle imprese*, in *Dir. e prat. soc.*, 2002, n. 6, p. 16 ss.; Id., *Gli effetti dell'utilizzo del condono nel processo di* "tax due diligence", in *Corr. trib.*, 2003, p. 1278 ss.; Id., *Responsabilità attenuata per i professionisti delle* due diligence, in *Amm. e finanza*, 2003, n. 10, p. 19 ss.; Id., *Interferenze nel nuovo T.U.I.R. sulla* "due diligence", in *Corr. trib.*, 2004, p. 3529 ss.; Id., *Effetti della riforma fiscale sulla* tax due diligence, in *Fisco*, 2005, p. 6108 ss.; Id., Legal due diligence *e* due diligence *fiscale: profili di responsabilità del professionista*, in *Rev. Contabile*, 2003, n. 49, p. 56 ss.; C. Cerabolini,

broad sense due diligence (in the sense that it may be done either by oneself or by a consultant), and that with a narrow sense (i.e. due diligence that is carried out by a third party)[2].

In particular, some provisions give to some economic operators the specific duty to inform about complex situations which are subject to discretional evaluation, precisely because, their complexity and the discretion of judgment require due diligence on some subjects (obligatory due diligence). In the area of these regulations one should distinguish between: a) those that place the obligation of information directly on the party that, in the presence of a conflict of interest, is structurally, advantaged by an asymmetry of information and; b) those that assign liability for the due diligence to subjects, outside the conflict of interest, about which the information is required.

In the first case, the subjects who have the duty to inform can carry out their investigation directly on their own and be the authors of the final report, or they can appoint a professional (an obligatory due diligence, but not reserved and thus a due diligence in a broader sense). Instead, in the second case, the subject must necessarily commission a third party to do the investigation and the final report (i.e. a due diligence in a narrow sense).

La protezione dei dati personali nelle "due diligence", in *Dir. e prat. soc.*, 2002, n. 8, p. 32 ss.; S. Tersilla, *La* due diligence *per l'acquisizione di un pacchetto azionario di controllo di una società non quotata in borsa: obblighi di informazione e responsabilità dei soggetti coinvolti*, in *Dir. comm. int.*, 2002, p. 969 ss.; A. Guerzoni, *Il lavoro di* due diligence *"certifica" l'acquisizione*, in *Amm. e finanza*, 2003, n. 15-16, p. 21 ss.; R. Oppido, *L'attività di* due diligence *nelle operazioni di acquisizione*, in *Manuale delle acquisizioni di imprese*, Milano, 2003, p. 239 ss.; T. Lomonaco, *Revisione volontaria e responsabilità extracontrattuale della società di revisione*, in *Giur. comm.*, 2003, II, p. 602 ss.; L. Picone, *Trattative*, due diligence *ed obblighi informativi delle società quotate*, in *Banca borsa e tit. cred.*, 2004, II, p. 234 ss., and also in *Banca Dati DeJure, at http://dejure.giuffre.it*; C. Gennaro, *La* "due diligence" *nelle operazioni di finanza aziendale straordinaria*, in *Dir. e prat. soc.*, 2005, n. 18, p. 20 ss.; Id., *Tipologie di* "due diligence"*: criteri di classificazione*, in *Dir. e prat. soc.*, 2005, n. 20, p. 20 ss.; A. Borghi, *Le* due diligence *e la verifica dei risultati dei servizi*, in *Fin. locale*, 2006, p. 171 ss.; F.L. Gambaro, *Problemi delle professioni – brevi considerazioni in tema di così detta* due diligence, in *Riv. dir. priv.*, 2006, p. 897 ss.; G. Alpa – A. Saccomani, *Procedure negoziali,* due diligence, *e memorandum informativi*, in *Contratti,* 2007, p. 267 ss.; L. Bragoli, *La* due diligence *legale nell'ambito delle operazioni di acquisizione*, in *Contratti*, 2007, p. 1125 ss. See also S. Tersilla, *Le clausole di garanzia nei contratti di acquisizione*, in *Dir. comm. int.*, 2004, p. 101 ss.; M. Speranzin, *Vendita della partecipazione di "controllo" e garanzia contrattuali*, Milano, 2006, p. 332 ss.; E. Pulitanò, *La* due diligence *legale*, in *I contratti di acquisizione di società ed aziende*, edited by di U. Draetta e C. Monesi, Milano, 2007, p. 111 ss.; U. Tombari, *Problemi in tema di alienazione della partecipa zione azionaria e attività di* due diligence, in *Banca borsa e titoli di credito*, 2008, p. 65 ss.; I.P. Cimino, *Modello di* due diligence *legale per l'acquisizione di un piccolo portale*, in *Dir. dell'internet*, 2008, p. 207 ss.

[2] Against the position of E. Corrà – C. Bondardo in *L'evoluzione del ruolo della società di revisione nelle operazioni straordinarie: da revisori a financial advisors,* in *I contratti di acquisizione di società ed aziende*, edited by U. Draetta e C. Monesi, p. 55 ss., particularly p. 57

Naturally, even when there are cases in which the due diligence is not mandatory, the analysis and the assessment of risks connected with an operation may be carried out spontaneously (optional due diligence). This frequently occurs in case of extraordinary operations and in particular of operations which involve the purchase of a company's shares or the sale of a business.

2. Mandatory but not reserved cue diligence

This is due diligence in a broad sense as provided for by art. 68, letter *d*. Reg. CONSOB No. 16190/07, according to which the savings management companies (SGR), for each closed-end fund they manage, after having researched and chosen the possible operations coherent with patrimonial, economic and financial plan review, before completing the operation, must carry out the due diligence.

It is necessary to do a due diligence in a broad sense also for the prospectus to be published before offering communitary securities or securities different from stakes or shares of organisms for collective investment of savings to the public (so-called O.I.C.R.) without binding obligation (art. 94, first paragraph d. lgs. 24 Feb. 1998 No. 58, entitled "*Testo unico delle disposizioni in materia di intermediazione finanziaria*"[3], hereinafter t.u.f.). It is necessary to do a due diligence in a broad sense also when communitary securities are admitted to trading on a regulated market (art.113, paragraph one, t.u.f.). These subjects (and in particular the "issuer" and the "offeror" – art. 94, paragraph four, t.u.f.) must publish an advance prospectus that "contains, in a form which is easy to analyze and understand, all the information that, depending on the characteristics of the issuer and of the financial products being offered, are necessary so that investors can arrive at an informed judgment regarding the patrimonial and financial situation, based on the economic results and the prospects of the issuer and of the possible guarantees, as well as on the financial products and relative rights. This prospectus must also enclose a summarizing note which outlines the essential risks and characteristics of the offer" (art. 94, paragraph two, t.u.f.).

It is necessary to do a due diligence in a broad sense also before the prospectus of an offer (whether complete or simplified) that are to be published by those who want to offer shares in open funds or stocks issued by investment companies whose capital is variable (so-called S.I.C.A.V.). The offering company files a complete and simplified prospectus to CONSOB, which will then be published. These prospectuses "have the information, varying according to the characteristics of the product and of the issuer, which are necessary so that the investors can arrive at an informed judgment of the proposed investment, on the rights connected to it and on the relative risks. The information of the prospectuses must have a clear, easily understandable and analyzable form" (art. 98-ter paragraphs one and two, t.u.f.).

[3] Published in G.U.R.I. 26 March 1998, No. 71

Another example of due diligence in the broad sense was the required informative documentation as per art. 102, paragraph one, t.u.f., before the implementation of Directive 2004/25/CE per art. 2 d. lgs. 19 Nov. 2007 No. 229, according to which "those who make a public offer to acquire or exchange will make previous communication to the CONSOB, including a document, that will be published, containing the necessary information so that those for whom it is meant are able to take an informed judgment regarding the offer". Another example of due diligence in the broad sense is the report drawn up and made public by board of directors of the offeree company, containing the information necessary to enable the holders of the company's securities to reach a properly informed decision on the bid (art. 103, paragraph tree, t.u.f. after the implementation of Directive 2004/25/CE).

Finally, for similar reasons, we must also consider a due diligences in a broad sense the prospectus that is prepared and sent to shareholders in order to solicit their votes or proxy votes[4] as provided for by art.138, paragraph one, t.u.f. (regulation about "solicitation carried out by an intermediary[5], as commissioned by a customer of this last[6], and using the distribution of a prospectus and proxy form") and regulated in the later art.143, paragraph one (according to which "the information on the prospectus or on the proxy form, or that made public during the solicitation, must be adequate so that the shareholder can take an informed decision"). It is obvious that one cannot arrive at an "informed judgment" or an "informed decision" unless he or she can base it on a balanced, informed and relative report of the type which we refer to as a due diligence.

In each of these hypotheses, operators are required to supply the controlling authority and the public with information from technical investigations and judgments about companies and investments. So, these cases of due diligence are mandatory. Further, in some circumstances the due diligence is mandatory but not reserved. In fact, in these cases, the issuer or the offeror of shares, stocks or securities have the duty to give information about this operation but it is not required that the operation is done by a third party.

Naturally, even if it is not mandatory, we cannot exclude that the operator can anyway appoint professional consultants to do an investigation and a final report, so they can carry out a narrow due diligence to improve the drafting of the prospectus, or to ensure standards of high diligence or perhaps to have a sharing of the responsibility with these consultants. Now, when there is an IPO

[4] As we know, "soliciting" which is the requesting of vote proxies addressed to all shareholders" must be kept distinct from the "collection of proxies", which is "the request of vote proxies carried out by shareholder associations exclusively among the members of the associations" (art. 136, letters *b* and *e*, t.u.f.)

[5] The "intermediary" is "the subject who carries out solicitation on behalf of another" (art. 136, letter *d*, t.u.f.).

[6] By "customer" we mean "the subject or subjects who jointly promote the soliciting, asking for support on specific questions on which a vote will be held" (art. 136, letter *c*, t.u.f.)

it is common practice to present CONSOB with a comfort letter, i.e. a letter in which a qualified professional subject, a third party without links to the issuer or to the offeror of the shares, stocks or securities guarantees for the information and the evaluations of the prospectus.

3. Mandatory and reserved due diligence

In the case of the due diligence which "evaluates the credit risk" of securitization operations in case of stocks offered to non-professional investors are different. In fact in this case, the law provides that the evaluations must be carried out by third parties (art. 2, paragraph four, 1. 30 April 1999, No. 130[7], entitled "regulations on the securitization of credits", hereinafter l. cart.)[8].

This type of evaluation is also called rating. However, independently from the circumstances that the evaluation of the quality of the credit in pursuance of art. 2, paragraph two, l. cart. can cause a spontaneous and voluntary rating, we must point out that the party's obligation to acquire the evaluation as per art. 2, paragraph five, l. cart. does not impose a classification on the operation, the financial product or the issuer. According to these conditions, it seems that the judgment coming from this rule must be called not a rating judgment but a due diligence in a narrow sense, which is mandatory and reserved to the subjects who have specific requirements of professionalism and independence as stated by articles 2 and 3 of the CONSOB Regulation adopted with the resolution of 2 November 1999 No. 12175.

Also we have a mandatory and reserved due diligence when we have public works projects or public utility projects. In fact these projects "must contain a study of the territorial and environmental framework, a feasibility study, a preliminary project, a conventional draft, an economic-financial plan submitted by a credit institute or by a services company, set up by the credit institute itself, and this company must be enrolled in the general list of financial intermediaries provided for by art.106 of the laws regarding banking and credit issues found in the legislative decree No. 385 of 1 September 1993, or by an auditing company in pursuance of art.1 of law No. 1966 of 23 November 1939, a specification of the characteristics of the service or of the management as well as an indication of the elements provided for by art. 83, paragraph one and of the guarantees that the promoter offers to the administration which will do the adjudgement" (art.153, paragraph one, d. lgs, 12 April 2006, No.163, entitled "Code for public contracts relative to works, services and suppliers in the enforcement of the directives 2004/17/CE and 2004/18/CE", hereinafter cod. l. p.)[9].

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7 Published in G.U.R.I. 14 May 1999, No. 111

8 More precisely, the regulation mentioned in the text establishes that "in the case in which the shares involved in a securitization operation are offered to non-professional investors, the operation must be submitted to a third party to evaluate it as regards credit issues".

9 Published in G.U.R.I. 14 May 1999, No. 111

Also in this case, we are unquestionably speaking about a due diligence in the narrow sense. In fact, the law provides that the economic-financial plan must be done by a third party, independent of the actors of this operation for which the due diligence is required, and this third party must affirm it (in fact, this is the task of the credit institute, of the services company enrolled in the general list of financial intermediaries or of the auditing company).

4. Optional due diligence with the obligatory publication of the results

It is useful to mention that in some cases the due diligence, which is carried out and is commissioned by listed issuers or by subjects that control them, can supply the operator with privileged information directly regarding these issuers and the controlling company, that is "precise information which has not been made public, directly or indirectly concerning, one or more issued securities, or one or more securities, that, if made public, could influence in a significant way the price of the securities" (art.181, paragraph one, t.u.f.), or, if this concerns directly or indirectly freight derivatives, it can supply information "that participants in the markets on whom that derivatives are traded expect to receive according to market practice admitted in the relative market" (art.181, paragraph two, t.u.f.).

In these cases, as in all those in which listed issuers acquire knowledge of privileged information, available in their environment, so-called insider information, these and the subjects which they control must communicate to the public "without delay" the privileged information of which they have become aware (art.114, paragraph one, t.u.f.)[10].

We note that in every case privileged information must be communicated to the public. This is even true when this comes from an optional due diligence, that is from an investigation and a final report, the results of which, were intended exclusively for those who carried out the due diligence or for subjects they wanted to show it to.

In this case it becomes a duty to publish the results of an optional due diligence or at least to publish the privileged information.

5. The relevance of the debate over liability for due diligence

In these conditions, analogously to what happens in the case of an audit of the accounts and in the assessment of the goods and credits to a publicly traded company, the due diligence can be: a) the source of a duty to behave on a certain

[10] For this see L. Picone, *Trattative, due diligence ed obblighi informativi delle società quotate*, in *Banca borsa e tit. cred.*, 2004, II, p. 234 ss, and in *Banca Dati DeJure*, in *http://dejure.giuffre.it*, par. 2 ff.

way coming from facts which precede negotiations of the investigations on the operation; b) the source of service obligations originating from the negotiated terms of the operation; c) the source of service obligations specifically ascribable to the due diligence contract and thus regulated by the relative written assignment; d) an instrument of obligatory or optional information that may transcend these pre-negotiation or negotiation relations and be a point of reference for the interests and choices of third parties.

In item a) the above-mentioned hypothesis coincides with the case of a preventive due diligence carried out by the interested subject and not regulated by a specific agreement with the target. Here, the duties of information are generically ascribable to duties of bona fide as provided for by articles 1337 and 1338 of civil code or for by other specific regulations in this field, in particular those that provide obligatory due diligence.

On the other hand, the hypothesis indicated by letter b) is that type of due diligence which is regulated in specific clauses of the pre-contractual agreement signed by the parties of the operation and which makes up the occasion and the term of reference (e.g. letter of intent).

A further hypothesis under the letter b) is the preventive due diligence following the stipulation of a contract which will make up the object of the operation. In fact the information supplied by the target regarding the situation of the company, the quality of the assets of the company which is the object of tranfer, could be the cause of contractual liability for vices or for lack of quality of the sold good, or either for an *aliud pro alio* delivery[11].

An example of letter c) is the case of a due diligence of the narrow sense, i.e. that which has been carried out by an appointed professional who is a third party to the operation to the occasion or the term of reference.

Finally, the hypothesis d) occurs at least in every case where the due diligence has an asseverative function to third parties, i.e. it issues a document for a wider or narrower public that will be the basis of trust of the third parties involved.

In conclusion, there are in reality two levels of infringement that can be generated by or connected with the activity of due diligence. On the one hand, there is the level of liability which is definitely contractual, which, from here on we will refer to this as liability of the first type: it includes violations of the rules that solve the conflicts in letter b) and c). On the other, there is liability that comes from violations of rules that solve the conflicts considered in letters a) and d), which we will call the second type.

The nature of the liability of this latter type is controversial. Some consider it contractual liability for a violation of the obligations of protection, but without the duty of performance. According to others, there is extra-contractual liability. A third guideline states that it is a new type of liability, which fits neither of the two traditional models[12].

[11] G. Alpa – A. Saccomani, *Procedure negoziali,* due diligence, *e memorandum informativi*, p. 271

[12] See F. Ricci, *Due diligence e responsabilità*, p. 102 ff.

6. The nature of due diligence liability

As I have more completely argued in a recent publication[13], in the relations governed by Italian regulations, differently from those of Germany, the first school of thought cannot be accepted. In fact in the Italian legal system only what is a violation of specific performance obligations has a contractual nature (cf. art.1218 civil code), and not what comes from a violation of other duties[14], as happens in the hypotheses of the second type.

The third opinion cannot be accepted. In fact, it is true that liability from due diligence can be traced back to so-called European civil liability, which as we know has a typical and transversal nature, and in this way solves many regulation problems as regards liability[15]. However, as this rule does not solve all of them, we cannot exclude the need to classify liability cases to be either contractual or extra-contractual, when we find it necessary to solve the residual problems, which are not solved by the regulations of this field[16].

It follows that due diligence liability of the first and second types, like all those that are connected with European civil liability, are regulated: a) uniformly as regards the cases in which we can apply directly or by analogy one of the rules or one of the transversal principles that we can identify if we analyse the laws on this field; b) these must be distinguished from cases in which such operations are not possible and it is thus necessary to use subsidiary principles established by general liability regulations, respectively, contractual in the first type and extra-contractual in the second[17].

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13 See F. Ricci, *Due diligence e responsabilità*, p. 129 ff.

14 Even if those duties are called obligations in consideration of the predetermined quality of the behavior due from the subjects of the relationship, the obligations are others, because as compared to service obligations, they are without the duty of having to supply a service (cf. among others C. Castronovo, *Gli obblighi di protezione* and Idem, *La nuova responsibilità civile*, p. 447, 455 and 469; L. Lambo, op cit, p. 331).

15 For this see G. Alpa – M. Andenas, *Fondamenti del diritto privato europeo*, Milano, 2005, p. 436 ff.

16 See F. Ricci, *Due diligence e responsabilità*, p. 199 ff.

17 In this sense, regarding an event of a due diligence defined as voluntary, the Supreme Court has clarified that "it is possible, using the assumptions found in art. 2043 of the civil code, to assign extra-contractual liability to an auditing company, for the damages sustained by third parties, if these damages occurred because of the company's audits of listed companies, even in the hypothesis of a voluntary audit, carried out for the company itself" (Cass. Civ. No. 10403/02, *Banca Dati DeJure*). On the event provoking this controversy see M. Conte*, Responsabilità della società di revisione in caso di revisione volontaria nell'ambito di una* due diligence, p. 439 and also T. Lomonaco, *Revisione volontaria e responsabilità extracontrattuale della società di revisione*, p. 602

7. Obligatory due diligence: Protecting investors

In particular, when the due diligence deals with an obligatory informative prospectus and the due diligence is carried out directly by the issuer of the financial instrument, or by the offeror, or by one or more guarantors, or – if this is a public offer of communitary securities or securities different from shares or stocks of open O.I.C.R. – by the intermediary placing the offering, for damages suffered by investors the rules which regulate liability of the foregoing subjects for a violation of their duties relative to information stated in art. 94, paragraphs 8, 10 and 11, as well as art.113, paragraph one, t.u.f. are directly applied. So, each of the subjects, relative to his own competence, must respond for damages suffered by investors who have reasonably trusted in the truth and completeness of the information contained in the prospectus, unless the former can prove to have adopted every diligence to ensure that this kind of information conform to the facts and it has no omissions which distort its sense (art. 94, paragraph eight, t.u.f.).

Even if we are speaking about a due diligence in the narrow sense, in the case of damage to investors, the same rules are applied, which, as we have seen, include also the liability of the so-called "persons responsible for the information contained in the prospectus". An extensive interpretation of this regulation as set up by art. 2409-*sexies*, paragraph two, civil code and by art.164, paragraph two, t.u.f. justifies the direct application even when the commissioned consultant is an auditing company, at least when speaking about prospectuses relative to joint-stock companies (whether listed or not). In both cases compensatory action must be carried out within five years from the publication of the prospectus, unless the investor can prove that he discovered the falsity of the information or the omissions in the two years preceding the action.

In fact, as regulations for obligatory auditing of accounts can be applied by analogy in the case of liability in mandatory due diligence (see above), in all cases in which the due diligence is entrusted to an agency rather than to a natural person, the joint and several liability of the agency and the appointees according to the regulation of so-called European civil responsibility can be justified even as regards the application by analogy of art. 2409-*sexies*, paragraph two, civil code and art.164, paragraph two, t.u.f. In this case, thanks to art. 2407 and to art. 2395 of the civil code the action should be exercised within five years from the completion of the prejudicial action, i.e. the publication of the prospectus. As we see, the difference between the two solutions only regards the enforceability of the more favourable rule concerning liability of the informative prospectus, according to which, even when more than five years has passed from the commission, the compensatory action could be attempted, if the investor can prove to have discovered only in the last two years the incorrect nature of the information he received.

8. The protection of the company, partners and third parties from damage

Liability toward the company, partners and third parties, perhaps not even investors, for damages caused by a due diligence carried out directly by a joint-stock company in preparing an obligatory informative prospectus is subject to an application by analogy of the liability of the auditors that oversee the accounts and draw up the reports for both the financial statement and the consolidated balance (art. 2429). On the contrary, because of the alterity of the relationship between the commissioning company and the auditor, who need not be an accountant, in case of a due diligence in the narrow sense commissioned to prepare an informative prospectus relative to the company's shares, the liability for damages toward the company, the partners and third parties, perhaps not even investors, is subject to an application by analogy of the regulations of liability for account auditing.

So as we can see, enforcement by analogy of art. 2407 of the civil code in both cases implies an evaluation of the damaging conduct with respect to the professional parameters and to the diligence required from the nature of the task (paragraph one), as well as the joint and several liability of the internal personnel in charged with carrying out the due diligence and the administrators for the actions or the omissions of these last, in case the damages would not have occurred if the former had been more vigilant in conforming to their obligations of the auditing job they were to do (paragraph two). In this last case, company action against those, charged with the due diligence inside the company, the administrators and the external agency of the due diligence, can be exercised under the conditions provided for by art. 2393 and 2393-bis of the civil code within five years respectively, of a company employee leaving his job or of the end of the external relationship (art. 2393, paragraph four and art. 2407 last paragraph, civil code), while individual action by partners or third parties can be exercised within five years from when the due diligence was issued.

When a third party is entrusted with the function of guarantor and controller over a mandatory and reserved due diligence for either a "credit risk evaluation" in a securitization operation for instruments that will be offered to non-professional investors, the regulations to be applied are those of art. 2, paragraph four, l. cart., or for a due diligence presented as part of a tender bid for public works or works of public utility (art. 153, paragraph one, cod. of public works).

9. Optional due diligences

Finally, also in the cases of optional due diligences, where protected interests can have suffered injury, we must apply the general European civil liability principles of the sector and these can be identified going through the regulations that define in particular: the expectation of a level of qualified diligence to be used in one's professional activity carried out by the agent and to the correlative trusting in the correctness in the conduct of the same, as well as the inversion of the burden of proof relative to the use of such diligence.

Furthermore, when there are the premises, an application by analogy of the temporal limitations established regarding the exercising of liability actions is admissible. As transversal principles they cover cases of both contractual and extra-contractual liability. They apply to due diligences of the first type, i.e. regarding contractual relations between a commissioning subject and a consultant charged to carry out a due diligence in a narrow sense. In fact in this case the omission of items of informative content, even in the form of a judgment, or the inclusion of content which does not reflect the reality examined, can be considered cases of non-fulfillment according to which the diligence of the agent has a specific relevance (which must be that required by the nature of the job), as well as the rule on the proof of his innocence as set up by the principles of this field and also the length of the terms within he has to carry out his functions.

Due diligence cases of the second type, i.e. when we do not have specific obligations to perform a due diligence, must be handled differently. In fact in these cases, in the absence of the duty to inform specifically established by regulations, it is difficult to ascertain that an incorrect due diligence injures a protected interest, because only in this case does the agent's diligence have a relevancy as regards the proof and even as regards the possible prescription term.

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Scientific review paper
Received: February 28th, 2009

UDC 340.137:347.73(4); 343.53(4)
ID 158254092

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CORPORATE INFORMATION AND FINANCIAL TRANSPARENCY IN THE LIGHT OF REGULATION OF CRIMINAL MARKET ABUSE: STORY OF A FAILURE THAT CARRIES THE EC TRADEMARK

Abstract: *The article studies the problems of corporate information and financial transparency in the light of criminal market abuse. Discussion raises the question what objectives should European intervention pursue to preserve the markets? After studying the limits of Directive 2003/6/CE, corporate transparency and financial information are analysed as two complementary perspectives on protection. Then, the arguments are given for the fact that European regulation currently in force still appears too fragmented with regard to the supervision of financial markets, which remains in the hands of each member country's national agency. Finally, regulatory dilemmas on corporate criminal law for financial markets are discussed.*

Key words: *corporate information, financial transparency, criminal market abuse, European regulation*

JEL classification: K42, L15, M40

1. What objectives should European intervention pursue to preserve the markets?

Not many years have gone by since the Directive 2003/6/CE, on the abuse of confidential information and market manipulation, was enacted by the European Parliament and Council and finally adopted on 2nd December 2002. Also, not many years have passed since its adoption within Italian law: starting from the provisions of law produced by the *Testo Unico* on financial intermediation

(*Decreto Legislativo* 24th February 1998, no. 58) as introduced by the Law no. 62 on 18th April 2005 (European Community law 2004) and by the Law no. 262 on 28th December 2005[1] - the latter with particular regard to the introduction of tighter punishments. Needless to say, how few are the applications of such law[2]. Nevertheless, the limits that were already visible at the time of its enactment are currently exacerbating and proving blatant as the current financial crisis worsens.

Indeed the novelties introduced by the law are worth considering. The path followed by the Directive can be traced all way back to the introduction of the *European Commission Action Plan for Financial Services* in 1992[3] and to the publication of the *Lamfalussy Report* in 2001[4] - the latter of which was drafted by the *Steering Committee for the regulation of European real estate markets*[5] and provided

1 Cfr. E. Amati, *La disciplina della manipolazione di mercato tra reato ed illecito amministrativo. Primi problemi applicativi*, in *Giurisprudenza Commerciale*, 2006, p. 992: "The implementation of the Directive and of the legislative measures for its effect has heavily weighed upon the financial markets' internal discipline, thus creating an extremely peculiar microcosm of regulations, due to which we went from a rather loose set of rules to an escalation of tightening sanctions that are incomparable to anything in the other branches of criminal law applied".

2 For a better understanding of the Directive and of the criminal regulations as implemented in Italy, please see S. Preziosi, *La manipolazione di mercato nella cornice dell'ordinamento comunitario e del diritto penale italiano*, Bari, 2008

3 European Commission Communication 11th May 1999, *Implementation of the framework of actions for financial services: action plan*, COM (1999), 232, unpublished in GUCE, available at www. europa.eu/scadplus/leg/it/lvb/l24195.htm – 26k

4 *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, Brussels, 15th February 2001, available on the European Commission website at www. ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf

5 The so-called "Committee of Sages" (known as *Comitato Lamfalussy*, in honour of the President Alexandre Lamfalussy and drafted also by C. Herkstroeter, L. Rojo, B. Ryden, L. Spaventa, N. Walter e N. Wicks) was appointed in July 2000 by the Council of Ministries of Economy and Finance, and it was given charge of elaborating a regulatory framework capable of adapting to the changing situation of the European financial markets, in order to promote their integration. Cfr. A. Tiseo, *La Direttiva 2003/6/CE relativa all'abuso di informazioni privilegiate e alla manipolazione di mercato (abusi di mercato)*, *Approfondimenti penali*, p. 1540 (note 3). On the topic of the Lamfalussy Committee, please also refer to S. Vincenzi, *Mercato finanziario e armonizzazione europea*, Rome, 2003. On the basis of the Lamfalussy procedure several European provisions have been enacted, all of which aim to promote the integration of financial markets at European level and the harmonisation of corporate reporting. Besides the European Directive, the text also deals with the so-called *Prospectus Directive* (no.71/2003); with the *Directive on Financial Instruments Markets* (no. 39/2004); with the *Take-over Bids Directive* (no. 25/2004); with the *Transparency Directive* (no. 109/2004), cfr. B. Petracci, *Informativa societaria e abusi di mercato*, Rome, 2004, p. 53. For a more in-depth analysis of the so-called Directive Mifid, please refer to A. Nigro, *La nuova regolamentazione dei mercati finanziari: I principi di fondo delle direttive e del Regolamento MIFID*, in *Diritto della banca e del mercato finanziario*, 1/2008, 3.

a framework that was reintroduced in the Directive 2003/6/CE and laid both the objectives and the contents that the European regulation ought to have adopted[6].

The proposal submitted by Steering Committee – the final review of which was approved by the European Council in Stockholm in March 2001 and by the European Parliament with the Resolution of 5th February 2002 – identified the need to create an integrated financial market, thus observing that, at the time, European markets formed an extremely scattered scenario with clashing powers and overlapping competences that were causing rigidities and inefficiencies, thus proving inappropriate for the modern markets. In particular, some of these negative externalities were being pointed out as proper diseases for the system, which may have hindered the development of European financial markets. According to the Steering Committee itself, consumers, investors, small and medium enterprises and governments were the very first to pay the consequences of the system's inefficiencies.

On the other hand, the Committee maintained that an integrated financial market would have been capable of generating remarkable economic advantages for the European Union, especially at macroeconomic level, by stimulating labour and capital productivity as well as by optimizing each country's growth potential and employment capacity within the Union.

It is from this very perspective that the regulation on the abuse of confidential information was meant to follow the same objective of the regulation against markets' manipulation, that is: *to guarantee the integrity of the EU financial markets and to increase investors' confidence in the markets themselves*. On this concept was laid the idea of adopting combined rules to fight both the abuse of confidential information (*insider trading*) and the manipulation of markets[7].

European regulation, on the other hand, represented (or was supposed to represent) not only an attempt of structural improvement and update within the wider framework of *unification of the markets for financial services*, which was in line with the interventions outlined in the *Action Plan for Financial Serv-*

[6] The topic has previously been the object of Council Directive 1989/592/CEE of 13th November 1989 with regard to the co-ordination of regulations on the matter of operations carried out by persons in possession of confidential information, in GUCE L 348 of 29th November 2989.

[7] Please also refer to E. Di Lazzaro, D. Spedicati, *La repressione penale della manipolazione: il primo caso di "risarcimento" alla Consob per danno all'integrità del mercato*, in *Riv. dir. soc.,* 2007, p. 110 s. The experience made in the years that followed the Directive 2989/592/CEE had highlighted the need for an intervention of a much broader spectrum, that could take into account the entire range of market abuses, amongst which insider trading represented a merely partial aspect, albeit significant, cfr. A. Di Amato, *Gli abusi di mercato,* in *Trattato di diritto penale dell'impresa*, directed by Di Amato A., IX, *I reati del mercato finanziario*, Padua, 2007, p. 88. In fact, despite the introduction of a comprehensive definition of abuse of confidential information, a rather weak enforcement could be observed on behalf of Member States (cfr. G. Ferrarini, *La nuova disciplina europea dell'abuso di mercato*, p. 43).

ices adopted by the Commission in 1999 (in which the need to produce a *Directive against markets' manipulation* was already highlighted). According to some commentators[8], such regulation would have also been the *European reaction to the great financial disasters* of major business companies, which started off with the infamous collapse of Enron at the end of 2001 in the United States.

The abovementioned proposals is mainly based on the solid belief that investors represent one of the most vital elements for the good functioning of markets and that, therefore, information quality and reliability, as well as financial transparency, remain essential in order to preserve people's confidence and their investments[9].

In this scenario, it appeared clear that the most detrimental factor among those that led to the financial collapse of large corporations was the ability to carry out *accounting frauds on the companies' real conditions*, which undermined people's confidence in corporate information thus igniting the crisis. On the other hand, the level of security of the market appeared unbalanced, leaving investors, creditors and workers incredibly vulnerable to several abuses. This became feasible due to a faulty regulatory system that has several weak points, such as:

a) *accounting regulations* (*Enron's management* could hide large deficits mostly by relying on a number of official rules – in particular, the so-called *SPEs, Special Purpose Entities*);

b) *abuses in the Stock Options Incentive System* (an excessive use of *stock options* led the so-called *management* to boost the (estimated) value of profits in order to inflate the value of company's shares);

c) *the role of "Statutory Audits" and of the "Corporative Governance"* (both managers and internal auditors found common interest in lowering

[8] Cfr. G. Ferrarini, *La nuova disciplina europea dell'abuso di mercato*, p. 45; A. Manna, *Tutela del risparmio, novità in tema di insider trading e manipolazione del mercato a seguito della legge comunitaria del 2004*, in *Riv. trim. dir. pen., ec*., 2005, p. 665. On the other hand, the following sources underline the need to tackle the Member States' concerns following the 9/11 terrorist attacks with regard to the fight against terrorism operations and their funding, F. Guariniello, *Gli abusi di mercato. La manipolazione di mercato: fattispecie penale ed amministrativa*, in www.tidona.com.; S. Salerno, *I fenomeni di Market Abuse: la disciplina dell'aggiotaggio sugli strumenti finanziari in Italia e la recente normativa comunitaria*, p. 298; A. Tiseo, *La Direttiva 2003/6/CE relativa all'abuso di informazioni privilegiate e alla manipolazione di mercato (abusi di mercato)*, p. 1539. Finally, with reference to the phenomenon of markets' globalisation and the need for debate on the methods for countering abuses, please see A. Di Amato, *Gli abusi di mercato*, 2007, p. 84-85.

[9] On the various economic aspects of market manipulation also refer to S. Salerno, *I fenomeni di Market Abuse: la disciplina dell'aggiotaggio sugli strumenti finanziari in Italia e la recente normativa comunitaria*, 297; A. Di Amato, *Gli abusi di mercato*, p. 85 ss. For a full description of the Stock Market please see M. J. Pring, *Analisi tecnica dei mercati finanziari*, Milan, 1989.

mutual control, to the detriment of the company's shareholders and of shareholders in general);

d) *the scarce independence of external auditors and of accounting supervisors* (external auditors, who are responsible for the company's auditing, ran the risk to have conflicts of interest and to loose their independence whenever they were appointed to provide much more favourable consulting services to the same companies. Accountants' supervision further experienced loss of independence due to the lack of an *ad-hoc* body in charge of supervising auditing companies);

e) *the role of intermediaries, financial analysts, rating agencies* (a number of merchant and investment banks appeared to have lowered their interest in overlooking the credits, loans and investments, as long as they could gain higher returns from those very companies. Financial analysts and rating agencies, on the other hand, did not seem capable of slowing down the enormous success they were enjoying, to the natural detriment of their objectivity in researching of the critical economic situations)[10].

To summarise, the attempt to avert the danger of accounting frauds and manipulative operations by investment banks and financial analysts that has generated the phenomenon of the so-called "speculative bubbles", by inflating financial instruments' prices, albeit not openly, seemed to be the main reason behind the Directive 2003/6/CE, alongside with the *Action Plan for Financial Services*.

2. Directive 2003/6/CE and its discontents

In contrast with the aforementioned observations, it is worth noticing that, as a matter of fact, European regulation of *market abuse* can hardly be separated from the major financial scandals that hit the largest business companies in the United States, first, and in Europe straight afterwards; nevertheless, the measures that were adopted to safeguard the market integrity, by way of increasing transparency and investors' confidence, according to me, already seemed incomplete and unbalanced at the time of enactment[11]. Repressing *insider trading* and the markets' manipulation was – and still is – only one of the several elements to guarantee the markets' integrity; in fact, the financial and commercial crises that broke out during the first half of the decade proved it true, as these were being largely ignited by accounting frauds.

It cannot be denied that financial and corporate transparency involves the market in all its aspects. If information determines the price of financial instruments

[10] Cfr. European Parliamentary Financial Services Forum, *The integrity of Financial markets Accounting Scandals and Corporate Governance*, 5th November 2002.

[11] Cfr S. Preziosi, *La manipolazione di mercato*, op.cit.

on the market and if, in turn, prices represent the synthesis of information that is available on the markets[12], it must also be assumed that market integrity and investors' confidence cannot be preserved solely by opposing manipulative practices.

This therefore emerged as a clear asymmetry and partiality in the perspective in the European regulation, already within the Directive 2003/6/CE and its immediate aftermath; as a matter of fact, the aim of preserving integrity, the normal functioning of financial markets and investors' confidence (cfr *Considerando 2*) through a very tight system of sanctions appeared as an evidently ambitious and broad-spectrum initiative. Nevertheless, in spite of such a wide purpose that should have affected the issue of financial transparency in all its significance, the Directive merely addressed one aspect – market abuse – that, albeit remarkable, could not be taken to represent the only decisive factor for the preservation of market integrity and for the appropriate price formation for financial instruments[13].

As it has been observed by several scholars, such asymmetry was and still remains especially evident within Italian legislation that – possibly due to the faults contained in the European regulation – with the Law no. 262 in 2005 («*Provisions for the preservation of the savings market and provisions for the financial markets*) contributes to increase the threshold of sanctions for the banking and financial system, thus «leaving de facto unchanged violations foreseen for the dissemination of false corporate communications and for the protection of company's capital, which therefore continue to provide a soft landing for anyone who intends to commit a crime and is clever enough to deceive the infringements prescribed by the laws on banking and financial matters»[14].

The outburst of the current global crisis makes the inadequacy of the European regulation on market abuse look even bigger.

On the basis of the information of the media on economic matters, the scenario of international financial markets, and in particular of the Italian markets, looks daunting. Such information highlights the break-out of *intangible assets* of credit institutions throughout the past decade, and not only that: "For instance, UniCredit rapidly saw the value of its goodwill multiply by ten times, going from 1.9 billion euros in 2005 to 19.1 billion euros in 2007, whereas the whole bank is now worth less than 11 billion euros. Over the same period of time, figures multiplied by twenty times in the financial statement of Intesa-Sanpaolo, shooting from 869 million euros to 17.5 billions, against a capitalisation that went down to

[12] This is maintained in R. Rordorf, *Importanza e limiti dell'informazione nei mercati finanziari*, in *Giur. comm.*, 2002, p. 773/I.

[13] In *Considerando 15* the same Directive maintains that *the abuse of confidential information and market manipulation hinder the market's full transparency, which is the fundamental prerequisite in order for the economic operators to be able to operate across integrated financial markets.*

[14] Cfr. S. Seminara, *Nuovi illeciti penali e amministrativi nella legge sulla tutela del risparmio*, in *Diritto penale e processo*, 2006, no. 5, p. 549.

18 billions last Friday. Goodwill will also grow in the 2008 financial statement of Mps, thanks to the onerous acquisition of Antonveneta that was paid twice the price of 4.5 billion euros, which the whole group is currently worth on the stock market. Nevertheless, the problem affects the even wider picture, including the industry and the service sector, as it has already been shown by Telecom's 44 billions worth of goodwill, or by Enel's 26 billions worth of intangible assets before the operation Endesa was even completed".[15]

3. Corporate transparency and financial information: two complementary perspectives on protection

If this is the current situation – and there is no evidence to doubt that it is not – it appears clear that price formation for financial instruments is severely affected by the heavy bias brought about by misleading *corporate information*. Market integrity, that was meant to be preserved by accurate *financial information* and through them a more efficient allocation of resources, results highly compromised by distortions and improper *corporate communication*[16].

Criminal dispositions on market manipulation and agiotage, which would protect it from misleading information and other distortions, seems to be totally inadequate and useless if, through financial statements and other forms of corporate communication, it is possible to have such kind of high distortions.

In synthesis, European and domestic lawmakers believed they could split the interest in supporting appropriate corporate communication from the interest in transparent financial information. In other words, they thought they could adopt double standards for corporate regulation and for market abuse, as if the issues causing price alterations were generated merely within negotiations and through financial information (that is, information regarding shares and other financial instruments) and not at the bottom of such problem, that is within corporate transparency and within the auditing processes carried out on companies' assets.

The conclusion that should be drawn as the decade comes to a close is that we cannot debate financial market integrity if a sound system of rules on transparency and corporate communication is still lacking. It should be noted with particular emphasis that it is corporate communication itself that cannot do without a sophisticated system of *supervision on auditing and rating agencies*.

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15 A. Olivieri, *Borsa italiana si sgonfia: ora è il 17% del Pil*, in *Il Sole 24 Ore*, 8th March 2009

16 Cfr. The sharp information of G. MARINUCCI, *Diritto penale dell'impresa: il futuro è già cominciato*, in *Rivista it. Diritto e proc. Pen*, 2008, 1471: "stricter and clearer rules and perceptive corporate and institutional controls are the only *guards* able to allow the timely discovery of corporate crimes".

4. On the issues of supervision and tutelary authorities

Furthermore, European regulation that is currently in force still appears too fragmented with regard to the supervision of financial markets, which remains in the hands of each member country's national agency.

In fact, despite the actual severe crisis of financial markets, the idea of spreading supervision across a number of countries – i.e. the countries where issuing companies are based – is far from being unachievable, together with the slow down that such idea has caused in the attempt of strengthening (or creating *ex novo*) the role of international authorities.

Beyond the idea of creating global regulations, the lack of a European regulatory authority represents an inexcusable vacuum. First of all, the attempt of harmonising Member States' regulations without a responsible authority appears rather inappropriate. As a matter of fact such authority would act as the fundamental propeller for an effective harmonisation that is necessary without any doubt.

Furthermore, it becomes evident in all its significance the discontinuity of Member States' regulations on market manipulation, especially if this is compared with the competition regulation. It still holds that preserving the markets from manipulative behaviours and preserving competition are two separate issues and could not be otherwise, due to the fact that – according to Art. 81 and 82 TCE – anti-competitive agreements and practices aim to protect a company or a number of them to the detriment of the other competitors; whereas manipulative behaviours (that must not necessarily have the form of agreements) aim to alter market conditions and possibly to make profits from prices which have been set up in an artificial way. In fact, such practices are often carried out in the attempt of generating speculative opportunities or, even more frequently, they are used as a means to realise so-called operations of 'financial piracy' aimed at much bigger scopes than the mere price alteration.

Nevertheless it is evident that efforts should be concentrated first of all on planning a coordination system that could mediate at European level between antitrust and market-abuse regulation. Even more importantly, a European system of sanctions should be conceived also for manipulative abuses, as they have already been conceived for anti-competitive behaviours. In fact, it would be appropriate to give regulatory authorities that are independent from the European Commission full powers pertaining to sanctions both in matters of antitrust and of market abuse[17]. The total lack of any form of coordination and the high fragmentation of national sanctionatory systems is with no doubt inappropriate to the times.

[17] "The European Commission must create and independent authority, with specific powers to safeguard European investors, and the right for them to resort to the existing European jurisdiction. Newly created bodies should not replace the Tribunal and the European Court of Justice, which should – on the contrary – be strengthened. On the other hand, it is vital that the authority is self-sufficient, that is that it does not outsource the power of intervention and investigation to the European Commission, as it has occurred previously (…) There are two reasons behind this recommendation: avoiding the European financial

Such is therefore the knot that needs be untangled: on one hand we could persist in the *status quo* outlined by the Directive 2003/6/CE, according to which national authorities remain effectively sovereign and the effectiveness of sanctions is entrusted to the competent administrative and judicial bodies in Member States; on the other hand, a unified strategy could be elaborated subject to prior creation of a European supervising authority that could overlook the financial markets and of appropriate tools of cooperating investigation and judiciary action, much more solid that those currently in place. According to the current state of the art, all investigatory attempts must rely on scattered and voluntary mechanisms of co-operation between national Stock Exchange authorities, which prove totally ineffective at least in the attempt of tackling illegal financial operations.

5. What corporate criminal law for financial markets?

In spite of the gravity of the crisis and the suspicion that heavily risky businesses may be taking place at this time[18], the current orientation expressed by the political class from Member States continues to be limited to strengthen national regulatory bodies, according to the model of CESR, the *European Securities Regulators Committee*, or that of *European Securities Committee* (both created with a European Commission's Decision on 6th June 2001). Both Committees – it must be admitted – do not seem to be capable of carrying out a particularly effective role in the prevention and repression of illegal activities.

From a different but nonetheless relevant point of view, the flaws contained in the regulation on market manipulation must be ascribed to the European lawmaker.

The unrealistic and, at the same time fanciful, expectation that creating a single market of financial services would be feasible before merging regulation and corporate law is now revealing all its failures. The issues are numerous and the truth is that they do not only involve the European lawmaker but national lawmakers, as well as the very relationship between national and supranational positive law, on one hand, and *lex mercatoria*, on the other.

It cannot be denied that there exist "regulatory dilemmas", on the solution of which (or the non-solution of which) largely depend the wellbeing and the living conditions of millions of citizens. In other words, market integrity cannot be feasibly and effectively preserved without taking responsibility upon oneself for legal and political choices that affect corporate law and that involve: minority

markets being influenced from the Commission and avert the danger of political conflicts that could stem between the Commission and the judges, as it has occurred in the past thus resulting in severe and unacceptable unreliability for the investors". G. Rossi, *Il mercato d'azzardo*, MI, 2008, p. 95.

18 Cfr. recently M. Onado, *Quei reati nell'ombra che colpiscono il listino*, in *Il Sole 24 Ore*, 8th March 2009

control and parasocial agreements, that – among other things – may alter sensibly the process of price formation within the financial markets, thus damaging their integrity and turning them into means of control for power elites that can operate in the dark with no control whatsoever on behalf of the investors; the role in the decision-making processes – and possibly the involvement – of the *stakeholders*, that is those external subjects whose interests are directly related with the company management and policy (i.e. workers, creditors, suppliers, etc.); a tight supervision and strict rules on the incompatibility for the auditing and rating companies, the possible strengthening of the shareholders' power, especially in the light of a separation between managerial powers and "ownership" – the latter of which ought to be reviewed as shareholders of large listed companies now tend to be represented by investment funds, pension funds and other entities that manage third party's money and savings, and whose interests are merely financial and, therefore, related to the financial market; the introduction of mechanisms to protect social assets that aim to generate value for the shareholders, which is highly endangered by the current situation of the financial markets due to the increasing participation of investors who do not pursue the so-called corporate liability interest, and on markets that "are no longer investment places, rather liquidity theatres", and whose flows are fed by operators that handle third party's money[19]; the role of statutory autonomy and of *corporate governance*, whose benefits remain uncertain and one of its hybrid products – such as organisation and management models for the prevention of crimes, under the Art.6, Decreto Legislativo no. 231/2001 – must still show its real effectiveness and preventive usefulness, and most of all its has still to prove that the creation of an internal organisational system capable of preventing economic crimes may be generated at *corporate* level with no imposition from higher levels of power.

In sum, this is all part of financial market protection or, to better say, it is the background against which effective regulation on market abuse must be placed. The idea that price trends for financial instruments may follow the free flow of demand and supply, simply relying on the "threatening" sanctions introduced in Italy by the Law no. 262 in 2005 and in total absence of a powerful deterrent against financial risks that may stem from a brand new corporate law, is nothing but a mere pipe dream.

[19] G. Rossi, *Il mercato d'azzardo*, p. 47

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Expert article
Received: February 15th, 2009

UDC 347.922.7; 366.542(450)
ID 158254348

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THE ITALIAN WAY FOR CLASS ACTION

Abstract: *The article discusses different legal practices concerning collective lawsuits for compensation claims of consumers. Class action rules in force in USA and some European countries are compared. It has been revealed that in Europe, class actions are subject to rules different from those in the United States. Special attention is paid to the new rules in Italian law that are regulating collective lawsuits for compensation claims.*

Key words: *class action, compensation claims, consumers, Italy*
JEL classification: D18, K13

1. Collective claims system in force in the United States

It is widely thought, but not entirely grounded, that the Italian lawmakers, by approving the new class action rules (as set out in the 2008 Financial Law, which introduced the new article 140 bis in the Consumer Code), have introduced a collective claims system similar to the one in force in the United States, where individual consumers who have been damaged by the bad or illegal behaviour of a company, are entitled to file a class-action lawsuit to obtain compensation, in representation of all the other consumers potentially damaged by the same behaviour.

Class-action lawsuits need to be authorized by a Federal court, which has the responsibility of determining whether, (i) the plaintiff(s) claiming to represent a whole class of similarly situated individuals, are capable of adequately protecting them; (ii) the class they claim to represent is so numerous that the filing of individual lawsuits by all those concerned would be too expensive; (iii) the matters for which a legal remedy is sought are effectively common to all the class members; and (iv) a class action is more advantageous compared to individual lawsuits.

Class actions also have the advantage of obtaining an effective judgement that is binding on all the class members who have not explicitly declared, during the legal process, their decision to opt out of the action (the so-called opt-out system).

Class-action lawsuits present a number of obvious advantages: first of all, they enable consumers who cannot or do not want to incur the legal costs

entailed by an individual lawsuit – which can be higher even than the damage sustained – to nevertheless obtain legal redress, with respect to the business that has infringed his or her rights; secondly, they relieve the courts and the tribunals from the burden entailed by a large number of lawsuits, which can even end in contrasting judgements; thirdly, they act as an effective deterrent on businesses, which are encouraged to invest in the quality of their products or in production safety to avoid the risk of very high compensation awards (in the US, in fact, the courts in addition to compensatory damages for the harm actually sustained by the plaintiffs, may also award so-called punitive or exemplary damages, the aim of which is to deter businesses from pursuing the course of action that led to the filing of the lawsuit).

The US experience, however, has shown that class actions can be subject to abuse and can be misused, at times with very serious effects for both businesses and consumers.

In the case of businesses, they can lead to the risk of bankruptcy – when they are unable to bear the financial burden of the compensation – with foreseeable consequences also in terms of employment, or to opportunistic class actions or forms of judicial blackmail (which risk is partially mitigated by the fact that, as mentioned above, a class-action lawsuit must first be authorized by a Federal court).

For consumers, the risk is that the broadness of the 'class' can lead to pitiful compensation for the individual class members, or even that the failure of the defendant will make any form of settlement impossible, or that the representative party of the 'class' filing the lawsuit (who is often chosen, advised and financed by a legal firm, whose fees consist in a percentage of the compensation) may enter into a settlement with the defendant in order to make quick money, regardless of the actual interests of the 'class' he or she represents.

On top of all this there's the risk of putting a decision concerning thousands of cases into the hands of a single jury.

2. Class action rules in UK, France and Spain

In Europe, class actions are subject to different rules than in the United States.

In the UK, group litigation is subject to the very broad powers granted by the law to magistrates.

First of all, a single plaintiff, or even an organization, cannot propose himself, herself or itself as the representative of a class of persons with the same interest in a claim, but it is the magistrate who decides, acting on his or her initiative, or on the request of one of the parties to an existing lawsuit, whether to consolidate similar proceedings already pending before different judges and refer them to a single specific court.

The latter court will then be responsible for regulating the different stages of the legal process, deciding whether or not to admit new plaintiffs, to appoint lawyers for the group or even a trustee to protect their interests.

On the contrary, the French model of 'action en representation conjonte' provides for the possibility of an organization being appointed by a number of plaintiffs to file a single lawsuit, in respect of a collective compensation claim.

In Spain too consumer organizations may bring a collective lawsuit to claim compensation for damage sustained by a group of persons, regardless of whether or not they are members of the organization, provided that they are individually identified.

3. Italian way

Under Italian law, instead, the new rules regulating collective lawsuits for compensation claims (which has not yet entered into effect: the initial effective date, 30th June 2008, in fact, having been postponed firstly to 1st January 2009 and, secondly, by article 19 of the Decree Law 207/2009, to 30th June 2009) provides, first of all, that the legal action cannot be promoted, as in the US, by any representative of the 'class' but only by the organizations and committees that "suitably represent the collective interests in need of protection".

Moreover, the collective lawsuit is subject to the prior judgement of admissibility by the competent court (which is similar to the prior assessment by the Federal courts in the US), in connection with which the magistrate must assess whether or not, (i) the organization filing the lawsuit is suitably representative, (ii) the lawsuit is manifestly groundless, (iii) there is a conflict of interest (between the consumers' representative and the consumers themselves) and, (iv) there is "a collective interest that can be suitably protected".

If the court allows the petition, it produces a decision which, unlike the judgement in a class-action lawsuit, does not grant compensation but merely sets out the criteria for achieving a settlement, which are then applied to stage two of the process consisting in an out-of-court settlement procedure.

The court decision is effective and binding only on opt-in claimants (the so-called 'opt-in system') and not on all the members of a same 'class'.

The system thus designed by the Italian lawmakers, which provides for a broad-ranging preventive judgement of admissibility by the court, seems to grant the court a means to set up an effective barrier against futile, opportunistic or even copycat collective actions (even though the cases of non-admissibility, according to their current formulation, may raise a large number of problems of interpretation, whose solution will be no easy matter).

Collective actions, unlike class actions, will be ineffective as deterrents against businesses (due to the fact that no punitive damages are provided for)

and does not remove the risk of multiplying lawsuits against a single defendant by other consumer organizations or individuals who, having opted out of a previous collective action, are not bound by the relevant court decision.

The Italian consumer organizations have welcomed the approval of the new law and have expressed the opinion that it will help to improve the level of protection of consumers.

On the contrary, members of the Confederation of Italian Industry (Confindustria) have expressed the fear that the new law may prove to be too financially burdensome for the industrial system and will further impair the competitiveness of Italian products on the international markets.

Even, the opinion of some authoritative judicial scholars is rather pessimistic; it has been said, in fact, that collective actions require "a very severe filter to prevent frivolous claims or even legal blackmail and to avoid that the large-scale multiplication of claims for limited damage caused to consumers lead to the destruction of services or production systems that are useful to the country and relevant for the market" (Guido Alpa).

Therefore, we can only hope that the postponement of the entry into effect of the new collective action rules has seen as an opportunity to further reflections on certain controversial aspects of the system.

Original scientific paper
Received: November 27th, 2008

UDC 341.232.5(497.11:73)"1919/1920"(093.2)
ID 158251276

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RECONSTRUCTION & DEVELOPMENT ASSISTANCE: THE CASE OF EUROPEAN TECHNICAL ADVISERS IN SERBIA AFTER WORLD WAR I*

Abstract: *The article analyzes the functioning of European Technical Advisers within American Technical Mission, who arrived in Serbia in October 1919 to provide counseling and concrete actions that would assist Serbia and the newly established state The Kingdom of Serbs, Croats and Slovenians with putting into function railroad and other traffic as well as reconstruct the old and open new mines. However, due to frequent interchanges of governments and disagreements among political parties, the representatives of the mission soon realized that they were made completely powerless to do the job they were paid for, which led, after only a year, to their withdrawal from Serbia.*

Key words: *development assistance after WW I, European Technical Advisers, Serbia*

JEL classification: F35, N44

1. Introduction

During the period of neutrality in World War One, United States of America founded over 130 humanitarian organizations that focused their activities on providing aid to destitute European civilians. *Committee for the Relief in Belgium* founded and directed by Herbert Hoover was one of the most important organizations of this type. When, in April 1917, United States of America entered the war, Hoover withdrew from this organization to facilitate the uninterrupted functioning of the organization and became the director of strong and strictly centralized *American Food Administration*, which in these war circumstances had wide jurisdiction when it came to protection and development of American

* The paper is the result of research conducted in Hoover Institution Archives, at Stanford University, where the author stayed as a participant of The Junior Faculty Development Program, organized by American Councils, Washington D.C. in the period January-May 2007.

food commodity market as well as supplying Allies with food. After over a year, and to personal demand of American president Woodrow Wilson, Hoover, on November 18th, 1918, traveled to Europe to assume the position of Director General for Relief the Allied Governments (or Director General of Relief in Europe). After successful negotiations with French, British and Belgian representatives, *Supreme Council of Supply and Relief* was founded in Paris which was once again under direct management of Hoover as Director General of Relief in Europe.[1]

In early February 1919, to insistence of American representatives, *Supreme War Council* formed *Supreme Economic Council* which included the above mentioned *Supreme Council of Supply and Relief* but this time as *Food Section of the Supreme Economic Council*. Later, on February 24th, 1919, American Congress passed a bill that granted 100 million dollars for the purpose of providing relief to European states (apart from former enemies). The law allowed President Wilson to establish, as early as on February 25th, 1919, *American Relief Administration* with Herbert Hoover as its chief.[2] Thanks to such strong and centralized American organization, which closely cooperated with *Food Section of the Supreme Economic Council*, all preconditions were made for providing constant and regular influx of humanitarian aid to European civilians gravely stricken by the consequences of war. The importance of such an institution was manifested in the fact that this was a manner of alleviating political pressure to which certain states, under the guise of providing aid, might have been exposed. Thus, through these organizations, in the period from December 1st, 1918 to June 30th, 1919, more than 3 million tons of food worth almost 800 million dollars was delivered. The Kingdom of Serbs, Croats and Slovenians alone did receive about 89.442 tons of different food commodities in this period.[3]

Food distribution to European states soon demonstrated disastrous consequences of the First World War. Apart from tremendous and irreplaceable casualties, vast devastation almost completely incapacitated traffic systems in Central and Eastern Europe. Herbert Hoover, as the director of *American Relief Administration,*

1 More on this see: Michael J. Hogan, "The United States and Problem of International Economic Control; American Attitudes toward European Reconstruction, 1918-1920", *The Pacific Historical Review*, Vol. 44, No. 1 (Feb., 1975) pp. 84-103; Arnold E. Peri, "The Great Engineer as Administrator: Herbert Hoover and Modern Bureaucracy", *The Review of Politics,* Vol. 42, No. 3, July 1980, pp. 329-348; James L Guth, "Herbert Hoover, The U.S. Food Administration and the Dairy Industry 1917-1918", *The Business History Review*, Vol. 55, No. 2, Summer 1981, pp. 170-187; Robert D. Cuff, "Herbert Hoover, The Ideology of Volunteerism and War Organization during the Great War", *The Journal of American History*, Vol. 64, No. 2, Sep,. 1977, pp. 358-372.

2 Ibid. U. Ostojić-Fejić, "Anglo-American Humanitarian Activities in Serbia in 1919", in: *Serbia at the End of WWI,* Historical Institute, Collected Papers, Book 8, Belgrade, 1990, pp. 105-111; *European Children's Fund* and *Food Administration* were under the management of *American Relief Administration* and all were governed by Herbert Hoover.

3 Ibid. The International Food Problem, *Political Science Quarterly*, Vol. 35, No. 3, Supplement, Sep., 1920, pp. 19-20

was the first to initiate action that would focus on the reconstruction of destroyed infrastructure by establishing, within *Supreme Economic Council, Communications Section for the Supreme Economic Council* to which he brought high-rank American Army officers who were up till then serving in the *17th Engineers Railway Regiment* stationed in France.[4] Their task was to coordinate the action of food distribution and to, together with their team, work on the reconstruction of railways, roads and river traffic. *Communications Section* was led by colonel Atwood (Colonel Coe replaced him as the Chief in Command of the *17th Engineers Regiment*) who was also in charge of controlling the operations in "Greater Serbia" region. Colonel Causey, up till then a captain in *17th Engineers Regiment*, was stationed in Vienna with the task to control the functioning of all railroads in former Austro-Hungary, and was given the authority directly by *Supreme War Council*. Colonel Ryan, up till then a Supply Officer u *17th Regiment*, was in charge of cooperation with German government on clearing the Elbe river bed for traffic since it was crucial for the delivery of humanitarian aid to Czechoslovakia.[5] *Communications Section* was to operate up till the termination of Paris Peace Conference. However, just before the end of the Conference and the dissolution of the *Communications Section,* several governments of newly established states addressed Herbert Hoover with an appeal to keep these American experts for a while as their advisors. Since American laws prohibited the stay of American officers on the territory of Europe after demobilization, it was necessary to find another mode for them to maintain the functions they had up till

[4] 17th Engineers was one of nine volunteer Railroad Regiments organized in early summer of 1917. It arrived in Europe in July and was one of four regiments personally visited by King of Britain George, in August 1917 in London. The regiment was organized and at that time commanded by Colonel John Stephen Sewell who was officially a regular army officer in Engineers Corps and later vice-president of Alabama Marble Company. The regiment was mobilized in Atlanta, and the majority of staff came from US South and South-East. Both officers and soldiers were enlisted from the same territory, and special attention was paid to selection of professionally experienced staff. After they had arrived in France, the Regiment was stationed in the vicinity of Saint-Nazaire where it constructed a number of pontoon bridges, roads, piers, hospitals and camps, as well as new aqueduct in St. Nazaire. After Colonel Sewell got transferred, 17th regiment came under command of Colonel William Atwood: Hoover Institution Archives, Stanford, *European Technical Advisers, Records, 1918-1923,* box 10, file 19, *Colonel Atwood's report on engineering advisors in European countries* September 30, 1919

[5] Ibid. When he was not on active duty in armed forces, Colonel Causey worked as a railroad engineer and Supt. of Chicago and Alton, Chicago and Northwestern and Chicago and Great Western Railroads. Colonel Coe gained enormous experience constructing Great Northern Railroad, and he was also a constructor of many railroad lines of Northern Pacific Railroad at the same territory. Later, he became a chief constructor of "seagoing railroad" at the Florida East Coast, and at that time he joined armed forces. Colonel Atwood spent 10 years in Alaska working on construction of Alaska Central Railroad. He later worked for New York Central Lines and was for a while chief engineer at The Lake Erie Western Railroad. Colonel Ryan was General Manager of Tehuantepec Railroad and representative of a group of English capitalists in Mexico.

then. Herbert Hoover saw the solution in establishing a separate, non-governmental organization named *European Technical Advisers*. Experts that would become participants of expert missions for each country would be paid from special funds superintended personally by Herbert Hoover. So as early as September 1919, colonel Causey was appointed chief of the special mission and advisor of Austrian government, and colonel Ryan was appointed advisor of Czechoslovakian government; his former assistant, regular army officer, colonel Barber, became head of mission and advisor within Polish government, while the chief of former *Communications Section,* colonel Atwood, was designated as the head of mission and advisor of the government of Kingdom of Serbs, Croats and Slovenians. Apart from them, two offices of *European Technical Advisers* were established: the first one was in Paris and it was personally managed by James A. Logan, who was also the head of *American Commission to Negotiate Peace* in Paris, while the second one was in New York. [6]

Judging by the reports, it seemed that the top priority of newly established European governments, in fall of 1919, was creating a trusting relationship with *Technical Advisers*. Railroad network of Central and Eastern Europe was in the state of extreme disrepair. Both operative and managerial disorganization were the consequence of the fact that these traffic systems in the newly established states were actually detached from different traffic systems that had once been managed by Austro-Hungary. The terms of the Paris Peace Treaty prescribed the division of former empires' vast traffic network, and it was assumed that this would be overseen by the American advisors themselves, who were at the same time in charge of the appropriation of necessary equipment for the newly established states. The process was additionally complicated by demands for indemnification which were under the jurisdiction of the Indemnification Commission. They were also expected to conduct similar supervisions when it came to the division of the floating equipment on Danube and other rivers. Engineering advisors thus soon became arbiters and assistants in the above mentioned states, wholeheartedly defending interests of their governments.[7]

2. The role of Mihailo Pupin in establishing the Mission

In November 1918, Serbian envoy in Paris, Milenko Vesnić, dispatched, marked Urgent, a letter to Serbian envoy in Washington D.C. Grujić, in which he made a request that the interest of American government should be raised in any possible manner so that the Government would send an engineering regiment to Serbia which would facilitate the reconstruction of railway, river and road traf-

[6] Hoover Institution Archives, Stanford: *European Technical Advisers, Records, 1918-1923*, box 64, file 1: Colonel Atwood's report on activities of American Technical Mission in Serbia and Kingodom of Serbs, Croats and Slovenians, 1919-1920

[7] Ibid.

fic. The letter informed that Serbian railway had been destroyed in many places, the material had been taken away or destroyed, railway workshop in Nis had been robbed and that there was a need for material, tools and engineers. Actually, traffic in Serbia did not virtually function, and because of the inability to transport humanitarian aid, hunger, cold and illness were looming. Due to the above mentioned demobilization law, the US government was unable to send one of its engineering regiments, but it directed representatives of Serbian government to address *Communications Section for the Supreme Economic Council* which was in the position to help in solving this grave problem by sending one of its representatives.[8] Colonel Atwood thus, in the period from January to June 1919, visited Serbia on several occasions and managed to form a complete picture of the adversity that befell this country in the past four years.

Having been engaged in endeavors to gain international recognition of newly established Kingdom of Serbs, Croats and Slovenians, Serbian government didn't react, in summer of 1919, to the news that *Communications Section* would be dissolved immediately after the termination of Peace Conference which would leave the Government without the necessary help of Ally experts. Insufficiently informed of the reasons for establishing the *Section*, Serbian representatives nearly assumed hostile attitude towards the entire organization *American Relief Administration*[9] confusing it with another Relief Organization comprised of representatives of Yugoslav peoples' to USA, who, apart from providing humanitarian aid, spread certain political propaganda claiming that the new state of Serbs, Croats and Slovenians should be a republic not monarchy.[10]

The confusion caused by this misinformation, was personally solved by Herbert Hoover when, on July 11th, 1919, he met in Paris a great American scientist of Serbian origin, Mihailo Pupin. On the very same day, Hoover put down the discussion they had in the form of a letter in which he stated that it was vitally important for "Greater" Serbia to get a reliable and eminent American engineer accompanied by several assistants, who would be advisors of the Government concerning the questions of traffic and mines reconstruction and the like. He explained in several points that Serbian government needed from the USA not only the material for the construction of railroads but funds as well, so it was of crucial importance to appoint a man who would operate on the field directly safeguarding the material and funds, and whose knowledge on American railroads and production might could be very important and useful to the Government. Since Serbian government also needed to settle the situation concerning

8 Serbia and Montenegro Archives, *Consular Office of the Kingdom of SCS in Washington D.C.* (371 – records under development), file 19

9 Hoover Institution Archives, Stanford, *European Technical Advisers, Records, 1918-1923,* box 7, file 9: the letter of American envoy in Belgrade Dodge to Herbert Hoover, August 1, 1919

10 Serbia and Montenegro Archives, *Consular Office of the Kingdom of SCS in Washington D.C.* (371), file 19

railroad network with neighboring countries, thus an eminent American representative could be extremely useful in these negotiations, especially considering the fact that all the other countries in the region would get their own expert missions, thus the presence of an American representative from Serbia as well, would surely improve the country's negotiating position. Hoover observed that Serbia should without delay free itself from the dominance of Hungarian and Austrian engineers, who had built railroads where it had been useful to them.[11]

In the same letter Hoover suggested that the chief of the Mission should be colonel Atwood, who had already been to Serbia and who, in his opinion, had excellent knowledge of the state of Serbian railroad system. He explained that the annual salary for an engineer of his rank should be about 20.000 dollars; bearing in mind that he would also need three or four assistants whose annual salaries should be between 5 and 10 thousand dollars and together with the additional expenses such a job would call for, he estimated that the total cost of the Mission would be about 100.000 dollars. In the same letter, Hoover reminded Pupin that in 1919 American government had granted Serbia, and via *American Relief Administration*, a loan for acquisition of food totaling 25 million dollars. If Serbian government would authorize the establishing of the Mission, Hoover offered to act on Serbia's behalf in reaching an agreement with the *U.S. Treasury Department* so that 100.000 dollars for financing American experts' Mission in Serbia would be set aside from the unspent amount of the loan.[12]

Regardless of Herbert Hoover's warnings concerning the urgency for making this decision, government of the Kingdom of Serbs, Croats and Slovenians reached the final decision as late as the end of August 1919. Nor was it able to reach it sooner. At the time when Mihailo Pupin initiated lobbying for establishing the Mission in Serbia, newly established Kingdom had just gained international recognition, and its government led by Stojan Protić from Radical Party had collapsed as early as on August 16th, 1919.[13] At the same time Milorad Drašković, newly appointed Minister of Traffic, took over the negotiations on the establishing of the Mission on the guidelines suggested in Hoover's letter to Pupin. New government led by Democrat Ljubomir Davidović displayed great readiness to accept help from such Mission and on August 26th, 1919 the Council of Ministers of the Kingdom of Serbs, Croats and Slovenians signed the establishing of *Technical Mission* with 150.000 dollar budget from the so called "Remittance Found". The amount was increased by another 50.000 dollars because, due to the retardation with which Radical government approached ratification of the treaty, all members of the future Mission,

11 Hoover Institution Archives, Stanford, *European Technical Advisers, Records, 1918-1923*, box 7, file 9: *Herbert Hoover's letter to Mihailo Pupin*, Paris, July 11, 1919

12 Ibid.

13 V. Stojancević, "Political and International Possition of Serbia from the Unification on December 1, 1918 to Paris Peace Conference 1919", in: *Anglo-American Humanitarian Activities in Serbia in 1919, Serbia at the End of WWI*, Historical Institute, Collected Papers, Book 8, Belgrade, 1990, page 9-21

together with Atwood and Hoover, had already left Paris and returned to USA, which increased the travel and material transportation costs.[14]

It is interesting that during the negotiations and the signing of the treaty, the government of the Kingdom was not aware of the true nature of the Mission. Namely, the correspondence between Minster Drašković and American envoy in Belgrade Dodge, during August 1919, shows that Yugoslav representatives didn't at all understand the fact that the Mission was, in fact, a non-governmental organization and not the channel through which the much needed financial loans from the *U.S. Treasury Department* could be obtained.[15] After resolving these misunderstandings, liabilities of the Mission's advisors were determined in detail by two acts of the Council of Ministers, with which, then, Herbert Hoover and colonel Atwood agreed. These liabilities concerned the following:

1) putting in efforts to obtain a sufficient loan from the government of the United States that would cover the costs of the material already ordered by the government of the Kingdom of Serbs, Croats and Slovenians from the United States Liquidation Board in France;
2) providing help with the obtaining of a loan from the government of the United States in order to purchase the surplus of the material from *American War Department*, as well as providing help with the obtaining of a credit that would cover the transportation of the said material from the USA;
3) establishing cooperation with American advisors in other countries in order to reestablish international transport service;
4) advising the Kingdom's Minister of Mining on how to reconstruct destroyed mines and open new ones; also, providing assistance with import of the material and tools necessary for accomplishing both objectives;
5) providing assistance to Minister of Finances with devising a financial scheme that would ensure loans in US banks, as well as providing help with establishing contacts with these banks;
6) advising the Minister of Traffic on all matters relating to the construction, reconstruction and operation of the railroads; this point explicitly emphasized that advisors would not have executive authority;
7) providing assistance to all other Ministries that express the need for American advisors.[16]

To ensure security and efficiency, it was decided that he advisors would submit reports to and get instructions from the Ministry of Traffic.

[14] Hoover Institution Archives, Stanford: *European Technical Advisers, Records, 1918-1923,* boxes 7 and 64: *Colonel Atwood's reports on the activities of American Technical Mission in Serbia and the Kingdom of SCS, 1919-1920*

[15] Ibid.

[16] Ibid.

3. The Mission in the turbulence of politics: ups and downs

To form the clearest picture possible of *American Technical Mission's* activities in the Kingdom of Serbs, Croats and Slovenians, it is necessary to divide the period of its one-year functioning into three intervals. Thus the first interval coincided with the rule of Democratic government of Ljubomir Davidović from August 16th, 1919 to February 19th, 1920. Dr Vojislav S. Veljković held the office as Minister of Finances; Ante Trumbić as Minister of Foreign Affairs; Milorad Drašković as Minister of Traffic; Dr Edo Lukinić as Minister of Postal and Telegraph Services while Anton Kristan was the Minister of Forestry and Mining. This government was reconstructed on October 18th, 1919 and all the above mentioned ministers who were important for the Mission's functioning remained in office until its second and final collapse on February 19th, 1920.[17]

During the Paris negotiations on forming the *Technical Mission*, Minister of Traffic Milorad Drašković made a particularly positive impression on American representatives. This is believed to be one of the reasons why the Prime Minister Ljubomir Davidović had insisted that the representatives of the Mission should be in direct contact exclusively with the Ministry of Traffic. Minister Drašković did in fact use his personal authority to convince the Council of the Ministers that the assistance of American experts to the Kingdom was necessary and benevolent.[18] Thanks to him, activities concerning each point of the Treaty with the *Technical Mission* were successfully coordinated. Thus colonel Atwood, who remained in the USA till December 1919, through other members of the Mission successfully organized the transportation of the merchandize previously purchased from the *United States Liquidation Board* in France by the government of the Kingdom, as well as the transportation of more than 8000 tons of material which had been collected and insured by that time. The operation was financed from an American loan approved from American funds in France. The loan totaled 40 million dollars, but only 25 million were spent.[19] Colonel Atwood was in charge of the arrangements for chartering ships. Due to certain restrictions imposed by the *United States Treasury*, first two chartered ships were under the control of *United States Shipping Board*, but since the payment installments were extremely high, Yugoslav authorities finally decided to charter ships in any other port that would provide cheaper service. From that moment on colonel Božidarević, Kingdom's delegate of the Ministry of War in Paris, took over the responsibilities concerning the charted ships

[17] Č. Mitranović, M. N. Brašić, *Parliaments and Assemblies of Yugoslav People*, Belgrade, Public Parliament of the Kingdom of Yugoslavia, 1937, pp. 341-349

[18] Hoover Institution Archives, Stanford: *European Technical Advisers, Records, 1918-1923*, box 7, file 9: *The letter of American envoy in Belgrade Dodge to Herbert Hoover,* August 1, 1919

[19] *The British on the Kingdom of Yugoslavia*:Annual Report of British Consular Office in Belgrade 1921 – 1938, Book One (1921-1930), Archives of Yugoslavia Belgrade, Globus Zagreb, 1986, page 79

while colonel Atwood handled financial matters. By the end of 1919 Mission's first liability from the above mentioned Treaty was successfully fulfilled.[20]

One of the reasons why colonel Atwood stayed in the USA during the first three months of the Mission was securing a low cost loan which would enable the government of the Kingdom of Serbs, Croats and Slovenians to purchase necessary material from *The American War Department*. He immediately delegated his second-in-command colonel C. S. Coe who together with mechanical engineer captain C.E. McMillan, railroad engineer J. H. Nelson and their families arrived to Belgrade in mid October.[21] Not long after, during November of the same year they inspected all destroyed Serbian railroads and bridges and on the basis of that inspection they prepared a detailed list of the necessary material that should be purchased from *The American War Department*. On the basis of these lists and the lists of material signed personally by Minister of Postal and Telegraph Services Dr Edo Lukinić, colonel Atwood, using his authority and connections in *The American War Department,* managed to reserve at extremely favorable prices 75 locomotives, over 3804 train cars, approximately worth 8 million dollars as well as cranes, machines for setting up posts, machines for air compression, tools, cauldrons, gas motors, generators, telephone and telegraph material, masonry tools and machine oil. At the time total worth of the selected material was under 12 million dollars.[22] Material reservation was of great importance since other European counties expressed the need for this material as well, and the priority was given to those that immediately ordered in bulk, of which Serbian envoy in Washington D.C. Grujić and colonel Atwood repeatedly warned by their letters and telegrams. In the meantime it turned out that the ordered locomotives were too heavy for Serbian rails so their purchase was abandoned, and modification of the already sent lists was a common occurrence even though material reservation based on them had already been made. Finally, on December 22nd, 1919 *The American War Department* on behalf of the USA government approved the loan for material purchase to the Kingdom of Serbs, Croats and Slovenians; the loan was worth 25 million dollars, with 5% interest

[20] Hoover Institution Archives, Stanford: *European Technical Advisers, Records, 1918-1923*, box 7, file 11: *Final Report of Technical Mission in the Kingdom of SCS*, William G. Atwood.

[21] Ibid. McMillan was a mechanical engineer who had at that time just returned from Russia where he had been at the post of major in the Siberian Transportation Corp. He was hired by colonel Atwood, among other reasons, because he spoke some Russian so he hoped that McMillan might speak Serbian as well, and he also spoke French, Spanish and Portuguese. Mining engineer H.I. Smith arrived to Belgrade on November 14, 1919. He graduated from Pennsylvania State College, he worked for years in The Bureau of Mines, and he came to Serbia from famous Vandalia Coal Company. J. H. Nelson was a railroad engineer with more than 30 year long experience acquired on American railroads.

[22] Ibid. Archives of Serbia and Montenegro: *Consular Office of the Kingdom of SCS in Washington D.C.* (371), file 19

to be paid half-annually and with loan duration from three to five years.[23] It seemed that the Mission together with Yugoslav diplomats managed to achieve another important objective from the above mentioned Treaty.

At the same time members of the Mission in cooperation with Minister of Commerce and Industry and Chief of American Technical Mission in Vienna worked on signing the contract with Austria concerning the delivery of 1000 tons of food in return for railroad, electrical, medical and other material of reciprocal value. The operation was conducted in secrecy due to the fact that Yugoslav public was strongly against food delivery to erstwhile enemy.[24] At the same time mining engineer Smith worked on appropriating, under favorable conditions, up-to-date mining lamps from American *Mine Safety Appliances Company* for coal mine Pečuj in Baranja.[25] Reports of the Mission from this period were quite optimistic, and the advisors often pointed out cooperativeness of Serbian officials and their readiness to, at any time, provide information necessary for their work.[26]

It was not long before the political turmoil in the kingdom along with increasingly unfavorable position of our delegations in indemnification commissions overshadowed all efforts of the Mission on reconstructing the destroyed economy of the country. In late December 1919 colonel Atwood accompanied by his wife finally arrived in Belgrade. The second and, it seemed, the most important stage of *The Technical Mission's* operation in Serbia was to begin. In January 1920 Yugoslav-Hungarian and Yugoslav-Rumanian borders were to be decided upon in Paris. On January 24th, 1920, James A. Logan, chair-person of *The American Commission to Negotiate Peace* in Paris, dispatched a letter to colonel Atwood, addressing it to American Consular Office in Belgrade, which was marked Confidential. He informed him that, with the goal of resolving Rumanian-Yugoslav relations, Supreme Council of Indemnification Commission had made "certain decisions" (January 10th, 1920) and that he urgently needed colonel Atwood's opinion so as to help the Kingdom of Serbs, Croats and Slovenians. However, Atwood's answer to Logan implied that he had received the letter not before March 10th, 1920, so Atwood expressed his fears that it was too late for any intervention. Among other things, he also stated in the letter: "this country has never been treated by the Allies in a manner that could be described as fair... and that is why this country deems that they shouldn't be trusted, that is to say not until resolving all the issues concerning territories that could be occupied in the

[23] Hoover Institution Archives, Stanford: *European Technical Advisers*, *Records, 1918-1923,* box 64, file 1: *USA Ministry of War contract with the Kingdom of SCS about awarding 25 million dollar credit*, December 22, 1919, Paris

[24] Ibid: box 8, file 12: Report *from the meeting of Mission's members and Minister of Commerce and Industry,* Kramer, February 3, 1920; *Colonel Atwood's letter to Herbert Hoover notifying him that the members of the Missions in the Kingdom of SCS and Austria agreed on the terms of the future contract*, February 6, 1920

[25] Ibid: *H.I. Smith's letter to Ministry of Forestry and Mining*, February 10, 1920

[26] Ibid.

future by others, it will not give up on this mining district (i.e. coal mine Pečuj – author's remark). I completely support their standpoint."[27] The letter merely illustrated the manner in which the Mission attempted to defend the Kingdom's interests. At the same time, the Mission thus attempted to explain complete disinterest in the outcome of the credit obtained in the USA. Namely, the material was reserved and what remained to be done was to authorize a person who would collect the material and sign the bonds on behalf of the Kingdom. At the same time, the New York office of *European Technical Advisers* managed to secure a credit from *The United States Shipping Board* for transportation of the said material to Yugoslav ports.[28] And then, on February 20th, 1920, the government of Ljubomir Davidović collapsed, and Radical Party led by Stojan Protić formed the new government. Dr Anton Korošec became Minister of Traffic, Dr Velizar Janković Minister of Finances, Dr Mata Drinković Minister of Postal and Telegraph Services and Minister of Forestry and Mining Ivan Kovačević.[29]

New government led by Stojan Protić was completely uninterested in the existence and functioning of *European Technical Advisers* in Belgrade. Not only did the coordination between the Ministry of Traffic and other ministries, on one side, and the Mission, on the other, cease to exist, but it also turned out that Yugoslav envoy in Washington D.C. hadn't been receiving instructions concerning further actions in regards to the already obtained 25 million dollar credit for months. The correspondence between colonel Atwood and Herbert Hoover and correspondence between envoy Grujić and the Kingdom's Ministry of Foreign Affairs, indicate that the common problem was the fact that the new government completely ignored the decisions and treaties made by the previous one. Minister of Finances claimed for months that he did not posses the credit contract made with *The American War Department*, and when the Mission confronted him with the copy, he thought that the loan duration was too short and that the state was unable to accept the credit under such terms.[30] Colonel Atwood wrote in one of his reports that to the request of Minister of Railways of the Kingdom of Greece the American advisors had initiated negotiations resulting in reopening of railroad service between Belgrade and Athens, and that the entire route was serviced by *Simplon Express*. However, after February 1920 members of the Mission neither received further information nor participated in these negotia-

27 Ibid, box 8, file 11: *Colonel Atwood's letter to James A. Logan*, March 10, 1920

28 Hoover Institution Archives, Stanford, *European Technical Advisers*, *Records, 1918-1923*, box 7, file 11: *Final report of Technical Mission in the Kingdom of SCS*, William G. Atwood.

29 Č. Mitranovic, M. N. Brašić, *Parliaments and Assemblies of Yugoslav People*, Belgrade, Public Parliament of KJ, 1937, pp. 341-349

30 Hoover Institution Archives, Stanford, European Technical Advisers, Records, 1918-1923, box 10, file 4: Atwood's letter to Herbert Hoover about the change in Yugoslav politics, April 14, 1920; Serbia and Montenegro Archives, Consular Office of the Kingdom of SCS in Washington D.C. (371), file 19

tions.[31] Moreover, in accordance with instructions given to him by Minister of Finances Dr Vojislav Veljkovic, colonel Atwood, during his stay in the USA, held numerous meetings with American bankers and financial corporations in order to secure commercial loans for the Kingdom of Serbs, Croats and Slovenians in the USA. Shortly after his arrival to Belgrade, colonel Atwood notified Minister of Finances of that in a special letter, but it seemed that after February 20th, 1920 intentions of royal government changed and that "the want for financial aid from the USA no longer existed. This part of Mission's liabilities attracted no attention of the Kingdom's government whatsoever".[32] Minister of Finances addressed the Mission requesting advice concerning the estimation of Ljubija mine and adequate conditions under which concession could be attained. These information were forwarded to him and that was the only time the Ministry requested Mission's assistance. On the grounds of the above mentioned, Atwood concluded that the Mission had been of no use to the Ministry of Finances and that the Ministry had given no opportunity to the advisors to fulfill their liabilities prescribed by the Treaty of Establishing the Mission.[33] In addition, Chief of the Mission in Austria informed them that the letters they had sent to him had been censured, and it was also a common occurrence that the letters arrived a month after they had been sent.[34] During the spring of 1920, credit contract with *American War Department* experienced final fiasco as well. Even though they believed the loan duration of the credit to be short, Yugoslav officials continued to order the material without consulting *European Technical Advisers*, altering orders made by the previous government. In that way they lost precious time so the necessary technical material for railroad and postal and telegraph traffic was sold to other European countries. The credit from *The United States Shipping Board* was also canceled since it had been awarded to the request of *European Technical Advisors*, which was completely understandable in the opinion of colonel Atwood, bearing in mind the fact that the royal government declined the services of the Mission's advisers to which it had previously consented.[35]

Till May 1920, Radical cabinet of Stojan Protić managed to completely suppress the functioning of the Mission. During that period American advisors turned their activities towards Serbian entrepreneurs who came to their Belgrade office looking for concrete aid or advice on the manners of reconstructing their

[31] Hoover Institution Archives, Stanford, *European Technical Advisers*, Records, 1918-1923, box 7, file 11: *Final report of Technical Mission in the Kingdom of SCS*, William G. Atwood.

[32] Ibid.

[33] Ibid.

[34] Ibid, box. 8, file 3: *letter of the Chief of the Mission in Austria, Causey, to Colonel Atwood*, March 1, 1920

[35] Ibid, box 7, file 11: *Final report of Technical Mission in the Kingdom of SCS*, William G. Atwood.

factories, mines, workshops and local roads. It turned out that this type of the Mission's assistance was much more productive since it conveyed the purpose of American Mission to wider Serbian public. Hospitality and good-nature of these people helped American advisors in deciding not to give up on their mission before the expiration of their one-year contract, even though the sense of complete uselessness was ever-present in their correspondence from this period. They, on their own initiative, visited the sites and participated in reconstruction of destroyed bridges and railroads south of Belgrade, and American major and mechanical engineer McMillan became a "local hero" among the Serbs. Colonel Atwood wrote to his New York colleagues in mid May 1920: "I found out from unofficial sources that the current Radical cabinet, just like the previous one, is unsympathetic towards our work. Judging by all the indications, this might be the cause for boycott. Certain indications exist that coalition Cabinet will be formed soon enough led by M. Vesnic who was up till recently Serbian envoy in Paris. He has been to America briefly on several previous occasions, his wife is an American and he speaks English. Former Minister of Traffic who was in office when we began the mission will once again become a member of the Cabinet as Democratic representative... However, there is a possibility the current Minister of Traffic will keep the post. If that happens, our work here will become useless so I would consequently be in the situation to ask you for the permission to terminate the Mission if I find that necessary. What remains for me is to attend the meeting with Crown Prince, though I doubt that he possesses enough authority to change the situation to the better... From the tone of the telegram I received from you, I have formed an impression that it seems to you that I do not appreciate the situation in which you found yourself (during negotiations about the credit with *American War Department*-author's remark)... I would like to assure you that the problems we have are mainly caused by the political situation in the country and if it does not improve after the new coalition Cabinet is formed, I see neither the possibility nor the use for our stay here. This country has been quite exploited by both the French and the English, and at the same time one English and French company whose shares are also owned by (an American company) J.P. Morgan & Co. is putting in efforts to acquire one of the richest iron ore mines in Europe, but none of those people is undertaking any action to constructively help the Government."[36]

Only a day later colonel Atwood's predictions came true. The Cabinet of Stojan Protić collapsed and coalition government was formed with Milenko Vesnic as its Prime Minister. On the very same day Atwood met both the new Prime Minister and Crown Prince Aleksandar Karadjordjević, who assured him that everything would be done so that the Mission could continue its operation

[36] Hoover Institution Archives, Stanford: *European Technical Advisers, Records, 1918-1923*, box 10, file 8: Colonel Atwood's letter to European Technical Advisers New York Office, April 16, 1920

uninterruptedly. But, the bad news was that Anton Korošec remained in office as the Minister of Traffic. As Atwood saw it, even though Korošec was exposed to strong opposition, he was still a powerful politician whose influence could hardly be eliminated.[37] However, assurances of Yugoslav officials soon proved to be more than just talk. Five days later, on May 22nd, 1920, representatives of the Mission were, after months of open boycott, invited to a meeting with Minister Korošec personally. The meeting confirmed every doubt the Americans had up till then. Korošec shifted the blame for lack of cooperation to former minister Drašković, explaining that Drašković was the one who suggested to him that the nature of *European Technical Mission* was actually political and that the extremely powerful political figure of Herbert Hoover was in the background of the entire situation. Atwood's own observation is quite interesting. Namely, in his report from the meeting, he noted that Minister Korošec had been extremely well-prepared concerning professional and technical aspects of the situation given the fact that he had known "that he would have to deal with political mission".[38] He thought that it had been quite obvious that, by shifting the blame to previous Democratic government, Korošec had attempted to evade personal responsibility for not cooperating with the Mission.[39]

After this meeting, it can be said that the Mission's operations entered their third and final stage. The work slowly continued and an impression was formed that the advisors could finally give their full contribution by assisting Yugoslav government in revitalization of the country's economy. On June 14th, colonel Atwood sent a letter to New York: "Since political circumstances, and consequently all other circumstances, have significantly changed in this country, it is possible to turn towards the future. One month ago I would have told you that we had to leave without delay because we were not wanted here. Since then we have been treated in significantly different manner, and I feel that there is a certain possibility that they might want us to stay here longer."[40] He even saw the opportunity in the fact that out of 150.000 dollars obtained through credits and designated for the expenses of the Mission, some 20.000 dollars remained unspent so he hoped that that money could enable them to stay in Serbia until the end of 1920. Through discussions he had with chiefs of the Mission in Austria and Poland, he found out that there was a possibility to refinance the missions provided the governments themselves would express the wish to keep the advisors in their countries for a longer period of time. He felt that their expenses in the following year would be significantly lower since they would not include travel expenses and movement of equipment, and he also

37 Ibid. *Atwood's letter to American delegate in Paris James Logan*, May 17, 1920

38 Ibid. *Memorandum from the meeting of American Technical Advisers with Minister of Traffic Anton Korosec*, May 22, 1920

39 Ibid.

40 Ibid. *Colonel Atwood's letter to European Technical Advisers New York Office*, June 14, 1920

highlighted that he would do anything in his power to minimize the expenses for he felt that the future would actually demonstrate true effects of such a mission in the Kingdom.[41] The answer from his superiors from New York arrived in a short while. As it turned out, apart from the mentioned 20.000 dollar surplus, there was no other reserve backup fund from which the stay of the Mission after the expiration of the contract on October 1st, 1920 would be financed. Expenses made by the *European Technical Advisers* New York Office, estimated at 10.000 dollars, additionally complicated the situation which meant that the Belgrade Mission would dispose with some 8 to 9.000 dollars. In such conditions their stay could only be extended till the end of December. Other option was for the government of the Kingdom, provided it expressed the wish to keep the advisers for another year, to finance the Mission itself which would amount to 100.000 dollars till a mode was devised to cover these expenses through a credit. In that case the state would be reimbursed for the money spent.[42]

The suggestion for the extension of Mission's activities was made at the worst possible moment for the Government. Burdened by the clashes and disputes between political parties on the issues of electoral law and establishing constitutional assembly, the Kingdom's government did not at first react to this offer. After the second letter from colonel Atwood, sent on August 5th, 1920, the Council of Ministers led by Prime Minister Milenko Vesnić, dispatched a letter to *European Technical Advisers* Belgrade office which stated: "Royal government, thankful for extremely successful and thorough assistance of the American mission on the jobs of traffic reconstruction, feels that the present state of our railroads, thanks to good cooperation between American technical advisors and state officials, makes the termination of the mission possible."[43] It was quite obvious that these were not the actual reasons for the termination of the mission. The pressure made by Radical politicians on the coalition government, unsettled situation among the political parties, lack of understanding for the importance of swift recuperation of economy and further development of the country were actual reasons that resulted in American advisors leaving the Kingdom before the end of September 1920. One report of the British consular office in Belgrade from the end of 1921 disclosed the actual state of Yugoslav railways: "the lack of functional railway network is still felt which represents a great obstacle to the development of the country and exploitation of forest and mining resources… Trains are still far from satisfactory and privately owned enterprises have very hard time to obtain train cars for transportation of their merchandize... Railway embankments are in

41 Ibid.

42 Ibid. *letter of European Technical Advisers New York Office to Colonel Atwood*, July 16, 1920; the same letter informs that the Missions in Austria, Czechoslovakia and Poland extended their activities for another year since these countries possessed additional funds from which these activities could be financed.

43 Ibid, the letter of the Kingdom's Council of Ministers to Colonel Atwood, August 5, 1920

extremely poor condition given the fact that they were not properly maintained during the past eight years so it would be dangerous for the compositions to travel at speeds faster than 20 to 30 kilometers per hour. The need for thousands of new railway sleepers has been demonstrated and even though they were once manufactured in the country, in the year of 1921 a little has been accomplished on that plan, since both the Government and the manufactures of railway sleepers were not able to reach an agreement on the price... Railway staff is not efficient and it shows the lack of practice, and in addition to that they are dissatisfied for being insufficiently paid… Living conditions of railway workers were generally poor, and many of them resided in disused train cars."[44]

4. Conclusion

Members of Belgrade *Technical Mission* traveled within less than a year approximately 35 thousand kilometers by trains and boats and 50 thousand kilometers by cars. They conducted complete examination of the railroad system and detailed analysis of several new projects that dealt with the issue of connecting the Danube Valley with Adriatic Coast. They wrote hundreds of pages of reports with maps about the most efficient ways of old railroads reconstruction and construction of the new ones. They personally helped in swift reconstruction of Belgrade – Thessaloniki railroad. At the same time, they inspected the mineral resources of the Kingdom and their surrounding areas with the exception of those in West Serbia, East Bosnia and Montenegro. The results of these analyses were recorded in more than 50 reports on each of those mines, the results were corroborated by numerous photographs, and the analysis of the found state of the mines and suggestions for further, faster development were supplied as well. In addition to that, they used their authority to secure the most favorable treatment possible to the Kingdom when it came to the appropriation of necessary equipment, and during their stay the country was visited by numerous American businessmen and bankers. All these endeavors have been left unrecorded in Serbian historiography till today. The closer inspection of the sources from that period in the history of Yugoslav Kingdom leads to an impression that the Mission had never even existed. None of the official publications by state railways, important treatise on the Kingdom's mines, serious book from the period on the subject of country's economic development does not mention the presence and assistance of American advisors.[45] Never did the government

[44] The British on the Kingdom of Yugoslavia: *Annual Report of British Consular Office in Belgrade 1921 – 1938*, Book One (1921-1930), Archives of Yugoslavia Belgrade, Globus Zagreb, 1986, page 79

[45] See: P. Milenković, *History of Railroad Construcion and Railroad Policy in Our Country (1850-1935),* Ministry of Traffic of Kingdom of Yugoslavia, Belgrade, 1936; *Anniversairy Book of State Railroads of Kingdom of Yugoslavia, 1919-1929*, Vreme, Belgrade, 1929;

of the Kingdom of Serbs, Croats and Slovenians officially thank them nor did they request their final reports. These reports became a part of *European Technical Advisers* archive records in Hoover's Archives at a prestigious Californian university, Stanford. Rusty paperclips on the documents and unopened maps of railroad routes indicate that they have never been seriously analyzed. However, one never proclaimed fact remains. Only two years later thanks to the presence of the Mission and their devoted efforts, the Kingdom managed to obtain from the American government a substantial so called "Blair's Loan" which amounted to 1 billion dollars[46] with the purpose of constructing the new railroad network that would finally connect the east of the country with Adriatic Sea.

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Original scientific paper
Received: March 15th, 2009

UDC 331.56:303.7(4/6-92)"1999/2006"
ID 158250764

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UNEMPLOYMENT ANALYSIS IN THE MED AREA

Abstract: *Unemployment in the MED area, together with other differences in income, is one of the principal causes of the migratory flow towards the UE. It is therefore fundamental to investigate those elements that affect the labor market within the geographical area of the MED. This paper examines the movements throughout the MED area and unemployment following two different perspectives. First, unemployment fluctuations are viewed as the outcome of the interplay between labor market shocks and prolonged lagged adjustment processes. Second, unemployment fluctuations are attributed largely to changes in the long-run equilibrium unemployment rate. To demonstrate this we present an empirical analysis on a number of countries within the MED area covering a period from 1999 to 2006. The analysis has consequences for the evaluation of labor market policies.*

Key words: *Unemployment, labor market shocks, employment, labor force participation, wage determination, dynamic adjustments, ARDL models, impulse-response analysis*

JEL Classification: J30, J60, J64, E30, E37

1. Introduction

In the context of globalization, the trade among two or more countries and the exchange of goods and services is not the only form of integration. The transfer of workers has also an important role. However, there are relevant political obstacles hampering workers' movements, as many countries impose restrictions on the migration flows of the labor force. Therefore, the immigration remains a main problem for Europe and the EU in particular.

The structural crisis of the European labor market and the strong pressure from North Africa have invalided the regulatory and control mechanisms that

have worked for nearly 30 years. The economies of European and Mediterranean (MED) countries are very different, especially in terms of allocations of factors and this generates an uncontrolled migratory flow.

In the last century, the world population has grown from 1,6 to 6 billion people, with an increase of more than three times, but the increase has not been equally distributed in all areas: in the rich countries the population has doubled while in the poorest increased four times.[1] Clearly, the migration from the non-industrialized areas highly depends on the demographic rate. It is estimated that in the next 40 years the population in the world will reach around 9 billion people. This process greatly concerns the Mediterranean area, its labor market and therefore the flow of workers coming from North Africa to Europe.

The analysis of the labor market in the MED countries shows that workers move inside the area searching for jobs.

The MED countries are characterized by a dual economy: industrial and agricultural. In the first, the productivity (production per worker) is 10 to 15 times higher than that for the worker employed in agriculture. This difference in the productivity generates a significant wage gap. The stock of capital is substantially higher in the industrial sector than in the agriculture: in the less developed countries, agriculture is performed by obsolete systems and technology, while the industrial sectors usually do not differ much from their industrialized counterparts. This means that workers employed in industry receive a higher wage than the workers employed in agriculture. In this case, each time a worker moves from agriculture to industry, there is an improvement in wellness, because there is a general increase of productivity and the marginal and total welfare of the system.

Some economists[2] analyze this phenomenon and adduce the problem to low training and education level: improvement of these will improve welfare. The theory of *selective pairing* states that if a country has qualified workers, this part of population will represent the managers of the country and it will leave space and job for the unskilled.

The model of Harris and Todaro[3], through an analysis of unemployment in some less developed countries, argues that the agriculture characterize rural areas while industry is typical in urban areas. In this model, the incentive for the workers to search job in the industry indirectly promotes the migration from rural to urban areas. This should suggest that urban areas should be characterized by full employment, in contrast to the rural areas. However, the two economists observed that even in urban areas unemployment is likely to occur, because

1 A. Gauthier, *L'economia mondiale al 1945 ad oggi*, Mulino, Bologna, 1998

2 M. Spence, "Competitive and optimal responses to signals: An analysis of efficiency and distribution", *Journal of Economic Theory*, 7(3), 1974, pp. 296-332; C. Baudelot, M. Glaude, "Les diplomes se devaluent-ils en se multipliant", *Economie et statistique*, 225, 1989, pp. 3-15.

3 J. Harris, M. Todaro, "Migration, Unemployment & Development: A Two-Sector Analysis", *American Economic Review*, 60 (1) 1970, pp. 126-142.

workers prefer the risk of being jobless rather than continue working in the rural areas. This is because the wages of industry are higher than those of agriculture: for one available job in town, three workers will move from the countryside, creating unemployment in town.

Considering the Mediterranean basin, one might observe that the European part, which in 1950 accounted for around 67% of the whole population of the Mediterranean area, in 2020 will not exceed the 34%. The most populated countries in 2020 will be Egypt and Turkey. Table 1 highlights this phenomenon.

Table 1: *Population (thousands)*

Country	**Actual**	**2020**
Italy	57.248	53.249
Greece	10.442	10.080
Portugal	9.912	9.730
Spain	39.170	38.348
France	58.027	63.543
United Kingdom	58.276	62.080
Holland	15.423	17.410
Belgium	10.131	10.535
Germany	81.553	81.183
Danemark	5.216	5.279
Luxemburg	407	410
Austria	8.040	8.248
Sweden	8.816	9.467
Finland	5.099	5.393
Ireland	3.577	3.876
Turkey	61.923	86.513
Cyprus	739	901
Syria	14.838	30.359
Lebanon	2.922	4.193
Jordan	5.333	10.865
Israel	5.361	7.488
Egypt	62.729	92.015
Libya	5.466	11.448
Tunisia	8.887	12.619
Algeria	28.046	42.786
Morocco	26.985	38.526

Source: Eurostat – UN forecasts

Nowadays, in the MED area the most important problem is unemployment and the migratory flow to the EU. The protection of labor-intensive sectors by some industrialized countries generates a considerable wage gap between the MED countries and their EU counterparts. This evidence encourages further migration to the old continent.

According to most common economic analysis, the solution consists in increasing the income of countries in the area, to reduce the wage differential with the EU countries and thus reducing the unemployment.

Recently, many papers have analyzed the employment market in the Mediterranean area.[4]

This paper will examine a number of variables that may affect the labor market in some countries of the MED area (see Section 2 for further details). The goal is to determine which variables influence the labor market and produce an increase of employment in the MED area, leading to a reduction in the immigration flows. The results may also shed lights in terms of policy for North African and European countries, which are cooperating in the framework of the Barcelona process and the more recent Union of the Mediterranean.

The layout of the paper is the following. Section 2 presents the econometric model for the analysis of unemployment. In Section 3 we detail on our data set and describe the main empirical evidence. Finally, in Section 4 we draw some concluding remarks.

2. The econometric model

We use multivariate dynamic models to analyze the unemployment rate in seven MED countries: Algeria, Cyprus, Egypt, Israel, Malta, Tunisia and Turkey.

The MED labor market is described through four equations, including a labor demand, a wage setting, a labour supply, a production function and an unemployment definition equation.[5]

The autoregressive distributed lag model (ARDL) for the four equations is:

$$A(L)y_t = B(L)x_t + \varepsilon_t \qquad t = 1,2,...,T \tag{1}$$

[4] L. S. Talani L.S. and E. Cervino E., "Mediterranean Labour and the impact of economic and monetary union: mass unemployment or labour-market flexibility?", in: *The political economy of European unemployment. European integration and the transnatiolalism of unemployment*, Routledge, London, UK, 2002, pp. 199-226; S.Bentolila, A. Ichino, "Unemployment and Consumption near and away from the Mediterranean", *Journal of Population Economics*, 21, 2, 2008, pp. 255-280; L. Laureti, *Economia dello sviluppo e dell'integrazione euromediterranea*, Franco Angeli, Milano, 2008

[5] M. Karanassou, H. Sala, D. J. Snower, "Unemployment in the Europe Union: A dynamic Reappraisal", *Economic Modelling*, 20, 2003, pp. 237-273

where y_t are the endogenous variables, x_t is a vector of exogenous variables, ε_t is an i.i.d. error term and $A(L)$ and $B(L)$ are polynomials in L of order p and q respectively:

$$A(L) = (I - A_1 L - \ldots - A_p L^p) \quad B(L) = (B_0 + B_1 L + \ldots + B_q L^q) \tag{2}$$

The model (2) is stable if all the roots of the characteristic equation $|I\text{-}A_1 L\text{-}\ldots\text{-}A_p L^p|=0$ lie outside the unit circle.

In our analysis the endogenous variables are employment (n_t), labor force (l_t), real wage (w_t) and output (q_t) (see Section 3 for details on variables used). The definition of the unemployment is:

$$u_t = l_t - n_t \tag{3}$$

Substituting the estimated ARDL equations (2) for l_t and n_t in the equation (3) of the unemployment rate, we obtain:

$$u_t = \sum_{i=1}^{p} \phi_i u_{t-i} + \sum_{j=0}^{q} \theta_j x_{t-j} + \varepsilon_t \tag{4}$$

The estimated equation (4) is used then to investigate the effects on MED unemployment rate of different labor market shocks. The shocks are represented by changes in the exogenous variables of our system. For this purpose, we decompose the exogenous variables into temporary (TC) and permanent (PC) component:

Temporary Component ≈ stationary variables (x_{2t})
Permanent Components ≈ trended variables (x_{1t})

The stationarity of the series can be verified through the application of unit root tests. The structure of the shocks of these variables on the unemployment rate and their dynamic repercussions can be summarized in the Figure 1.

The direct effect of an exogenous variable on the unemployment is the contemporaneous effect (not lagged) and is given by the terms $\theta_0 x_t$ in the model (4).

The dynamic adjustment shows the response of the shocks through times on the unemployment. We can distinguish between temporary and permanent shocks. Temporary shocks are one-off unit increase in an exogenous variable only at time t, wherever permanent shocks start in period t and remain after that time. The dynamic effect of an exogenous variable on the unemployment rate can be described applying the impulse response analysis, assuming a one standard deviation in one-off shock or permanent shock.

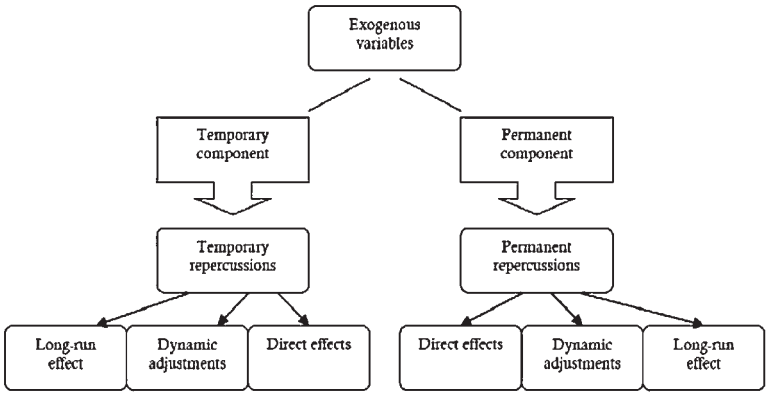

Figure 1: *Unemployment rates and shocks repercussion*

The long-run effect of the exogenous variables is obtained by computing the steady state solution of the unemployment equation (4) with respect to the initial values of the exogenous variables. The frictionless equilibrium unemployment rate (FEU) can be identified as the sum of the long-run unemployment effects of the temporary and the permanent components.

3. The empirical evidence

The empirical exercise focuses on the analysis of unemployment dynamics of 7 Mediterranean countries over the period 1999-2006. The sample includes only some of the countries participants to the Euro-Mediterranean Conference held in Barcelona in 1995: Algeria, Cyprus, Egypt, Israel, Malta, Tunisia and Turkey; in fact, the data are not completely available for all the other countries.

In table 2, the selected countries are divided in classes of income, according to the World Bank classification. This table classifies economies among income groups according to 2007 gross national income (GNI) per capita, calculated using the Atlas method.[6] The groups are: low income, $935 or less; lower middle income, $936–3,705; upper middle income, $3,706–11,455; and high income, $11,456 or more.

Table 2: *Classification of selected countries in income level*

Income Level	Country
High Income	Cyprus, Israel, Malta
Upper Middle Income	Turkey
Lower Middle Income	Algeria, Egypt, Tunisia,

Source: The World Bank, 2008

[6] The World Bank, *World Development Indicators 2008*, Washington D.C., 2008

Most of the countries, as well depicted by Table 2, are classified in the lower middle-income class and only Cyprus, Israel and Malta are in the high income.

The definition of variables used in the present research is not easy, as it seems at first glance. Here, we follow the path outlined particular, by Karannasou.[7] In particular, we have used: labor force, employment, unemployment rate, real Social Security benefits per person, taxes as a percentage of GDP, interest rate, real GDP, real capital stock, real compensation per person employed, real oil prices, productivity defined as the ratio between GDP and number of employments and working age population.

The variables are very different among them and so, the building of data set has been very complicated. In fact, the availability of data is not the same for all the variables considered and for all the years under investigation. For these reasons, our data set derives from different sources.

First, labor variables (i.e. labor force, employment, unemployment rate) are provided by International Labour Organization (ILO), Bureau of Statistics. Instead, some other economic variables (i.e. real social security benefits per person, taxes as a percentage of GDP, interest rate) are drawn from International Monetary Fund database that publishes a great range of time series data on exchange rates and other economic and financial indicators. The residual economic variables (i.e. real GDP, real capital stock, real compensation per person employed) are obtained from the World Development Indicators (WDI), and Global Development Finance (GDF), provided by the World Bank.[8] The oil prices are derived from the Energy Office Administration of US Government. Unfortunately, some series contained missing values, and, therefore, in order to integrate our dataset other sources as Eurostat and OECD have been used.

Now, some further specifications are needed. Data on capital stock are not always available and sometimes inadequate, especially for Mediterranean countries. As a consequence, it has been a diffused practice to proxy capital stock in various ways (see, for example made by McCombie and de Ridder,[9] for some ideas on how to estimate capital stock). In this research, the capital stock has been proxied by Gross Capital Formation

All the variables used in our model are taken as natural logarithm and are expressed in constant US 2000 US dollars. Unfortunately, some economic variables are expressed in local national currency. In order to solve this problem, we have performed some initial transformations to homogenize them. First of all, we have converted the data into current values in accordance to PPP. The adjusted series thus obtained is now expressed in terms of current dollars, so we have to transform the

[7] M. Karannasou et al., ibid.

[8] See the web-sites for further information: respectively, http://laborsta.ilo.org/ for ILO, http://www.imfstatistics.org/imf/ for IMF, and http://web.worldbank.org/ for the World Bank.

[9] McCombie, J., & De Ridder, J., "The Verdoorn's law controversy: some new evidence using U.S. data", *Oxford Economic Papers*, 36(2), 1984, pp. 268-284

data in constant values using the US GDP deflator with base in 2000. The implicit GDP deflator is given by the relationship among the nominal GDP of one year and the corresponding real GDP and it measures the variation of the prices during the period under study. For further details on these harmonization processes of data set see the work from Laureti and Postiglione.10 The definition of the endogenous and exogenous variables used in our model is summarized in the Table 3.

Table 3: *Definition of variables*

Variable	symbol	Variable	Symbol
Labour force	l_t	Real oil prices	o_t
Employment	n_t	Long-term real interest rate	I_t
Real GDP	q_t	Unemployment rate	u_t
Real wages	w_t	Indirect taxes	τ_t
Real social security benefits	b_t	Productivity	θ_t
Real capital stock	k_t	Working-age population	ζ_t

The analysis presented in the previous sections has been applied following the lines outlined by Karanassou et al.[11] on the seven MED countries for the period 1999-2006. We estimated a dynamical panel data model with fixed effects for the four endogenous variables. The equation of the unemployment rate u_t was derived from the panel models, as an autoregressive distributed lag model (4). In estimating the model we pooled the data across the countries to increase the efficiency of our estimates, because of the small time range of the available data. All the series were log transformed, except the long-term real interest rate and the taxes (as % of GDP).

As a preliminary analysis, useful also to distinguish between temporary and permanent exogenous variables, we verify the stationarity on all the 12 pooled series. Recent literature suggests that panel-based unit root tests have higher power than unit root tests based on individual time series. We compute the following types of panel unit root tests: Levin, Lin and Chu,[12] Im, Pesaran and Shin [13] and the Fisher-type tests using ADF and PP tests Maddala and Wu.[14] These tests are all characterized by the combining of individual unit root tests to derive a panel-specific result.

10 Laureti, L. and Postiglione P., "The effects of capital inflows on the economic growth in the Med Area", *Journal of Policy Modeling*, 27, pp. 839-851, Elsevier, The Netherlands, 2005

11 M. Karannasou et al., ibid.

12 A. Levin, C. F. Lin, C. Chu, "Unit Root Tests in Panel Data: Asymptotic and Finite-Sample Properties", *Journal of Econometrics*, 108, 2002, pp. 1-24

13 K. S. Im, M. H. Pesaran, Y. Shin, "Testing for Unit Roots in Heterogeneous Panels", *Journal of Econometrics*, 115, 2003, pp. 53-74

14 G. S. Maddala, S. Wu, "A Comparative Study of Unit Root Tests with Panel Data and A New Simple Test", *Oxford Bulletin of Economics and Statistics*, 61, 1999, pp. 631-52.

The Levin, Lin, and Chu (LLC) test assumes that there is a common unit root process, so that is identical across cross-sections. The Im, Pesaran, and Shin (IPS), and the Fisher-ADF and PP tests all allow for individual unit root processes so that may vary across cross-sections. Im, Pesaran, and Shin[15] begin by specifying a separate ADF regression for each cross section:

$$\nabla y_{it} = \alpha y_{it-} + \sum_{j=1}^{p_i} \beta_j \nabla y_{it-j} + X'\delta_i + \varepsilon_i \quad \forall i$$

The null hypothesis may be written as: *H*o: $\alpha_i = 0$ $\forall i$.

An alternative approach to panel unit root tests uses Fisher's (1932) results to derive tests that combine the *p*-values from individual unit root tests. This idea has been proposed by Maddala and Wu, and by Choi.[16] If we define π_i as the *p*-value from any individual unit root test for cross-section *i*, then under the null of unit root for all *N* cross-sections, we have the asymptotic result that:

$$-2\sum_{i=1}^{N} \log(\pi_i) \rightarrow \chi^2_{2N}$$

In all the tests applied in the paper the null hypothesis is that the series has a unit root (is not stationary). The results of the tests are reported in the following Table 4.

Table 4: *Unit roots tests*

	b_t	k_t	l_t	n_t	o_t	q_t	i_t	u_t	w_t	τ_t	θ_t	ζ_t
LLC	R	R	A	R	A	A	R	R	R	R	R	A
IPS	R	R	A	A	A	A	A	R	R	R	A	A
ADF	R	R	A	A	A	A	R	R	R	R	A	A
PP	A	A	R	A	A	A	A	R	A	A	A	A

Note: A = the null of I(1) is accepted, R = the null of I(1) is rejected

The lags used in the tests were automatically chosen through AIC criterion. From the analysis we can observe that b_t, k_t, i_t, w_t, τ_t , u_t are stationary and the other are *I*(1). From these results we can decompose the exogenous variables in:

Stationary variables ≈ Temporary variables: b_t, k_t, i_t, τ_t
Trended variables ≈ Permanent variables: o_t ,θ_t , ζ_t .

The econometric analysis suggests a distinction between temporary and permanent variables that is not standard from a classical economic perspective. However, we will conduct our empirical analysis on respect of the results of the unit roots.

[15] K. S. Im, M. H. Pesaran, Y. Shin, *op. cit.*

[16] G. S. Maddala, S. Wu, op. cit., I. Choi, "Unit Root Tests for Panel Data", *Journal of International Money and Finance*, 20, 2001, pp. 249-272

We estimate a stationary dynamic panel with fixed effects for the 7 MED countries (Banerjee,[17] Baltagi and Kao,[18] Smith[19]). The stationary series were considered in their deviations from the mean, while the non-stationary series were detrended. To due this we apply on them the Hodrick-Prescott filter and compute the stationary-cycle series as deviation from it. In this way we don't miss any observation. The main results are summarized in Table 5.

Table 5: *Estimated equations*

Dependent variables: n_t				**Dependent variables: w_t**			
	Coeff.	**St. e.**	**t-St**		**Coeff.**	**St. e.**	**t-St**
C	0.000592	0.000378	1.567774	C	0.002075	0.003320	0.625117
n_{t-1}	0.278437	0.061700	4.512735	w_{t-1}	0.660853	0.088546	7.463368
n_{t-2}	-0.293927	0.152280	-1.930168	w_{t-2}	-0.242829	0.083407	-2.911392
I_t	-0.001366	0.000539	-2.532161	θ_t	0.716258	0.331552	2.160323
ζ_t	-0.241062	0.085538	-2.818200	b_t	0.188585	0.042842	4.401916
θ_t	-0.530366	0.233399	-2.272358	l_{t-1}	2.636678	0.573413	4.598216
θ_{t-1}	0.256362	0.065039	3.941654	k_t	0.185222	0.081789	2.264623
O_t	0.051180	0.017798	2.875535	k_{t-1}	-0.139777	0.078851	-1.772676
τ_t	-0.000321	0.000184	-1.745548				
R-squared	0.868113			R-squared	0.925342		
F-statistic	12.69429	0.000000		F-statistic	26.69547	0.000000	
Dependent variables: l_t				**Dependent variables: q_t**			
	Coeff.	**St. e.**	**t-St**		**Coeff.**	**St. e.**	**t-St**
C	-0.000146	0.000417	-0.349861	C	-0.000310	0.000707	-0.438546
L_{t-1}	0.120143	0.063658	1.887327	q_{t-1}	0.101118	0.091195	1.108818
L_{t-2}	-0.234982	0.064321	-3.653277	q_{t-2}	-0.262446	0.083693	-3.135837
n_{t-2}	-0.147527	0.036445	-4.047969	k_t	0.043934	0.015370	2.858365
q_{t-1}	0.229314	0.072626	3.157479	k_{t-2}	0.055111	0.014128	3.900907
w_{t-2}	-0.054769	0.009047	-6.053861	o_{t-1}	0.028496	0.011811	2.412638
b_{t-1}	0.034246	0.005503	6.223270	θ_t	0.138651	0.068187	2.033393
o_{t-1}	-0.016614	0.007358	-2.258043	l_t	0.380748	0.117389	3.243474
k_{t-2}	0.018337	0.009550	1.920144				
R-squared	0.800209			R-squared	0.827690		
F-statistic	7.724386	0.000000		F-statistic	10.34597	0.000000	

All the equations satisfy the condition of stability. The labour demand depends negatively on the real interest rate, the indirect taxes and the growth rate of productivity and positively on change in oil prices. The labor forces depend

[17] A. Banerjee, "Panel Data Unit Roots and Cointegration: An Overview", *Oxford Bulletin of Economics and Statistics,* 61, S1, 1999, pp. 607-629

[18] B. Baltagi, J. Kao, Nonstationary Panels, "Cointegration in Panels and Dynamic Panels: A Survey", in: Baltagi B., Fomby T.B. and Carter Hill R. (eds), *Advances in Econometrics: Nonstationary Panels, Cointegration in Panels and Dynamic Panels*, 15, 2000, pp. 7-51

[19] R. P. Smith, *Estimation and inference with non-stationary panel time-series data*, 2000, mimeo

negatively on the level of wages, whereas growths in social benefits, GDP and the capital stock have a positive effect. The real wages depend positively on social benefits, productivity and labour force. The production function has a positive relationship with respect to capital stock, productivity and labour force.

Figure 2 shows that the model fit reasonably well, except for Tunisia. This can be explained by the data available for this country, which presented many lacks and adjustments. The assumption in the model that cross-country differences can be explained only by the constants in the equations (panel with fixed effects) was acceptable.

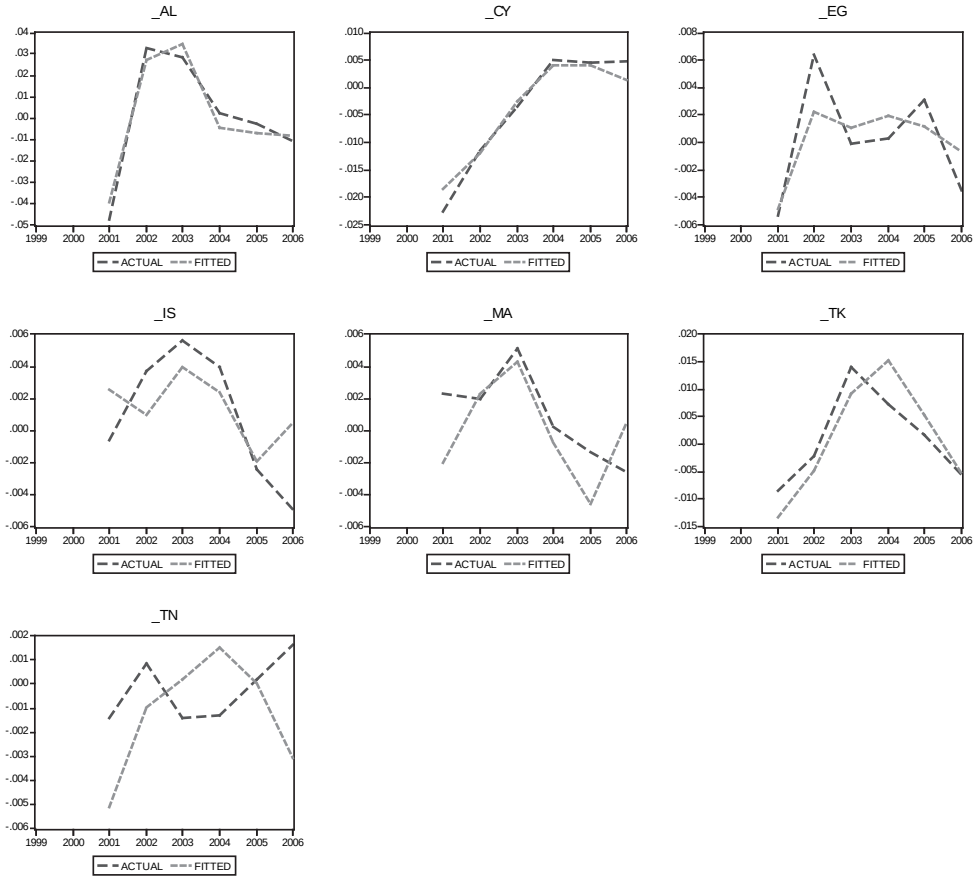

Figure 2: *Actual and fitted* u_t

We use now the fitted model to capture the direct effects and the dynamic adjustments of the exogenous variables on the unemployment rate. The following analysis is shown at an aggregated MED countries level to save space, however it can be considered also at a single country level.

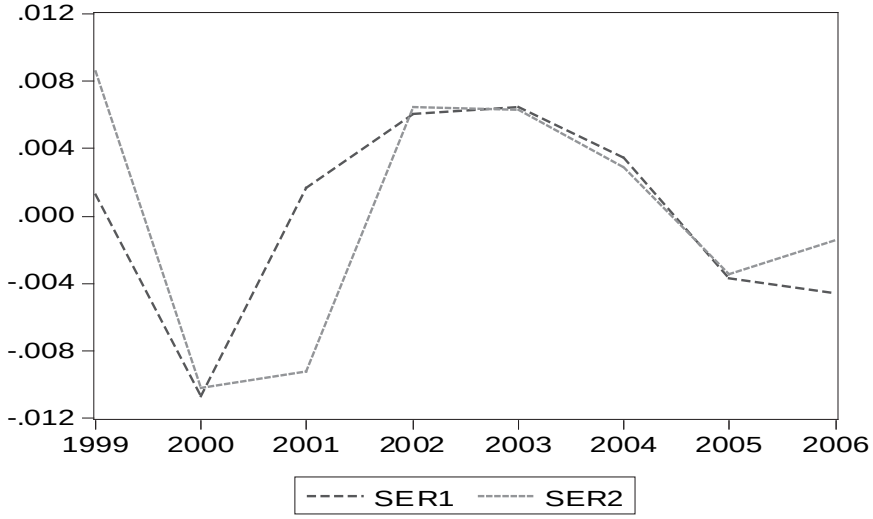

Figure 3: *Direct effects of Permanent components*

The exogenous variables introduced significantly in the model were: Real social security benefits (b_t), Real capital stock (k_t), Real oil prices (o_t), Long-term real interest rate (i_t), Indirect taxes (τ_t) and Productivity (θ_t). Only the oil price and the productivity were nonstationary (i.e. permanent exogenous variables).

We present in the next two figures the direct effects (Figure 3) of the nonstationary (oil price and productivity) and of the stationary (Figure 4) variables (social benefits, capital stock, indirect taxes and interest rates) on the unemployment rate.

The direct effects of the exogenous permanent variables on the unemployment rate are captured by $\theta_0 x_{1t}$. In Figure 3 ser1 denotes the direct effect of changes in oil prices and ser2 adds to this the effect of the growth rate of productivity. We can see that the contribution of the productivity on the employment is remarkable in the first half of the sample and in the last year. From 2002 to 2005 the productivity had an irrelevant direct impact with respect to the changes in the oil prices.

The direct effects of the exogenous temporary variables on the unemployment rate are $\theta_0 x_{2t}$.and are presented in Figure 4. Ser3 represents the direct effect of the social benefits, ser4 adds to this the direct effects of the capital stock, ser5 adds the direct effects of indirect taxes and ser6 adds the direct effects of the interest rates. We can see that the direct impact of the social security benefits had a stabilization (compensation) impact on the unemployment with respect of the other temporary variables. The direct impact of the capital stock is very significant, the indirect taxes has amplified the effects of the capital stock, wherever the interest rate has a very small contribution.

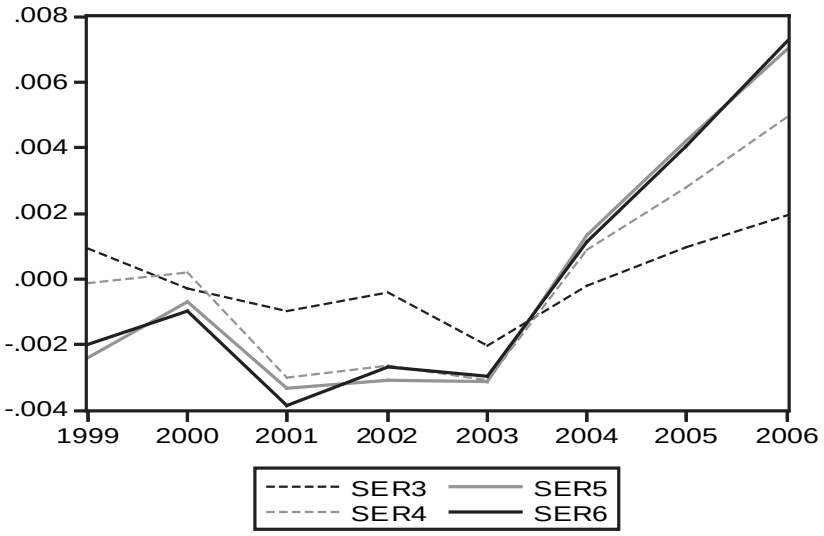

Figure 4: *Direct effects of Temporary components*

The analysis of the dynamic adjustment of the exogenous variables on the unemployment rate is performed using the estimated model, through the impulse-response analysis. In the following Figure 5 we can observe the dynamic effect of all the exogenous variables considered in the model.

The *dynamic adjustment* shows the response of a shock through times on unemployment. We consider a one standard deviation one-off shock of the exogenous temporary and permanent variables.

We can observe that social benefits and changes in the productivity have a small dynamic impact on the unemployment, instead the capital stock, indirect taxes and changes in oil price have a more evident and permanent impact on the unemployment. The response to one-off shock of the five exogenous variables is absorbed after seven year, except for the social benefits, which has a longer adjustment. The indirect taxes exercise a positive dynamic adjustment on the unemployment rate; instead the capital stock and the changes in oil prices have a greater oscillatory dynamic impact on unemployment. It is interesting to note the decrease of unemployment in the first four years as a response to a shock in capital stock.

Finally we can study the effects of the exogenous variables on unemployment in the long-run equilibrium. To perform this analysis we assume that the exogenous variables have completed their dynamic adjustment and remain constant (in absence of other new shocks) and the endogenous lagged variables will be set equal to its current values. In this way the steady state equation is obtained by solving the ARDL estimated model (3).

The long-run unemployment rate obtained in this way is reported on the graph, together with the actual unemployment rate (see Figure 6).

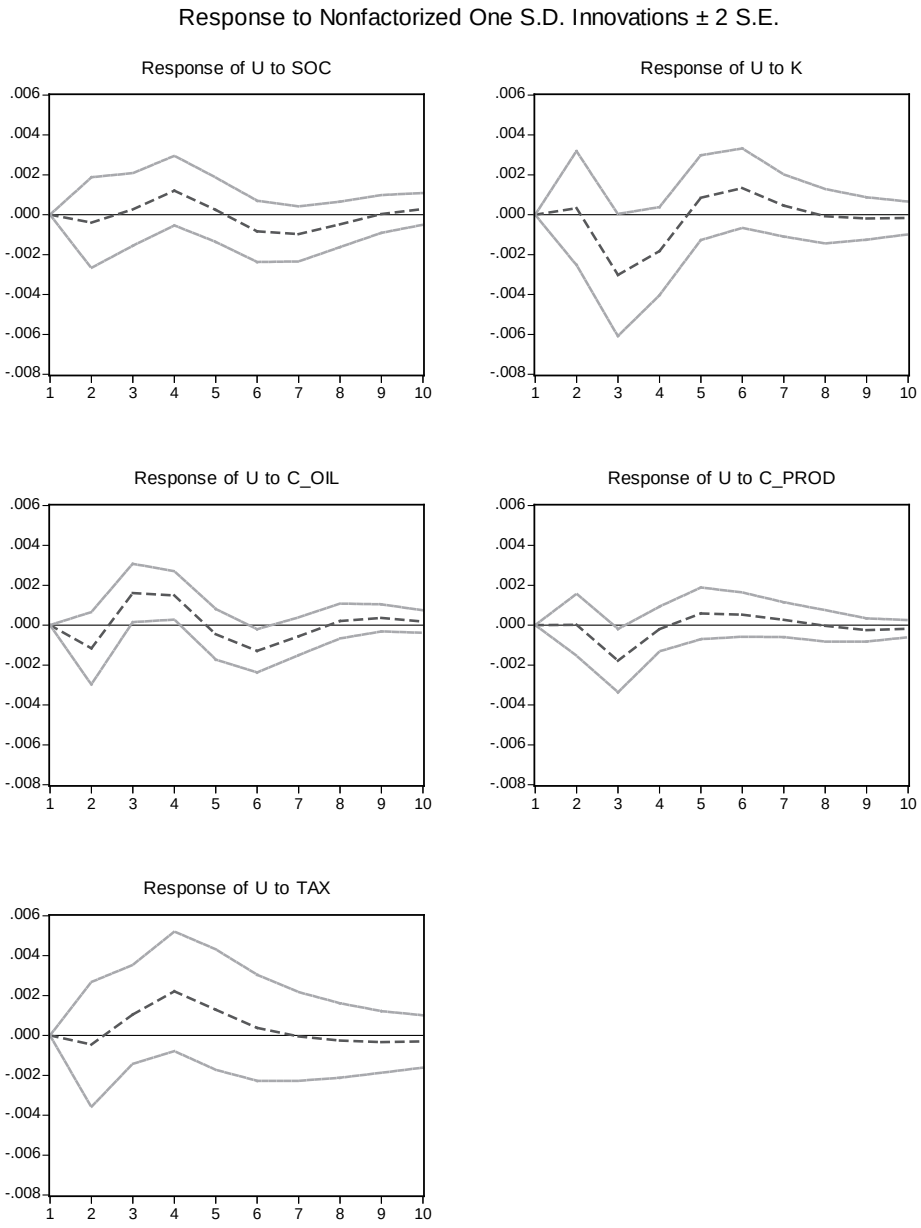

Figure 5: *Response – impulse analysis*

Looking at the graph we can see that the long-run dynamic of the unemployment rate would be more oscillatory than the observed one. The dynamic of the actual unemployment is not explained too much by its long-run dynamic. Regressing the actual on the long-run unemployment rate we obtain an $R^2 = 0.016$,

that means that less than the 2% of the actual unemployment rate is explained by its frictionless dynamic. The direct and dynamic adjustments cover more than the remaining 80% of the behaviour of the unemployment rate. Our empirical analysis shows that in absence of the lagged labour market adjustment process, the MED unemployment would have been lower in recession period and higher in expansions period. The lagged adjustment processes have played an important role in the determination of the movements of the MED unemployment.

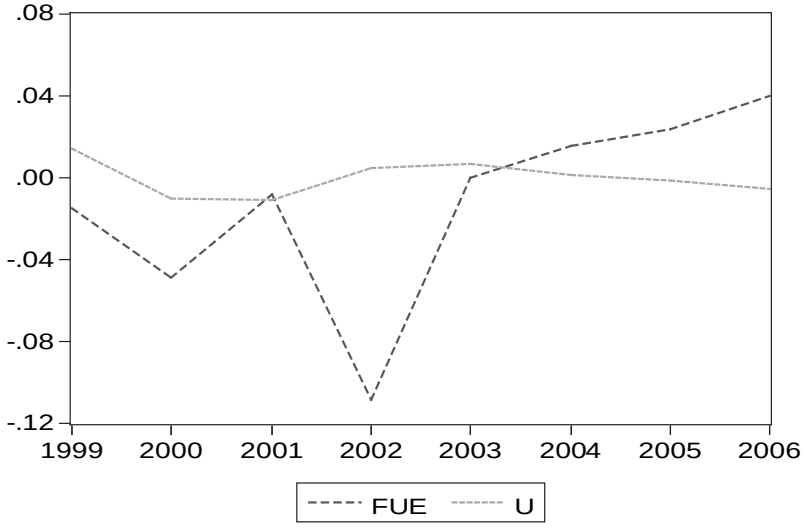

Figure 6: *The Frictionless Equilibrium Unemployment rate*

4. Conclusions

In this paper we analyse, by applying a multivariate econometric approach, the unemployment and the labour market in seven MED countries. The MED labour market is described through four dynamic pooled equations: a labour demand, a wage setting, a labour supply, a production function and an unemployment definition equation. Focusing on the unemployment rate equation, we investigate how some key variables have influenced its dynamic. In this respect, we distinguish between direct, dynamic and long-run effects of some exogenous variables included in the model of unemployment.

The exogenous variables are divided into two groups: productivity and oil price represent the first non-stationary group, while capital stock, social benefits, interest rates and indirect taxes the stationary one.

Regarding the direct (contemporaneous) impact on unemployment, we observe that the productivity has a remarkable effect up to 2002, then it is not

distinguishable from the direct effect produced by the oil price. In the stationary group, the changes in the capital stock and the indirect taxes have a crucial direct effect on the unemployment, whereas social benefits and interest rates effects are not significant.

There is a clear evidence of the impact of changes in the capital stock on lagged adjustment process of unemployment. The oil prices are also found to have a clear dynamic adjustment. Though social benefits do produce small fluctuations in MED unemployment, such fluctuations persist for a long time.

The long-run unemployment rate shows a different dynamic compared to the observed one: the first is characterized by higher volatility, and is lower than the second in the first part of the sample and higher in the second sub-period. This suggests that the lagged adjustment processes have played an important role in the determination of the MED unemployment rate.

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Original scientific paper
Received: March 5th, 2009

UDC 005.51; 005.7
ID 158251788

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LEADING & CONTROLLING STRATEGIC CHANGE: A DYNAMIC VIEW

Abstract: *In this article a dynamic model has been proposed that could be used to explain strategy making in large and complex organizations, whereas top management could influence the definition of the direction but the effective realized strategy depends on the actions of many people within and around the organization. After explaining static and dynamic approaches in strategic management, different schools of thought on strategy formation are studied. Then, a dynamic model of strategic change has been presented and the issues of strategic control discussed.*

Key words: *strategy making, strategic change, top management*
JEL classification: L1, L21

1. Introduction

In this article, a dynamic model of strategy-making in large firms is proposed that, to a certain extent, could be useful for top managers involved in strategic change processes.

The role of top management had a dramatic change in the past few years: by one side, top managers have to confront with a dynamic context, in which it is of no use a long-term scenario planning; by the other side, they have to convince middle managers and all workers of the company about the good quality of their vision, in order to get alignment from them, having individual behavior coherent with the corporate scheme of social values and corporate objectives.

Facing these two big changes, top managers are now conceived as "architects", more than planners. Middle managers are not only mere executors of a corporate strategy, while their role is more and more involved in innovative processes, by allowing a corporate culture that incentivizes entrepreneurial behaviors.

The dynamic model of strategic change that is proposed focuses on three main strategic processes, so called "engines" of strategic change: a) the strategy execution engine; b) the learning engine; c) the innovation engine.[1] The first and the second engines are concerned with a top-down approach to strategic management, that sees top management in a central role of strategy definition and execution. The latter needs a bottom-up involvement of middle managers (and if the corporate culture is pervasive, of all employees).

Once described the cause-effect model of strategic change, it is proposed a strategic control system based upon three systems: i) corporate governance control systems; ii) strategy execution control systems; iii) strategic assumptions control systems.[2] This model capitalizes on research studies both in the strategic management field and in management accounting, in order to emphasize the role of top management in building and controlling the strategy formation processes.

2. Static and dynamic approaches in strategic management

One of the themes which has stimulated research and debate in the strategy field is about relationship among strategy and performance of a company over a long-term. Why there are companies that maintain leadership positions over years and other companies shine like stars only in a limited period of time? When a company could be considered really successful? What is the role of top management in leading successful companies?

The answer is different if we adopt a static or a dynamic approach. The static approach is focused mainly on the contents of strategy, while the dynamic approach considers also the processes of strategy making, that involve a lot of people in a company and that in many cases could not be centrally governed. Main differences in the two approaches are clarified in Table 1.

Table 1. *Static and dynamic approaches in strategic management*

	Static approach	Dynamic approach
Success as...	Superior economic performance in a well specified industry (ROI > Average industry ROI)	Profitable growth (dimensional and value-based oriented)
Drivers	a) Industry attractiveness b) Strategic position	a) Industry evolution b) Strategic innovation
Role of top management	Identify and sustain a good position in a certain industry	Identify a strategic vision and forcing the company to adapt to this
Focus on...	Strategy content	Strategy making processes

1 V. Coda and E. Mollona, "Il governo della dinamica della strategia", *Finanza, Marketing e Produzione*, anno XX, n. 4, December 2002

2 A. Garzoni, *Il controllo strategico. Modelli e strumenti per il controllo dei processi di gestione strategica*, Egea, Milano, 2003

The static approach is that of cross-sectional analysis, that is focused on a certain period of time (3-5 years) and measures success as superior economic performances (that means a Return on Investment that is above the average in a certain industry). This is commonly related to a superior strategic positioning, based on unique and coherent activities that could not be easily imitated by competitors. The role of top management, in this approach, is mainly centered on the identification of the best strategy (that configures a competitive advantage) and in the sustaining of this position through consolidation of the business model. So far, top management are obsessed by the definition of the strategy (so called strategy content) instead of focusing on processes of strategy making.

This approach is, to a certain extent, useful to understand differences among company performances in different industries and within industries,[3] while it is of no use in explaining how could a company maintain success over the long run. What distinguish a company with a long run success model from a company that has only few years of brightness? And what could drive leading companies into crisis?

The dynamic approach is complementary to the static one as it could explain better than the latter the historical causes of the success in a longitudinal way. This shift the focus from strategy content to strategy making processes: a better position is the goal to tend, while the problem is how could get to this goal, how to maintain the position and how could identify new sources of profitable growth.

So, in a dynamic approach, success companies are those able to sustain a constant profitable growth, both dimensional and value-based driven. By this, successful companies are focused on industry evolution trends and strategic innovation, boosting (today) productivity in order to get resources for (tomorrow) growth. In this case, the role of top management is mainly focused on governing strategic change, identifying a good long term vision and forcing the company to adapt to that. Examples like Jack Welch at General Electric or Lou Gerstner at IBM demonstrate that, without leadership, strategy making is process without end, whereas only chance could explain success. In this paper is argued that chance is important, but it could not be the only ingredient of a continuous success recipe, as explained in the next paragraph.

3. Strategy formation: schools of thought

Strategic management scholars were traditionally involved in understanding what brings a company to successful performance, focusing both on contents of strategy and strategy formation processes.

If we focus our attention on strategy formation processes, we can identify some schools of thought that are at the heart of the debate. In our perspective,

[3] M. E. Porter, "The five competitive forces that shape strategy", *Harvard Business Review,* January-February, 2008

we can distinguish among *prescriptive* schools and *descriptive* schools. The first schools are concerned with how strategies should be formulated, while the second ones pay attention to how strategies do form. In addition to these schools, we can consider as different the *evolutionary* perspective, that considers strategy as continuous process.

3.1. Prescriptive schools

Prescriptive schools found their origins in Selznick's work from 1957 on leadership in administration. In his book he introduced the notion of "distinctive competencies" and discussed the need to bring the other organization's internal state with its external expectations. Starting from these concepts Andrews 1971 work on corporate strategy found the so called *design school*. This school were largely based on the Harvard Business School convictions about what a strategy should be and could be synthesized in the following statements:

- strategy formation should be a controlled, conscious process of thought and strategies should be developed in a deliberate process based on formal training;
- responsibility for that control and consciousness must rest with the CEO, that is "the" strategist or the architect of strategy;
- the model of strategy formation must be kept simple and informal, as an imposing idea that is coherent with internal and external situation;
- strategies should be unique, as result of a unique process of formation;
- strategies emerge from this design process full-blown, as conceptions;
- strategies should be made explicit and, if possible, articulated, while kept simple;
- strategy formulation is a process that is before its implementation, in a sequential model,

According to this school, strategy is the result of choices that determine the positioning of a company in different competitive contexts. These choices are conscious and explicit, while the deliberate direction comes from a top-down perspective that considers top management as the unique player in this process. After strategy formulation, comes implementation, that is thought mainly as a structural organizational change instead of a cultural change.

Often confused with the design school, the *planning school* started with the work of Ansoff (1965). The two schools have similar premises: the role of top management in strategy definition, the rationality of the strategy formulation process, the separation between formulation and implementation phases. The main difference is in the role of planning: where Ansoff try to identify procedures for explaining decisional processes, Andrews is much more concerned with the strategy formation process, that should be, in his view, kept flexible. With Ansoff

a certain conduct on "strategic planning" took place both among the academics and in the practice. The Planners, in that period, tried to convince companies that a certain long range planning system should be useful to cope with dynamics over the long run, and the simple and effective model of the *design school* became more and more a complex mix of procedures and checklists, with the effect of making strategy too rigid to cope with environmental changes.

Mintzberg (1994) was critic about these methods, that could be synthesized as follows:

- fallacy of predetermination: in dynamical contexts is impossible to predict the direction of changes;
- fallacy of detachment: it is difficult to assume that formulation is strictly separated from implementation, as top managers are not completely detached from the operations;
- fallacy of formalization: it is difficult to translate strategies in checklists, while detailed plans could not include all the variables of different scenarios.

A third school that could be considered as prescriptive starts from the work of Porter (1980). The work of Porter is much more concerned with the idea of a certain "quality" of strategy, that means a good understanding of the environmental context and a choice of a good positioning in an industry or in a strategic group. For a certain extent, the work of Porter (and its *positioning school*) went in depth in the Andrews SWOT analysis model, where the five forces model was conceived as a strategic tool to better understand Opportunities and Threats, while the Value Chain was a managerial tool to better understand Strengths and Weaknesses. Although the positioning school accepted most of the premises that underlay the planning and design schools, it added content in two ways: by adding literal content, emphasizing strategies themselves more than the process by which they were to be formulated; by adding substance, with two very-well known managerial tools that were introduced in master programs and changed the way strategy was conceived in the practice.

3.2. Descriptive schools

These schools focus their attention on the description of processes (cognitive, entrepreneurial, cultural, political, and so on) more than on normative prescriptions.

The *entrepreneurial school* the attention is mostly paid to the leaders behavior, and stresses the most innate of mental states and processes – intuition, judgment, wisdom, experience, insight. Normann (1977) conceived the strategy formation

process as a learning process guided by an entrepreneurial idea. In his view, this business idea take place as a result of a learning by doing process that consists in a continuous redefining of a vision. In this model do not exist a separation among thinking and action, as do not exist a separation among formulation and implementation processes. The premises of this school are the following:

- strategy exists in the mind of a single leader as perspective specifically, as a sense of long-term direction, a vision of the organization's future;
- the process of strategy formation is semiconscious at best, rooted in the experience and intuition of the leader;
- the leader maintains close personal control of the implementation as well as the formulation of the vision, tying the two together tightly through personalized feedback on actions;
- the strategic vision is thus malleable, as is the leader's organization, a simple structure responsive to his or her directives;
- the entrepreneurial strategy tends to take the form of niche, one or more pockets of market positions protected from the forces of outright competition.

On the one hand, the entrepreneurial school has viewed strategy formation as wrapped up in the vision of a single individual. On the other hand, the process remained a black box, buried in human cognition.

Very close to the entrepreneurial school is the *cognitive school*. This perspective investigates the mental models of top management, as a result of their experience. These cognitive models are filters by which managers perceive the environmental changes and the internal situation. These perceptions could be more or less accurate according to the environmental dynamics. The cognitive school has its origins in Simon 1957 work on bounded rationality: the world is large and complex and human brains are small; their information processing capacities are limited. Following Simon work, Weick (1979) added a significant contribution in identifying strategic initiatives as effect of the variation, selection, retention model. So the emergence of initiatives is a variation in a context, while top managers pay attention to selection of good opportunities and retention of the best ones.

Fundamental premises of this school are:

- strategy formation is a cognitive process that takes place in the mind of the strategist;
- hence, strategies are perspectives, or concepts, that form in that mind
- the strategist's environment is complex, his or her cognitive capabilities limited by comparison; consequently, the receipt of information is restricted and biased and the process of strategy formation thereby distorted;

- specifically, strategies are difficult to attain in the first place, considerably less than optimal when attained and subsequently difficult to change when no longer viable;
- as a results of their individual cognitive make-ups, strategies vary significantly in their styles of strategy formation.

The main critique to the cognitive school is that seems to apply best to strategy formation as an individual rather than a collective process.

Another school that is similar in premises, but much more focused on collective processes is the so called *learning school*. This school has its origins in the works of Mintzberg (1978 and followings) and Quinn (1980). These two authors have distinctive convictions about strategy formation, but both believe that this process is driven by learning. According to Quinn, strategy is a "logical incrementalism" process of top management: by doing top management adapt his perception to events and build a grand strategy. Mintzberg points out that deliberate strategies could be thought only by top managers, while strategy process is a combination of deliberate and emergent strategies. The latter that emerge in a bottom-up process, alternative to the top-down approach of the design school. Premises of this school are the following:

- complexity and dynamism often preclude deliberate control; strategy making must above all take the form of a process of learning over time, in which, at the limit, formulation and implementation become indistinguishable;
- while the leader must learn too, more commonly it is the collective system that learns: there are many potential strategists in most organizations;
- learning proceeds in emergent fashion through behavior that stimulates thinking retrospectively. So strategic initiatives are taken by whoever has the capacity to learn and the resources to support that capacity;
- the role of leadership becomes not to preconceive deliberate strategies, but to manage the process of strategic learning;
- strategies appear first as patterns out of the past, and only later perhaps as deliberate plans for the future.

Among different schools, the learning school grew in importance according to the pragmatism by which describe how strategies form in big and complex companies. Nevertheless, the heavy weight assigned to the emerging part of strategy instead of the deliberate one could bring the risk of not being able to converge on a clear strategy.

The other descriptive schools (named political, cultural, environmental school) represent single visions of the strategy formation process, while they do

not explain the whole process of strategy formation. According to the *political school* strategy forms as a result of a negotiation process among groups of individuals within organizations, that have different political power in addressing one or other directions. This school find its origins in the work of Cyert and March (1963). Within the strategic management field we can consider the works of Pettigrew (1977) and McMillan (1978). Premises of this school are the following:

- the strategy formation process is fundamentally a political one – that is, based on illegitimate means and usually parochial ends that often generate conflict, whether focused within the organization (micro politics) or reflecting actions by the organization (macro politics);
- political strategies, whether realized via deliberate plans or emerging patterns, tend to take the formed positions;
- in micro politics, there is no dominant actor, but rather a number who vie with each other to control organizational outcomes, or else who challenge vulnerable central actors;
- in macro politics, the organization promotes its own welfare through aggressive deliberate strategies of political nature.

According to the *cultural school*, strategy comes out from a collective behavior that takes place in a specified cultural and organizational context. It is the value system, in this case, that allows a strategy to emerge and become dominant. This school, that has its origins in the work of Clark (1970), has been at the heart of the work of Ohmae (1981) and Allaire and Firsirotu (1984). In Europe this school is traditionally linked to the Swedish school of Rhenman. Fundamental premises of this school are:

- strategy formation is fundamentally a process of collective behavior, based on the beliefs shared by the members of an organization;
- as a result, strategy takes the form of perspective above all and is rooted in intentions (though not necessarily explicit) and reflected in patterns, which makes it deliberate;
- coordination and control in the organization are largely normative, based on the influence of the shared beliefs;
- given the importance of the internal belief system, the organization tends to be proactive in comparison with an environment that appears to be passive and diffuse in its influence;
- culture and especially ideology do not encourage strategic change so much as perpetuate existing strategy; at best, they allow for shifts in position within the organization's overall strategic perspective.

The *environmental school* conceives strategy formation as process of adaptation to environmental changes. This school is traditionally rooted in the work of Hannan and Freeman (1977) on population ecology. For these authors best

organizations are the ones that survive and find a way in a constantly changing environment. The theoretical model sounds like a Darwinian one and empathizes the role of the context in shaping the organizations. Premises of this school are:

- the environment, in general or manifested as a set of abstract forces, dictates strategy by forcing organizations or their attributes into ecological-type niches; those that refuse to so adapt must eventually die;
- thus there is no real internal strategist nor any internal strategy-making process, and leadership, as it has long been depicted in the strategic management as well as its own literature, in a myth.

Each of these latter schools presents an interesting picture, while none of them can describe the entire process. So the political school is too much involved in explaining negotiations and conflict that misses other causes of strategy formation. While cultural school went so in depth in the organizational context that missed the explanation of the relationship among strategy and organization. And the environmental school explain well the behavior of groups of firms instead of focusing on one single process.

4. A dynamic model of strategic change

Historically, the relation between strategy formation and firms' adaptation has been at the heart of the debate involving Ansoff and Mintzberg.[4] How could be a strategy planned or shaped is a question that stimulated many authors to express their opinion and take a position in the debate.

More recently, the evolutionary perspective in strategic management suggests that corporate strategies emerge as a bottom-up guided evolution.[5] This perspective is well-rooted within the strategy field, since the work of Burgelman[6] on the Bower[7] model of corporate strategy making. Within this theoretical framework, firms' adaptation depends on top managers' ability to balance selection processes, to maintain order and direction in strategic action, to induce strategic innovation processes by defining a certain strategic and organizational context that could drive initiatives both from top and bottom of the organiza-

4 H. Mintzberg, "Strategy formation: ten schools of thought", in: J. Fredrickson (Ed), *Perspectives on Strategic Management*, Ballinger, New York, 1990

5 Lovas B. and Ghoshal S., "Strategy as guided evolution", *Strategic Management Journal*, Vol. 21, 2000

6 R. A. Burgelman, "A model of interaction of strategic behaviour, corporate context and the concept of strategy", *Academy of Management Review*, Vol. 8, n. 1, 1983

7 J. L. Bower, *Managing the resource allocation process: a study of corporate planning and investment*, Harvard University Press, Boston, 1970

tion. The Burgelman model of strategy making is derived from the Weick variation, selection, retention scheme[8]: too much emphasis on selection and order inhibits strategic innovation; on the other hand, excessive push on variation may lead to disorder and resource dissipation. Such a dilemma between order and direction, by one side, and innovation and disorder, by the other side, has been studied by Stacey[9] as "bounded instability" in a theory of deterministic chaos as a source of innovation.

In complex organization (such as middle-size and big companies), top managers could not be able to control the evolution of strategy, being the latter defined by choices and actions of many people within and around the organization. In the next pages it is proposed a dynamic model of strategy making that could be useful for top managers that are involved in processes of strategic change. This model identifies three "strategic change engines":

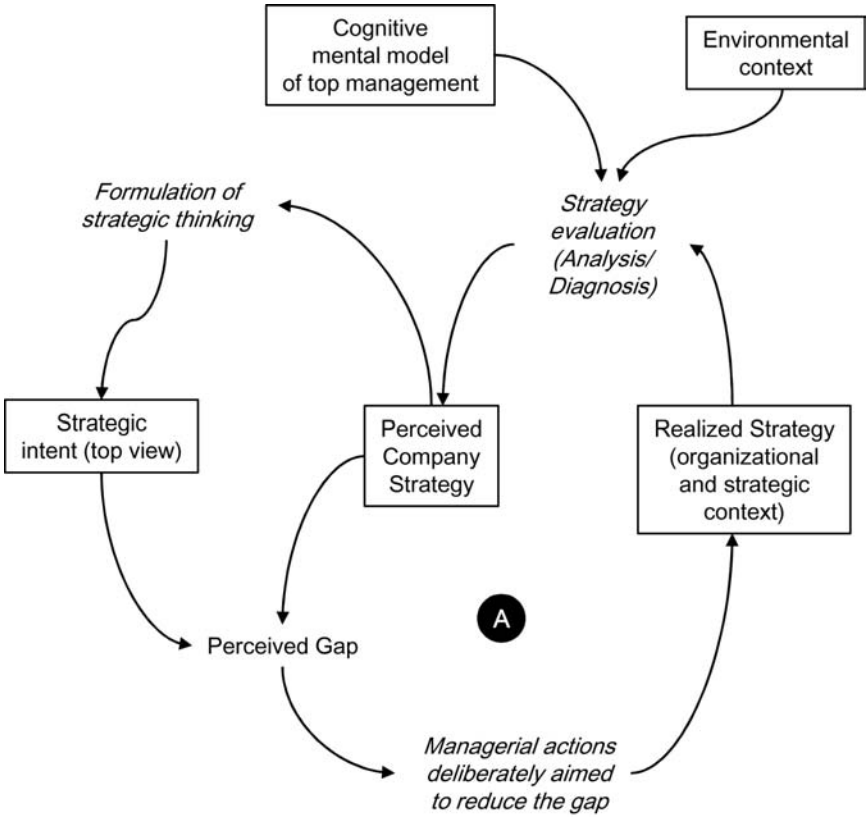
a) the *strategy execution engine*, that is focused on the reduction of the perceived gap among top management strategic intentions and the company situation at a certain time;
b) the *learning engine*, that is centered on the Chief Executive Officer (CEO) as the architect of strategic intention formation and on the learning before and by doing that could modify perceptions on environmental context evolution or on organizational and strategic context of the company;
c) the *innovation engine*, that describes bottom-up innovation processes that are expression of corporate entrepreneurship in middle and functional management.

The strategy execution engine (named A in graph 1) depicts how strategy could be effected in a top-down approach. It is largely based on a deep conviction of top management that defines its strategic intent (or long-term vision). This strategic intent comes from a perception of the company situation (as the CEO sees it) and of the environmental context (as the CEO sees it). So far, cognitive mental models and cultural beliefs and values of the CEO are the lens by which the reality could be perceived.

Once defined a strategic intent, the role of top management is in shaping the organization in order to realize what he thought (that means, reducing the perceived gap among "what you are" and "what you want to be"). That comes with managerial actions deliberately devoted to reduce the gap, like: communicating strategic intentions, (re)structuring business portfolio, reshaping organizational structure and operating mechanisms, launching corporate challenges.

8 K. Weick, *The social psychology of organizations*, Random House, New York, 1979

9 R. D. Stacey, *Strategic management and organizational dynamics*, Pitman Publishing, London, 1993

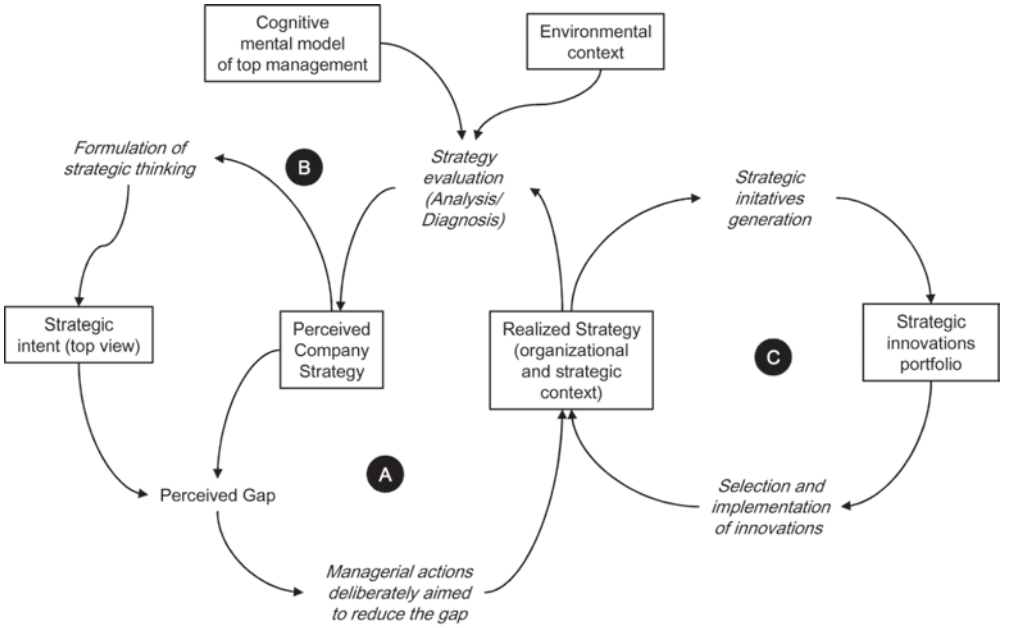


Graph 1. *The strategy execution engine*

The results of these actions change the organizational and strategic context of a company, until the perceived gap is filled.

By acting to reduce the perceived gap, top and middle managers are involved in learning processes, that can drive elsewhere their strategic convictions and boosting a reshaping in strategic thinking. This learning process, named B in Graph 2, could change the strategic intentions of the top management and forcing new actions in order to adapt the organization to deliberate strategies.

In some companies, whereas corporate entrepreneurship is diffused, middle and functional management work for idea generation, in a strategic innovation perspective (that is described in Graph 2 as C). An entrepreneurial company – say, a company that stimulates entrepreneurship in middle and functional management – has different organizational rules that allow people to express themselves in an innovative manner. In a general way, the development of strategic initiatives in a bottom-up way is more common in lean organizations, where resources are assigned to new projects with less bureaucracy procedures and where control systems don't penalize new strategic ventures.



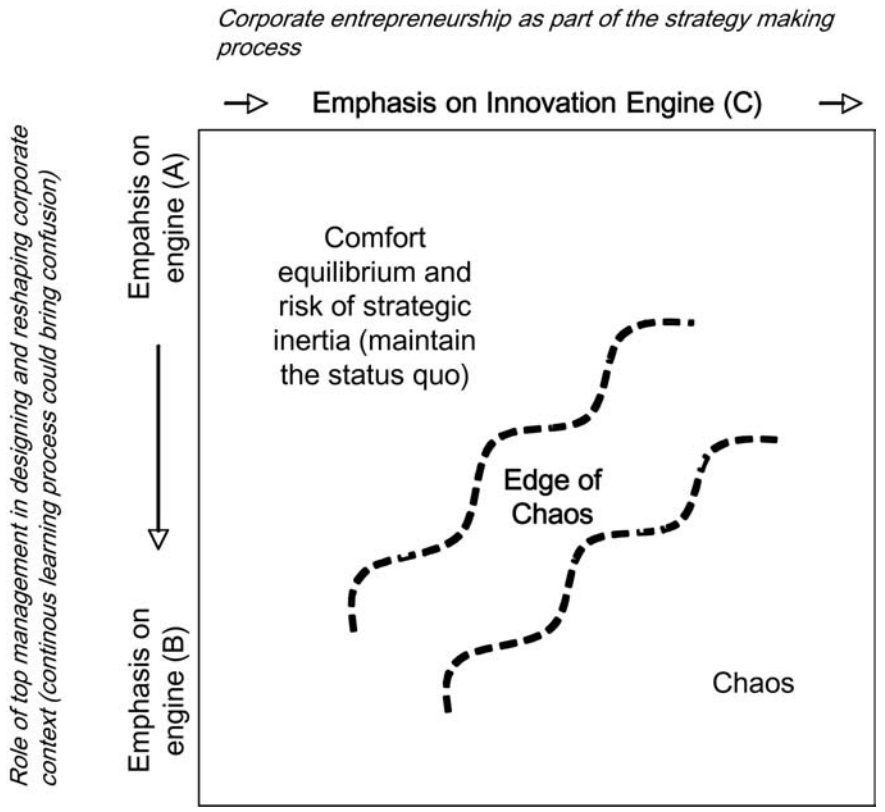
Graph 2. *A dynamic model of strategic change in complex organizations*

Strategic initiative proposal is only the first part of the game. The second is the role of top management in selection the innovations that have to be implemented, thus changing the organizational and strategic context of the company.

As a matter of fact, companies that are lead mainly with the A engine have the risk of a comfortable organizational inertia, that means lack in innovation that could drive success over the long run. While focusing on A+B strategic change model, in order to continuously adapt to change in the environmental context, could bring companies into chaos (due to the constant shift in the strategic objective that could not be well understood by people within and around the company). Even an emphasis on the C engine (the innovation one), without a straight control of A+B engines, could bring companies into chaos, shaping a "bubbling up" model of strategy making that could not be coherent with a long term strategy. This could be observed in Graph 3.

5. Leading change: strategic control

In the previous section it has been proposed a dynamic model of strategic change in complex organization, based on three engines. When an environmental context becomes ever and ever turbulent, which kind of control systems could help top managers in governing the organization?



Graph 3. *Strategy formation at the edge of chaos*

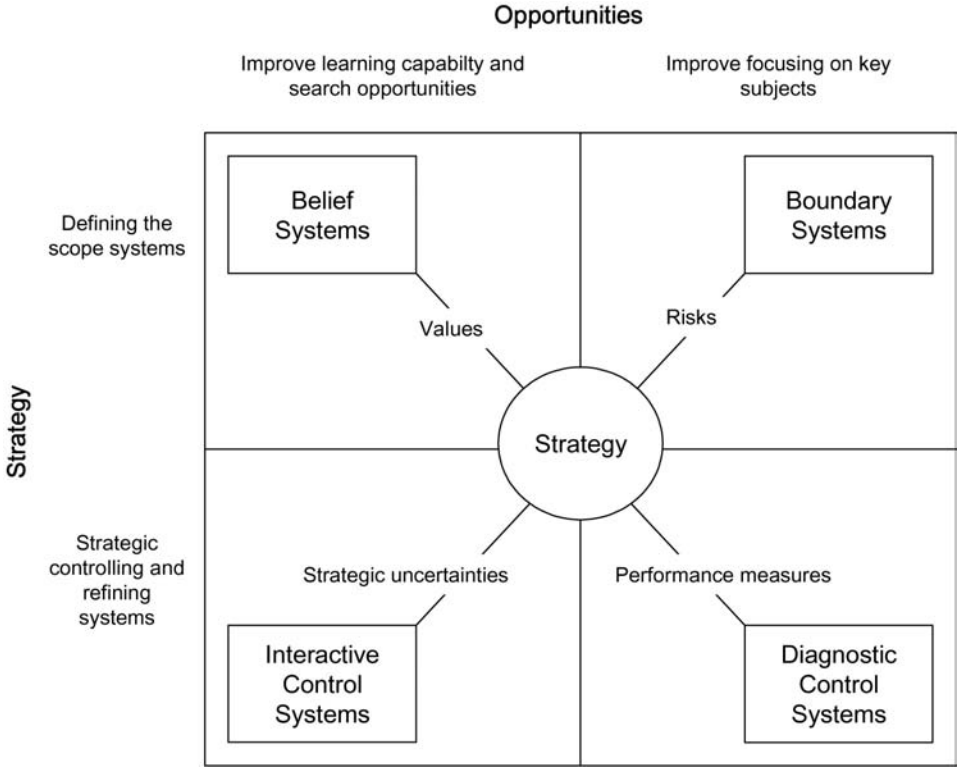
According to the Simons[10] view of strategic control, there are four levers that top managers can use in order to control strategy making in a dynamic way (that means both with feedback and feed forward control systems):

i) beliefs systems, used to inspire and direct the search for new opportunities;
ii) boundary systems, used to set limits on opportunity-seeking behavior;
iii) diagnostic control systems, used to motivate, monitor, and reward achievement of specific goals;
iv) interactive control systems, used to stimulate organizational learning and the emergence of new ideas and strategies (see Graph 4).

These four levers act for balancing tensions within organizations. Two levers (belief systems and interactive control systems) bring corporate attention on searching opportunities that are not totally defined in the strategic plan,

[10] R. Simons, *Levers of control. How managers use innovative control systems to drive strategic renewal*, Harvard Business School Press, Boston, 1995

stimulate organizational behavior in a unfocused way, finding new directions for growth. An example of "beliefs" used as strategic control levers is the statement of corporate vision and mission: Nestlé, for example, stimulates values like innovation, customer care, operational effectiveness in production and logistics, which every employee and manager must pay attention on. When Nestlé entered in the mineral water business, managers were asked to draw innovation (and this is not so simple in a traditional business like that one). Product managers acted in redefining marketing concept and packaging according to selected target of consumers, in order to be innovative even in a traditional market.



Graph 4. *The levers of control*

Interactive control systems are designed to cope with strategic uncertainties. They answer the question: what assumptions or shocks could derail the achievement of our vision for the future? An example of how these systems could change top management perception of environmental context is given by the so-called "competitive intelligence" systems.[11] These latter are focused on gathering infor-

[11] A. Garzoni, *Competitive Intelligence. Strumenti per l'analisi dell'ambiente competitivo*, Egea, Milano, 2006

mation and giving industry or competitor insights to senior managers, in order to let them change the (intentional) strategy according to significant environmental changes. All interactive control systems have four defining characteristics:

1) Information generated by the system is an important and recurring agenda addressed by the highest level of management;
2) The interactive control system demands frequent and regular attention from operating managers at all levels of the organization;
3) Data generated by the system are interpreted and discussed in face-to-face meetings of superior, subordinates, peers.
4) The system is a catalyst for the continual challenge and debate of underlying data, assumptions and action plans.

The other two levers of control (boundary systems and diagnostic control systems) act in a focused way, in order to align corporate behavior and actions to intentional strategy. Boundary systems are part of the culture of a company, as beliefs, but they could be described as limits. So boundaries are limit to actions that, if processed, could bring strategy very far from the direction intended. Senior managers define what subordinates should not do and relying on individual creativity to search for ways of creating value within these boundaries. An ethic code, for, example, is a boundary that forces an organization to align to a certain behavior. Even if perceived as prescriptive or negative systems, these systems allow managers to delegate decision making and are, in many cases, the prerequisite for organizational freedom and entrepreneurial behavior. They act as the brakes in a car: is their function to slow the car down or to allow it to go fast? Boundary systems are like brakes on a car: without them the organization cannot operate at high speeds.

Concerning diagnostic control systems, they could be distinguished by three features:

1) The ability to measure the outputs of a process;
2) The existence of predetermined standards against which actual results can be compared;
3) The ability to correct deviations from standards.

These systems focus on critical performance measures (KPI) that are linked to business strategy and describe how can an organization perform better than others (in terms of productivity and growth). Strategic plans and balanced scorecards[12] are examples of systems that try to align organizations to intentional strategies. They allow the organization to achieve goals without constant management oversight, as individuals are held accountable for results, even as

[12] R. S. Kaplan and D. P. Norton, "The balanced scorecard. Measures that drive performance", *Harvard Business Review*, vol. 70, 1992

they have the freedom to choose how to accomplish desired goals. Accounting measures that include revenues, costs, cash flows and profits are predominant in many diagnostic control systems because these metrics are objective, reliable and verifiable. Nonfinancial measures are anyway a growing phenomenon in all control systems, as these metrics can help managers to focus corporate actions to well-specified directions.

In the previous section it has been presented a dynamic model of strategy making in large firms and complex organizations. How could top managers use this framework in order to control strategic change?

We can identify three strategic control systems, that operate at different levels in the strategy-making framework described in Graph 2.

The first strategic control system is in the hands of stakeholders (mainly, in the hands of shareholders), that could force the change of a Chief Executive Officer (or other senior managers) if they are not convinced of its vision and strategic moves. The real functioning of this kind of control depends on the corporate governance context. A good governance is a prerequisite of a good functioning of the board of directors with respect to property and management issues. This system bring the choice of the senior management, stated their important role in being architects of the strategy.

The second strategic control system assume that top management has a clear vision and a planned strategic direction, which want to see executed. By this way, senior managers in a organization have to define what behaviors are coherent with their vision and act in order to set up the new organization. This set of control act as an home heating thermostat: set the temperature and the system self-regulates.

This type of automatic feedback system is not useful in the face of major changes in competitive dynamics. In order not to be blind-sided in rapidly changing markets, the search of relevant information must not be limited by diagnostic routines and procedures. This could be avoided by installing a third kind of strategic control systems, that are focused on validating the strategy by constantly checking the assumptions underlying a certain position.

The second and the third strategic control systems are in the hands of the top management, whose objective is to understand if the strategy is well functioning and if the strategy is still correct (considering environmental changes).

6. Conclusions

In this article a dynamic model has been proposed that could be used to explain strategy making in large and complex organizations, whereas top management could influence the definition of the direction but the effective realized strategy depend on the actions of many people within and around the organization.

It has been argued that strategy is a coral phenomenon and that top managers are architects, instead of planners. The model, also, identified three engines of strategic change, that could be moved by the top management in different ways: the strategy execution engine, the learning engine, the innovation engine. Not in all the organizations these engines work. In some organization, strategy is forced by top management in a top-down manner. In some others, strategy comes bottom-up, through an entrepreneurial process of innovation. In all cases, strategy making is strictly linked to the ability of understanding environmental evolutions and adapting (or anticipating) changing in the organizational context.

When rapidly changing could not allow a diagnostic control of strategy making, other levers could be, in some extent, useful to top managers. These are depicted in the previous section as cultural systems (beliefs and boundaries) or as interactive control systems (challenging the assumptions of the strategy in order to find new ways of growth).

Managing the tensions between creative innovation and predictable goal achievement is the key to profitable growth and, in this paper, it has been attempted to demonstrate how management control systems are critical levers for the control of strategy making. All these levers should be used to balance organizational tensions: control and learning, efficiency and innovation, reward and punishment, leadership and management are part of the fabric of organization grow and sometimes make organizational like uncomfortable. Yet, controlling strategy with the levers discussed in the previous section represent very basic and simple processes: providing goals; telling people what they will be rewarded for; telling them what not to do; telling them what you believe in; asking for their ideas; sharing knowledge. These are basic human processes that are evident whenever people rely on leaders to direct collaborative enterprises toward ambitious goals.

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Original scientific paper
Received: March 5th, 2009

UDC 334.72:005.7
ID 158252300

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CO-GOVERNANCE, CO-PRODUCTION & THE MIXED ENTERPRISE[1]

Abstract: *The article studies new organizational and new managerial models emerging from public-private partnerships. After defining the partnership' concept, an overview of the various relational formats in international literature is presented. Then, the concept of "co-governance" is explained from a systemic perspective to a partnership one; and the concept of "co-production" is studied, from "citizen participation" to public-non profit joint production.*

Finally, the evolution from coordination to partnership is explained possible only at a collaborative stage of interested parties. It has been argued that establishing a proper partnership presupposes a level of mutuality between interested parties, and such mutuality only a formal relationship can actually grant.

Key words: *co-governance, co-production, mixed enterprise, public-private partnership*
JEL classification: M11, D23, H32

1. Introduction

After years of analysis and debate, today the issue of co-governance and co-production in the sector of public personal services[2] requires the definition of new organizational and managerial models concerning not only relations between existing firms, but also the characteristics of a new model of enterprise.

At a moment when the definition and the components of the "social enterprise concept" are still under investigation, we have to address the issue as to whether this form of entrepreneurship is always the best answer to the require-

[1] This term is used both by French scholars such as M. Bedard, E. Poltier, M. Tereraho (who talk of co-enterprise), and English one, such as S. Brooks, L. D. Musolf, D. L. Spencer, A. R. Vining (in terms of mixed-enterprise), in order to refer to the economic agent with public-private ownership and governance.

[2] "Public personal services" are here understood as social services (eldercare, handicap care, individual and family care), healthcare services, educational services, cultural, sport and leisure services.

ments of co-production and co-governance of the system as a whole and/or its most important parts.

The need to broaden and articulate the debate, about these exchange processes and the actors operating in the sector, is also the result of new practices which have developed in Europe, as a result of the evolution of public-private partnerships from contracting-out models (agreements, contracts, accreditation…) towards new forms of integrated entrepreneurship.

At the same time, thanks to the emphasis on the local dimension and on the dynamics of the community, the boundaries of the analysis overcome the mere practise of "zero sum games", where stable conditions of balance are achieved.

Table 1.

PERSPECTIVE	CHARACTERISTICS	RESEARCH HYPOTHESIS
Political	• Instrument of public policies • Conformity/ divergence of interests between public and private	• Decisive factors for the definition of the participation (public vs private capital) • Company policies • Accountability and control mechanisms
Economic	• Instrument of resource allocation • Means to pursue effectiveness and efficiency • Instrument of governance of the public service system • Means to regulate/activate exchanges • Means to reduce the primarily social risk of public actors. • Means to reduce the primarily economic risk of private actors • Competition between public and private interests	• Characteristics and modes of measuring the social and economic value produced. • Governance gear • Mechanisms of resource allocation on the basis of defined goals. • Mechanisms for the resolution of potential conflicts • Mechanisms for the regulation of the exchanges • Mechanisms for the sharing of the value produced
Organizational	• Hybrid organization, deriving from the merger between interests and models of public and private management • Divergence of interests and models of public and private management • Divergence between public and private interests	• How the relations of purely public enterprises with the environment, the structures and the conduct differ from those of purely non profit enterprises • A model for the development of an appropriate and peculiar management system • A model for the development of an appropriate system of governance and control • A model of financing • Organization models

We can actually say that there is the need

- to increase the level of transparency and the quality of interaction among actors
- to increase the level of involvement and participation of organizations and individuals
- when the same amount of resources is available, to increase the qualitative and quantitative level of responses to the needs of the community. On the contrary, when there's a lesser amount of resources available, to keep the level of such responses constant.
- to increase the propensity to long term strategic planning of public actors
- to acknowledge and codify the governance role of the sector and the non profit actors
- to improve the individuals' predisposition and their ability to work in an integrated environment towards long-term relationships.
- to activate all communitarian resources in order to support shared goals
- According to the perspective chosen[3], the concept of mixed enterprise and inter-firm relations may assume peculiar characteristics and raise a series of questions which, as shown in table n.1, represent different possibilities in terms of possible research hypotheses.

As a consequence of all this, the characteristics of mixed enterprises can be briefly defined as follows:

1) the mixed enterprise is an integral part of the social and economic "system" of the community;
2) it can play the role of a coordination mechanism in order to overcome the inefficiencies of the sector and ensure the efficiency of the answers provided, making relations more fluid and improving the processes of exchange;
3) it can act as a mechanism of managerial experimentation;
4) it is characterised by a strategic alliance meant to reduce uncertainty and facilitate the access to resources;
5) it is characterised by a strategic alliance that allows partners to pursue new organizational models and new managerial strategies;
6) it is an organization with governance and control mechanisms defined on the basis of:
    - Statutory agreements (level of participation, nomination of Board' members and directors, etc…)

[3] For further details, see M. G. Bédard, M. N. Tereraho, L. Bernier L, "La configuration stratégique de l'entreprise mixte: pour la distinction public vs privé au plan organisationnel", *Annals of Public and Cooperative Economics*, vol. 69, n. 1, 1998

- Organizational processes (reporting, planning and controlling process, quality certification, social balance, analysis of stakeholders' satisfaction, etc…)
- Strategic management of human resources (mechanisms of recruiting, training, informing, rewarding; balance of competences etc…)
- Informal mechanisms (social control);

7) it provides citizen – consumers with a warrant mechanism.

2. A definition of the partnership concept

The recognition of the important role of non-profit actors in the creation of public personal services is leading to the legitimation of their public function.

However, their development has gone through different stages which have been associated to the different forms used to structure the relations between Public Administrations and the non profit sector.

We shall analyse these forms, in order to understand their evolution and, above all, in order to explore new types of organization that could be adopted in the production of personal services.

2.1 Overview of the various relational formats in international literature

There are several kinds of classification of public-private relations.

R.M. Kramer analyses the different relational forms on the bases of their underlying strategies He identifies five main typologies of relationships, which move from "nationalization", "government dominance" and "pragmatic partnership", to "empowerment" and "reprivatization"[4]. The distinctive features of these categories of collaboration are determined by the different degrees of **power** and **decisional autonomy** typical of each part. As such, they range from relations where the government maintains strategic and operational control over the production of services, (as with "nationalization"), to the antithetical phenomenon of "reprivatization", where market-oriented logics prevails.

By focussing, in particular, on the production of public personal services, B. Gidrom, R.M. Kramer and L.M. Salamon (1992) formulate a similar distinction and identify four relational models[5].

The first one, "government dominant", sees the State as a main financer and service producer; in the model "third sector dominant", on the contrary, the main responsible for such functions is the Third sector. The "median ways"

[4] R. M. Kramer, "Voluntary Agencies in the Welfare State", University of California Press, 1981

[5] B. Gidron, R. M. Kramer, L. M. Salamon, "Goverment and Third Sector in comparative perspective: allies or adversaries?", in: Gidron B., Kramer R. M., Salamon L. M (Eds), *Government and the Third Sector: Emerging relationships in welfare states*, Jossey-Bass, 1992

are represented by the "dual" model, where public and non profit actors operate independently from each other, interacting as little as possible and by the "collaborative" model, where the interaction between the two sectors is at its highest. In this model, the emphasis is on the role the Third sector plays in the production of services, and on their public financing.

According to the degree of discretional power held by the non profit part, we can further distinguish, within the collaborative forms, that of "vendor variant", where the non profit part operates as a governmental agent, and that of "partnership variant", where the non profit organisation enjoys significant discretionary powers in the formulation of public programs.

In order to classify public-non-profit relations, D.R.Young, in his turn, adopts what we could call a "layer approach", and anticipates a development of the collaboration[6]. Initially, this means that non-profit players operate independently, partaking in a sort of ancillary relationship with the government. During the following stage, the two actors establish partnerships where they work complementarily. The process ends with alternative options: either "adverse" or "mutual accountability" relations.

Clearly, different modes can be used to classify the existing relations between governments and non profit sectors. However, those described above seem to be particularly coherent with the theoretical model that we are going to define in this article. Indeed, what these "collaboration typologies" have in common is, on the one hand, the fact that the different level of **balance** of both parts' discretional power is considered a discriminating parameter. On the other hand, the **dynamism** which underlies the logics according to which it is possible to move progressively from one form to another, seems to confirm empirical evidence. A third differentiating factor is a neat separation between the generic concept of "relation", and that of "partnership", a notion here understood more as a complex collaborative expression which implies a **greater involvement** of the participants.

J.M. Brinkerhoff, for instance, distinguishes partnerships form other types of relations.

Indeed, partnerships would be characterized simultaneously by the preservation of the participants' organizational identity and by a high level of mutuality between them, in terms of both accountability and the sharing of resources, decisional processes and responsibilities[7].

Beginning with the dimensions of analysis discussed above, it is now possible to make them converge into the broader concepts of co-governance and co-production of public personal services, in order to propose a new classification of collaborative forms.

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6 D. R. Young, "Alternative models of government-nonprofit relations: theoretical and international perspectives", *Nonprofit and Voluntary Sector Quarterly*, vol. 29, n. 1, 2000

7 J. M. Brinkerhoff, *Government-nonprofit partnership: a defining framework*, Public Administration and Development, 22 (1) 2002

Both notions of co-governance and co-production actually call to mind this idea of partnership, in terms of sharing of resources and decisional power, and, at different levels, the variables of the involvement and the discretionary influence of the collaborating parts.

Thus, by adopting the concepts of co-production and co-governance as new dimensions of analysis, it is possible to elaborate, through a dynamic and progressive approach, the path towards a real form of partnership.

2.2. The concept of "co-governance": from a systemic perspective to a partnership one

The diffusion of the New Public Management paradigm[8], in Europe, has introduced a series of market-based mechanisms in the management of local public services, which, while not representing a clear sign towards the construction of authentic partnerships[9], has however managed to delineate a series of contractual instruments that could govern relations between local governments and their non profit partners.

This model, however, has been criticised on the basis of the fact that its collaborative approach allows governments to maintain the control over the "policy making process", relegating the Third Sector to the role of a mere "service agent"[10].

Yet, even within these limits, we must acknowledge that this paradigm has stimulated the debate (which would later develop considerably), concerning the concept of "public governance".

Here the concept of *governance* is to be understood as opposed to the concept of *government*, which is identified as a form of direct and incisive top-down action over the forces of the system and which appears to be based on a rigid exercise of formal power.

Thanks to the concept of governance, the emphasis moves to the government's ability to deal with the needs of the community, through an adequate governance of the system and the economic parts involved, focussing on the importance of public-non profit forms of cooperation.

Thus, further value is given to the concepts of *pluralistic governance* and (particularly inter-sector) *partnership*: "this paradigm pushes for a lean, efficient government whose main role is to support private and voluntary action with a minimum of regulation and interference. Thus the dominant, controlling State gives way to the facilitator, partner State.[11]"

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8 C. Hood, "A Public Management for all seasons?", *Public Administration*, vol. 69, n. 1, 1991

9 M. Mackintosh, "Economic cultures and implicit contracts in social care", *Journal of Social Policy*, vol. 29, n. 1, 2000

10 R. Gutch, "Partners or Agents?", NCVO, 1990

11 J. M. Brinkerhoff, D. W. Brinkerhoff, „Government-Nonprofit relations in comparative perspective: evolution, themes and new directions", *Public Administration and development*, n. 22, 2002

The participative dimension of the concept of governance is also strong in the Anglo-Saxon meaning of "community governance"[12], which gives emphasis to the role the non profit sector should play dueing the phase of "policy formulation and service management".

Suggesting, once again, that "governance" should indicate the use of *organized forms* of public-private interaction, at different levels, J.Kooiman identifies cooperation and collaboration as the basic mechanisms of exchange amongst the players involved in the implementation of public policies[13]. More precisely, he introduces the meaning of "co-governance", emphasizing the aspect of "comparticipation". Among the various forms that could be suitable to exercise this "comparticipation", he distinguishes the "public-private partnerships", a notion on which we are going to focus for a moment.

The fundamental characteristics of these partnerships he identifies are: trust and reciprocal adaptation; the pursuit of common goals; the clear definition of inputs, risks and compensation mechanisms, together with the sharing of authority and responsibilities.

All this is intended as a dynamic process on the basis of which we can define the possible balance in terms of power structures and determination of rules. Moreover, we should bear in mind that both parts have the possibility to determine conditions and possible changes within the relation. It appears clear that whereas at the beginning the more generic notion of governance is understood at a systemic level, it progressively identifies a more restricted level, a level which could be defined, strictly speaking, in terms of partnership. From this perspective, the interactions and the symmetry of decisional power, among the actors who interact in the governance process at the level of the system, can be similarly traced by the mechanisms used to define the roles and relative influences within the partnerships' field.

The conceptual variant of "co-governance", defined by W. Kickert and J. Koppenjan as a "negotiating governance" according to which the negotiating procedures that link the parts involved are emphasised[14], appears likewise interesting. In this sense, the idea of co-governance is very close to that of corporate governance, understood here in its "broad perspective". Indeed, in this sense "governance" comprises, on the one side, the "institutional order" on the basis of which the organisation is governed; and, on the other, those mechanisms and conditions that regulate the relationship among various actors, in order to realize the company's goals. The players considered in this perspective are not only managers and shareholders, but also the stakeholders. Consequently, this con-

12 M. Clarke, J. Stewart, *Community governance, Community leadership and the New Labour Government*, YPS, 1998

13 J. Kooiman, "Governing as Governance", Sage, 2003

14 W. Kickert, J. Koppenjan, "Public management and network management: an overview", in: Kickert, W., Klijn, E., Koppenjan, J. (Eds), *Managing Complex Networks-Strategies for the Public Sector*, Sage, 1997

notation seems extremely appropriate to the analysis of the relations between actors such as public and non-profit ones, whose institutional aims involve different typologies of stakeholders[15]. Thus if, in a way corporate governance means public governance, so that "the same underlying principles you find in corporate governance also apply in their standards for good public governance", it becomes possible to claim that the concepts of co-governance and corporate governance are mutually dependent.

In fact, the underlying principles of both concepts are indeed those of transparency, participation and accountability.

The analysis of the functionality of co-governance in a specific partnership, at both systemic and corporate levels, will also imply the examination of the tools used to balance a series of elements. In particular, we are referring to the roles assigned to each stakeholder and his/her relative importance; the amount of resources provided by each one; the extent to which culture, norms and controls are shared; the mechanisms of reward and compensation. All this considered, it is now possible to give a succinct definition of co-governance, in particular within the context of personal services. In order to determine "co-governance", we shall therefore adopt "the involvement and participation of the collaborating parts in the governance of the accord; the balance of decisional power in the phases of planning, other than delivery, of services; as well as the sharing of the mechanisms of reward and control". This is the same meaning that will be used as future dimension of analysis, for a new classification of public-private collaborative forms.

2.3. The concept of "co-production": from "citizen participation" to public-non profit joint production

The idea of co-production appears in the 1970s in response to the growing financial crisis of the public institutions in charge of social services, in an attempt to find possible solutions to this problem.

There are several perspectives from which we can analyse this phenomenon, ranging from the economic to the social and organizational ones.

According to the economic approach, L.L. Kiser and S.L. Percy consider the overlapping between "consumption" and "production" as the very origin of the concept, stating that "co-production involves a mixing of the productive efforts of regular and consumer producer", so that "consumers can increase the amount and/or quality of the service they consume by directly contributing to their production"[16].

[15] F. Manfredi, *Le strategie collaborative delle aziende non profit. Economicità, etica, conoscenza*, EGEA, 2003

[16] L. L. Kiser, S. L. Percy, "The concept of coproduction and its implications for public service delivery", *Annual Meeting of the American Society for Public Administration*, 1980

Similarly, J. Brudney and R. England define co-production as a "direct citizen involvement in the design and delivery of services with professional and service agents (…)", in the attempt to produce **more services at less cost**[17].

G. Whitaker[18] and E.B. Sharp[19] keep the meaning of participation of citizen-consumers in the production of services, mainly in the phase of "execution". According to them, the interaction between those who benefit directly from the service and the authority that officially delivers it, should be able to **improve its efficacy**. The service is therefore understood as a **"joint product**" of the activities of the State and the citizens[20] and, as it is emphasized, citizens have the possibility to influence the formulation and the implementation of those public policies of which they are the beneficiaries.

By referring also to the advantages in terms of cost reduction, C.H. Levin highlights the social aspect of co-production, presenting it as a **mechanism which could generate social capital,** therefore reinforcing the relationship between citizens and Public Administration[21].

Although different aspects of the phenomenon are emphasised, it is clear that the general meaning of the concept is basically the direct involvement of citizen-consumers in the production of services.

Nevertheless, while initially literature was characterized by a political or sociological tone, recently the debate about co-production has found new directions of analysis.

While fundamentally maintaining the "consumer-co-producer" idea, the attention has been shifted to the organizational, as well as inter-organizational, logics lying behind this concept.

In more recent works we can find definitions that seem to be more appropriate to seize the heterogeneity of a phenomenon that is actually witnessing a proliferation of collaborative forms in the production of services, also thanks to the involvement not only citizens but also of different parts,.

E. Ostrom, for instance, defined co-production as "the process through which inputs used to provide a good or service are contributed by individuals who are not in the same organization"[22]. This definition was criticized because it

17 J. Brudney, R. England, "Toward a definition of the Co-production concept", *Public Administration Review*, vol. 43, 1983

18 G. Whitaker, "Coproduction: Citizen participation in Service Delivery", *Public Administration Review*, vol. 40, n. 3, 1980

19 E. B. Sharp, "Toward a new understanding of Urban Services and Citizen Participation: the Coproduction concept", *Midwest Review of Public Administration*, vol. 14, 1980

20 E. B. Sharp, "Toward a new understanding of Urban Services and Citizen Participation: the Coproduction concept", *Midwest Review of Public Administration*, vol. 14, 1980

21 C. H. Levine, "Citizenship and Service delivery – the Promise of Co-production", *Public Administration Review*, vol. 44, 1984

22 E. Ostrom, *Crossing the Great Divide: Co-production, Synergy and Development*, vol. 24, n. 6, 1996

was considered too generic, and because it depicts inter-organizational cooperation as an exception rather than the common practice it actually is[23]. In spite of the fact that Ostrom himself actually would consider citizens or groups of these as co-producers, this basic notion could be useful to encapsulate the distinctive elements of new public-non profit collaborative forms adequately.

The idea of **collective action** and **joint contribution of input** to the production, on the part of **distinct organizations**, appears fairly close to the concept of partnership was discussed before.

A still broader characterization of co-production is provided by T.L.Cooper and P.C. Kathi, who identify it as a "deliberative democracy, where there is an emphasis on eliciting broad public participation in a process"[24]. In this sense, the **participation** of **different kinds** of parties is highlighted as a key aspect, and through the concept of deliberative democracy, the creation of a context of institutional practices that promotes collaborative plans is encouraged.

The organizational perspective is further emphasized by the concept of "instituzionalized coproduction" elaborated on by J. Johsi and M. Moore and defined as a "provision of public services through regular, long-term relationships between state agencies and organized group of citizens, where both make substantial resource contribution"[25].

It is clear, then, that the tendency is towards **long-term collaboration** with **significant resource contributions** from participants.

Apparently, the *leit motiv* of the literature on co-production is the fact that the latter is perceived as a process able to improve both effectiveness and efficiency of the service delivery, while creating more opportunities for citizens to take part in the "public action" in a democratic way. International research on several cases, in different areas of production involved in the public and social services, confirms the positive effects of co-production, as discussed above[26]. Nonetheless, the concept of co-production seems somehow incomplete. Indeed, although the positive effects of this phenomenon which were previously pointed out, have been by now accepted, it has not been demonstrated that these effects are to be exclusively related to the fact that the co-producers coincide with the citizens who are also the direct consumers of the services. In other words, the more generic definitions of co-production, that emphasizes the importance of common contributions and collaborative long-term relations seem better suited

[23] A. Johsi, M. Moore, "Institutionalized Co-production: unorthodox Public Service Delivery in Challenging Environments", *The Journal of development studies*, vol. 40, n. 4, 2004

[24] T. L. Cooper, P. C. Kathi, "Neighborhood Councils and City Agencies: a model of collaborative coproduction", *National Civic Review*, Spring 2005

[25] A. Johsi, M. Moore, "Institutionalized Co-production: unorthodox Public Service Delivery in Challenging Environments", *The Journal of development studies*, vol. 40, n. 4, 2004

[26] V. Pestoff, *Co-production and Personal Services in Eight European Countries*, Ljubljana EGPA Conference , Third Sector Group, 2004

to account for the factors determining the potential of improvement of the service themselves.

What determines the development of the supply of services seems actually to be the **sharing of goals and resources**. And this "sharing" can exist between government and citizens, but not in an exclusive relationship. Without doubt, the literature mentions that there exist more complex organizational forms, collective or group-based, participating in the production of services[27]. However, in this case no formal mechanism of coordination is presumed, neither among citizens, nor between these and the government.

Existing literature refers to the existence of voluntary associations, cooperative forms and, more generally, social enterprises, that is, organizations acting as "vehicles" to help the relation of co-production between State and citizens. Also in this case, then, the value conferred to the Third sector is mainly instrumental and as it concerns proper entrepreneurial organizations, even though they might still be non profit, the concept of co-production must be differentiated from the notions of "parallel" and "ancillary" production[28], (which can be amalgamated to the notion of supply), or, on the contrary, to concurrent relations between the State and the Third sector[29].

Somehow, we still seem influenced by a rigid separation between public and private organizations, but the time has come to overcome these anachronistic Weberian influences. Indeed, if we talk about the involvement of social enterprises, it has not so far been conceived any relation which might assume an actual sharing of goals and resources between the government and the Third sector, something that, on the contrary, seems to happen only at an elementary level. Their participation in the production of the same services they benefit from, also raises problems that have not been thoroughly investigated so far: for instance, co-producer-citizens and other consumers of the same service (or indeed co-producer-citizens and the community in general) might have different interest. This is particularly true if we consider the potential utilitarianism and the limited rationality that characterise individuals' behaviour; and even when human conduct is inspired by solidarity and altruism, the limits of the "hedonistic egoism" that often leads human moral action has to be taken into consideration.

Thus, the single citizen that becomes co-producer, irrespective of the fact that s/he could be inspired by "self interest", "altruism or other social values"[30],

27 J. Brudney, R. England, "Toward a definition of the Co-production concept", *Public Administration Review*, vol. 43, 1983

28 V. Pestoff, *Co-production and Personal Services in Eight European Countries*, Ljubljana EGPA Conference, Third Sector Group, 2004

29 D. R. Young, "Alternative models of government-nonprofit relations: theoretical and international perspectives", *Nonprofit and Voluntary Sector Quarterly*, vol. 29, n. 1, 2000

30 V. Pestoff, *Hurdles to the Third Sector and the Democratisation of the Welfare State*, Berna EGPA Conference , Third Sector Group, 2005

might assume a sort of "altruistic utilitarianism"[31] as the goal of his/her actions, thereby mistaking the individual good with the common good. Furthermore, there are also reservations about the professional competences and the experience that citizen-co-producers should have. Equally important is that, in the sector of public personal services, consumers alone do not have the possibility to judge the quality of the service received correctly. As a consequence, it is necessary to have a multidimensional evaluation of quality, which involves the different actors engaged in the service[32]. For these reasons, the focus should be on the definition of co-production forms capable of generating the same effects described above, but which act according to the economical orders of institutions that might go beyond the mere inclusion of citizens in the production.

Furthermore, we should consider, in terms of co-producers, those organizations that have the necessary competences and that are able to represent a broader spectrum of stakeholders. We should therefore move from a "customer oriented" perspective to a "stakeholder oriented" perspective, in the pursuit of a truly "public" interest[33]. And this representation should act through organizational and managerial structures and mechanisms, which go beyond the simple participation of parents in the activities of the nursery school attended by their child.

The managerial repercussions implied by the administration of such relations and their outcomes actually become fundamental. We are therefore faced with a new concept of "co-production", understood here as the "involvement of different organizations in the production of services, with significant contribution and concrete sharing of inputs, in a long-term collaborative perspective and with a democratic participation in the formulation and implementation of the policies and strategies related to the services".

The aim of al this is of course the pursuit of the same benefits initially outlined by the former concept, through forms which, however, are now more similar to that of partnership. The organizations considered in the present analysis are public and non profit organisations, being the latter considered fair representatives of a variety of stakeholders in the field of service delivery.

S.P.Osborne and K.McLaughlin had already assumed a similar position in relation to the concept of co-production, anticipating for the non-profit actor, rather than for citizens themselves, the role of co-producer[34]. However, according to their definition, the production is carried out in parallel or coordinated forms, so that inputs are not shared and co-transformed. The connotation given to the term of "co-

[31] Locke, 1690

[32] F. Manfredi, *Le strategie collaborative delle aziende non profit. Economicità, etica, conoscenza*, EGEA, 2003

[33] F. Manfredi, "Moderne strategie di marketing per il settore non profit", *Terzo Settore*, Il Sole 24 Ore n. 4, 2003

[34] S. P. Osborne, K. Mc Laughlin, "The cross-cutting review of the Voluntary Sector: where next for Local Government-Voluntary Sector relationships?", *Regional Studies*, vol. 38, 5, 2004

production" - actually intended by Osborne as productive coordination - is therefore different. In addition, this connotation is residual, in the sense that the perspective of coordination still conceives of the Third sector as a mere supplier of services.

To sum up, in comparison to the previous definitions, this new concept tries to keep the economic dimension (optimisation of resources, higher level of efficiency) and the social one (greater interaction among stakeholders, better understanding of customer needs, creation of social capital). What is now different, is the managerial and organizational perspective, which is now more complex and which individuates in the inter-organizational partnership the basis for an effective co-production.

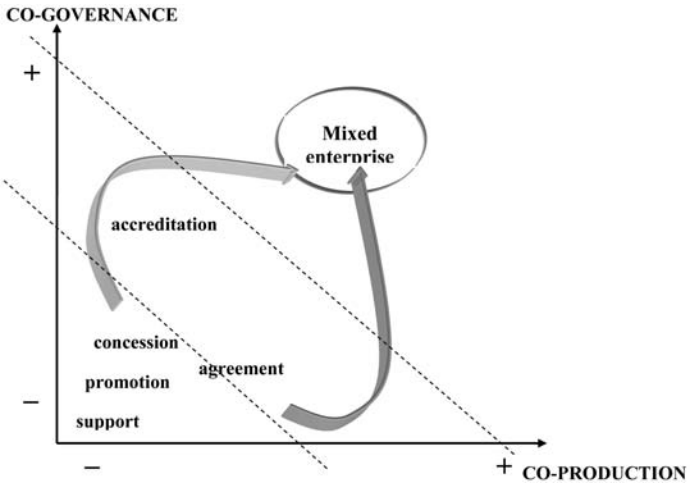
3. From coordination to partnership

As previously discussed, in comparison to what happened in the past, empirical evidence and the interests of non profit actors are progressively moving towards forms that involve the Third sector in a more effective and determinate way. In the normally used forms of "support", "promotion" and "agreement", there is no joint action and no reciprocal obligation, neither in the use of resources that could be dedicated to the activities nor in the results to be achieved. The form of "concession" is however different, since it can allow a greater sharing of resources in terms of inputs (as an example we can think of a public asset managed by non profit staff), even though the managerial function remains an exclusive task of the private part. In spite of this, the role of the Third sector in a collaborative relationship clearly remains subjugated to the preferences of the Public Administration and the available resources.

Indeed, it is the mixed enterprise that seems more easily comparable to a partnership.

Although its diffusion has been hindered by political forms of resistance and inconstant legislation actions (both at a national and a European level), this enterprise preserves some room for exploitation, as it has not been completely explored yet. Setting aside all considerations regarding legislative disputes, that would go beyond the purpose of this work, it appears interesting to analyse the innovative potential of this enterprise, in organizational and managerial terms, focussing in particular on the role that the Third sector might assume as a partner, in its relation to the government.

The use of a mixed form of enterprise might represent a significant improvement of the process of legitimating of the role of non-profit sectors, from mere suppliers to "partners" of the Public Administration. And this seems particularly true in the field of the management of personal services. If we want to outline a classification of the different relational forms adopted, by referring back to the dimensions of co-governance and co-production, it is clear that the mixed enterprise seems to be the form that leans more than others towards these concepts.



Graph 1.

In actual fact, the paradigms inspiring both co-governance and co-production appear evident in this form. This can be easily demonstrated by comparing the contents, in the different relational forms, characteristic of these concepts. For the sake of simplicity, we shall compare only those forms that have already been mentioned, as these are normally adopted when contracting-out.

It is clear that, only the mixed enterprise presents features that can be properly defined typical of a "collaborative" relationship. Indeed, if we consider the "determinants of the collaboration process"[35] of non profit organisations, it is clear that these are fully applicable in the mixed enterprise.

As underlined just above, the collaboration may be conceived as a progressive process, where the various phases in which the same parts were previously related in other forms (such as "coordination" or "cooperation") converge. In the first case, the relationship is characterized by "informal interaction and the attempt to create reciprocity without explicit roles"[36]. Relational forms as "support" and "promotion" should belong to this category. Similarly, "concession", should also belong here, at least partially, even though in the governance and the management of the service the non-profit actor is not granted any valuable role but rather maintains an instrumental position. "Cooperation", in a similar way to the procedures of "accreditation" and "agreement", is on the contrary characterized by a greater formalization of the relational spheres. Indeed, with "collaboration", the parts explicitly want to determine formal relations, with clearly defined roles (or roles which can be defined *in itinere* under common agreement), and the transparent features of the participants.

[35] F. Manfredi, *Le strategie collaborative delle aziende non profit. Economicità, etica, conoscenza*, EGEA, 2003

[36] F. Manfredi, ibid.

Table 2.

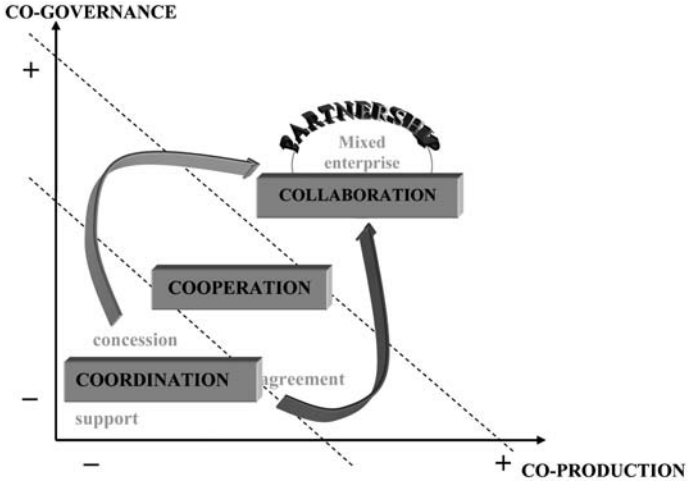
CO-GOVERNANCE	**Participation of the parts in the governance of the relationship**	**Balance of decisional power in the planning phase**	**Sharing of control mechanisms**
Support	Absent: public financial support	Absent: the NPO does not undertake any obligation	Absent: no negotiated target to achieve
Promotion	Low: procedural agreement	Very low: duties assumed by NPO are limited to the entity of promotional benefits	Absent: discretional control of PA
Agreement	Moderate: contract in relation to the economic-financial content of the relationship	Moderate: exercise of public functions on the part of the NPO	Very low: right of "exit" for the NPO
Concession	Very low: unilateral action of PA	Very low: clear supremacy of PA	Absent: PA's exclusive control and right to revoke. These are effective at anytime and without restrictions
Accreditation	Very low: limits determined by the contract	Moderate: participation in the formulation of general plans	Moderate: PA's ex-ante control
Mixed enterprise	Significant: formal contract, expression of the negotiating and organizational autonomy of the parts	Significant: direct participation in the governance' process	Significant: rights of "voice" and "exit" for both partners

Table 3.

CO-PRODUCTION	**Significant contribution and sharing of inputs**	**Democratic participation in the implementation of the policies of service delivery**	**Long term perspective**
Support	Absent: mere transfer of subsides from PA	Absent: no integration of activities	Absent: PA's *una tantum* action
Promotion	Absent: PA's dispensation of benefits	Very low: PA only promotes initiatives related to the social purposes of the NPO	Absent: short-term agreement
Agreement	Very low: potential sharing of assets and resources distinctively owned by PA	Moderate: agreement on the process of service delivery and the conditions of accessibility	Very low: short-term contract
Concession	Absent: the NPO operates with its own means and withholds every related income	Very low: NPO manages the service Autonomously	Very low: no guarantee of continuity is offered to the NPO
Accreditation	Very low: PA subsidizes or finances those services that are delivered by the NPO with its own means	Very low: NPO delivers the service autonomously	Very low: no formal obligation on PA's part and precarious conditions for the NPO
Mixed Enterprise	Significant: contribution of capital and specific resources	Significant: representation of both parties in the Board and in other executive bodies	Significant: intrinsic to this enterprise

Table 4.

DETERMINANTS OF THE COLLABORATION PROCESS	SCOPE OF APPLICATION IN THE MIXED ENTERPRISE
Participated re-composition of differences	Effectiveness of the respective functions and adequate representation in the company's bodies
Creation of reciprocal connections	Fair investment in the relationship, in terms of social and economic capital
Level of interdependence	The creation of a new juridical entity allows the concrete pursuit of joint goals, while maintaining the independence of the participating parts
Joint decisional processes	Formal processes / tools to share information and fair involvement in the relevant decisions making process
Convergence and connection of activities	Convergence on common goals and values; panels especially created to manage connections that could facilitate common technical processes
Agreement about the future evolution of the relationship	Unanimous efforts towards long term relations
Process in progress	Tool that allows the formalization of trust relations that have already been built and consolidated



Graph 2.

Thus, it is only at a collaborative stage that it becomes possible to establish a proper partnership which, as underlined before, presupposes a level of mutuality between parts, a mutuality that only a formal relationship can actually grant[37]. And this guarantee should be ensured in a mixed enterprise.

The shift, from one form to another, is clearly a gradual and incremental process, resulting from the development, over time, of different characteristics

[37] J. M. Brinkerhoff, "Government-nonprofit partnership: a defining framework", *Public Administration and Development*, vol. 22, n. 1, 2002

of both public and non profit organizations. And this change determines and is determined by the growing of the various problems related to the environment, among which we can refer to the "vagueness about the role, the competences and the boundaries between public and private sectors"[38], that require the formulation of new strategies. These strategies have to support the process of redefining roles, tasks and respective missions, of increasing stakeholders' involvement in the processes of strategic planning, of reducing decision time, of creating consent about policies and a common agenda of actions[39]. Thus, it becomes necessary to have at our disposal more complex and structured tools than before.

This is why mixed enterprises represent the most appropriate answer.

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Expert article
Received: March 9th, 2009

UDC 005.591.45:334.012.3
ID 158253068

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INSTRUMENTS OF CORPORATE GOVERNANCE IN THE RELATIONSHIP BETWEEN PRIVATE EQUITY FUNDS & SMEs

Abstract: *The instruments of corporate governance in the relationships between private equity (PE) funds and small and medium sized enterprises (SMEs) are studied in this article. Special attention is given to the PE fund's need for corporate governance tools and the issue of balancing the opposing (though not necessarily conflicting) interests of the company's existing shareholders. The "diverging factors" and the peculiar features of the governance issues in PE transactions are particularly analyzed. Then, the most common special rights granted to PE funds are explained.*

Key words: *corporate governance, private equity funds, SME*
JEL classification: G32, G34

1. Introduction and scope

The expression *corporate governance* covers the classic area of company law that refers to the "governing structures" of a company, namely the schemes according to which the decision-making and management powers are assigned and allocated within the corporate organisation, pursuant to (default) legal criteria (the so-called *equity split* and/or the coexistence of administrative rights allocated outside the share capital) and/or specific agreements which may be entered into by a company's shareholders.

Therefore, translating these principles within the context of private equity transactions involves the review of the instruments and mechanisms through which a PE fund is typically involved in the management of the SME recipient of the funding, with functions of monitoring along with an active role (to a greater or lesser degree) in the decision-making and management processes of the SME; and, prior to that, the question why the PE fund seeks and obtains rights of active intervention (*lato sensu*) in the management of the financed company.

Indeed, a preliminary observation from which it is appropriate to begin is that, when an "investment" transaction in private equity is set up, specific problems of corporate governance arise which (*A*) on the one hand, distance the transaction itself markedly from the typical contractual features and issues of a conventional financing transaction; (*B*) on the other hand, have certain peculiarities (and thus give rise to legal and drafting technique issues) which distinguish the contractual aspects of governance of a private equity transaction from the typical issues arising in an ordinary context of company law.

2. The PE fund's need for corporate governance tools and the issue of balancing the opposing (though not necessarily conflicting) interests of the company's existing shareholders)

As to the profile *sub* (*A*), in an ordinary financing transaction, the problem of corporate governance, in the strict sense, does not even arise. And yet, except for certain extreme cases of particularly complex and structured financial transactions, never (or almost never and, if so, only marginally) does the investor aspire to obtain (nor perhaps does it have the contractual power to obtain) rights to take part in (to share) the management of the financed company.

In the case of private equity, instead, a characteristic of the transaction is that, while it is certainly attributable to the *genus* of "corporate financing" instruments, nevertheless it differs from the traditional forms insofar as it arises in equity and not in debt, consisting of a contribution to the share capital of the company and not to its liabilities.

Actually, the PE fund underwrites company's shares against the payment of the "new financial resources" contributed, which, thus, involves the "participation *(in the legal and not just in the economic sense)* in the business risk". In fact, it bears not only the economic risk of insolvency of the debtor, but also assumes the legal risk, as it is not vested with a subjective right to repayment of the capital paid out, nor a subjective right to remuneration on the investment, placing instead its expectations of economic return in the transaction on the prospects of a capital gain on the risk capital contributed.

The bearing of the "business risk" (in a legal sense) by the PE fund, which is unusual in traditional types of financing, therefore involves its request to be vested with the right to take part in the corporate governance of the company.

3. The "diverging factors"

As to the profile *sub* (*B*), the granting of corporate governance powers and their corporate regulation gives rise to peculiar issues in comparison to the traditional corporate governance perspective, and to complex and extremely detailed negotiation and drafting techniques.

In practice the process of negotiating the admission of the PE fund to the share capital of the "portfolio company" leads to shareholding patterns and to corporate governance structures which are directly influenced by the following three diverging factors: (*i*) the fact that the PE fund asks to be vested with governance powers that exceed those to which it would be entitled pursuant to the legal criteria which determine the allocation of the corporate rights among the shareholders (thus asking powers *more than proportional* to what it would be entitled to as a result of underwriting a certain portion of share capital); (*ii*) the need to balance the request for governance powers made by the PE fund and the natural vocation of the majority shareholder (or group) to deprive itself of the smallest possible amount of governance powers and to grant to the PE fund only what is strictly necessary and unavoidable in order to have access to the financing; (*iii*) the fact that the company that should receive the funds (the "portfolio company") has a complex shareholding pattern, as it is the case, for instance, when some shareholders who are not interested (or are "no longer" interested) in being involved in the "active" management, but who hold however a significant amount of share capital [as typically happens in the SMEs where there has been a first- or second-level generation change] and where it is essential to seek a contractual solutions which meet their (more specific) financial expectations as well.

Nevertheless, reaching a compromise between these opposing interests is made easier by the specific features of the private equity financial transaction. And, specifically: (*a*) by the peculiar economic/financial reasons underlining the transaction which leads the PE fund to ask for an active role in the governance and /or in the management of the target company; (*b*) by the peculiar features of the equity investment; (*c*) as well as by the reasons of economic and financial convenience which made this kind of financing appealing under the majority shareholder (or group) perspective.

Sub (*a*), **the PE fund** asks to be vested with rights of governance for two reasons that are closely connected to the (albeit *financial*) peculiar features of the transaction. The first reason is that it accepts to bear a business risk (in a legal sense) that is totally different to all kinds of ordinary investment, even where junior or mezzanine: as already observed, the "new financial resources" are made available to the financed company without a corresponding "right to repayment" and to a clear remuneration; and in the event of bankruptcy of the financed company, the repayment of the capital invested is subordinated to the repayment of all corporate debts (either junior, senior or mezzanine). The second reason is that

the remuneration for the transaction lies on the expectation of high capital gain, which however presupposes that there is a significant increase in the value of the portfolio company during the agreed time period; which, in turn, presupposes that the company has been managed in accordance with a logic of continuity with the previous management, with high qualitative standards, and according with a pre-negotiated business plan (at least in its basic strategic lines).

Sub (*b*), **the investment in equity**, insofar as it is motivated by purposes of *financial* (and not industrial) nature, is therefore *temporary* and not permanent or for an indefinite period of time: the time period varies between three and seven years, with a typical average duration of five years and usually turns into a *minority shareholding* (save for certain possible cases of start-up financing).

Sub (*c*), **the majority shareholder (or group),** in turn, is ready to grant the PE fund special rights of governance insofar as the portions of sovereignty transferred are limited and temporary; insofar as the transaction allows it to have access to "new financial resources" without impacting the profit and loss account of the financed company and without reducing (indeed, increasing) the extent to which it is possible to make use of traditional indebtedness, thanks to the increase in its own net equity and to the consequent rise in possible financial "leverage"; and insofar as it can obtain further advantages from the PE fund participation in governance in terms (*inter alia*) of visibility and improved perception from external parties (first of all the borrowed capital providers) and of contribution in terms of management and financial know-how, which is useful to improve management quality.

Indeed, given these characteristics, the PE fund has no interest in asking to take over control of the financed company (and therefore the request to participate in governance does not arise in invasive or aggressive forms that are such as to be unacceptable to the current corporate organisation). Instead it is interested in obtaining instruments to "monitor" the management and of "participation" (*lato sensu*) in the management itself; and therefore special rights to information and monitoring; rights (or powers) of veto in relation to the decisions of the BoD and/or the shareholders' meeting; obtaining one or two positions (but as a minority) in one or more of the corporate (governing and/or control) bodies. And it asks for these powers just for the time that is strictly necessary for carrying out and completing the transaction (based on the so-called way-out timing and instruments already pre-arranged according to precise and specific exit strategies), with the consequent return of full "sovereignty" to the corporate organisation (even here according to strategies strictly connected to the objectives pursued by the transaction itself and therefore differentiated according to whether the purpose is to develop the business, but preserving the pre-existing ownership structures; replacement the capital; opening to the market, perhaps by going public).

4. The peculiar features of the governance issues in a PE transactions

The grant and regulation of such rights presents peculiar and specific aspects, compared with the typical problems of governance for an ordinary corporate organisation, which require the use of particularly complex and sophisticated techniques of negotiation and drafting (of the several agreements between the PE fund and the portfolio company).

Crucial factors which are "traditional" and common to every project for conventional regulation of governance structures that do not correspond to those generally arising from the application of legal criteria (the so-called *equity split*) are: (*i*) choices in relation to the allocation of individual provisions in the by-laws or the shareholders' agreement, depending upon complex evaluations concerning the validity or non-validity of certain clauses in the by-laws; the different strength and effectiveness of the individual provisions in the by-laws with respect to those in the shareholders' agreement; the (potential) greater flexibility of the clauses in the shareholders' agreement with respect to those in the by-laws; and (*ii*) choices of the most suitable type of company, having specific regard particular to the fact that in some types of companies there might be legal mandatory time limits for the shareholders' agreement and less flexibility in the drafting of the by-laws, yet greater organisational complexity, better suited to more structured financial operations.

Further *crucial factors are "specific"* and therefore common in drafting conventional regulations within PE transactions.

First of all, it should be pointed out that the rights of governance granted to the PE fund are, by their own nature, "ancillary" rights, destined to be modified or to expire at a certain deadline and/or upon the occurrence of certain agreed events (e.g. "time vested" or "performance vested" rights). So that the fact that the contractual regulation is merely embodied into shareholders' agreements does not give rise to any peculiar aspects that, on the other hand, it is likely to arise when special governance rights are given in the "by-laws".

Moreover, the negotiation of special rights of governance is complicated very often by the presumably complex and disparate ownership structure of the portfolio company.

Both the previous considerations are even more complex when the aim of the transaction and the exit strategies pursued by the PE fund involve the development of the financed company towards ownership structures that are significantly (if not sharply) different to those existing at the time when the transaction is initially undertaken (replacement capital, bridge financing, buy-out or buy-in transactions).

5. The most common special rights granted to PE funds

The PE is primarily interested in receiving information about the management of the financed company which has to meet certain requirement in terms of *quality, content* and *time*. So that it would typically asks for periodical reports with pre-arranged drafting criteria, information content schemes and time schedules, along with the right to ask for further specific information relating to the kind of business or financial transactions (or, sometimes, referring to the management activity in more general terms).

Obviously this information will have a (general) monitoring purpose, together with the specific aim of reporting possible events of default, or failure to comply with the agreed contractual requirement of the portfolio company; and/or by so strengthening veto rights, if contractually agreed.

Besides, the PE is interested in being able to appoint one or more members of the board of directors and/or one or more statutory auditors, since the participation in the board of directors and/or the role of statutory auditor shall naturally fulfil the monitoring purpose; shall have an instrumental function for the exercise of any rights (or powers) of veto; and moreover shall have a (general) purpose of participation in the management of the portfolio company, insofar as it is related to the extent of the delegated powers, by the number of seats reserved to the PE fund and by the structuring of the *quorum*.

In the concrete contractual provisions, such right may be variously expressed, according to several variables (mainly including, *inter alia*): (*i*) the percentage of share capital held by the PE fund; (*ii*) the extent of the delegated powers and the frequency of the BoD meetings (in other words, the effective level of collective involvement of the body as a whole in the management decisions); (*iii*) whether or not it is requested a specific increased *quorums* for the approval of certain decisions of peculiar business relevance.

As to *sub* (*i*), as already stated above, the PE fund usually holds a "minority" interest (1/3, 2/5, etc.) and just in some special cases (i.e. start-up transactions) it owns the majority of the share capital or the majority for a certain limited period of time and/or until certain conditions are met). Likewise, in some circumstances it could be suitable that each part of the transaction is entitled to appoint a director and the third member of the board is identified by common agreement; or, in the event of failure to reach an agreement, it could be designated by an independent third party, previously identified according to the terms of the shareholders agreement. Further cases of joint composition of the BoD are those of a chairman of the BoD who has a casting vote and whose appointment has been granted by prior agreement to one of the parties). In more complex situations, the special rights may be structured as an initial minority interest which is destined to turn into a majority upon the fulfilment of certain conditions (normally, on the failure to reach specific performance targets or upon the occurrence of certain events of default).

As far as profile *sub* (*ii*) is concerned, it should be outlined how those arrangements can both be the object of appropriate regulations, whether through the shareholders' agreement or through the by-laws.

Furthermore, the PE fund is interested in being vested with a right of veto in relation to certain transactions, and primarily in those which may have a relevant impact on the financial investment of the PE fund or, in more general terms, on the economic perspective of the portfolio company. Those transactions are usually identified by type and size and their choice presupposes a complex negotiation, insofar as the ownership pattern of the company is complex and thus includes shareholders who are directly involved in the management of the company, as well as shareholders who remain extraneous to the active management and are instead more interested in the economic perspective of their investment.

As stated for the previous special rights, the veto right can be granted alternatively by contractual provisions or directly embodied in the by-laws, provided that it is necessary to find a governance mechanism which is able to distribute the financial advantages among the different "classes" of shareholders.

Book review
Received: February 24th, 2009

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BUSINESS – ART DE VIVRE

An essay on the book: "Business – Art de vivre",
by Professor Mića Jovanović, PhD,
Megatrend University, Belgrade, 2008

As it is an undeniable fact that I have read an enormous number of books from various fields in my lifetime, so it is an equally indisputable fact that none, especially none that I have recently read, have absorbed me in all possible ways as the recently published *Business – Art de Vivre*.

The book was written by Prof. Mića Jovanović, full professor and rector of Megatrend University in Belgrade, a well-known professor of management both in Serbia and abroad. What Professor Jovanović brings to readers by way of his book is his enormous, quite diverse and, certainly, current knowledge from the fields of his expertise, which all have to do with business and its development in both Serbia and the world, as well as with the general globalization of business. Professor Jovanović presents to the reader an analysis and proper proposals for resolving the most complex issues related to business, as well as to its development and further progress. What is characteristic for this author and is, at the same time, his unique virtue, is the way in which he presents the most complex business and management-related issues to the reader in the most understandable way, with the added ability of not only intriguing the reader but of drawing him into the "game", by making him think about how he himself would act in a given situation.

We will provide only one example, in which the author, at the beginning of his professional career of world-renowned university professor, developed the topic in a very simple way, with the goal of highlighting the significance of human resources in the development of business, i.e. of management: "Recruiting the right people for a company is one of the most complex tasks in business".

Employers and managers have the not-so-easy task of discovering people who will not only work but also 'carry' responsible tasks.

One should ad here to the following principles: First, seek work-oriented people. In other words, avoid people who are lazy or indolent. Second, choose only

creative people. The notion that creative people are needed only in top management, while creativity is not of decisive importance in the executive portion of an organization, is obsolete. In modern business, executives must often be creative themselves. Third, education is one of the decisive principles. There is no place in an organization that aspires to success for 'self-styled' 'know-it-alls.'"

Even at that early time, the author showed that he possesses intuitive built-in potentials for properly recognizing the significance of human potentials necessary for business development. This had been confirmed by the observation made by one of the greatest and globally most recognized scholars, Prof. Park Sung Yo. At an international scholarly conference held in Vajoh in 2005, on the topic of Strengthening the Competitiveness of Companies and Economies he said that Megatrend University has all the prerequisites that allowed South Korea to become a top-notch IT economy, which is now helping North Korea in following the same path. Those are:

1) A highly educated, motivated work force that speaks multiple languages,
2) Stability of the social system as a fertile soil for long-term projects,
3) The option of a knowledge-based economy concentrated on software (not hardware), i.e. software processing, one based on commissions, which does not require large-scale investments or the use of expensive physical inputs,
4) Establishing the position of the limitless potential of the Serbian work force,
5) The appointmnent of Serbs abroad who possess high technology potentials.

And, last but not least! Megatrend has demonstrated strong leadership in the areas of innovation and risky undertakings.

Also important to emphasize is that, in his work, the author never separates three items: business, management and human resources.

We must present only one of many such examples from the book:

"In speaking about management, one is also speaking about leadership, i.e. management. When these two topics are mentioned, business is what inevitably comes to mind. Thus, successful business leadership lies at the base of all management. It is important to emphasize here that management should not be identified with leadership, as management is before all oriented toward organization, i.e. toward the company's inanimate resources (technology, energy, space…), while leadership is almost exclusively tied to the only living computer resource, to man. In the third phase, all levels are mobilized in order to forcefully move the company forward. At that stage it is necessary to once again determine the roles and joint goals, and then motivate people in that direction."

In 1993, such an approach gave birth to the concept of business longevity, which the author merely implied at the time, but which gained momentum through another concept subsequently developed by Professor Park: Lifestyle

Industry, by which the production of goods, services, ideas and visions contribute to a tight interconnection between *business and quality of life*.

The cogent explanations of even the most complex business and management-related issues, accompanied by adequate proposals for improvement are of special value to readers, especially younger readers and students. I myself often felt "compelled" to re-read the "blue" pages in which these issues are elaborated, which I heartily recommend to all future readers, especially students, who will find it a most valuable exercise, especially when considering how these lessons could be applied in their future practice.

Another side of the book that bears attention is that which reveals the author's literary and artistic tendencies, as well as those virtues that served as the key inspiration for this book while it was still at the conception stage.

Perhaps it is best to let the author's words describe the process: "Initially, the book was conceived as a textbook that would provide students with the most current knowledge in the said field. However, the concept subsequently evolved into the idea that this should be an unusual book, that is, conditionally speaking, the author's autobiographical textbook, a sort of a textbook of life.

The author's literary and artistic tendencies influenced both the contents and the final shape of the book, while also playing a role in choosing the title for this essentially scholarly book. The author's proven competence and expertise in the areas of business and management are, to a great extent, couched in a literary form of expression and conception, which is reflected in the way the material is organized and presented. Hence the impression that the book's title – *Business as the art of living* – as the basic idea that gave birth to this book, represents an intriguing and attractive story about the relationship between man and business and the role of human resources in the development of management as the moving force behind the further development of business.

All the above-said contributed to my reading this book differently from any other up till now. I say this in the context of being able to read, using the diagonal method, volumes of books each day, from the most complex scholarly, expert and literary fields. This book, however, required many days of reading, for many of the previously mentioned reasons. Before all, from the first to the last page, the book is brimming with extremely interesting yet true events that represent testimony of both our overall past and present. At the same time, the book draws the reader into the "game," regardless of the reader's gender, age, profession or education, opening the way for the use of all of life's possibilities offered to each and every human being at birth, including undreamed-of business possibilities through which all dreams of a better and more successful life may be realized, dreams linking business and the art of living, always, however, accompanied by great work, effort and risk, dreams that can be realized both by learning from this book and by learning at Megatrend University, which in fact represents the realization of the author's own dreams.

The rest should be left to the reader, both to read and to experience, if only in dreams.

Due to all of the above, I warmly recommend Prof. Mića Jovanović's book to the broadest reading audience, especially to students of Megatrend University, as well as to students of other schools of business, but also students of other colleges, so that they, too, may share in the new knowledge and undreamed possibilities offered by business, as well as realize their dreams about a joyful and true living of the life that was given them, with the hope and belief that reading this book will bring them the same happiness and joy that it brought me.

Book review
Received: January 16th, 2009

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LEADERSHIP IN COMPANIES

An essay on the book "Leadership in Companies",
by Prof. Momčilo Milisavljević, PhD, Megatrend University, 2008

In the present-day global economy, leadership is a quite highly valued characteristic and, at the same time, seen as one of the key competitive advantages of the future. Leadership is a very important factor when a company has to change, i.e. face changes in its external environment, as well as during the actual process of change. Today's daily turbulent changes in the environment require a larger input of leadership in management. Team leadership is needed, or at least an individual leader's ability to create a strong coalition of managers that will initiate and carry out major changes. More and more research is confirming the rightness of authors who view leadership as the single most significant factor of company success in the present-day, knowledge-based economy. It is interesting to note the rapid growth in the number of published books about business leadership and leaders throughout the world. Testimony to the significance of leadership as a factor of success of any organization is not only provided by numerous books and studies but also by the fact that leadership is increasingly studied as a subject in both MBA and graduate programs in universities throughout the world, including transition countries.

In 2008, nine years after the first edition, Megatrend University issued the second revised and supplemented edition of Prof. Momčilo Milisavljević's book, "Leadership in Companies." In the context of a lack of proper domestic literature and the growing perception of the importance of leadership, this monograph represents a valuable contribution. The purpose of this paper is to concisely present relevant aspects of effective leadership in companies and to explain changes in the theory and practice of contemporary leadership. The monograph is divided into eight chapters, just like in the previous edition, but their titles and contents have mostly been changed.

The first chapter (*Understanding Leadership*) begins by giving various definitions of leadership, emphasizing that contemporary business needs people with leadership abilities, as it is believed that they represent a specific form of

company asset. The chapter goes on to discuss the leader's role and explains that influencing followers is the essence of leadership. It is also underlined that the leader has a special responsibility – company effectiveness. Various leadership characteristics are also reviewed, with special emphasis on the leader's expertise and the power at his disposal.

The second chapter (*Leaders and Followers*) points to the interdependence of leaders and followers and that, besides a leader to lead, a successful organization also requires followers who will know how to follow him. Great significance is attached to the leader's communication with his followers and his ability to win them over for changes, which is a sign of leadership in contemporary companies. It is also important for the leader to have an understanding for the feelings of others. Another observation is that an effective way to establish partnership between the leader and followers is delegation. Followers' varying styles are also analyzed, underlining that good followers support effective leaders and vice-versa. The end of the second chapter is devoted to leadership and the use of power and their tight interconnection, since leaders use their power to influence others.

The third chapter (*Leader Behavior and Effectiveness*) analyzes a leader's behavior and effectiveness. Having in mind the misconception that a particular style of leadership is always effective regardless of the situation, the chapter reviews situational theories of leader behavior, which indicate that a leader's characteristics and behavior depend on the given situation. Leadership is tied to a company's superior performance, and it is underlined that a leader achieves effectiveness via his associates and employees, influencing them to contribute to the achievement of company goals. It is also emphasized that the basic determinants of a leader's performance are knowledge and expertise, and that effective leadership is also dependent on effective communication.

The next chapter (*Leadership and Company Culture*) explains that company culture grows stronger the more its employees accept key values and the greater their devotion to them is. Since culture is the most important determinant of an organization's behavior, it is emphasized that leaders hold significant responsibility for its creation, maintenance and changes. It is also observed that employees believe in their leaders and are willing to support their actions in improving company performance only in an atmosphere of a healthy culture. Within the context of the multiple challenges and demands of the global environment, intercultural management and the great importance of respecting the interests and goals of the broader environment are also treated.

The fifth chapter (*Leadership and Changes*) talks of the leader's role in initiating and executing changes in the company. A successful creation and execution of changes requires creative managers who possess an ability for complex thinking. Emphasis is given to a leader's characteristic of dealing with changes of a transformational character, as no one has become a great leader by championing the maintenance of the status quo. It is also important for a manager

with leadership characteristics to possess vision. In reviewing various models of change, it has been concluded that it is necessary to choose methods of strategic change that are both feasible and acceptable.

In the era of knowledge, in which the quantity of information and knowledge grows by the day, a leader's task is to create the conditions for the acceptance and use of new knowledge, which serves as a basis for struggle and survival on the market. In a time of rapid changes and business globalization, the ability of organizations to learn and to quickly transform what they learn into action, i.e. to change, is increasingly becoming a basis for creating sustainable competitive advantage. The sixth chapter (*Leadership and an Organization that Learns*) is devoted to leadership and to an organization that learns. The leader's new role is highlighted – creating an organization that learns, which means that it is precisely the leader's responsibility to create an organization in which people will continually expand their abilities to shape their own future. The characteristics of an organization that learns are highlighted, along with its striving for its learning curve to be equal to or greater than the rate of changes in the external environment.

The seventh chapter (*Types of Leadership*) deals with various types of leadership in the available literature. Strategic leadership is dealt with, along with the fact that the primary task of leadership is indeed strategic, i.e. to move the company toward the future. This is followed by an analysis of visionary leadership, underlining that the creation of a company vision is one of the most important functions of leadership, as a vision is necessary in order to guide changes. At the same time, the need for global and ethical leadership is also highlighted. Another important segment is that dealing with transformational leadership, whose essence is the management of changes of a transformational, i.e. radical character. Finally, the chapter deals with similarities and differences between transformational, transactional and charismatic leadership.

Companies will not be able to successfully solve the problems they face in the present-day global economy without effective leadership and efficient management. A strong leadership combined with weak management, or a weak leadership with a strong management can bring a company into an unfavorable condition. The eight chapter (*Management and Leadership*) tells us that the role of the leader is to create visions and strategies, while the role of the manager is to create plans and a budget that will ensure company success. The logical conclusion is that management involves facing complexity, while leadership means facing changes. The chapter then goes on to show the basic similarities and differences between leaders and managers, emphasizing their mutual connection. The chapter also deals with the leadership of the board of directors, which must possess knowledge, information, power, motivation and time in order to successfully fulfill its role. When it comes to members of top management, it is important that they possess the necessary leadership qualities and not just the ability to carry out regular company tasks. The very end is devoted to the general director

and leadership, concluding that the best leaders are those from companies possessing the objectivity of an external candidate, as they are acquainted with both the people and the company as well as with ways in which everything needs to be changed in the foreseeable future.

This current and timely book will certainly be useful to business students at undergraduate, master's and doctoral level, as well as to those who already possess current business experience. For all of them, this book represents essential, highly expert literature. Due to its simplicity of presentation and logical paths to proper conclusions on effective company leadership, Prof. Momčilo Milisavljević's monograph "Leadership in Companies" represents essential reading in the education of generations preparing for the future.

Leadership requires relevant literature in order to keep track of the time and its ever-increasing demands. We have such a work before us.

The Library of Congress Catalog

Megatrend review: the international review of applied economics.

LC Control No.: 2007201331
Type of Material: Serial (Periodical)
Uniform Title: Megatrend Revija. English.
Main Title: Megatrend review : the international review of applied economics.
Published/Created: Belgrade : ill. ; 24 cm.
Description: v. : Megatrend University of Applied Sciences, [2004]-
Year 1, no. 1 ('04)-
ISSN: 1820-4570
CALL NUMBER: HB1 .M44

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33

MEGATREND review : the international review of applied economics / editor-in-chief Nataša Cvetković. - Year 1, 1 (2004) - Belgrade: Megatrend University of Applied Sciences, 2004 - (Belgrade: Megatrend University of Applied Sciences). - 24 cm

Dva puta godišnje. - Je izdanje na drugom jeziku: Megatrend revija = ISSN 1820-3159

ISSN 1820-4570 = Megatrend review
COBISS.SR-ID 119185164

"Megatrend Review" is registered
in The International Bibliography of the Social Sciences (IBSS)
produced by the London School of Economics and Political Science
since May 17th, 2007.

* * *

"Megatrend Review" is registered
as the scientific review of national interest (M 52),
by settlment of the Board of Social Sciences,
Ministry of Science of Republic of Serbia, on May 12th, 2008.