

**University American College Skopje**  
**Eight Annual Conference on European Integration**

**OUT OF THE CRISIS:  
EU ECONOMIC AND SOCIAL  
POLICIES RECONSIDERED**



**Skopje, 2013**



## **University American College Skopje**

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**OUT OF THE CRISIS: EU ECONOMIC  
AND SOCIAL POLICIES RECONSIDERED**

**Thursday 16 May 2013**

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**Edited by:**  
**Ivan Dodovski**  
**Stevo Pendarovski**  
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## OUT OF THE CRISIS: EU ECONOMIC AND SOCIAL POLICIES RECONSIDERED

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Robert Hudson and Ivan Dodovski

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## **Out of the Crisis: EU Economic and Social Policies Reconsidered**

### **Introduction**

*Robert Hudson, Ivan Dodovski*

This volume includes a selection of papers presented at the 8<sup>th</sup> international conference on European integration entitled: “Out of the Crisis: EU Economic and Social Policies Reconsidered” which was held in Skopje on 16 May 2013. The volume seeks to reconsider current EU complexities across diverse policy areas and suggest perspectives on growth and ways leading out of the crisis. One overriding theme was that the crisis should be viewed as an opportunity for thinking and rethinking the EU as well as an opportunity for positive developments.

When we held the conference in May 2013, the European Union was experiencing the deepest economic recession since the European Economic Community had been first established by the treaties of Rome in 1957. Faced with the Euro - crisis, there was not a single day that went by without a reference in the media to: austerity measures; how to overcome the economic deficit; and the continuing rise in unemployment across the European Union. The sovereign debt crisis had, in turn, led to a profound crisis in public confidence in the European economy and in the European project as whole and we witnessed the crisis spread from one EU member state to another, impacting upon both their economies and the well-being of their societies, from Greece, to Portugal, to Spain, to Ireland and Cyprus, each in turn, as the process continued, with the potential to impact upon south-eastern Europe and on other member states.

In the background were other concerns expressed by individual European Union member states: such as the implications of the so-called European democratic deficit, particularly with regard to the implementation, support and maintenance of human rights laws; or, to

insufficient economic growth in a European Union which is faced with an ever aging population. One of the most successful achievements of the European project, European enlargement in turn was accompanied with the threat and fears expressed amongst the populations of some EU member countries of increased immigration, where there were concerns that, the further opening up of border restrictions might lead to indigenous unemployment, with concomitant strains on welfare, health care and educational provision. By contrast, might it be that the opening up of borders and an increase in migration actually stimulate economic growth rather than serve as a drain on educational, welfare and medical resources. As such our book is made up of nineteen chapters and divided into two parts. The first part concerns “EU Politics and EU social policies” and the second part is dedicated to “Economic and Financial Aspects of the EU Crisis”.

## **Part One: EU Politics and EU Social Policies**

Concerns about sovereignty are taken up in our first chapter ‘We, the States of the Union....’ by the late Gáspár Bíró. His paper considers how transformation in the EU has led to a gradual relinquishing of the attributes of sovereignty to the organs of the European Union. The main question addressed by this text is: What happens with the basic components of the nation, both political and cultural, if the dismantling of the nation-state continues? Can a supranational integration deal with these elements in the same way that the nation-state does? And, will the deepening of European integration within Europe lead to a European super-state, a federation, or as Professor Biro claims, to something else?

In the second chapter Dimitrios Akrivoulis posits that the deep causes of the Eurocrisis may be found in the neo-liberal rationality that has been permeating all spheres of European economic, social and political life in recent times. He considers the main features of what he has termed the European liberal predicament, whereby Akrivoulis claims that if the system is transmogrified into a taboo it only serves to generate the crisis, so that the system itself should be reconsidered rather than saved within its existing premises. Akrivoulis goes on to cleverly argue

that the crisis actually provides us with a positive opportunity to reflect on what and where the European Union is and on the direction which it should be taking in the future.

With an eye to the future, but referring in turn to the past, Zlat Milovanovic considers the nature and development of migration within and without the European Union and argues that if the EU were to close its doors on external immigration in the future it would put future economic development at risk and that the end result would be emigration from Europe to other parts of the world. By contrast he focuses on the benefits brought about by immigration into the EU, particularly given that Europe has an aging population and that European leaders must confront the long-term future of the EU focusing on the year 2050. This process would include a moratorium on armed conflict in a bid to enable greater economic development.

In our fourth chapter Biljana Sekulovska Gaber and Marijana Sekulovska investigate the concept of territorial cohesion by looking at territorial cooperation as a way in overcoming the problems of the European Union, especially against the backdrop of the current economic crisis. Is there a need to reconsider or revise EU Cohesion Policy by actively implementing the concept of territorial cohesion? Indeed, could territorial cohesion serve as a “bridging concept”? At the end of the day can the EU territorial cohesion policy serve as an instrument that turns territorial diversities into a strength and become a means of overcoming the existing priorities among the EU regions?

Stevo Pendarovski and Zoran Sapurik argue that the most successful foreign policy project in the history of the European Union has been EU enlargement, and in their chapter ‘The EU Crisis and the Western Balkans: Enlargement Unaffected’ they advocate that this process has not been damaged by the protracted political turmoil in Brussels. Indeed, although many western Balkan countries are not yet part of the current debate, they will be heavily affected by the outcome. The basic assumption of this paper is that regardless of the transformations that have been made, EU enlargement policy towards the Western Balkan states is going to stay, because the region can be integrated without the necessity of applying substantial EU resources. Furthermore, because of the relatively small size of the Western Balkan economies, they are not able to inflict a serious impact on the overall EU budget. There are of

course a number of challenges that need to be overcome and the authors readily acknowledge that in the process, it is clear that Croatia endured the most rigorous enlargement process ever in EU history, perhaps as a result of Brussels' frustration at the level of preparedness for the entry of Bulgaria and Romania, a year before the Eurozone crisis erupted. Meanwhile, Serbia will have to resolve issues with Kosovo. The Republic of Macedonia will have to reach a mutual solution with Greece over the naming dispute. Whilst Bosnia-Hercegovina and Albania are challenged by democratic obligations related to internal cohesion and in the case of BiH conflicting interpretations of the Dayton accord, to say nothing of the desire for the Bosnian Serb Republic to become independent. Only Montenegro seems to have been successful in its recent bid for candidate status, given that in 2010 the European Commission issued a favourable opinion on Montenegro's application and consequently granted the country candidate status with the accession negotiations with Montenegro opening on 29 June 2012.

The role of e-democracy in the Republic of Macedonia and a comparison with e-democratic strategies in other EU Member States is taken up by Ganka Cvetanova and Veno Pachovski in the fifth chapter of our book. E-democracy refers to using new information and communication technologies (ICT) to increase and enhance the citizens' engagement in democratic processes. The research for this chapter was based on the authors' application of the questionnaire used in the EU-funded EPACE project, in the *Handbook on European Democracy*. As such, this chapter analyses the E-democracy strategy and levels of citizen involvement in the Republic of Macedonia whilst attempting to compare this with the E-democracy strategies and citizens' involvement in other European states.

This is closely followed by 'The Constitutional Principle of Voting Equality Viewed through the EU Standards – the Case of the Ex-patriot Vote' which is analysed in the seventh chapter by Natasha Gaber Damjanovska. This focuses on one of the recent issues regarding elections that have been attracting the attention of comparative politics, which are the mechanisms countries adopt in order to allow their expatriate community who have permanently moved out of the country to nevertheless vote in their own country. Though the focus of this paper is on the situation in Macedonia, it should be noted that

this is also an issue which impacts on many countries right across the European Union.

Krum Efremov then considers how economic diplomacy can serve as a strategy for sustainable economic growth. So what is economic diplomacy? Well, amongst other things, the object of economic diplomacy is: to raise the standard of living; to co-ordinate trade policy; and to promote open markets. Economic diplomacy achieves these objectives by engaging contacts with foreign institutions, businesses and international organisations in order to advance economic interests. Some of the issues that arise from economic diplomacy are: the formulation of official policy for development; the facilitating of negotiations on trade-related agreements and treaties; and, the co-ordination of financial assistance to troubled areas (a subject which is very topical in the European Union at the moment). The focus of this paper advocates that the future challenge for the European Union is for economic growth to be achieved through economic diplomacy. As such, the paper analyses two small EU countries, Denmark and Slovenia, and compares and contrasts them with the Republic of Macedonia and it posits two research-based questions: Is economic diplomacy in accordance with the policy of sustainable economic growth given the significant economic and fiscal challenges which member states are currently confronting. And, secondly what is the position of economic diplomacy in Macedonia?

In spite of the economic crisis the EU has remained faithful to the idea of promoting renewable energy and energy efficiency as a means for achieving sustainable growth and society. In her chapter 'Green, Greener, Greenest: Western Balkan Countries on Test Lessons for Macedonia' Ana Stojilovska argues that the EU has transformed the crisis as an opportunity for investment in its own competitiveness and growth in a similar vein to Akrivoulis' claim in the second chapter that the crisis can be used as an opportunity for thinking and rethinking the EU in a positive and beneficial light. She provides examples of green policies and processes from other states in south eastern Europe and demonstrates how Macedonia can both learn from these developments and contribute to the greater greening of Europe.

In his chapter 'EU Consumer Protection and the Implementation in Macedonia and Countries of the former Yugoslavia' Kimo Cadvar and

Zoran Sapurik demonstrate how the European Union has been making positive steps to harmonize consumer protection legislation, which is a core EU value and one of the positive effects of EU policy. This chapter considers the harmonization of consumer protection legislation in the Yugoslav successor states, by focusing on the liability for defective products. This chapter demonstrates how specific terms and normative decisions have been transposed to fully harmonise with both the national laws on obligations and EU norms.

Emilija Tudzarovska Gjorgjevska turns her attention to higher education and human capital and outlines the importance of investment in the quality of education as a key stimulated to greater employment, economic growth and competitiveness in a post-transitional state such as the Republic of Macedonia. By making comparisons with Croatia and Germany her chapter sets out to address the knowledge based economic outcomes of contemporary management approaches to investments in knowledge and education. Using data from the World Bank as well as other indicators the author advocates the internationalization of higher education and the building of bridges between business enterprises and higher educational institutions. By implementing effective and comprehensive investments in education and human capital, Macedonia can address the key challenges of unemployment and economic growth.

## **Part Two: Economic and Financial Aspects of the EU Crisis**

In the first chapter of this section, Zoran Sapurik, Ninko Kostovski and Elena Klisarovska focus their study on the implementation of the Fiscal Stability Treaty by considering the future challenges to the EU presented by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. This is the treaty that introduced new rules in the Euro zone and strengthened fiscal discipline through the introduction of new rules for balanced budgets and budget limits.

In the next chapter the potential role of development banks in solving the EMU crisis by focusing on the crisis in the Eurozone's southern periphery is taken up by Lukasz Czernicki. This is where countries have

experienced strong foreign capital inflows over the last decade, yet they have failed to sufficiently increase their export capacities to repay foreign loans, which in turn has led to a structural shift in the peripheral states. In a nutshell they had borrowed money, without becoming more competitive from the loans they borrowed and they failed to increase exports over imports. Czernicki advocates that the way forward is to establish development banks in a bid to solve the crisis.

The financial crisis has powerfully demonstrated the need for a new approach to banking regulation and supervision. Evica Delova Jolevska, Jadranka Mrsik and Bogoljub Jankoski assess the challenges to single European banking supervision. The authors advocate that one of the strategic directions is to establish a regulatory and institutional framework at the European level with the aim of protecting and ensuring financial stability through the effective and consistent application of a single and uniform rulebook. The single supervisory mechanism is designed for those countries within the Eurozone, but is also open to other EU countries. The authors believe that closer coordination would ensure that responses to EU-wide economic problems are coordinated and therefore much more effective. Single European Banking Supervision will have a statutory objective to promote the safety and soundness of the EU banking system. It is one of the measures that has the potential to overcome the debt crisis in the Eurozone and could have far-reaching implications. Ultimately, the vision for the future of the EMU in the long run, undoubtedly lies in a deeper financial, fiscal, economic and political integration of the Eurozone.

Suela Kristo, Raimonda Duka, and Eri Gjoka go on to ask how similar the CEE and SEE countries are in terms of the efficiency of their financial Institutions. They do this by applying cluster analysis techniques for the period 2003-2010 in order to appreciate the trend of homogeneity in these countries. The results show that Bulgaria, the Czech Republic and Slovakia are more integrated countries, while Hungary and Poland have fewer similarities by comparison with the other countries. Croatia, Macedonia, Bosnia - Herzegovina have greater similarities with the other CEE countries that are EU member states than with Serbia, Albania and Montenegro, which are usually classified in a separate group. Therefore, because of their geopolitical position the authors have included Greece in the cluster analysis of the SEE countries that are not members of

the EU. This inclusion clarified the position of Albania, which seemed to have many more similarities with these countries. Furthermore, it seems even more obvious that Macedonia and Bosnia - Herzegovina should be included in the same group, while Serbia remains again at some distance from the other countries. Such differences appear to be maintained during the period under consideration, leaving scope for further integration.

In chapter five Dimche Lazarevski and Jadranka Mrsik analyse the role of small stock exchanges in the South-East European countries and reflect on the future of the crisis. The authors set out to identify the effects of regional and global stock exchange mergers and integrations, and to recommend options that South-East European stock exchanges should consider in future. The global financial crisis brought considerable economic decline in 2008, and this has remained the case until today, thereby putting the future existence of South-East European stock exchanges into question. This chapter focuses on the impact that these mergers have had on market liquidity, and the required rate of return. Based on their analyses, the authors recommend several options for SEE stock exchanges: developing on their own for which aggressive policy measures for developing internal financial markets must be devised; building links with substantially larger and better developed markets to establish virtual trading venues, borrowing advanced platforms and visibility; and, to start regional integration process through mergers and acquisitions.

Bulgaria's Economy Minister has recognized the anti-competitive nature of business in the European Union noting that only smuggling generates any growth. He noted that "if we have to choose between grey economy and no economy, Bulgaria is definitely better off having grey economy." Specific examples of the causes of the need for small and medium size business to adopt the methods of the grey economy will be documented. Specific examples of external anti-growth business competition from non-Bulgarian companies financed by European funding institutions will also be documented. The need to bypass existing legal distribution networks will also be documented. Jeremy Cripps, Kalin Sergeev and Boris Minchev examine the bureaucratic constraints on growth in Bulgaria a member of the European Union. The aim of the chapter is first to document these constraints with examples from small

and medium size business enterprises. A second aim is to demonstrate how bureaucratic constraints, particularly the existing distribution network, contribute to the necessity of small and medium size business smuggling to remain competitive. The third aim is to put the situation in Bulgaria into the European context following the arguments of Prime Minister Cameron who has proposed “a leaner and less bureaucratic European Union.” The paper offers a solution to bureaucratic constraints; the introduction of a Uniform Commercial Code for the European Union, following the example of the Uniform Commercial Code adopted in the United States. The Uniform Commercial Code “a comprehensive code addressing most aspects of commercial law, is generally viewed as one of the most important developments in American law.”

The factors influencing the salary expectations among Macedonian students is taken up in a comparative study of students across the EU by Marija Andonova and Nikica Mojsoska Blazevski who assess the salary expectations of Macedonian students, and the main factors that shape their expectations. Previous research elsewhere has shown that salary expectation is a major determinant that influences' schooling decisions. Given that the main pathway to developing human capital of an individual is schooling, learning about the factors that affect an individual's decision whether or not to acquire more education can contribute towards better educational policy in any given country. The authors' findings show that expected university earnings are significantly correlated with the father's education, year of study, sources of information on earnings in the labour market, gender, ethnicity, a regular job during studies, perceived employability, the chosen field of study and the country of future employment. In other words, Macedonian students form their salary expectations in a similar vein to those of their European counterparts. The major contribution of this study is to provide a pioneering study of salary expectations of Macedonian students, as well as providing a comparative analysis of the salary expectations of students in Macedonia and their peer colleagues from the EU Member States.

Finally, Ema Kastratovic, Marjan Bojadziev and Venera Krliu Handjiski, have written a comparative study on the creation of a market oriented organizational structure as a key to overcoming the financial crisis. The interconnectedness and the ever-growing interdependency of

the European countries have set in motion a vast number of processes that have ultimately led to the current financial crisis. Now, as we are taking the first steps out of this tight spot, it is of significant importance to look back and examine some of the factors that have aided certain companies to prevail during the crisis. Therefore, the purpose of this paper is to provide a theoretically based review and analysis of the organizational effectiveness of a selected number of medium sized banks in South East Europe (SEE), with particular emphasis on the role of organizational structure during and after the financial crisis period. The main result of this comparative study is to substantiate the underlying hypothesis of the research, which is to examine the positive link between the market driven organizational structure and organizational effectiveness.

# EU Politics and EU Social Policies



## We, the States of the Union...

Gáspár Bíró

### Abstract

*In the past two decades the member states of the European Union have undergone a process of transformation leading to a gradual relinquishing of attributes of sovereignty to the organs of the Union. The content of citizenship, traditionally the basic mark of the political nation has also been changed. The main question addressed by the text is: what happens with the basic components of the nation, both political and cultural, if the dismantling of the nation-state continues? The reflection is reduced here to some questions related to territory, language, ethnicity, genealogy, and the fate and vocation of the nation in a historical perspective. Can a supranational integration deal with these elements as the nation-state does, channeling and moderating towards the common good their distinctive and potentially explosive political potentials? The democratic nation-state, among others through the rule of law, has been able to rationally limit potential excesses of popular sovereignty. Will the deepening integration within Europe lead to a super-state, a federation, as many claim, or to something else? This is open to speculation, but the survival of the basic components of the nation on a longer term seems almost sure.*

*Keywords: United States of Europe, nation-state, political nation, ethnicity, ethnogenesis, fate, vocation, dominion*

According to Article 1 of the Consolidated Version of the Treaty on European Union the High Contracting parties, all nation-states and members of the Union resolved that the "Treaty marks a new stage

in the process of creating an ever closer union among the peoples of Europe.” (Official Journal of the European Union, C 83/13. 30 March 2010) In Article 3 the member states enounce the goals of all political communities, namely “to promote peace, its [the Union’s] values and the well-being of its peoples.” The difference is significant from the classic model of social compact: the contracting parties are nation-states, not individuals, and the principal beneficiaries are the peoples of Europe. Paragraph 2 of the same article proclaims that there will be no “internal frontiers” within the Union. However, Article 4 states, among others that the Union “shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each Member State.”

The following thoughts are not about the devaluation of the concept of the political nation to the benefit of the cultural nation, although such assumptions might be fairly consistently argued, but about the future of their components in a world where nation-states are losing ground continuously. As Fr. Meinecke noted in *Cosmopolitanism and the National State* “political nations (...) are primarily based on the unifying force of a common political history and constitution.” In the case of cultural nations what counts is “some jointly experienced cultural heritage.” Nevertheless, he added: “The cohesive force a national religion and church can provide is especially evident in former political nations that have lost their statehood, perhaps centuries ago, and that are struggling to attain it again.” He admitted “it is difficult to distinguish cultural and political nations from each other on the basis of either internal or external structure”, and gives the examples of Switzerland and Germany (Meinecke 1970, pp. 10-11.) If it was difficult then, it is much more difficult nowadays. The assumption is that in these days both the political nation and the state, as the highest concentration of politics, undergo presently divergent processes of diffusion. The nation and the state have been subjects in the past centuries of a specific metamorphosis bringing the nation-state to life. This transformation has reached its peak in the second half of the 20th century and it seems to have entered in the past 20 years into a specific phase of entropy. The thesis of the eternal character of the nation-state, as the strongest

link between generations past, present, and future is being strongly challenged on different grounds.

European nations were born either in revolutions, or wars or both. In some cases the state, as a hierarchy of orders and titles has just inherited and amalgamated the nation, initially a body of select individuals united by tradition, culture, and specific interest related to their status (by birth mainly). The political nation comprised the totality of individuals holding the citizenship of a given state, not to be confused with the population of that particular state. In other cases the nation, perceived as a living tradition, culture, common will and destiny preceded the state, a project yet to be concluded.

The nation-state compels individuals embodying tradition, culture etc. into one territorial framework, on the one hand, and on the other into a coherent set of representations and actions. In the absence of the state, or in a failed state, elements such as language, ethnicity, destiny, vocation, and others become political in their own right, unleashing distinct energies that may turn them against each other. The mutual safety and advantage of those constituting the body politic, paramount for the men of the 18th century is suddenly compromised, or is fragmented into the safety and advantage of some at the expense of others. This is well researched and known. (It will be exciting, however, to see whether the present energetic, sometimes aggressive actions of the economic-financial sphere to establish and consolidate primacy over politics and all things political will be successful in Europe at least, keeping in mind that in many parts of the world quests for control over people, including their minds, territories and resources employ all the means available and routinely overwrite economic rationality.)

In an unprecedented way, those who were regarded as the most stable and effective nation-states of Europe, are contemplating that they themselves in the first place, and also other members of the European Union will further dilute basic state prerogatives and become part of a larger, all encompassing entity. Talk about the United States of Europe (USE), an idea at least two centuries old, is again being heard. But because the international system, i.e. the system of nation-states still exists, and a number of important actors still not only want to, but actually do behave as classic nation-states (unity of territory, absolute sovereignty of the central power controlling the territory and the population living

on it), the future USE might itself be transformed into a nation-state. It could be called Union, federation, super-state, superpower, or anything else except empire, yet it must follow the pattern or paradigm of the nation-state. For example, the internal structure of the new entity must be hierarchical, emulating the state. It also has to have a precisely delimited territory, regardless of the fact that future accessions to the Union are in principle possible. What is not certain is the future status of the existing political nations and the individual citizenship holders belonging to them, and of those peoples that consider themselves as both political and cultural nations. As seen, the Treaty in force is an agreement between states aimed at creating “an ever closer union among the peoples of Europe.” There are historical examples when autonomous political actors united into a single entity, let it be a nation-state, but in those cases there was some common ground as regards the existing main cultural national features, or some degree of popular consent, or both. Integration by empires was different.

Even with the thesis of the Westphalian system accepted, it must be kept in mind that nation-states have a very brief past in comparison with thousands of years of documented human history. Despite the post-1945 forbidding rhetoric about the territorial integrity of states and the inviolability of their borders, nation-states are far from being stable entities. This is partly reflected in terminology, partly by the history of existing individual states.

For this purpose, writing political, as a noun, designates the open ended endeavor, often the struggle by force of arms, to stabilize an existing hierarchy at a certain moment in time between the strong and the weak, and the rulers and ruled. It follows that such hierarchies cannot be crystallized, they are in constant flux and transformation, sometimes lasting centuries, driven by the internal dynamic of the participants. In this context there is a historically established hierarchy of nation-states, stabilized more or less by the end of the 1970s, partly modified after 1991, undergoing severe transformations before our eyes. It is called the international system of states known as global power(s), super power(s), continental states, regional powers, and small states. In certain parts of this system there is an unprecedented concentration of power, in others, on the contrary, a high level of dispersion. While nation-states can be grouped on both accounts, the dynamic of concentration/

diffusion has penetrated already the virtual space and is likely to move also into outer space, both largely beyond the reach of traditional nation-state hardware.

## Territory

Talking about the voluntary renunciation of state sovereignty and planning the process may seem coherent with the idea of federation. The most frequently referred to model is that of the creation of the United States of America. Analogies are useful to highlight various aspects of a problem faced at a certain point in time in order to avoid past mistakes, but their replication is next to impossible. The creation of the Union by 13 colonies in North America stands out - from the perspective of the views expressed here - by the fact that only a few sovereign states existed at that time and even those were far away. The status of territory was also fundamentally different. Conquest, annexation, acquisition, or cessation of territories was largely regarded as being the legitimate actions of the great powers, just to name one aspect that makes a difference. Nowadays territorial expansion by force is not legitimate; in addition state frontiers are mostly the (common) frontiers of at least two states. In addition, a great number of states are unwilling to renounce the basic prerogatives of state sovereignty which they regarded as being absolute. Therefore the decision, should it be taken, by a number of states to mutually give up elements of their sovereignty may work in certain areas, such as finance and trade, but can easily run into serious obstacles in other fields, such as national security and its various components and aspects. Exclusive jurisdiction related to territory provides one of the most solid frameworks of the nation-state for the integration of other constitutive elements of the nation. If anything, the dissolution of three important federative states in Europe between 1989 and 1993 should be taken into account when discussing the matter, obviously with the caveat that they had all been the results of very different, but nonetheless tumultuous political processes.

It is a common place that state borders are “made”, indeed, most frequently imposed, in other words they are essentially political, results of bi- or multilateral agreements, international arbitration, or peace treaties. Even those called natural, like seas, large rivers, or crossing

high mountains or the Arctic shall be recognized politically – sometimes they are not. The map of the states of the world shows a politically frozen situation in time, depending on the region in question. There are few internationally recognized states that are completely happy with their borders, even if this may not be part of the public discourse in the countries concerned. From the Schengen-agreement one can draw the conclusion that the frontiers with non-members of the perspective USE will be its outer political limits, while “internal” state borders will become administrative delimitations, orienting the territorial competence of various member state bodies and organs.

Territorial defense was from the beginning one of the main rationales of the nation-state. Defense of the territory meant also the defense of the population, of the resources, the infrastructure, and all matters known as pertaining to the security of the state. In many aspects, as noted, the sovereignty of the nation-state, and not only in Europe, is eroded or transcended by a number of mainly economic and financial factors and processes, but as recent developments show, states are inclined to perceive their sovereign attributions in national security issues as absolute. Even states that are closely cooperating in such matters, for instance in antiterrorist activities, tend to keep for themselves a certain degree of monopoly of information and liberty of action under the aegis of sovereignty and are surrounded by a kind of tacit mutuality. Latest developments in cyber-warfare tend to strengthen this argument. Since this would lead in a different direction, we would not go further into this issue.

State sovereignty over territory is in fact a full dominion that includes title and possession, and presumes similar powers regarding public benefit and the exercise of state functions. In this regard sovereignty over territory differs from the proprietary rights of the state. The state can own land, forests, rivers and buildings, can grant concessions, and can conclude various other contracts within the limits of the law. Under international law however, some activities that states may decide to pursue under the principle of sovereignty on their territories — for example underground nuclear testing — are deemed unlawful. Nevertheless the practice in this regard overrides such rules of international law and strengthens the principle of absolute state sovereignty as dominion over territory.

In a conscious process of deconstruction the transfer of sovereignty must go hand in hand with a transfer of authority. In other words, it is not sufficient to delegate powers and competences, the recipient must have strong legitimacy or acceptance among the population. Let us remind ourselves here, that the history of the modern idea of popular self-determination started with the outrage expressed by the men of the Enlightenment at the practice of monarchs of exchanging territories without the consent of the population of the land. The negotiated change of the legal status of the territory does not mean acceptance *per se* by its inhabitants, especially if the territory is regarded as the birthplace not only of the individuals belonging to the nation, but of the nation as a whole.

The issue becomes extremely difficult in those cases where the 19th century view still prevails, according to which the nation, the state and its territory constitutes a single, monolithic political unit. For example, the 1982 Constitution of Turkey in its Article 3(1) provides that "The Turkish state, with its territory and nation, is an indivisible entity. Its language is Turkish." Twentieth century theory of the ethnocratic state maintains that the state and its territory are the exclusive property of the nation, because ethnos and not demos creates the state. The nation is perceived as a moral person with absolute powers, both transcending and constituting legal rights. Taken to its extreme consequences, every square meter of land where the nation, through its ethnogenesis was present in any form, whether effectively by the property rights of its members, or just symbolically, belongs to the nation as a whole. Restoration of property understood in this way may lead to an open ended process of revision of the status quo, a permanent source of conflict. No government or individual, regardless of its status is entitled to concede anything; this ideology may be outdated, although the wars on the territory of the former Yugoslav Federation are a sinister warning as to their vitality. Fissures between the components of the nation are conducive to the mobilization of the latent energies inevitably present in the concept itself, especially given the fact that territory means for a great number of people much more than a piece of land. It means also: birthplace, Vaterland, breeding place, cradle, fatherland, home, homeland, incubator, la patrie, mother country, motherland, native land, native soil, patria, just to remind ourselves, at random of a few.

## Language

The great variety of races, tribes, peoples, religions and languages existed as a fact thousands of years ago, and is still a dominant feature of mankind. We are not supposed to deal here with the causes of this phenomenon, but cannot avoid mentioning briefly the history of the Tower of Babel. (Here and elsewhere in the text I use the text of The New American Bible, easily accessible and with short and useful notes on the website of the United States Conference of Catholic Bishops.) This story, according to the interpreters of the Bible, was inserted in the Old Testament to show the wickedness and audacity of men trying to build an artificial world beyond God's will and teachings, and served as an explanation to the variety of languages on earth. In the beginning,

The whole world spoke the same language, using the same words. (...) the LORD came down to see the city and the tower that the men had built. Then the LORD said: "If now, while they are one people (ecce unus est populus), all speaking the same language, they have started to do this, nothing will later stop them from doing whatever they presume to do. Let us then go down and there confuse their language, so that one will not understand what another says." Thus the LORD scattered them from there all over the earth, and they stopped building the city (Genesis 11).

Whether it was the punishment of the Lord or for other reasons, the fact is that the persistent existence of a great number of languages has long been regarded as a burden, not a value. Language diversity as a universal cultural value was recognized in the past two decades of the 18th century, and the active protection of lesser spoken, minority or regional languages threatened by disappearance is a recent, post Second World War development, accelerated in the 1990s.

St. Augustine, for example, addressed the issue in Chapter 7, Book XIX of *De Civitate Dei* under the title "Human society divided by differences of language. The misery of war, even when just." In the world, he writes, "the diversity of languages separates man from man."

For if two men meet, and are forced by some compelling reason not to pass on but to stay in company, then if neither knows the other's language, it is easier for dumb animals, even of different kinds, to associate together than these men, although both are human beings. For when men cannot communicate their thoughts to each other, simply because of difference of language, all the similarity of their common human nature is of no avail to unite them in fellowship. So it is this that a man would be more cheerful with his dog for company than with a foreigner (St. Augustine 1984, p. 861).

Latin was the dominant language of the age in Western Europe, and it was only obvious that the Church, European monarchs and their chancelleries, and educated people in general accepted this language both as the official, and frequently the interpersonal means of communication, long after the Western Roman Empire collapsed.

With the Protestant revolutions of the 16th century a revival of local or national languages (native tongues) emerged and developed at an increasing scale. Two hundred years later, German romantic idealism began emphasizing the cultural value of linguistic diversity, thereby emphasizing the cultural value of national languages, which of course meant German in the first place. During the French Revolution, Jacobins urged measures enhancing the knowledge and use of the French language. "Linguistic nationalism" took shape and spread in a matter of decades throughout Europe. Wilhelm von Humboldt (1767-1835), one of the most prominent early German liberals was of the opinion that "absolutely nothing is so important for a nation's culture as its language", a statement that became a proverb in the last two centuries. Another famous statement, which has been widely quoted ever since, is that "Since language, in whatever shape we may receive it, is always the mental exhalation of a nationally individual life" (Humboldt 1999, pp. 25, 64).

Notwithstanding his epochal inquiries on linguistic issues, from our perspective the influence of Johann Gottfried Herder (1744-1803), the 'discoverer' of national and world history, reveals itself from another angle. Herder advanced two main theses which have determined the course of historicism over almost two centuries. According to one of the

most authorized interpreters of this school of thinking, Georg Iggers, the first ran plainly against the philosophy of natural law. For Herder all values and knowledge are related to history and are individualistic. The second stand is that history is in a constant motion, nevertheless, “within the flux of history, there are certain centers with at least relative stability: the nations.” Also,

They possess a morphology; they are alive; they grow. They are not rational in character, but dynamic and vital; things in themselves, not means. It is the historian’s task to understand them. Nations have the characteristics of persons: they have a spirit and they have a life span. They are not a collection of individuals, but are organisms (Iggers 1968, p. 35).

As Iggers further noted, Herder was a supporter of liberal state reforms and received with sympathy the news on the outbreak of the French revolution, but “his view of history certainly undermined the theoretical basis upon which the tradition of classic liberalism was based. Herder’s theories of truth and value were incompatible with the philosophy of natural law or the theory of the social contract.” (Iggers 1968, p. 36)

Herder’s philosophy struck a chord all over Europe, where he was read. In the 1820s, Edgar Quinet translated his main, voluminous work, *Ideas for the Philosophy of History of Humanity* (1784–91) in French. Other works were translated in English and the Slavonic languages, becoming known and debated by the intelligentsia of the peoples of Eastern and Southeastern Europe looking for national emancipation. While the idea of peoples’ self-determination was disseminated before the French revolution, Herder’s concept of the people emphasized not only the equality but also the uniqueness of all peoples which, in the words of Georg Iggers are “contributors to the richness of the human spirit” (Iggers 1963, p. 38). Such emphatic discourse on the uniqueness of each of the European peoples is still with us, promoted by individuals holding a variety various political affiliations, sometimes with exclusive motivations.

If it is true that such a strong bond exists between the nation and its language, the issue of its preservation, development, use, and transmission to the offspring, then it is no wonder that these and related issues have been formulated in the past two centuries sometimes in dramatic terms. From the assertion “the nation lives through its language” it follows logically that for the survival of the nation the survival of its language is crucial.

### **Ethnos, Ethnicity, Ethnogenesis, Genealogy**

Ancient civilizations, as well as medieval kingdoms and empires had no problems as to where they come from and what they were for. What is called today ethnogenesis (from the Greek *ethnos* and *genesis*, the latter meaning in general origin, birth) is a modern phenomenon and it means the conscious research and explanation, often an innovative construction of the origin of a certain group, claiming to be a people defined as an “ethnic group”, ethnic meaning in fact “common origin”. Such endeavors intensified with the religious fragmentation of Western Europe and increased in number and intensity with the linguistic revival of the 18th century, briefly described above.

There is a problem with the notion of “people” within this context. A 1939 reference report of the British Royal Institute of International Affairs drew the attention to the fact that:

People is a wider term which can cover, in addition to nation, the members of the political unit, the State, and of the ethnological unit, ‘the race’, and is in addition an apt name for any aggregation of individuals which cannot be described by the other terms (Nationalism 1939, XVII).

In the German tradition, traced back to Herder, and the scientific literature of the 19th century, the term *Volk* (people) mostly meant the politically organized entity, while Nation was interpreted either as the natural unit (of common descent) or as the cultural community. The influential Swiss born German lawyer, Johann Kaspar Bluntschli wrote in the 1870th, after the German unification:

By a Nation (Volk) we generally understand a society of all the members of a State as united and organized in the State. The Nation comes into being with the creation of the State. It is the consciousness, more or less developed of political connection and unity which lifts the Nation above the People (Bluntschli 1885, p. 86).

Previously, he argued that in the Middle Ages the Germans “were at once a people (Nation) and a nation (Volk),” while in the last few centuries “they ceased to be a nation, and were rather a people divided into a number of different states, countries, and one may say nations” (Bluntschli 1885, p. 82 Italics in the original.)

After the First World War, the term Volk took precedence, due to a movement aimed at purging foreign words from the German language, designating “a body of men who are physically, and therefore spiritually, or common (or at least similar) descent” and a will to live together; “Volk is now {in the 1930s – GB} taken to include all Germans who are still conscious of their descent, no matter where they are living” (Nationalism 1939, XIX). The Greek “ethnos” has been translated generally by “people” as an “ethnic group”, a group with a common origin, that is of the same race, i.e. “blood”. Aristotle has used the term ethnos (εθνος) in his Politics (1252b 20 and 1326b 5 respectively) to describe „a number of people accustomed to live together, a company, a body of men.” Other words in English used to translate “ethnos” are: nation, people, caste, tribe.

If we accept that ethnos means in principal a “body of men” of common origin, the notions of “people” and “ethnic group” are interchangeable, and it can be rightly claimed that the nation is a specific ethnic group. From a political perspective a nation is a people taking its fate into its own hands, in other words the nation exercises its right to self-determination by constituting a state. International law, as developed after 1945, implicitly equates the term “people” with the population of a state.

At this junction it is the sequence of events that counts. Modern nation-states are a result of Western European cultural and political development. Those peoples which created first their own states have been and still are at an advantage by comparison all latecomers. This is

where genealogy, and in particular the genealogy of peoples enters the stage and gains prominence.

As in many other cases referred to so far, the composite word “genealogy” is also of Greek origin: it comes from γενεά, genea, “generation”; and λόγος, logos, “knowledge”. In its daily meaning is the systematic study of families, their generational lineages and history. In Western European genealogy used to be concerned with the kinship and descent of kings and aristocrats: the specific lineage was the basis of legitimacy to personal and family wealth and rule.

The ethnogenesis of modern nations is in some cases, especially in Eastern and Central Europe follows the same logic: there is an exceptional event in the beginning, something great, heroic, with or without supernatural elements. According to the secular approach, not really characteristic to this region, the nation comes into being not through the will of God, or as a result of the organic development of the spirit of the people, but of the (free) will of its constituents. Its origin is a political act, like a revolution, with its immanent destructive and at the same time creative energy, the palpable “earthly” result of the process of being the nation-state.

The “nations” of Eastern and Central Europe had to define themselves first as consolidated ethnic groups, possessing a language suitable for philosophy, poetry, and law, and secondly, for recovering their ethnogenesis. A solid genealogy was necessary to anchor their existence in time and space, for title to territory, among others, was based on the claim of “being first” there. In fact, the historical title to territory was usually subject to great power approval, acquired according to the general practice of the age following conquest or transaction, inheritance, exchange, compensation, or successful wars against external domination.

## **The Political Nation Par Excellence - The French Revolution**

The word nation, as it is well known, originates in the Latin word nation meaning principally birth. Further meanings in classical Roman literature are breed, stock, kind, species, or race, the latter being used

sometimes in a contemptuous sense. Further, according to the Latin Dictionary by Charlton T. Lewis and Charles Short: “[it means] in a more restricted sense, a race of people, nation, people (used commonly in a more limited sense than gens, and sometimes as identical with it; cf.: gens, populus; usually applied by Cicero to distant and barbarous people).”

The Middle English Dictionary under the entry “nation” (also n ci un (n.) also nacoun) provides the following main interpretation: “A nation, people; a race of people; a political country, nationality; ~ and lede, nations and peoples; of english ~, of English nationality; (b) in pl.: country; (c) fellow countrymen; also, members of a delegation; (d) an Irish clan.” The sources attached to the entry are dated between early 14 century (cca. 1330) and early 16th century”.

According to the *Dictionnaire critique de la Révolution Française* the word nation appears in one of the first dictionaries of French language at the beginning of the 17th century. In 1694, the *Dictionnaire de l'Académie* defines nation as the inhabitants of the same state, the same country, who live under the same law and use the same language (Furet-Ozouf 1992, p. 340). These are only some examples indicating that the word nation has been known and used for the past two millennia in the sense that we understand it today.

This term became one of the most politically charged words in a matter of roughly seven months in the first year of the French Revolution. In January 1789, Joseph Sieyès, a Roman Catholic Abbé, a clergyman with no great religious vocation, published his incendiary pamphlet entitled *What is the Third Estate?* He started straight: “There are three questions that we have to ask of ourselves: 1. What is the Third Estate? Everything. 2. What, until now, has it been in the existing political order? Nothing. 3. What does it want to be? Something” (Sieyès 2003, p. 94). The Third Estate, he claimed, in opposition to the first two, the aristocracy and the clergy, in other words, the privileged, provides all the activities that any support society. The passionate text continues with an astonishing self-confidence from a man, who as a priest belonged to the First Estate:

Who then would dare to say that the Third Estate does not, within itself, contain everything needed to form a complete

nation? It resembles a strong, robust man with one arm in chains. Subtract the privileged order and the Nation would not be something less, but something more. What then is the Third Estate? Everything; but an everything that is fettered and oppressed. What would it be without the privileged order? Everything, but an everything that would be free and flourishing. Nothing can go well without the Third Estate, but everything would go a great deal better without the two others. (...) The Third Estate thus encompasses everything pertaining to the Nation, and everyone outside the Third Estate cannot be considered to be a member of the Nation. What is the Third Estate? EVERYTHING (Sieyès 2003, pp. 96, 98. Capital letters in the original).

After a brief digression on ethnogenesis and genealogy (“descent from the Gauls and the Romans might be at least as good as descent from the Sicambrians, Welches, and other savages from the woods and swamps of ancient Germania?”) Sieyès formulated detailed demands aimed at representation and voting in the Estates-General, some of which have been enacted in the following period.

Among the first revolutionary acts, the renaming of the Estates-General as the National Assembly, the parliament of the nation (Assemblée Nationale), was crucial. “The Third Estate, it is said, cannot form the Estates-General all by itself. Very well! So much the better! It will form a National Assembly”, because, as he explained “the deputies of the clergy and the nobility have nothing in common with the national representation” (Sieyès 2003, pp. 147-8).

The logic is clear and the message was understandable for everybody. The underprivileged, the people as the Nation must claim the absolute power that belonged to the king. On 17 June 1789 the political take-over took place in the form of a motion by Sieyès, as a deputy of the Third Estate, followed by the self-constitution of that body into the National Assembly. As it is sometimes said, the French nation was born on that day. As Pierre Nora emphasized in the entry Nation of the quoted *Dictionnaire*, until that day the idea of the nation could inspire “neither organic solidarity, nor collective conscience, nor political configuration” (Furet-Ozouf, 1992, *Idées* p. 344).

The old, abstract and sacred frontier between the king and his subjects had been abolished and replaced with a multitude of new and much more concrete and palpable boundaries, Nora noted. And the list is not short: territorial borders establishing the space where the sovereignty of the nation is exercised; legal frontiers, defining equal rights and duties of citizens, over whom the law rules; psychological frontiers that transformed the nation into a refuge, a shelter, a secure place for the community of citizens, then into a symbol of belonging and mobilization. Most importantly from our perspective, the move created a special alignment between the nation and its territory, the latter as the space on Earth where the former settled, took roots, in other words stabilized once and forever (Furet-Ozouf 1992, *Idées* pp. 345-7).

## Fate and Vocation

In a world where peoples, nations and nation-states have but rights and obligations, among them the paramount, but impossible task of maintaining international peace and security, talk about their fate and vocation after the “short” 20th century may sound suspect, or just strange. Except, perhaps, superpower exceptionalism, or plans such as creating an “ever closer union.” There is no great design at the moment, attractive enough and acceptable by and large. Not so in the 19th century. An influential school of thinking considered peoples and nations as citizens of humanity, everyone with its own vocation as a contribution to the great cause of unifying mankind. Blessed by God, destiny and vocation were in fact purely political: great energies were concentrated on the recognition of peoples as nationalities, and then the creation of their own states. All these were not just possibilities or rights, they were after all duties before mankind, history and God. Giuseppe Mazzini (1805-1872) was one of the greatest and persuasive promoters of these ideas.

According to Mazzini and his contemporaries, some of whom constituted the Italian school of international law, influenced among others by Giambattista Vico’s views on history, nation-states at a later stage and through them their peoples will necessarily unite in supranational federations. As Martin Wight emphasized, Giuseppe

Mazzini, a prominent and controversial personality of the 19th century, a prolific writer and active politician, called sometimes "the Soul of Italy" for his role of the national unification of his country, was deeply convinced that religion and politics are inseparable. As Wight noted, "for Mazzini God in politics meant, in effect, three things: providence, progress, and duty" (Wight 2005, p. 92). Distancing himself of the mainstream of the era, Mazzini has advocated the primacy of duties on rights: rights to him are the consequences of the fulfillment of duties, while "progress is the law of God" (Wight 2005, p. 96).

Both imperialism, as the universal domination of a single state, and cosmopolitanism, perceived as the dissolution of nation-states into a world order whose units would be only individuals, were unacceptable, "for the individual fulfills himself in the nation, the nation fulfills itself in humanity, and cosmopolitanism left out the essential middle link." The obligations due to humanity presuppose the association of individuals into nations, along the principle of self-determination. It was this general framework within which national vocation had been interpreted by Mazzini. While others imagined a different background, the essence was the same for similar thinkers of the 19th century, and those who share such ideas nowadays. It is worth quoting Martin Wight again, who best summarized the problem dealt with here:

A national vocation he loved to dream of, and hope for, was that of Italy's revolutionary leadership. The myth of the revolutionary hegemony of a special nation was part of the stock-in-trade of nineteenth-century revolutionary nationalism: the myth of the nation-messiah. (Fichte claimed primacy for Germany, Guizot for France, Mickiewicz and Cieszkowski for Poland, Hirzel for Switzerland, and Gioberti besides Mazzini for Italy.)

Mazzini's logic and claims for Italian primacy have been very different, as Wight noted "...in its shyness, inclusiveness, and humility. It was a primacy of service, duty, self-sacrifice, and initiative, and of course it flowed naturally from and was congruous with the doctrine of the Trinity of History, of Rome the Third Rome."

That faith is crucial not only to the acceptance of the nation's, but to the fate and vocation of all highly cohesive and integrated

communities was emphasized long before by St Paul in his Letter to the Romans:

He [Abraham] is our father in the sight of God, in whom he believed, who gives life to the dead and calls into being what does not exist. He believed, hoping against hope, that he would become “the father of many nations,” according to what was said, “Thus shall your descendants be.” (Romans 4, 13; 16-18)

Mazzini was an idealist, but not a naïve. He knew that God’s will shall not be realized automatically after its proclamation by his faithful. Therefore struggle, including the use of force is needed to achieve national independence and concomitantly the alliance of the peoples of Europe, what he called “the Holy Alliance of peoples”, as opposed to the then very much alive Holy Alliance of monarchs. As Stefano Recchia and Nadia Urbinati noted in the preface of a recent collection of Mazzini’s main texts:

Mazzini was no liberal pacifist who believed in a natural “harmony of interests,” like his contemporaries Richard Cobden and John Bright. His fundamental reasoning was that where despotic oppression and foreign domination made peaceful political contestation all but impossible, violent insurrections might be justified in the short run to establish free and self-determining democracies in the future (Recchia-Urbinati 2009, p. 22).

In the 1849 program of action, “Toward a Holy Alliance of the Peoples” the main ideas of his thinking have been reiterated. No question, Mazzini wrote, “Our victory is foreordained.” It took a huge dose of optimism and faith to make such a statement in 1849, but the arguments as ideology remain persuasive and coherent. Individuals have a duty to promote the “power and prosperity” of the nation, and the latter has an obligation to assume and execute its “special mission, according to its special capacity”, in order to achieve the all encompassing goal, “the progressive advance and prosperity of humanity” (Manzzini

1891, pp. 272-276). In 1850, he took his program further, mentioning the necessity of a United States of Europe. “The task of the people who comprise each Nation is to organize their own life”, he wrote. Similarly: “the task of the Congress of Nations is to organize the life of international relations. God and the People should be the motto of each single Nation; God and Humanity that of all of them together. We do not simply strive to create Europe; our goal is to create the United States of Europe” (Manzzini 2009, pp. 134-135).

In Mazzini’s view, therefore, is that the main agent in the creation of a united mankind is the nation, not the individual. Although he repeatedly claimed that he was not religious, like a Roman Catholic believer was, he had a strong faith in his own vision, as strong as any religious beliefs.

## A Few Concluding Remarks

The vocation of states and their constitutive political nations, squeezed after 1945 between unchangeable political borders, nominally independent and *de facto* and *de jure* responsible for their own affairs, in an optimistic view is to ensure and preserve the common good for the benefit of successive generations and mankind. On a less optimistic note, we know that the system operates on the principle of self-help within an anarchic environment, producing continuously unforeseen developments, among them clear and present dangers. In this sense, vocation slips into the highest degree of national selfishness, asserted with proudness under the banner of all inclusive national interest. Nobody questions the need of cooperation, but when it comes to how, where, when, and with whom the system, or some of its parts become paralyzed: suddenly nobody wants to take responsibilities, or when some steps are taken, they are wholly inadequate. Within the nation-state political responsibilities have been more or less transparently allocated, and in some cases leaders were held accountable.

As regards cooperation, including integration in Europe, not only is the unshakable faith of Mazzini and others lacking, but basic trust is non-existent. What else shows the fixation on legal agreements and the modes of their enforcement? The threat of sanctions is by itself

problematic, but their implementation, should it happen, raises a whole class of grave political and moral questions.

Until well into the mid-19th century the cultural and spiritual elements of the nation dominated, especially in the case of nationalities as peoples that regarded themselves ready for establishing their own states. Language, ethnicity, proclaimed fate and vocation have been strong factors of mass mobilization against the empires which dominated those groups that identified themselves along such lines. Once the new territorial states were created, those elements have played a crucial role in stabilizing the frontiers, or in some cases, legitimizing further claims to land, together with the political program of cultural, and later the total social homogenization of European nation-states. Until the end of the 1940s, when the territorial status quo was frozen into the form that by and large survives until these days, secession, irredentism, or various forms of regionalism have been the order of the day. A regionalization of Europe by consensus may look feasible, although there are a number of problems that can be seen already. Within the framework of envisaged supranational integrations the territory and frontiers of prospective member states are regarded as of secondary importance. The Schengen-model is instructive in this sense. But discarding completely the idea of a territorially-bound nation might not be acceptable for everybody, especially if migration increases and newcomers will claim not only rights but also some forms of title to the land. Making land a commodity freely available for anyone who can afford to buy it is already raising strong sentiments in some parts of Europe, especially when land contains precious resources, such as water. As regards the other elements, we know how empires have dealt with them. It is almost sure that those practices cannot be revived, if Europe wants to remain democratic and liberal at the same time.

As mentioned at the beginning of this text, the political nation and the state, as the highest concentration of politics continuously undergo divergent processes of diffusion. There is only hope, and it requires a strong leap of faith to claim that a super-state will be able to transform the huge energies unleashed into something positive, viable and acceptable for all.

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## **'We All Knew This': Digging Ourselves Out of the Hole**

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### **Abstract**

*Despite the seemingly self-evident characteristics of the eurozone crisis, neither the policy reactions to it, nor the existing proposals for economic reform, nor the long-term solutions proposed, or already tested in practice, nor the reactions to those policy options attest to an agreement as to how to exit the crisis, but most importantly as to what the crisis is all about to begin with. This article suggests that the deep causes of this crisis should be traced in the neoliberal rationality that has been consensually permeating all spheres of European economic, social and political life. Addressing the characteristics of this European neoliberal predicament, the paper concludes that the crisis should be treated as a vantage point of reflection on what and where the European Union is and, most importantly, on what and where it should be.*

**Keywords:** Eurozone crisis; European neoliberal predicament; political rationality; pharmakon; Paul Ricoeur

*We all knew this. We all knew that it would take more time than any of us want to dig ourselves out of this hole created by this economic crisis.*

– US President Barack Obama (2010, September 6)

“To dig ourselves out of this hole created by this economic crisis”, as the US President suggests, we first need to find our way out. We need to plan and persistently follow a strategy that would allow us a safe exit, but also help prevent a return to the hole, let alone an *amor fati*, eternal return. We also need to imagine what-is-not-yet and carefully demarcate the steps that would lead us there. Yet, neither the exit itself, nor the exit strategy, nor even the desired end of what-is-to-be could become meaningful, if what is remains elusive. In other words, to formulate an exit to the crisis, we have to be clear as to what this crisis is in the first place. To put it more bluntly, it is only if we agree as to what is that we could sustainably imagine what is-not-yet and how we can get there (see Ricoeur, 1986).

This paper will start by suggesting that despite the seemingly self-evident characteristics of the eurozone crisis, neither the policy reactions to it, nor the existing proposals for economic reform, nor the long-term solutions proposed or already tested in practice, nor the reactions to those policy options attest to an agreement as to how to exit the crisis, but also, and most importantly, as to what the crisis is all about to begin with. The remedies proposed or tested so far seem to respond to different pathologies altogether. Insisting on the necessity to introduce the spark of our political imagination into a certain *penser plus* (Ricoeur, 1978, p. 303) on the subject matter, the paper stresses the urgency of a questioning that would allow us to realize, first, that what have been already described as the deep causes of this crisis, have been nothing but its mere symptoms, and, second, that the policy options opted have been functioning less as the remedies than as the accelerators of this crisis. The importance of such a reverse order of questioning is evident: It implies that instead of “digging ourselves out of this hole”, we are actually digging ourselves deeper into it. Arguing that what we really “knew” concerns less the nature of this crisis, than how all spheres of economic, social and political life have been consensually operating for years in Europe, the paper suggests that the deep causes of this crisis should be traced in the neoliberal rationality that has been permeating those spheres. Addressing the characteristics of this European neoliberal predicament, the paper concludes that instead of being seen as a hole, the crisis should be treated as a vantage point of reflection on what and where the European Union is and, most importantly, on what and where it should be.

## Contesting the Truism

It seems almost a truism to reflect on the nature of the EU crisis. We all refer to it as the European sovereign-debt crisis or the Eurozone crisis. We know when it started. We know how it developed. We know and we live its consequences. We have already seen a number of policy reactions being tested in practice since the global financial crisis erupted in September 2008, such as the various bailout programs (Cyprus, Greece, Hungary, Ireland, Latvia, Portugal, Romania, Spain); the creation of the European Financial Stability Facility (EFSF), agreed upon by the EU member states on 9 May 2010 and authorised to borrow up to €440 billion, and the European Financial Stabilisation Mechanism (EFSM), created on 5 January 2011 and relied upon funds guaranteed by the European Commission using the EU budget as collateral; the 2011 Brussels agreement, signed by the eurozone leaders and characterised by the President of the European Commission, José Manuel Barroso (2011, October 27) as a set of "exceptional measures for exceptional times", providing for a number of emergency measures, including a 50% write-off of the Greek sovereign debt held by banks; the second bailout package, agreed on 20/21 February 2012 between the Eurogroup, the IMF and the Institute of International Finance; the measures introduced by the European Central Bank (ECB) to reduce volatility in the financial markets and improve liquidity; the conduct of Long Term Refinancing Operations (LTRO); the reorganization of the European banking system; the Outright Monetary Transactions (OMTs); the establishment of the European Stability Mechanism (ESM) replacing EFSF and EFSM, which entered into force for 16 signatories on 27 September 2012, and now operates as a permanent bailout fund and financial firewall mechanism; and the introduction of the European Fiscal Compact as a stricter version of the previous Stability and Growth Pact.

A number of proposals for economic reform and recovery have been debated so far or carried out already. The June 2012 euro area summit agreement permitted the direct recapitalisation of banks by the ESM to avoid adding to sovereign debt, also providing for banking regulation by the ECB. Keynesian economists like Krugman (2012; 2009; 2012, June 27) have posed severe criticisms over the austerity measures implemented to counter the crisis. Voices of concern and disapproval have

been also raised against the unjust treatment of the working population for the mismanagement fallacies of economists, investors, and bankers (“European cities hit by anti-austerity protests,” 2010, September 29). Against this criticism, and although the IMF (2012, October, pp. 125-126) itself admitted that certain austerity policies of wealthy states to shrink their deficits through tax hikes and spending cuts have proved to be far more damaging than experts had assumed, the eurozone option has almost exclusively been the path of austerity. Some European initiatives, such as the Euro Plus Pact or the Fiscal Compact, focused more on growth, by supporting innovation and promoting small and medium-sized businesses. Internal devaluation has been also pursued by several policy makers to restore competitiveness and to balance national budgets, whereas neo-Keynesians have proposed instead the implementation of fiscal devaluation, a policy measure based on an idea first coined in 1931 by Keynes (1931) himself (Sinn, 2010, pp. 27, 47, 52, 153, 165). Others have suggested that the crisis may have to do less with public debt levels, than with trade deficits, addressing current account imbalances and, evidently, a totally different cause of the crisis itself (Pearlstein, 2010, May 21). A number of competing proposals have been also made to purchase the debt of distressed European countries, such as Spain or Italy (Thomas, 2012, July 31).

Furthermore, a number of long-term solutions have been proposed or already put into practice. One of them stresses the significance of implementing a fiscal union, a proposal recently supported by the German Chancellor, Angela Merkel, and the President of the Deutsche Bundesbank, Jens Weidmann, echoing ideas first coined by Jean-Claude Trichet, former president of the ECB (see Allard et al., 2013, September; Majocchi, 2011; Fuest & Peichl, 2012, March). Interestingly enough, although the argument for fiscal federalism and the US model have been used against the monetarist persistence to introduce the euro without a prior fiscal union, the current eurozone’s push toward the prospect of such a fiscal union is now seen with increased scepticism, not only as a development that could eventually undermine the EU, but also as Germany’s attempt to dominate Europe (“European fiscal union,” 2011, December 2; Milne, 2013, February 19; Henning & Kessler, 2012, January). Another proposed long-term solution advocates that a sole persistence on the fiscal lens is “a recipe for

disappointment", suggesting alternative options for escaping the "new impossible trinity" that involves no-corresponsibility over public debt, strict no-monetary financing rule and national banking systems (Pisani-Ferry, 2012, January). Another solution stresses the significance of European Bank recovery and resolution authority, such as the legislative proposal for a harmonized bank recovery and resolution mechanism recently adopted by the European Commission (2012, June 6), further prompting economists like Stiglitz and Krugman to suggest that Europe is not suffering from a sovereign debt crisis but rather from a banking crisis (Bowers, 2013, October 6). Other proposals insist that Eurobonds would be the best way of solving a debt crisis (European Commission, 2011, November 23), or suggest transforming the EFSF into a European Monetary Fund (Schulmeister, 2012, June), or even stress the need for a drastic write-off financed by wealth tax (Herndon et al., 2013, April 15; Rhodes & Stelter, 2011, September), or a 30-year debt-reduction plan, similar to the one Germany used after World War II (Spehl, 2011, October 30; Paus et al., 2011, January 14; Göbel, 2011, January 17; Wagenknecht, 2011, August 9).

The reactions to what has already been put in practice are also significant. Most of them (Antonopoulou, 2012, March 22; Whittaker, 2011, November 14; Reich, 2011, October 5; Janssen, 2012, March 28; Roubini, 2012, March 7) insist that the European bailouts simply shift the burden from banks and others primarily responsible, onto taxpayers. Some (Vehelst, 2011, June; "The ticking euro bomb," 2011, October 6) insist that the Maastricht Treaty itself (Articles 125 and 123 TFEU) rules out intra-EU bailouts, or that many European countries (e.g. Greece and Italy) have substantially exceeded the convergence criteria specified in the protocols of the EU Treaties (see European Commission, 2011). Some reactions focus on the negative role of certain actors that are thought to fuel the crisis, such as the media ("There is no conspiracy to kill the euro," 2010, February 6; Hewitt, 2010, February 16; "A media plot against Madrid?," 2010, February 15; Cendrowicz, 2010, February 26; Tremlett, 2010, February 14; "Spain and the Anglo-Saxon press," 2010, February 9; Paye, 2010, July), credit rating agencies (Lowenstein, 2008, April 27; Kirchgaessner, 2010, April 24; "Rating agencies admit mistakes," 2009, January 28; Wachman, 2010, April 28; Warner, 2010, April 28; Tait, 2010, April 29; "European indecision," 2010, March 9; Willis, 2009, April

24; Mackenzie, 2012, April 16), financial speculators and hedge funds (O’Grady, 2010, March 2; Clark, 2010, February 26; Wearden, 2010, May 19). Post-Keynesian theorists (Feldstein, 2012; Ricci, 1997, June; Evans-Pritchard, 2011, July 17; Hankel et al., 2010, March 25) blame the very monetarist design of the euro-currency system, suggesting that it allowed abandoning national monetary and economic sovereignty, without first providing for a central fiscal authority, calling even for the disbandment of the Eurozone or individual national exits from it (see Godley, 1992, October 8; “Germany’s interest rates have become a special case,” 2011, June 10; Joffe, 2011, September 12; “It is Germany that should leave the eurozone,” 2011, May 19; Auerback, 2011, May 25; Forelle, 2012, May 21; Roubini, 2010, June 28). Others object to this proposal, calling for greater integration instead (Erlanger, 2012, May 20; “The future of the European Union,” 2012, May 24; Douthat, 2012, June 16; Soros, 2011, October 13; Cowie, 2012, May 16) or burden-sharing between the currency union’s creditor and debtor countries (de Grauwe, 2013, September 2013). Others (Mottas, 2011, June 11; Kitidi et al., 2011), more radical ones, protest that the debt should be characterised as odious debt. Others (Magnus, 2013, September) blame political miscalculation, weakness and inertia, whereas others (Simkovic, 2009, January 4; Simkovic, 2011, January 11; Simkovic, 2010; Cox & Archer, 2012, November 18) the “creative accounting” practices of manipulating statistics by countries like Greece and Italy, but also the United Kingdom, Spain, the United States, or even Germany (Newmark, 2008, October 21; “Time to remove the mask from debt,” 2010, February 16; “Brown accused of ‘Enron accounting’,” 2002, November 28; Mallet, 2011, May 16; Goodman, 2011, March 31; “Botox and beancounting,” 2011, April 28; Vits, 2011, September 23; Siems, 2011, June 21).

Simply put, my point so far is one: We are absolutely lost. We thought we knew what this crisis is all about, but still all the above indicate only one thing: There is no agreement on what this crisis is, to begin with. Different remedies are proposed not simply on the ground of their effectiveness, but on the ground of responding to different pathologies altogether.<sup>i</sup> Indeed, there is some agreement that the crisis resulted from a combination of complex factors, such as the globalisation of finance, the global financial crisis and recession, the international trade

imbalances, real-estate bubbles, the easy credit conditions resulting in high-risk practices of lending and borrowing, the fiscal policy choices related to government revenues and expenses, or national policies of bailing out banks or corporations, violation to EU rules, the role of rating agencies and financial officials profiting from the growing debts of countries like Greece, the discrepancies between national economic policies within the EU, monetary policy inflexibility, the slow and indecisive actions from European officials, and the structural problem of the eurozone system (see "Eurozone crisis explained," 2012, June 19; "Five main reasons for European debt crisis," 2013, April 8; "The causes: a very short history of the crisis," 2011, November 12; Lewis, 2011; Story et al., 2010, February 13; Knight, 2010, December 22; Akerlof & Shiller, 2009; *Les économistes atterrés*, 2011, October 27; Krugman, 2012, January 30; Economist Intelligence Unit, 2011, March; Krugman, 2009, March 1; Emsden, 2012, June 13; Johnson, 2012, June 21; Greenlaw et al., 2013, February 22; "Europe's banks," 2012, June 7; Friedman, 2012, June 12; Alderman & Craig, 2011, November 10; Wools, 2012, May 17; Thomas, 2012, June 17; Castle, 2012, June 4; Ewing, 2012, May 31; Ewing & Kanter, 2012, June 5; Jolly & Castle, 2012, June 12).

Yet, are we really sure that all these are the deep causes rather than the symptoms of a much graver European pathology? Are we sure that these factors answer more to why this crisis started, rather than simply to how it developed the way it did? Even if we assume that all those constitute the real causes of the crisis, isn't it that they explain more why this crisis broke up at a given instance, rather than why it broke up at all? Aren't these factors that we now describe as the causes of the crisis, the very factors that allowed growth and development to boom in the past? What was really novel, unique, or exceptional in all this? Wasn't it European (and global) business as usual?

Indeed, it is easy, and superficial I would add from both an economic and a political perspective, to blame the member states of the European South for inconsistencies or poor performances altogether. We have even come up with the aptest word to describe them, "PIGS", whereas newer versions also add a second I (PIIGS), including Ireland, and/or a second G (PIIGGS or PIIGGGS), for Great Britain. Yet, isn't it the case that most of what those "PIGS" have been practicing, had been also practiced by other EU states? Take, for example, the so-called "creative

accounting” practices. Have such practices been foreign to European states, or abroad (e.g. the United States)? Numerous studies so far attest to the contrary (Koen & van den Noord, 2005; de Castro et al., 2011; Beetsma et al., 2011; IMF, 2011, September; von Hagen & Wolff, 2004; Milesi-Ferretti, 2003; Sopelsa, 2010, February 16; Balzli, 2010, February 8). The so-far European record of “one-offs”, “creative accounting” and “reclassifications” concerns not merely dubious business behaviour (Jones, 2011; Baralexis, 2004), but also similar behaviour of European states, including of course Greece and the rest of the so-called PIGS, but also countries like Ireland, Belgium, the Netherlands, Austria, Denmark, Finland, France, Germany, Sweden, and the United Kingdom (Koen & van den Noord, 2005).

Furthermore, was it not Germany that received €15.5 billion from the securitization (Lambe, 2005, October 1; Brown & Chambers, 2005, September; Santos et al., 2006; “Securitization”, 2005, July 1) of pension-related payments from Deutsche Telekom, Deutsche Post, and Deutsche Postbank in 2005-2006, “but it guaranteed the payments so investors bore only the risk of the German government’s credit – and the transactions were ultimately recorded in Europe’s fiscal statistics as government borrowing, not asset sales” (Irwin, 2012, March 28)? Furthermore, were countries like Germany truly ignorant of the inconsistency of such accounting practices and of the inability of countries like Greece to limit their deficit spending and debt levels meeting the Maastricht criteria? Or were they simply confident that by politically ignoring and allowing such practices, their own national economic and political interest would be best served?

It seems that what is truly at stake here concerns less state inconsistencies to eurozone regulations than, *a contrario*, state consistencies to already established corporate practices in a market economy. In any case, the way we would answer questions such as the above may tell us more not only on issues of responsibility and accountability, but also on how this crisis should be dealt with in the future. Even more, it may tell us something more on the deeper pathologies of the European project altogether.

## **The *Pharmakon* of the European Neoliberal Predicament**

The kind of questioning proposed above neither reverberates the already banal, yet still unverified, claim for the demise and eventual collapse of the state, nor implies that the neoliberal practices followed are essentially anti-statist, nor merely suggests that economic neoliberalism has permeated all spheres of social and political life (Harvey, 2005, chs. 3 and 7). Quite paradoxically, this questioning calls for a reversed mode of thinking, centred around the argument that it is simply not enough to conceive neoliberalism solely in economic terms. Instead, I hold that the problem may be addressed differently once we conceive neoliberalism as an overarching political rationality (Foucault, 1988) that delineates the organization of all three: state, society and individual (see Brown, 2005).

Understood as such, this neoliberal political predicament in Europe, pertains already to the following distinctive characteristics: Political life in its entirety is subdued to the rationality of economic neoliberalism. Every action, from state policies to individual behaviour, is no longer "action" in an Arendtean sense (Arendt, 1998, p. 7), understood as a condition of human plurality, a condition for political life. It aims at profit and is idealized as rational entrepreneurial action, the outcome of self-interested calculations of individualistic monads based on utility and profit, succumbing to the laws of supply and demand. Due to its current neoliberal sway, the European Union has already turned into an assemblage of institutional mechanisms that promulgate discourses and practices that, in turn, reward the enactment of this shared belief and discipline and punish any deviation from the rule.

A set of laws, regulations, state sanctions and social norms have been already enacted to direct and protect this enterprise. Nevertheless, it is neither the legislating EU institutions nor the hegemonic whims of its most powerful member state(s) (i.e. Germany) that control the market. Instead, it is the market that dictates all policies, measures, regulations, and sanctions. By that I mean the following: First, EU member states respond to the needs of the market and are evaluated on the ground of their success in this domain. This success is further measured, indexed,

graphed, and reported back to the member states themselves and the EU monitoring institutions, generating policy changes and state sanctions. Second, EU member states have to follow this market rationality. They do not just have to think and talk economics rather than politics. They have to think and act as market actors. Third, the success of the economic policies of an EU member state and their economic performances become their own legitimating basis and the guiding principle behind any state action in all spheres of social and political life.

Once this neoliberal predicament reaches the level of the European citizen through the means of sanctioning regulations and the culture they help disseminate, individuals come to behave as rational, self-interested, calculating entrepreneurial actors that identify economic and moral behaviour. Quite interestingly, given the realm of freedoms that the system generates, this gives rise to a new sense of individual responsibility (similar to the one developed at the state level), which becomes understood in a way indifferent to systemic or cultural necessities, specificities or constraints. Once both EU member states and the EU citizen are imbued by this neoliberal rationality, social policies are formed and evaluated on similar terms, and partly assumed, at least for now, by corporations rather than the social welfare state.

To conclude, in this neoliberal rationality, the EU member state does not merely facilitate the operation of a market economy, but organizes and realizes itself and its own operations in market terms. Quite interestingly, and against what is normally expected, this process does not necessarily weaken the role of the state. Instead, it allows the prevalence of those states that already have the economic power not only to survive the crisis and profit from it, but also to project this power as moralized state power, that should be exercised both at home and abroad.

Elsewhere, I have suggested (Akrivoulis, in print) that this development is but a manifestation of the seemingly contradictory contemporary convergence of neoliberalism and neoconservatism, as well as a distinctive element of neoconservatism, that departs from and, eventually, abandons the older commitments of classic conservatism (Norton 2004) “to a modest libertarianism, isolationism, frugality and fiscal tightness, moderation, and affinity with aristocratic values of refinement, rectitude, civility, education, and discipline.” What I find to

be equally interesting and relevant to the present analysis is the fact that, at least so far, many of the neoliberal policies and strategies followed by the European Union to deal with the crisis, could themselves be held accountable for the crisis. This is remarkable, indeed, but should be hardly seen as striking. Even the Ancients recognised that the medicine itself (*pharmakon*) is at the same time both a poison and a medicine, both the cause of sickness and its remedy (Plato, 1965; Derrida, 1983). Marx is often claimed to have suggested that the many crises of capitalism bring it closer to its own unavoidable "collapse". To my reading, at least, of Marx, those crises constitute less the progressive stages of the systemic self-demise of capitalism, than the distinctive phases of its own empowerment. The collapse of capitalism still remains to be put to its historical test. But what is of interest here relates more to what the crisis truly is and what needs to be done to exit it successfully.

Returning to national currencies and the idea of exiting the Eurozone or even the Union itself has been already politically securitised (Williams, 2003, p. 512; Buzan et al., 1998), it has been, that is, represented as a high national security issue. As such, it is normally and easily excluded as an option. As no alternatives are left, the remedy opted is more often than not the same neoliberal *pharmakon* that has brought us here. If this is the case, is it not possible that instead of digging ourselves out of the hole, we are actually digging ourselves deeper into it?

## Conclusion

The present paper first suggested that the various policy measures proposed or already implemented to deal with the eurozone crisis attest not merely to a controversy on how to exit this crisis, but to a far more fundamental discord as to what this crisis is all about. The paper called for a reversed mode of questioning of what we take for granted. Such questioning would allow us to realize that what have been so far described as the deep causes of the crisis are nothing but its symptoms, and that the already implemented policies have been functioning less as the remedies than as the accelerators of this crisis. I then argued that what we really know about this crisis – and have been knowingly consented to

– concerns less its nature than the very conditions that generated it: the fact that all spheres of economic, social and political life in Europe have been consensually operating for years imbued by a neoliberal rationality.

Political discourse is already framed, and has been framed for years, by the strict confines of possibility allowed by neoliberal options. For years now, European leaders have been meeting in Brussels discussing less on politics, than on economics, and especially an economics of this neoliberal sort. For years now, succumbing to the entrepreneurial rationality of neoliberalism, the EU member states follow practices reflecting those followed by competitive corporations rather than peoples that aim at the Aristotelian ‘good life’ “with and for others in just institutions” (Ricoeur, 1992, p. 172). For years now, the European Union has been attempting to teach liberal democracy to newly integrated states with no liberal democratic memory or tradition, by way through exposing them first to the opportunities and perils of the neoliberal *mare nostrum*. These neoliberal practices have been so strongly attached to the European project, that one is eventually seen as pro-European or anti-European depending on one’s own position toward such practices. This is why I insist that now, perhaps more than ever, it is high time we asked ourselves what this crisis is, what the European Union is, and what and where it should have been. This is the task of all political beings, policy makers, laypeople and academics, in particular.

The eurozone crisis, just like any other crisis, is indeed always already an opportunity. But first and foremost it is a moment for crucial decisions and judgement. According to Koselleck’s (Koselleck & Richter, 2006) seminal reminder of the self-evident, for the Ancients, the very word crisis (*krisis*) has its roots in the verb *krino*, which means to “choose”, to “judge”, to “decide”, as a means of “measuring oneself”, to “quarrel”, or to “fight”.<sup>ii</sup> *Krisis* is most necessary for the community, representing what is both just and salutary. My point is simple and clear: The Eurozone crisis is not a simply or merely a hole. Quite paradoxically, it is always already a vantage point of reflection on what and where Europe is, as well as what and where it should be. This decision truly adheres to our tasks as European citizens.

### ***Endnotes***

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<sup>i</sup> This notable discord on what the crisis is, what the proper remedies are, and how the European economy will look in the future, is more than evident in the contrasting views of four leading European economists, Paul de Grauwe, George Magnus, Thomas Mayer, and Holger Schmieding, invited recently by the Centre for European Reform to include their arguments in a collective volume. As Simon Tilford (2013, September, p. 10) suggests in the volume's introduction, "the future of the European project will to a large extent depend on which of the four authors has best predicted the future."

<sup>ii</sup> The term was central to Ancient Greek politics, defining the ordering of the civic community. As Koselleck (Koselleck & Richter 2006, p. 359) suggests, "from this specific legal meaning, the term begins to acquire political significance."

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## **Migrations in the European Union: Looking Ahead to 2050**

*Zlat Milovanovic*

### **Abstract**

*Migration can be defined as a process whereby people move from one place to another, either for a certain period of time or forever. Europe was built on migrations and its peoples have helped populate other continents. The European Union (EU) is an international organization *sui generis* which has a new form of migration – intra organizational migration. If the EU decides to close its doors to further immigration from outside the EU (or to end the process of enlargement), its economic development will be at risk. Its aging population will not be able to compete in the global market as successfully as now. Shrinking numbers of workers and employees will not be able to produce the resources needed to bear the burden of the pensions of those retired or for the repayment of the sovereign debts of various EU nations. The financial crisis will continue, leading to emigration from Europe to other parts of the world. If, on the other hand, the EU decides to open its gates to greater immigration, especially from the developing nations, it would be helping not just the immigrants themselves but also its own people. States and international organizations exist to provide services for their people, increasing their standards of living within international solidarity. This paper shows that a reduction of natural population growth will affect the EU and the world, that the candidate countries (Turkey excluded) are in a population crisis greater than that of the EU, and that global solutions for peace and prosperity should be leading ideas in creating future migrations policies. Europe will need a larger population, from its candidate countries and*

*beyond, in order to maintain its position in the world. Further academic research as well as consultations among EU and non-EU nations on migration will provide the main avenue to a better world.*

*Keywords: Immigration, EU policy on immigration and enlargement, population size, aging population, labor shortages, pensions crisis, debt crisis, war and population, moratorium on warfare, United States of Europe, defining Europe.*

“Migration is a part of our past, present and future. It has always been and always will be a part of what makes Europe, and if looked upon as an opportunity, rather than a threat, migration can make us grow stronger, economically, culturally, [and] morally.” (Malmström, 2012).

These are the words of Cecilia Malmström, EU Commissioner of EU Home Affairs, on the occasion of the 2012 International Migrants Day. She is the EU official who proposes policies within the Commission and deals with the complex issues of immigration. It is almost a truism to suggest that EU immigration policies affect future developments within the EU and throughout the global community. The policy choices are not easy, especially since the EU is still in the midst of an economic and financial crisis. That crisis, and the EU’s inability to reach decisions on how to solve it, affects every aspect of the EU, preventing it from formulating a clear concept of its enlargement, of necessary future institutional reform, and of its foreign and security policy as a global power. With respect to immigration there is the same lack of clarity. The EU’s growth through immigration is both accepted as needed and rejected on various grounds as being too difficult.

In the next pages we will seek to describe: a) EU immigration policy today; b) present and future population development trends; c) the situation of the candidate countries, and d) some proposed solutions based on traditional ideas of peace and prosperity. Looking ahead toward the year 2050, the mid-century, there are important questions to be answered: Does the EU need a population increase? Does population growth ease the tax burden, the debt burden and the pension crisis? How is population growth related to war and peace, if at

all? What contribution can today's researchers, intellectuals and citizens make?

## **EU Immigration Policy Today**

Immigration, refugees and asylum are a part of the same EU policy, formerly contained in pillars one and three, now within the Area of Freedom, Security and Justice. The scope of EU action has steadily widened, most recently with the Stockholm program (2010-2014). Since the conclusion/implementation of the Lisbon Reform Treaty, decisions have been made by the Council by qualified majority, with an expanded role for the Commission and the Parliament. The free movement of persons is a fundamental right guaranteed by the Treaty of Maastricht (The Treaty on the European Union, The Consolidated version, C 321 E 1). Migrations cover three categories: nationals from each EU nation, nationals from other EU member states (27/28) and third country nationals. The EU's task is to strengthen the external borders of the Union, regulate legal entry and residence of non-EU nationals and adopt a common immigration, refugee and asylum policy.

The EU common policy, which is currently under development, is built on the basis of mutual solidarity and responsibility of the member states, their labor force needs, the immigrants' integration into host country societies and the avoidance of a brain-drain in the countries of origin. The so called "Immigration Pact" was adopted on October 14, 2008. Immigrants from third countries should belong to one of the following categories: highly qualified workers, subject to the Blue Card Directive; students and researchers; family members of the above categories (family reunification); long term residents (EU Long Term Residence Directive); seasonal workers and intra-corporate transferees (Single Permit Directive, 2011). In some of the situations listed above temporary residence may be granted on the basis of an EU Green card which is an employment permit. An immigrant accepted by one member state can also move to another member state under certain conditions and using the same permit.

The goals of the common policy are to: a) facilitate admission to the EU (harmonize entry rules and residence conditions); b)

simplify procedures; c) attract highly qualified workers; d) enhance EU competitiveness. There are also new common rules for refugees and asylum seekers, all better defined than previously but still not completely agreed upon by all member states. An online information source, called the EU Immigration Portal, has been introduced to explain the new legislation to potential immigrants. Many technical improvements have already been made to implement the new system. In Strasbourg, the Central System I – otherwise known as SIS I (Schengen Information System), which lists all persons inadmissible to the EU, is being transformed into a new Central SIS II by convention. In general, the policy and procedures adopted so far have many advantages over the previous system. The system has become unified and the differences between one country and another, which were sometimes enormous, have been eliminated.

## Population Trends

Demographic movements, as is well known, go in cycles. In the 20th century, the world population rose from 1.6 to 6.1 billion. This trend is, however, unlikely to continue in this century. In 2013, the population of Europe is estimated at 741 million (US Census Bureau, IDB 2013). The EU population is estimated at 503.50 million (Eurostat, 2012).

TABLE 1: below contains population figures in 1900, in 2008 and in 2050 projection (in millions):

Country	1900	2008	2050
France	40	60	66
Germany	56	82	71
UK	32.5	54	64.3
Russia	133	142	104
Italy	32.4	59	43
Turkey	31	79	98.8
EU 27 (reconstructed)	308	504	471.4
USA	76	303	397

(STAT/05/48 and Eurostat for 1900 and 2008)

With a few exceptions, there is an increase by 2008 and a decrease by 2050. Additionally, the population of Europe, which constituted 24% of the World's population in 1900, fell to about 11% by 2008 and is projected to further decrease to 8.20% by 2050. (UN World Population Prospects Report, 2005-2010).

The figures above are indicative yet not completely comparable due to constant changes to the borders and territorial size of states, notably due to wars and peace agreements. The great empires were built on the expansion of their territories. This has been the case even for smaller states. Population size changed with territorial changes. In World War II, for example, states' borders changed, populations were exiled, and refugees resettled. Even in internal conflicts, those practices have continued.

Looking at the figures, the population of many states has increased since 1900. The European citizens of today, however, were in 1900 citizens or subjects of empires, such as Austro-Hungarian, Russian, German, and Turkish (Ottoman) Empires. Those empires ceased to exist after 1918. The EU of 27 member states taken together has grown by 63% since 1900. Meanwhile, the US population has grown by 299%, in large part due to immigration from Europe. Turkey, which remained neutral in the Second World War, and now has a population 155% greater than that of its empire in 1900.

The total population of any country or group of countries depends on its natural growth plus its net immigration (i.e. immigration – emigration). The present worldwide average fertility rate is 2.52 children per woman, while 2.1 is the so called natural replacement fertility. Many European countries are now at the low rate of 1.5; some of them even have a negative growth, that is a population decline. No nation is likely to disappear by 2050, although we know that many nations have already disappeared from the map of Europe (such as Livonians, Ragusians, Venetians and Oldenburgers).

Europe faces many challenges relating to population and migration. There is insufficient manpower available, significant and rapid growth in the numbers of senior citizens, and a resulting support burden on workers and employees (Eberstadt, 2010). Some estimates predict that 50 million working age people will be needed in the EU 27 by 2050, with the figure possibly rising as high as 100 million. The

pace of globalization, the need to attract more highly skilled workers, the need to remain competitive, the need to control illegal immigration all are manifest even today (BBC, EU Immigration Policy, 2008).

Unless natural population growth increases, EU senior citizens will need to remain active in the workforce far longer (therefore implying an increase in the age of retirement age) and/or a much higher level of immigration will need to be allowed if not actively fostered. Additionally, Europe will find itself competing for immigrants with Russia, India (Southern India), China, Japan and the US, as all those nations will need more skilled immigrants due to their own population dynamics (Eberhardt, 2010). Despite the favorable situation today, most regions of the world will have population problems of some kind, the only exceptions being Sub-Saharan Africa and Latin America. For the EU, aside from liberalization of third country immigration, an obvious alternative is the expansion of membership in several directions.

In 2008, 3.8 million people immigrated into the EU while 2.3 million emigrated, yielding a net increase in population of about 1.5 million. In 2010, 3.1 million immigrated, while 2 million emigrated for a net gain of 1.1 million (Ecostat, 2011, Statistics in Focus). There were about 8 million illegal immigrants (Eberstadt, 2010).

Looking at 2010 immigration figures, 21% of the total is represented by nationals of EU countries returning home, 31% are nationals of other EU countries moving within the EU, and 48% are third country (non-EU) nationals.

TABLE 2: The largest number of non-national immigrants chose to come to the following four countries:

UK	591,000
Spain	465,200
Italy	458,900
Germany	404,100

In 2010, 810,500 immigrants acquired citizenship of a member state, up 4.4% from 2009. The countries with most new citizens were (TABLE 3):

UK	194,800
France	143,300
Spain	123,700
Germany	104,600

TABLE 4: The total numbers of non-nationals living in the EU in 2011 (millions):

Germany	7.2
Spain	5.6
Italy	4.6
UK	4.5
France	3.8

Those non-nationals come mainly from Turkey, Albania, Ukraine and Morocco, with some 15.5% from the Americas. (Eurostat, 2012, Statistics in Focus / for the above data).

The problem with immigration is that it brings in numbers but not necessarily the high qualifications needed in the host countries. Thilo Sarrazin, in his book published in 2011, argues that the immigrants are “destroying Germany” as they are refusing to integrate. Angela Merkel even said that multiculturalism had failed in Germany (Jacoby, 2011). Germany has taken measures, within the EU and its national legislation, to attract more qualified professionals by such measures as the Blue card, the Green card and several new kinds of visas. The German government has organized so-called “immigration courses” in which language instruction is essential (*ibidem*). Immigration into the UK, France and Spain also encounters problems of integration too, although immigrants to those countries mostly speak the languages involved (i.e. English, French and Spanish). Immigration to Hungary concentrates on Hungarian-speaking nationals of other countries, two of which are already within the EU (Romania and Slovakia). In Sweden, immigrants are considered more like contributors to the country in terms of economics, culture, and society. Sweden has helped large numbers of refugees, most recently from Iraq, Ethiopia, Eritrea, Yugoslavia, and Turkey. Among the Iraqi nationals, a large number of Mandeans have been saved, an ethnic group of Aramean origin and gnostic religion who

are subject to discrimination and destruction in their country. Sweden has saved many Assyrians as well. Belgium has accepted a number of Turkish citizens, some of whom are Aramean, Lykian, Kurdish and other minorities. Many EU countries, including the largest ones, have acted similarly in so many cases and for centuries.

\* \* \*

There are many other issues that need to be looked at least briefly, at least in passing.

a) *The pensions crisis.* This refers to a predicted difficulty in paying for corporate, state and other pensions. The ratio of active workers and employees to retirees is diminishing, making it more difficult to cover the future pensions of those working today. In the EU, there are now 3.5 workers to one retiree. In 2050, this ratio will be 1.8 to one. In the US, for instance, the underfunded obligations of the Social Security System have been estimated to be 1 trillion dollars. EU citizens aged 65 – 80, will represent 29.9% of the population in 2050, up from 16.4% in 2004, which is almost double. Their number will be 134 million and they will not be able to retire at 65. The percentage of those 80 years old or older will be 10% in 2050, that is some 44 million people. (European Commission, Report on Populations' Projections 2004 – 2050, April 8, 2005).

b) *The debt crisis.* Another problem is that, as smaller populations will have the obligation to pay higher debts. The amounts involved are trillions of dollars or Euros. The larger and richer nations can afford to have debts but the smaller ones cannot.

TABLE 5: Public debt per country expressed as a percentage of GDP (in percentages):

	2012	2050
France	182	82.30
Germany	142	15
Italy	108	25.4
Spain	84	107.6
Ireland	108	234.20
Greece	174	232.9
USA	64.8	152.9

(Based on IMF, World Economic Outlook, 2011).

The situation will get substantially worse with those countries that already have considerable debt problems. The only way to solve this is to increase taxes as a proportion of GDP. Although unpopular, they can be made less unpopular by a more equitable distribution of income and wealth. General welfare increases with more equality. (Governments and Foreign Debt, Global Projections to 2050, Project Link Conference, New York, Oct. 26, 2011). Of course, a tremendous growth of GDP per country could help!

c) *Wars and population.* Wars, both international as well as intra-state conflicts, increase the flow of emigration from those countries at war and immigration into those not at war. Individuals and whole ethnic groups are forced to leave their countries. This phenomenon has been well known since time immemorial. Even limited wars kill people and reduce population even when they are successful in remaining limited. Wars increase national debt and inflation, they prevent trade and development. If some 250 wars have been fought in the sixty-eight years since 1945, it is likely that some 138 more wars will have taken place by 2050, not taking into account a potential Third World War. Right now, there are wars in Congo and the Great lakes Area, in Mali, Niger, Somalia, Sudan (Darfur), Afghanistan, the Philippines, and Syria, to mention just a few.

d) *Economic crisis:* We are assuming that the EU will find a way out of it before too long.

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Although we can use currently available projections for the future, we do not know the real shape of the things to come. For instance, how many countries will join the EU before 2050 and consequently how large will the EU be? The enlargement can be limited or it can take the borders of the EU far in every direction. If it doubles the size of the EU's population, it can solve a lot of problems more easily, while at the same time the EU becomes a major global power in its own right. An increase rather than a decrease in population will be the way to go.

## **The Situation of the Candidate Countries**

At the time of writing, one country, Croatia, which applied in 2003 is acceding to the EU and is to become a member state on July 1,

2013. The remaining current candidate countries are Turkey, Macedonia, Iceland, Montenegro, and Serbia. Turkey, which had been an Associate member since 1964, applied in 1987 and became a candidate on December 12, 1999. Negotiations started in 2005. It has been in a Customs Union with the EU since 1995. Macedonia applied in 2004 and became a candidate on December 17, 2005. Iceland applied in 2009 and became a candidate on June 17, 2010. Negotiations started in 2010. Iceland is a European Free Trade Association (EFTA) member, a part of the European Economic Area (EEA) as such implementing already a part of the *acquis communautaire*. Montenegro applied in 2008 and has been a candidate since December 17, 2010. Serbia applied in 2009 and has been a candidate since March 1, 2012.

Albania applied for membership in 2009. Other potential candidates are: Bosnia and Herzegovina, Moldova, Switzerland (EFTA member), the mini-states (e.g. Lichtenstein, EFTA and EEA member) and Cape Verde. Kosovo could also be considered a potential candidate. Norway became a candidate and concluded its negotiations with the EU, but its voters rejected membership in 1994. Norway is a member of EFTA and the EEA. Morocco applied as well but its application was not accepted by the EU due to the fact that it is not a European country.

Population trends among the candidate countries are similar to those among the EU 28, although the decline may be more pronounced in some cases.

TABLE 6: Population of Candidate Countries in 1900, 2012 and 2050 (millions):

Country	1900	2012	2050
Croatia/Slavonia	2.2	4.3	3.9
Dalmatia	0.6	Part of Croatia	Part of Croatia
Turkey/Ottoman Empire	31	79	98.8
Macedonia	1.2	2.06	1.6
Iceland	0.8	0.3	0.3
Montenegro	0.3	0.6	0.6
Serbia	2.6	7.1	5.9

TABLE 7: Other countries in the Area:

Slovenia (EU)	1.0	2.06	1.6
Greece (EU)	2.8	10.8	10.04
Bulgaria (EU)	3.1	7.4	4.6
Romania (EU)	6.6	19.04	18.06
Cyprus (EU)	0.24	0.8	1.4
Bosnia and Hercegovina	1.4	3.8	3.9
Moldova	1.9	3.6	2.3
Albania	0.83	2.8	2.82 (3.1 in 2025)

(US Census Bureau, 2012 some figures from national data used by the USCB, 1900 from encyclopedias).

Aside from Turkey, countries in the area show a clear decline in population in most cases, some of it greater than that of the EU 27. The EU members from the area remain close to non-member states in their population trends. Taking into account all the candidates other than Turkey by 2014, as originally proposed by Greece in the Thessaloniki Plan, would mean a population increase of 10.6 million for the EU. If Turkey is included, the new members would make up 17% of the EU population. The Thessaloniki Plan is not being followed.

Turkey remains a challenging candidate for several reasons. For some EU members, Turkey is not a European nation (although about 20 million of its people are European). Were it to join, Turkey would become the largest nation within the EU, which would change the balance which has been developed to date among member states. Furthermore, some EU states do not consider Turkey to be sufficiently democratic. There are also some other differences, e.g. Turkey is predominantly a Muslim country, while most of Europe is Christian.

By contrast, Turkey is a member of every other European and Euro-Atlantic organization, including NATO, OSCE, OECD, and the Council of Europe. Historically, Turkey was a major power in Europe from at least the 16th century, and has been a participant in European affairs and conferences despite its Islamic leadership then of the whole world (the Caliphate). Along with other European powers, Turkey was responsible

for peace and war in Europe. It was an imperialist and a colonialist power, shifting its alliances, as others did. For instance, when in 1885 the Congress of Berlin divided Africa, the Ottoman Empire participated in those decisions too. Turkey is a link with Asia and the Middle East, a factor of stability and progress, and a necessary and inseparable part of Europe.

Geographically, the EU is already present on several continents, including in Asia (Cyprus), in Africa (Reunion, Canary Islands, Ceuta and Melilla), America (French Guyana, Martinique, Guadeloupe, Dutch territories). The Mediterranean basin in its entirety was the organizing principle of the Roman Empire and is now linked with the EU within the Union for the Mediterranean. North Africa is traditionally connected to Europe and could logically be an area of EU enlargement provided that it makes the right choices in its further development.

If all of the European nations get equal chances to join the EU, there are only a few remaining non-member states in addition to those already mentioned: Belarus, Ukraine, Russia, Switzerland, Kazakhstan (with a small part of its territory in Europe). By including all of Europe, the EU could have a population of about 800 million.

A number of nations in the East, led by the Russian Federation, are working on a new Euro Asian Economic Union (EAEU), a parallel organization, with a population of 207 million which would compete with the EU. The EAEU is already a customs union, organizing a common economic space and envisioning even a common currency. It was originally established by an agreement signed in Kiev on October 10, 2000. Its member states are looking at Turkey as a potential member, as well as some other countries which have not received or are unlikely to receive EU membership. Could this be the beginning of a new division of Europe into East and West? Would that kind of future be preferable to enlargement or increased immigration to the EU?

Ukraine is divided between those who favor full EU membership and those who are in favor of the EAEU. Ukraine and Armenia have observer status within the new organization, Armenia being a non-European European while de facto and historically European. Russian foreign minister Lavrov said recently that the Euro-Asian integration is a "contribution to the collective efforts to stabilize the world economy" He wished Ukraine would join, thus expanding the market labor force to 160-170 million. (Sergei Lavrov, The Voice of Russia, July 9, 2012). He

also said that the EU and the EAEU do not contradict each other “as they are promoting the same economic processes including the free flow of capital”.

The question of the two organizations is more political than economic. At this stage, Russia and the EU have bilateral cooperation although Russia has shown no interest in EU membership. Historically, Russia has been a great European power, one of the leading ones in the 19th century and the beginning of the 20th. More than Turkey, Russia is responsible for some of the ups and downs in European history. Most of its population is European and it is a natural link to Asia and the Far East. Unlike Turkey, Russia participated in the Second World War and became a superpower thereafter, participating in the division of Europe and the world. The OSCE territory extends “from Vancouver to Vladivostok” which is the broadest definition of Europe and encompasses three continents, including in North America the US and Canada. Ultimately, the OSCE version of Europe could become the world’s largest economic power. It would take a union of that size to match the populations of the world’s most populous nations and continents. Such integration would still be smaller than a world federation. But not going that far, one can say that Russia too is an inseparable part of Europe.

## **Some Traditional Ideas on Peace and Prosperity**

“Our country is the world, our countrymen are all mankind. We love the country of our nativity only as we love the other lands. The interests, rights, liberties of American citizens are no more dear to us than are those of the whole human race. Hence we can allow no appeal to patriotism, to revenge any national insult or injury.” (William Lloyd Garrison, 1838)

By comparison, the predominant modern idea is to exclude foreigners, whether by law or by force. Today’s leaders rarely state those things as clearly as Garrison expressed his idealism. Modern nations use their navies to stop refugees from reaching their shores, they build walls, they use police and border guards, occasionally endorse xenophobia and racism. They encourage those who have already arrived to decide to leave, even by paying them money to do so. Yet, in so many cases, they accept refugees and give them asylum.

The Roman Empire, which covered the territories of some EU member states, candidate countries, the whole Mediterranean area and more, discovered the advantages of immigration and the incorporation of foreigners into the Empire. Cicero, speaking to the Senate in the year 56 BC, said the following: Without doubt, what has done most to increase the power and reputation of the Roman people is the precedent laid down by Romulus, the founder of the City, when he made the treaty with the Sabines and showed us that we make ourselves stronger by welcoming even our enemies as citizens. Our ancestors never forgot his example in granting and bestowing citizenship on others. (Cicero gave as examples the communities in Africa, Sicily, Sardinia, worthy foreigners who helped Rome from anywhere, even slaves). In 212 AD, Emperor Caracala enacted the *Constitutio Antoniana de Civitate*, making all free men of the Empire Roman citizens!

By following Garrison's idealism or Cicero's realism, modern leaders should be thinking about future alliances and federations with other nations, as well as about an increased immigration. The idea of a European federation goes back for centuries, to Dante, to Erasmus, to Kant, to Rousseau *inter alia*. Both in the US and in France, following their respective revolutions, the idea was linked to pacifism, that is to preventing future wars, especially since wars became increasingly more deadly and devastating. The international community adopted a more peaceful attitude after the Napoleonic wars, and the longest period of generalized peace in Europe emerged in 1815 and lasted until 1914. The American Civil war raised fears of a new war in Europe and prompted the Peace conferences as well as the pacifist movements.

Speaking at the Peace congress in 1849 in Paris, Victor Hugo spoke of the United States of Europe:

A day will come when you, France, you Russia, you Italy, you Germany, all of you, the nations of the continent, without losing your distinct qualities and your glorious individuality, you will merge closely within a superior unit, and you will constitute a European fraternity, absolutely as Normandy, Brittany, Burgundy, Lorraine, Alsace and all our provinces have merged within France... The two infinite forces, the United States of America and the United States of Europe will be working together for the good life of all... (Kurlansky, 2008)

In 1867, together with George Sand and Alexandre Dumas, Hugo called again for a supranational state, (“enormous, free, illustrious, rich, thinking, peaceful, cordial toward the rest of humanity”.) Wars between Paris and London, Petersburg and Berlin, Vienna and Turin, will be pointless and unthinkable! (Kurlansky, *ibidem*).

The same year, the conference of the League for Peace and Freedom met in Geneva, gathering some 6000 participants, among them William Randal Cremer, Michael Bakunin, Giuseppe Garibaldi, Emile Acollas, John Stuart Mill, and Louis Blanc. They called for the United States of Europe (USE), for the abolition of standing armies, for the right to work and an end to racism.

Later on, in connection with the First World War, a Women’s International League for Peace and Freedom was formed in 1915 after first becoming a US political party. It called for a conference of neutral states to mediate for peace in Europe. That League is still in existence, active within the UN system and within the United States.

After the First World War, there were serious attempts within the League of Nations to make international arbitration compulsory in solving inter-state disputes. In 1929, the French Prime Minister Aristide Briand proposed the creation of a European Federal Union to the Assembly of the League of Nations. This proposal was not well received given the growing nationalism which was ultimately to take over.

After the Second World War, it was Churchill who was the first to propose the United States of Europe in 1946. The EU Fathers – Monnet, Schumann, Adenauer, De Gasperi – were all in favor of a united, integrated Europe. Many accomplishments of the EU lead in that direction: the four freedoms, the single market, the common currency, the European citizenship, the common policies, the Common Foreign and Security Policy, etc. More than the United Nations, the EU is unifying its member states.

What is missing is the will to unify politically, like the US states did, to become one nation. What is also missing is the will to enlarge the union in various directions, yet to be defined; the will to open all its member states to immigration from Europe and other parts of the world; and the will to stop warfare as national policy of member states and globally.

The EU must decide how far it wants to expand: all of geographic Europe with some political corrections, the Council of Europe (47 states working for European integration), the OSCE area (56 states)? The EU needs a leadership that is able and willing to make that decision sooner rather than later.

At the present stage, the EU needs a larger population, something that should be achieved by immigration, in cooperation with other states (candidates and potential candidate countries). Increasing immigration does not have to await further enlargement: The new immigrants may have to be trained and educated in Europe before joining the future labor force. Incentives are needed for immigration to all EU countries, and should be tailored to the needs of those countries while taking into account the needs of Lesser Developed Countries (LDCs), i.e. the process of "brain circulation", to use the term invented recently by the EU.

Concerning warfare, if it is to be continued in this century, the EU will need a much bigger population. Those intellectuals and philosophers who wanted to relegate artillery to museums in 1867 were mistaken. The EU can trust many nations but not all of them. Strategically, a larger population means more power. At the World Fair in Paris, also in 1867, the most modern canon made by KRUPP was presented by the Emperor of Prussia at a time when no one thought that a war was to follow only three years later, a war that led to the First World War which later led to the Second World War.

A peaceful United States of Europe would have been a much better idea than the subsequent loss of millions upon millions of young people. For one thing: Like Turkey in the Second World War, Europe would not have experienced the population decline, it would have been richer and more developed, and the whole world would have been better off. (Both world wars spread from Europe to the whole world, though not affecting it to the same degree as Europe or parts of Asia). Permanent warfare in the world should be replaced by international agreement providing for a provisional and complete warfare moratorium for 20 years with international prohibition of all civil wars. Nations could have the time to pay off their debts, control inflation, take significant steps in arms control, real disarmament and increase the living standards everywhere. New procedures for changing the status of ethnic groups within nations should also be examined, adopted and applied. International conflicts

should be turned into a chance to develop international friendship, solidarity and cooperation. This could be an EU global initiative.

The EU Reflection Group Horizon 2020-2030 established by the Commission in 2007 and chaired by Felipe Gonzales presented its report in May 2010. The report deals with many important issues, including the organization of the EU, but not the strategic issues which are left to the member states. The Commission presented a “Proposal for European 2020 Strategy” on May 3, 2010. It is a “strategy for smart, sustainable and inclusive growth”. The main targets of this proposal are: employment, education, research and innovation (i.e. an “Innovation Union”), social inclusion and poverty reduction and climate/energy initiative. Altogether, seven “flagship initiatives” for more jobs and better lives. The population issues were not dealt with in either document, although there is a report on population quoted above (European Commission, Report on the Population Projections, 2005).

## Conclusion

Too engaged in solving the present crisis, which is obviously essential, the EU is unable to confront its long-term future. Although the EU leaders are conscious of the need for political changes to support their economic progress, they are not at that point yet. What is really needed is a reflection group or a convention focusing on the year 2050, with strong participation of the academic sector, of the business community, the major political forces and the NGOs. Both the EU and its neighbors should participate, as the consultations to be dealt with are about a common future. Academic research should be instrumental in this process, at national, regional and European level, including the US and Canada and other OSCE member states.

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## **Territorial Cohesion: A Bridging Concept**

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### **Abstract**

*The purpose of this paper is to provide an insight on the concept of territorial cohesion in the direction of its enhancing the EU Cohesion Policy. In order to present that territorial cooperation as a new way of overcoming the problems of the EU regions, especially with regard to the current economic crisis, the paper will at first refer to the evolution of economic and social cohesion into a territorial cohesion which if it were to be appropriately implemented could lead to a maximum usage of the so called territorial capital and potential of the urban regions defined as urban systems. Furthermore, the paper will shed a critical reflection on the issue of "Whether [or not] there is a need to reconsider/revise EU Cohesion Policy by actively implementing the concept of territorial cohesion?", Therefore the paper shall try to answer whether territorial cohesion could actually become a 'bridging concept', by explaining the functionality of this concept in practice, due to the very fact that it represents a combination of territorial cooperation policy and EU Cohesion Policy. Finally, the paper will present the process of how to build EU territorial cohesion policy perceived through the EU institutions (also referring to the Territorial Agenda 2020 and the Territorial State and Perspectives 2020), and will further reflect on the capacity of this instrument to turn territorial diversities into strength. It is expected that the conclusions that shall be drawn in this paper will demonstrate that it is the territorial cohesion concept that will represent a driving force for both the successful realization of the agenda Europe 2020 as well the overcoming of the existing disparities among the EU regions.*

**Keywords:** territorial cooperation, territorial cohesion, cohesion policy

## Introduction: Territorial Cohesion – A Bridging Concept Chronology

Since its creation, the European Union has aimed at promoting the harmonious development of the economy by reducing regional disparities. But only until recently (starting with the Lisbon Agenda) did it introduce a new way of overcoming the problems of the EU regions, known as territorial cooperation. The proposals of the Commission as presented in the Lisbon Agenda placed a strong emphasis on regional development by dedicating a third objective of the Structural Funds to territorial cooperation, especially cross-border and transnational cooperation with the mainstream programs of the 'Convergence' and 'Competitiveness' objectives.

Up to the present date, territorial cooperation has been supported by the Structural Funds mainly through the Interreg Community Initiative (Interreg CI). Interreg CI was introduced in 1990 and since then it supports projects of regional cooperation at different scales in different fields to enhance overall territorial cohesion. Following the phases of expansion and diversification, the program is currently in its fourth round (Interreg IV C), for which the Operational Program was approved in 2007 and will provide for the period 2007-2013. This initiative consists of three strands, and each of these strands refers to a different geographical as well as thematic scope (Mirwaldt, K., McMaster, I. & Bahtler J., 2009):

1. Cross-border cooperation (strand A) supports the development strategies in adjacent regions;
2. Transnational cooperation (strand B) covers larger groupings of European regions setting up more strategic and conceptual initiatives; and,
3. Interregional cooperation (strand C) launched in 2000 for the purpose of focusing on the generation of policy by learning through the exchange of information and experience within the networks of non-contiguous regions.

With reference to these Interreg strands, it is important to emphasize that the topic of urban development is given a priority in all the three of them (A: Promotion of urban development; B: Development strategies at transnational level including cooperation between towns

or urban and rural areas; C: Exchange on interregional cooperation in the field of urban development).

The above mentioned shows that territorial cooperation provides a new way of overcoming regional problems; and, as means of enhancing territorial cohesion, it makes territorial cohesion a bridging concept between economic growth and balanced development. Thus, it becomes obvious that Cohesion policy needs to be reconsidered and to be included in any approach to territorial cohesion in order to enable the development of regions, through a European territorial cooperation that is especially focused on cooperation between structurally weaker regions and the stronger ones. It should be reconsidered because of its integrating character and cross-sector nature which make this policy an instrument for implementing territorial cohesion.

In order to understand how this bridging concept has been achieved, a closer look at the actual evolution of economic and social cohesion into territorial cohesion has been given in the first place (Part I). After that, we give a notion to the added value of a territorial approach (Part II) as well as to the new role of the cities as urban systems (Part III), and a place-based approach (Part IV). At the end we give final conclusions and remarks.

## **I. Economic and Social Cohesion - Evolution into Territorial Cohesion**

Cohesion policy with its overall purpose of contributing to European integration by promoting economic and social progress and a high level of employment, seeks to achieve this in such a way that will ensure the consistency, effectiveness and continuity of EU policies and actions by applying principles of good governance.

In order to promote territorial cohesion, Cohesion Policy requires specific problems and opportunities of particular territories (such as urban and rural areas) to be addressed through a territorial approach. It was the Lisbon Treaty which introduced the idea of territorial cohesion as a new common objective of the European community and made it explicit that space or territory is relevant to promoting competitiveness and to addressing regional and social inequities. This is something that

EU policy seeks to address in the balanced way which is in fact the essence of the ‘European model of society’ advocated by Jacques Delors (Faludi ed. 2007). The message is: (1) that inevitably relevant policies take shape in territories: cities and regions, (2) that success is conditional upon the active participation of public and private stakeholders there, and (3) that the configuration in these territories and their governance – what Barca calls ‘integrated bundles of public goods’ – play an essential role.

However it was the Green Paper on Territorial Cohesion (COM, 2008, 616 final) and the public debate in 2008 that followed which brought the topic into focus, due to the existing economic crisis. According to the Green Paper on Territorial Cohesion- Turning territorial diversity into strong territorial cohesion has the main function of working towards a harmonious development of all types of places, at the same time ensuring that the citizens of these places are making the best of the inherent features of their territories. Thus, territorial cohesion represents an approach that aims at transforming territorial diversity into strength as a that aims at achieving harmonious, balanced, efficient and sustainable territorial structure, where different territories (regions, cities, macro-regions), wherever they are, can make the most of their territorial potentials and reach their optimal long-term development. The main justification of the notion of territorial cohesion is its integrative character because it represents a tool to build networks of functional areas thus strengthening the interdependence of the regions and consequently stressing the need for networking between the cities, as well as enhancing the ooperation and integration between various territories of EU at all territorial levels.

All the above mentioned resulted in territorial cohesion being closely analyzed and reported about by Fabricio Barca (2009) in the Barca Report, prepared upon the European Commission’s request, and published in April 2009. It is in this report that Barca advocates the “place-based approach”, a notion that had been previously explored by the Organization for Economic Development (OECD), and which had been further referred to in the Territorial Agenda 2020 adopted by the ministers responsible for spatial planning and territorial development in the EU member states. It was more than obvious that EU Cohesion Policy needed reconsideration where territory especially matters.

Thus the Europe 2020 Strategy, which is a joint strategy for EU27 and a follow-up of the Lisbon Strategy, showed that the EU can be turned into a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion. It also showed that if the territoriality of this Strategy is respected by considering the fact that the development opportunities of the diverse regions are different in all dimensions of the defined targets, then the success of Europe 2020 Strategy can be achieved.

## **II. The Added Value of Territorial Approach**

One of the definitions of economics is that it concerns the functioning of a variety of processes of a social, economic, ecological and political nature, and when talking about these processes one has to consider that they have a specific territorial dimension (in other words, that they are located in a concrete place, they interact with neighbors, generate flows of goods, people and ideas, and support concentration). With regard to economic growth, it takes place in distinct territories, so the overall economic performance in Europe is an aggregate of a range of actions undertaken by firms scattered across the continent, and the firms, during their operation partially depend on territorial assets such as transport connections or the quality of the labor force. The actions of the public bodies lay grounds for development and growth. In this direction, the decisions about functioning urban areas – FUAs directly influence the competitiveness of enterprises; to be more precise these are the kinds of decisions where the territorial dimension of EU policies and the Territorial Agenda 2020 (Bohme, K., Doucet, Ph., Komornicki, T., Zaucha, J., Swaitek, D., 2011) could contribute to a richer and broader understanding of the concept.

The territorial context is extremely important for growth, and this is widely recognized not only by planners but also by those responsible for various policies that impact on economic development. If there is improvement in the settlement pattern and other aspects of the spatial structure, it is then when it shall result in significant agglomeration economies and lower costs of moving goods, people and ideas. As pointed out in the Territorial Agenda 2020 (EC, 2011), with low

trade barriers and the acceleration of economic globalization, local non-movable assets come into focus. In this case it is critically important that the ability of local institutions to deliver solutions for the proper exploitation of those assets and for the external agents (national and regional governments) to help develop the capacity of such institutions in that direction.

If considering the recent years' results (see Figure 1) it becomes visible that for the period from 2000-2006 there were 213 billion Euros allocated to the structural funds for the EU15, and an additional 22 billion Euros were made available to the new member states for the period 2004-2006; this amount represented one third of the total budget of EU.

In the financial framework 2007-2013 there were 354 billion Euros allocated to the Cohesion policy which represented 35.7% of the total budget of EU, and for the next financial perspective 2014-2020 there has been a proposed amount of 325 billion Euros to be allocated to the Cohesion Policy which shall represent around 34% of the total budget of EU. Thus, no matter the fact that according to the proposed 2014-20 financial framework the expenditure for Economic, Social and Territorial Cohesion (Structural Policy) declined for 8.4% in comparison with the 2007-13 financial perspective (see Figure 2), it represents a decline of only 1.7% (as a percentage of the total budgets).

Cohesion Policy has made a positive contribution to the reduction of disparities across EU Member States and regions by promoting economic growth, employment and competitiveness. Nevertheless, disparities across EU regions remained high, and considering the continuing existence of pressures towards regionally imbalanced development – especially during the crisis – the need of maintaining an active Cohesion Policy at the EU level is clearly and widely considered. Furthermore, there is a recognition that the economic benefits of Cohesion Policy do not accumulate solely to the poorer regions and Member States of the EU, but they also spread to the more prosperous parts of the Union contributing to economic growth and employment throughout all the Member States. Finally, besides contributing to EU level objectives and goals, it is recognized that Cohesion Policy has had important positive influences, as indirect impacts, among other things on cross-border cooperation, urban regeneration, improving access of

services in rural areas, environment protection and last but not least on a range of domestic institutions, processes and policies.

Thus, we can conclude that the EU Cohesion Policy in the programming period 2007-2013 has made a significant contribution to the sustainable growth and development of the EU regions, and in order to pursue its active contribution, for the upcoming Financial perspective 2014-20 it is recommended that it “has to maintain its integrated approach as it ensures the harmonized coordination of different development aspects, taking into account real territorial needs, urban-rural relations, flows and networks between territories” and “according to the place-based approach that has to be supported at all scales and in all types of regions in Europe, better tailored territorial messages are needed for regions, cities and other functional territorial units within the interventions of Cohesion Policy (e.g. allowing greater flexibility in organizing operational programs).”

### **III. Territorial Cohesion – with Territorial Capital and Potential to Polycentric Regions (the New Role of the Cities as Urban Systems)**

Putting emphasis on the ‘territorial capital’ of the regions implies shifting policy from equity alone to equity and efficiency at the same time (i.e. putting more emphasis on areas of potential rather than areas of need) and shifting efforts from ‘reactive’ measures that deal with the improvement of the social, economic and environmental situation of the cities, to more ‘proactive’ measures which aim at creating conditions for the full exploitation of the cities’ true economic potential.

The new concept of the role of cities as engines for growth together with the need for more such engines across the territory of Europe is the concept of polycentric development. This concept interprets the role of the cities in relational terms by transcending the role of individual cities and advocating the possibilities of creating synergies and networking between them, all for the purpose of strengthening the overall competitive standing of the ‘polycentric regions’.

Polycentric development aims at describing an ideal development path based on an interacting network of specialized urban centers (or

Functional Urban Areas- FUAs) distributed evenly across the European, national and regional territories. The concept of polycentric spatial development has often been described as a ‘bridging concept’ between two not always congruent policy aims covered in ESDP i.e. ‘economic growth’ and ‘balanced development’. This concept was mentioned in ESDP (European Spatial and Development Perspective) and examined in the research carried out under the framework of ESPON programme (European Spatial Planning Observatory Network) (EC, 2004)

The concept applies to three levels:

- European/transnational - where the goal is the stimulation of ‘global integration zones’, beyond the pentagon, able to compete in the global economy;
  - National/cross-border/interregional – which implies shifting from a dominant city to a system of cities, by improving economic performance and service provision through networks of neighboring cities;
  - Regional/local - at this level the main goal of polycentric development is to shift from one or two main regional centers to a number of small medium centers that can provide services (e.g. through strategic alliances between towns and /or common projects).

Polycentric territorial development can be a key element for achieving territorial cohesion, where the most developed cities and regions are distributed in a balanced way within Europe, and cooperate as parts of a polycentric pattern. In this way added value can be achieved and the strong centers can contribute to the development of their wider regions. Cities are encouraged to form networks in an innovative manner to improve their performance in European and global competition. Urban development policies can have a significant role in strengthening territorial development, thereby imposing the need to foster the territorial competitiveness of EU territory outside the core ‘Pentagon area’ in order to connect other areas into the main European and global flows. However, polarization between capital or primary cities and secondary, medium-sized cities on a national scale should be avoided, while still strengthening metropolitan areas outside the Pentagon. Policy efforts should aim at reducing strong territorial polarization of economic performance and high regional disparities

within the European territory. In this respect, small and medium-sized towns have a crucial role at regional level.

The crucial role of cities in balanced and polycentric territorial development should be strengthened. Cities need to become efficient motors of development and attractive places for living. To move in this direction urban development and regeneration policies need an integrated and multi-level approach. The cooperation and networking of cities could contribute in the long term to the smart development of city regions at varying scales. All the actors involved in the planning and management of urban settlements should look over their administrative borders and focus on functional regions that include their periurban neighborhood. Growing urban regions should seek a better integration of migrants and ways to best restructure their regions to accommodate their increasing population. In line with these territorial challenges and potentials, the objectives and concerns set by Ministers responsible for urban development in the Leipzig Charter on Sustainable European Cities (2007) and the Marseille (2008) and the Toledo Declaration on Urban Development (2010) should be taken into account.

#### **IV. Cohesion Policy – The Notion of Territorial Cohesion and a Place-Based Approach in One Place**

Currently the Commission seems to use territorial cohesion to transform Cohesion Policy towards a place-based development policy simultaneously with the emergence of the concept of the “place-based approach”. It is this place – based approach that promotes the territorial logic behind the cohesion-type interventions that may prevent the regions from uneven development.

When observing it on the strategic level, we can see that Cohesion Policy is being further fine-tuned in the context of EU enlargement, the economic crisis and global challenges such as climate change and poverty reduction. Although, the central features of the policy are based upon solidarity and a redistributive rationale, yet the competitiveness and efficiency aspects of the policy may be presumed to have gained increasing importance. The fact that intensifying global challenges have asymmetric territorial impacts, there may appear a

necessity for the Cohesion Policy to respond in compliance with the Europe 2020 Strategy's main objectives for smart, green and inclusive growth, by putting more emphasis on some territorial aspects such as cities, macro-regions, territorial co-operations and the environment.

In order to ensure the success of Europe 2020 it is perfectly sensible to reassess whether a headline target of 40% of the younger generation with a tertiary degree should be pushed forward mainly in the metropolitan rather than the rural peripheral areas, or to consider the acceptability of making a combination between both areas. Similarly, for the 20/20/20 climate energy targets (20/20/20 means reducing greenhouse gas emissions by at least 20% compared to the 1990 levels or by 30%, if the conditions are right; increasing the share of renewable energy resources in the final energy consumption of 20%; and a 20% increase in energy efficiency) it makes perfect sense to think again about how in the long run to maintain the specific territorial "strengths" of "green" EU territories that offer climate-friendly services but fail in terms of prosperity indicators. Considering the abovementioned, smart, sustainable and inclusive growth can only be achieved if policy making takes into account the territorial diversity of development potentials and challenges within Europe.

With regard to the abovementioned, there are two complementary and mutually reinforcing territorial principles that are emerging as the cornerstones of Cohesion Policy: (1) flexible territorial programming and (2) strategic territorial cooperation. Flexible territorial programming emphasizes the need to utilize territorial capital by making use of a results-oriented approach, which is in line with EU objectives and is also flexible enough to address the specificities of the regions; whereas strategic territorial cooperation recognizes the importance and the added value of territorial networks with a thematic focus.

Regarding the recent programming period, Cohesion Policy has still supported polycentric development and is also orientated to the specific problems of the urban areas. Vast amounts of resources became available for the new Member States to develop their infrastructure in order to reach the EU average development level (COM, 2011, 17 final). Namely, according to a proposed budget for the period 2014-20 (see Figure 3), the Community intends to allocate 34% of its Budget to the

cohesion policy instruments and to distribute this amount between the different areas as follows:

- a. EUR 162.6 billion for convergence regions;
- b. EUR 38.9 billion for transition regions;
- c. EUR 53.1 billion for competitiveness regions;
- d. EUR 11.7 billion for territorial cooperation;
- e. EUR 68.7 billion for the Cohesion Fund.

## Conclusion

As a conclusion to the above mentioned, the wider context of EU Cohesion policy is changing, with global challenges receiving increasing attention. After putting the concept of territorial cohesion under scrutiny, both chronologically and from an evolutional aspect reflecting on its evolution from economic and social cohesion to territorial cohesion and consequently to territorial cooperation among the regions, we came to a conclusion that territorial cohesion really represents a concept that through polycentric spatial development manages to 'bridge' economic growth and balanced development, thus contributing to the more effective consideration of the territorial dimension in the policy making.

Bearing in mind that Cohesion policy is so far the only substantive policy that is explicitly targeted spatially, we can conclude that there are grounds for its being reconsidered in the direction of fully encompassing the territorial cohesion as a means of turning territorial diversity into potential and challenge. But, in order to avoid 'Europe 2020' reproducing the Lisbon strategy failure, it is of the utmost importance that due attention is paid to the territorial dimension and potential for smart, sustainable and inclusive growth.

It then becomes clear that the common agreement that economic cohesion that aims to improve competitiveness and add to a better balance between Member States and NUTS2 regions, and the social cohesion aims at more labor market participation and equity, should be balanced, and perceived from a new and beneficial perspective, the territorial one, because "geography really matters". Finally, even though 'Europe 2020' headline targets are broad and universal, yet, their

implementation should be place –based. If perceived and taken into consideration, this territorial dimension can contribute towards having ‘smart, sustainable and inclusive growth’ as defined in Europe 2020.

By doing so, this paper to a certain extent has succeeded in shedding a new light on the Cohesion policy pointing out the need of its being reconsidered with the more active implementation of the territorial cohesion concept, and all for the purpose of enabling smart, sustainable and inclusive growth across Europe, in line with the latest strategic documents i.e. Europe 2020 and the Territorial Agenda 2020.

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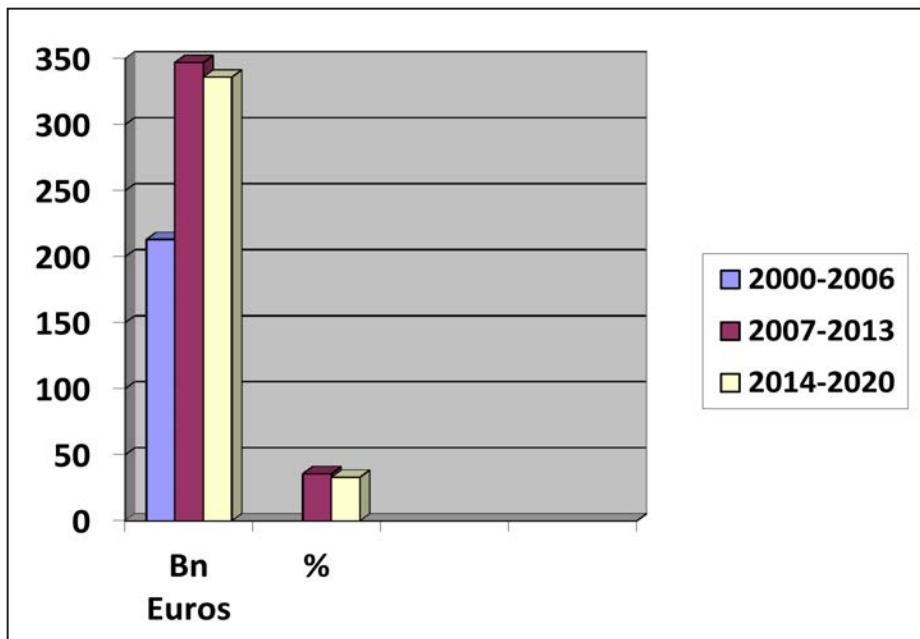
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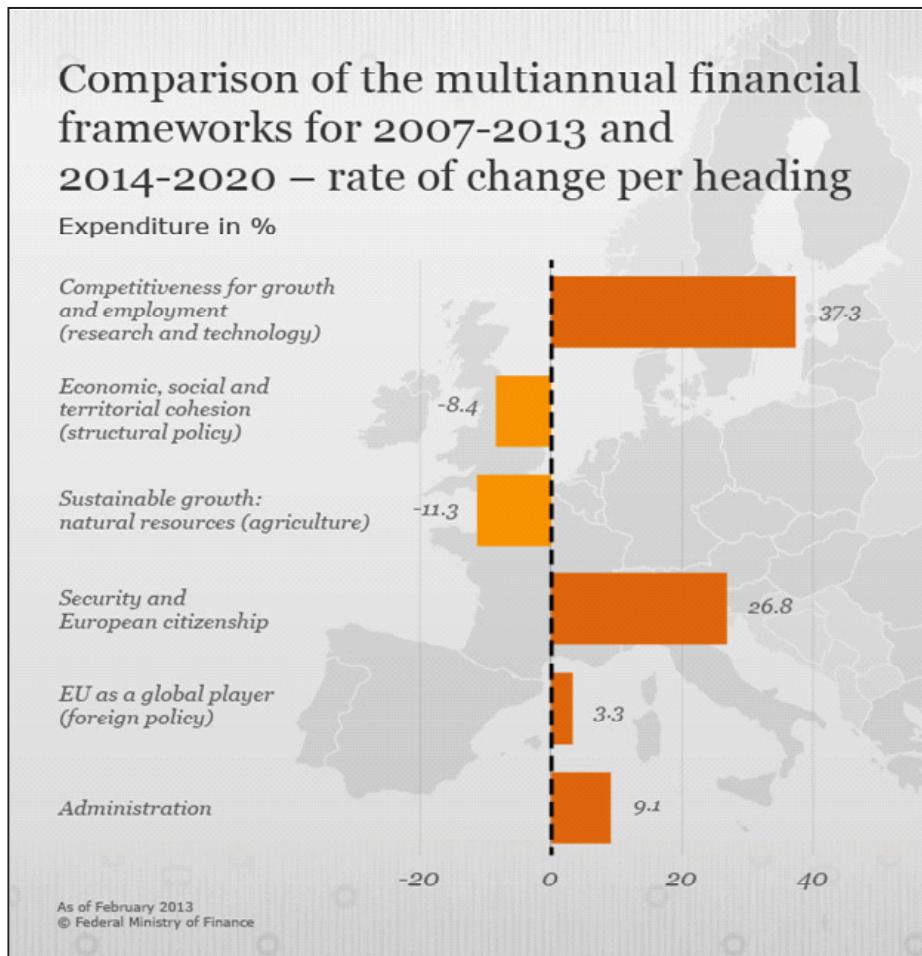
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[www.notre-europe.eu](http://www.notre-europe.eu)  
[www.aer.eu](http://www.aer.eu)  
[www.ec.europa.eu](http://www.ec.europa.eu)  
<http://epp.eurostat.ec.europa.eu>  
<http://eur-lex.europa.eu>

Figure 1: EU Cohesion Policy funding over the multiannual financial frameworks for 2000-2006, 2007-2013 and 2014-2020



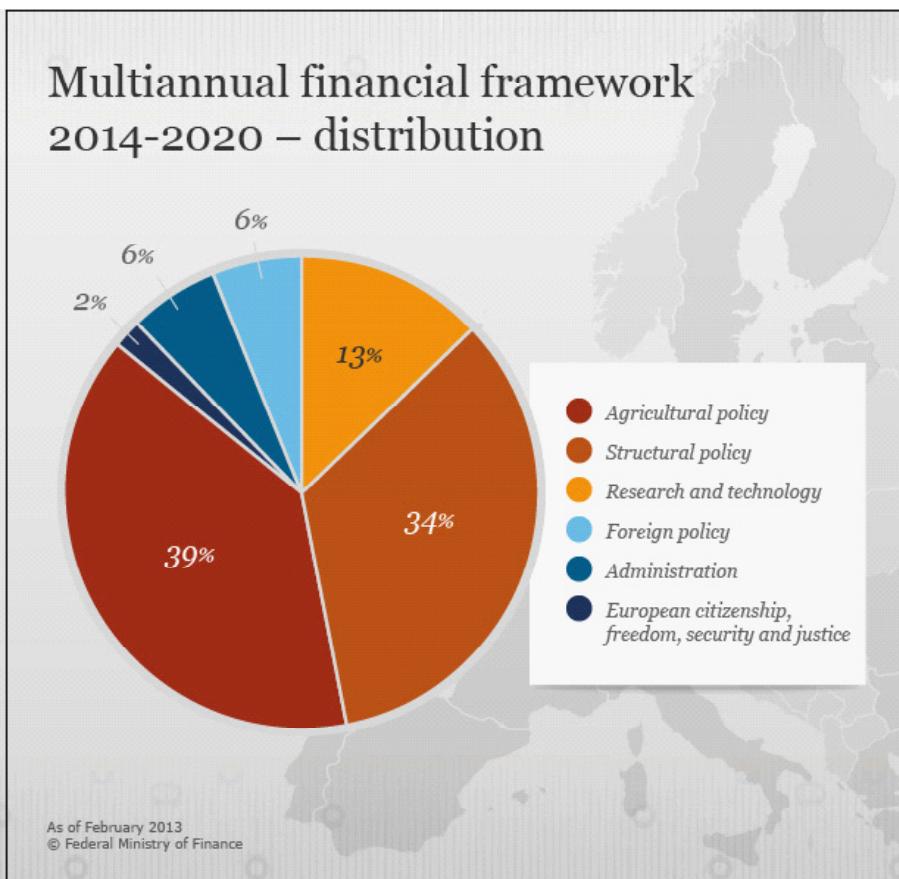
Note: Own figure made with data collected from  
[http://ec.europa.eu/regional\\_policy/what/milestones/index\\_en.cfm#4](http://ec.europa.eu/regional_policy/what/milestones/index_en.cfm#4)  
and [http://europa.eu/legislation\\_summaries/budget/bu0001\\_en.htm](http://europa.eu/legislation_summaries/budget/bu0001_en.htm)

Figure 2



Source: [http://www.bundesfinanzministerium.de/Content/EN/Bilder/Media\\_Centre/Graphics/eu-finanzrahmen-04.jpg?\\_\\_blob=normal&v=2](http://www.bundesfinanzministerium.de/Content/EN/Bilder/Media_Centre/Graphics/eu-finanzrahmen-04.jpg?__blob=normal&v=2)

Figure 3:



Source: [http://www.bundesfinanzministerium.de/Content/EN/Bilder/Media\\_Centre/Graphics/eu-finanzrahmen-03.jpg?\\_\\_blob=normal&v=2](http://www.bundesfinanzministerium.de/Content/EN/Bilder/Media_Centre/Graphics/eu-finanzrahmen-03.jpg?__blob=normal&v=2)

## **EU Crisis and the Western Balkans: Enlargement Unaffected**

*Stevo Pendarovski, Zoran Sapurik*

### **Abstract**

*What started as the fiscal challenge later exposed dormant structural problems within the European Union, at large. Among the other crucial areas the crisis impacted on was the coherence and content of the EU foreign policy, as well. Surprisingly, the most successful foreign policy project in EU history – EU enlargement has not been seriously harmed by the protracted political turmoil in Brussels. Common EU efforts to preserve the Euro have long overcome the parameters of the economy and have become a catalyst for transforming the overall patterns of the organization. The aim of this chapter is to analyze different options contemplated thus far for the reform of EU foreign policy and their direct dependence upon the changes eventually made on a broader political level. Western Balkan countries are not part of the current debate, but, they will be heavily affected by its outcome. Our basic assumption is that regardless of the transformations that may be made, EU enlargement policy towards the Western Balkans is going to stay. We would argue that this is because the region can be integrated without substantial EU resources being applied, and also because Western Balkan countries have weak capacities to fundamentally affect the pillars of the future Union once they are admitted in it.*

*Keywords: euro crisis, transformation, enlargement, reforms, Western Balkan*

## Introduction

The long-standing assumption both in Brussels and in the capitals of the Western Balkans is that enlargement fatigue is deployed more on the “other side” than in the organization itself or in the region. Balkan euro skeptics are routinely applying the thesis that infighting in Brussels has undermined the attractiveness of the European project and that this has increased enlargement fatigue especially among the older members of the EU. What they avoid to mention almost by default are the lasting bilateral disputes between the local nations and the sluggish pace of structural reforms which have been holding some of them back for years. However, a hypothesis never before presented to the regional public is that the process of enlargement towards the Western Balkans had been practically unaffected by the financial and political turmoil which embraced the European Union over the past few years. A quick glance at the fact sheets regarding the individual candidates and would-be-members would confirm the absence of influence of the ongoing EU crisis over the tempo of rapprochement between the candidates and the Union.

Croatia has just been through the most rigorous enlargement process ever in the history of the EU, but, the membership criteria have been previously sharpened because of frustration in Brussels with the level of preparedness for the entry of Bulgaria and Romania, a year before the Eurozone crisis erupted. Intra-European discussions on the future of the organization, also, are not associated with the package of preconditions laid out for Serbia since it would be inconceivable to neglect the interdependence between Belgrade and Pristina after the experience in 2004 when the divided island of Cyprus was admitted. A key requirement for the Republic of Macedonia to reach a mutual solution for the name dispute with Greece before commencing negotiations was imposed on it during the NATO Bucharest summit in the spring of 2008, half a year before the collapse of a number of US banks and insurance companies heralded the coming of the global financial crisis. Among would-be members, Bosnia-Herzegovina and Albania have been challenged for many years by the same set of basic democratic obligations regarding the internal cohesion and viability of the Federation and the sustainable political dialogue, respectively.

The previous line of reasoning can be applied to explaining the status of the two other candidate-countries which formally do not belong to the Western Balkan group: political logic for Turkey to be frozen on the road to enlargement is in no way connected with the current EU crises. With regard to the current leadership in the key continental European Union member states: France and Germany are formally respecting their commitment to a fully-fledged membership status for Turkey, but, in practice are supportive of a special partnership with Ankara. Iceland is advancing rapidly through the Chapters of the EU *acquis communautaire* and the preconditions already specified by Brussels hold much less potential to halt its candidacy than the growing resistance by the domestic electorate.

In the next sections the performance of the European Union during the current (or recent?) crisis will be examined with special emphasis on the conduct of its Common Foreign and Security Policy. A separate section is dedicated to the positioning of the so-called “big three” in EU foreign policy (Germany, France and United Kingdom) and their political maneuvers between national interests and declared European goals. At the end of the article the most probable scenarios for the future of EU foreign policy will be considered and within it the prospects for future enlargement with the Western Balkans states. But, at the very beginning, a brief paragraph about some of the real effects of the previous, fifth round of the EU enlargement will ensue.

## **Myths and Reality about EU Enlargement**

Before the massive 2004 enlargement, but, more intensively after the accession of the ten countries, eight of whom with a communist past, many of the EU members supported two incorrect assumptions about the future functioning of the European Union. First, the deepening of the European integration allegedly has to proceed in step with the EU enlargement and second, a fundamental overhaul of the decision-making processes should be introduced before considering the new applicants at all (Leigh, 2012). In the ensuing period an attempt to adopt the Constitution was heavily defeated by the French and Dutch citizens and until the approval of the Lisbon Treaty in 2009 no significant

steps toward building political unity or major internal restructuring was agreed upon. Even the key Lisbon Treaty provisions about creating the European External Action Service (EEAS) and a much stronger role envisaged for the European Parliament were not beneficial for increasing absorption capacity, developing a more effective decision-making process or overcoming the much criticized democratic deficit of the organization (Ibid).

The European Union has always been notorious for its lengthy and laborious decision-making processes regardless of the formal number of members. However, the most visible paradox which exists in the enlarged EU is that the biggest disagreements, particularly after the euro zone crisis erupted have been recorded among the older EU member states. Furthermore, the sovereign debt crisis which later translated itself into a profound crisis of public confidence in the economy, in the political class and in the European project as a whole (Stokes, 2012, p. 1) has severely destabilized Greece, Spain, Portugal, Italy and Ireland, all of them part of the so-called “old Europe”. Within the same context, also, could be placed the incoming challenge to the EU, the referendum announced by London about its status and relations with the future Union. Though never considered by the rest of the field as “faithful” Europeans, the reality is that the United Kingdom has been one of the most influential members of the EU since its entry in 1973.

Instead of blaming enlargement for the current EU setbacks (Leigh, 2012), the EU countries should concede that in reality eastern expansion has: “extended the European zone of peace and prosperity to the Baltic region in the north and the Black Sea in the east”. Nowadays, only a few people and politicians are mentioning these values. Public perceptions are predominantly focused on immigration and the inflow of workers from the new member-states which are allegedly threatening labor markets and the salaries of the domestic work force (O’Brennan, 2012). However, there are several studies on the subject, including a detailed analysis of the intra-EU population movements provided by the European Commission which demonstrate that the “overall level of migration from new to old member-states has been very modest”. To the Commission’s findings even suggested that a contribution to the economic growth of the receiving countries was made by these migrants

who “helped alleviate labor market shortages” without any negative impact “on wage levels or employment conditions” (Ibid).

EU enlargement for the period 2004-2007 was not the first case of this process, but, was nevertheless certainly unique due to the huge income differences between the old and new member states. Interesting findings emerge when juxtaposing the immigration numbers from the new member states and the consequences on the biggest EU economies, Germany in the first place, whose government has restricted access to its labor market for the workers from the new entrant states. Having in mind the restrictions imposed, around 6% of the Polish, Latvian and Slovak workforces, and 9% of the Lithuanian workforce after 2004 have emigrated, mainly towards the UK and Ireland (Elsner & Zimmermann, 2013, p. 12). What happened there was rather unexpected by a general public that had long been cultivated to fear and not to cheer the arrival of the foreign workers: immigrants who were better-educated than the average native and who mostly compete for jobs with previous migrants, not with the domestic workforce. Overall, free migration brings small economic benefits to the countries which did not impose restrictions, but, for Germany as a whole, the “costs of the restrictions exceeded the benefits by far” (Ibid). Considering the positive net economic benefits for the old member states they clearly can compensate for the “fiscal burdens of the EU budget resulting from the net transfers to the accession countries” (GEFRA, 2007). Lastly, two more arguments about the lack of the negative macroeconomic effects: firstly, fears about the systemic relocation of firms due to the comparative disadvantages in Germany did not materialized and secondly, despite earlier predictions, even the border regions on the German-Polish frontier were neither positively nor negatively affected by the enlargement (Ibid, p. 15).

Overall, migration waves remained below the expectations in some countries and were within the previous forecasts in some others (Traser, 2008, p. 4). On the level of the EU 15 (membership before the enlargement in 2004) the share of the EU 8 workers (all new members without Malta and Cyprus) was under 1% of the total employed workforce. Migrant workers do not “crowd out nationals”, they simply “fill in the employment gaps and consequently contribute to production growth” (Ibid, pp. 4-5). The unbiased conclusion should echo the words of the former EU Director-General for enlargement who said that the

false assumptions about the negative effects of the eastern enlargement turned out to be “enormously costly in terms of political capital” and the attractiveness of the EU project as a whole (Leigh, 2012).

## The Euro Crisis and European Foreign Policy

In the past three years the economic crisis has pressed European leaders to dedicate more time to EU financial problems than to its geopolitical role. Europe’s soft power continued to erode on the global level with the ever decreasing budgets for its international activities (European Council on Foreign Relations, 2013, p. 9).

Although the crisis has reinforced the drift towards the renationalization of European foreign policy the foundation of the EEAS has partially reversed the trends (ECFR, p. 20). The Lisbon Treaty in 2009 introduced the post of EU High Representative for foreign affairs and security policy and a common diplomatic corps with the aim not to replace, but, to complement national embassies (Park, 2012). The conclusion of the experts was that despite the ongoing crisis “European foreign policymaking is happening...” and in September 2012 an informal group of EU foreign ministers issued a report with a few far-reaching policy proposals for a more unified and effective security and defense policy on the pan-European level (*Ibid*). In September 2012 a crucial message to the political elite and the public was dispatched by the President of the European Commission Barroso who called on the organization to remain engaged and explicitly “warned against turning inwards” (Mason, 2012). Even in the midst of the turmoil the impact of the euro crisis EU capability to act as a plausible foreign player was insignificant: Europe reacted promptly to the Arab awakening, and relatively quickly over the Iran case and it “has been weak on all of the other issues that it has traditionally been weak on” (Techau, 2012). Surprisingly to some, but, the crisis has even brought America and the EU closer together since in Washington D.C. It was well understood that a stable Europe would be beneficial for the US in the long run (*Ibid*).

Since the outbreak of the euro zone crisis there were no doubts that not only with 'both' the EU economy and indirectly the world economy would suffer the consequences. The immediate effect was a

decline of the reputation of the EU as a model of competent economic policy management and successful regional integration (Emerson, 2012, p. 1). What was less clear was the outcome for European foreign policy and for European enlargement in particular. For years there was a widely shared assessment that enlargement is the most powerful tool through which the EU exerts its transformative influence in its “near abroad”. According to some extreme interpretations, the EU even does not have a foreign policy, only an enlargement policy (Kral, 2010, p. 2).

While in 2011, with the euro crisis at its peak the European Union has recorded progress in the area of enlargement. In 2012 the EU started exporting economic aftershocks to its already weak periphery which to some extend has undercut its efforts in the region (ECFR, p. 76). Even so, it is fair to say that in a complex environment some of the regional countries had successfully fulfilled their pro-European agenda and have been rightly awarded for their achievements: Croatia *became member* in July 2013; Montenegro started accession negotiations; Serbia was granted candidate status and is expecting a date for negotiations and Kosovo received a positive feasibility study by the European Commission to sign a Stabilization and Association Agreement as a very first step towards membership. But, efforts made by the European Commission and the EEAS had not paid dividends in the cases of Macedonia, Bosnia-Herzegovina and Albania. Macedonia is blocked by the EU member Greece over the so-called “name dispute” where no visible signs of progress have been seen in the lengthy UN-sponsored negotiations between the two parts; Bosnia-Herzegovina had not met any of the essential EU preconditions because of conflicting domestic interpretations about the non-functional Dayton Accord; relevant Albanian politicians have for a long been unable to produce meaningful political dialogue about the country’s political priorities. Unfortunately, any relative overall progress of the enlargement process has not been matched by any significant improvement in the areas of democratic governance, rule of law and human rights and freedoms in the region. To that end apart from the EU commitment, the engagement of the local political elites is a condition *sine qua non* for improving democracy (ECFR, p. 79) in the region still in the final stages of the democratic transition.

Analyzing the relationship between the long –term effects of the economic crisis and European enlargement some questions are likely to

appear on the horizon related to the costs of future accession. Namely, the gradual convergence of the candidates in the past requested significant sums of money from the EU pre-accession funds. Nevertheless, having in mind the relatively small size of the Western Balkan economies they are not able to inflict any serious impact on the overall EU budget which is nowadays smaller than in the past. In this regard, only Turkey would appear to be an exception to the rule (Kral, 2012, p. 4).

## Regional and EU Views on Enlargement

EU foreign policy was reasonably resilient in 2012 as the EU itself appeared to emerge from the crisis (ECFR, 2013, p. 7). Nevertheless, a critical requirement for a sound EU foreign policy and any further enlargement would necessitate sustainable public support in the member-states which has in fact been on the decline since the crises began. The latest polls have only confirmed the negative trends over the past five years: 36% of European citizens were against further EU enlargement at the end of 2007, but, by the end of 2011 the numbers had risen to 50%. In the same period the percentage of people in favor of enlargement had dropped below 50% for the first time (Di Mauro, Fraile, 2012, p. 1). A complex mixture of economic and cultural reasons (in the case of Turkey) has become a breeding ground for the increasing frustration against enlargement. The citizens of the future EU of 28 countries with very different cultural and religious traditions could sustain these anti-enlargement reservations even without the massive economic problems (Ibid, p. 5).

In good times the EU exported prosperity towards the region, at the times of crisis it is exporting instability. Once in the past the regional politicians and functionaries in Brussels alike firmly believed that the EU provided the solution for the post-communist societies of the Balkans; nowadays many predict that a “disintegrating EU” could be a danger for them (Bechev, 2012, p. 1). An array of polls shows that popularity of the EU among the Western Balkan nations is on the decline, but, is still respectable with Euro-realism instead of Europhilia emerging slowly (Ibid, p. 3). But, why should the Western Balkans still need Europe? First, nearly two-thirds of the region’s exchange

is with the EU and trade and financial liberalization has almost been completed. The Russian Federation mentioned in some regional circles as an alternative to Europe lies in a distant second place with only 5.5 percent of the overall volume. Secondly, the EU is the most important source of foreign direct investment and remittances from the sizable Balkan diaspora living in Western Europe (Ibid, pp. 3-4). Thirdly, in spite of a few sporadic successes the region as a whole is still far away from the highest international standards of democracy as is confirmed time and again by the consequential Freedom House reports (Ibid, p. 6).

What are the potential losses to the European Union in the case of a stalled Western Balkan integration? The risk of regional instability has significantly diminished, but, has not disappeared by any means. The unresolved status issues, disputed borders, interethnic tensions are still on the table and could quite easily cause economic migrants and criminals to migrate to the rest of the continent (Leigh, 2012). Security experts agree that the EU's security will be greater once the Western Balkans become an integral part of the Union. Certainly, organized crime and corruption would pose a far bigger threat to EU citizens if the Balkan countries remain outside the EU (Schily, 2009).

Another, different type of an impact to the EU global standing would certainly come in the case of its failure to irreversibly transform and democratize the Western Balkans. If the organization is not capable of making a difference in its backyard no one would be convinced that the Europeans could be credible actors in the Middle East, the post-Soviet space or East Asia where the contexts are much more complicated and overcrowded with respective players (Bechev, 2012, p. 7).

## **The Triangle of Power and European Foreign Policy**

In 2012, to the surprise of many the leadership of the so-called "big three" in the European Union: Germany, France and United Kingdom was on the decline in the field of foreign policy. As for enlargement policy it would appear that the EEAS and the European Commission executed a much stronger coordinating role and that was obviously beneficial for the Western Balkan countries (ECFR, p. 17). The key innovation introduced by the Lisbon Treaty, the EEAS is slowly,

but, gradually developing into an important actor in shaping the EU positions on many issues stemming from the foreign policy agenda of the organization. According to some predictions, in due course it can overtake some functions currently informally managed by the “big three”, but, a crucial precondition for something like that to happen would be the EEAS’ capacities to be substantially upgraded (Lehne, 2012, p. 4). The EU’s foreign policy is very different to the management of national foreign policy, but as a result of the Lisbon Treaty the EU had already developed an extensive diplomatic network of about 140 embassies in the world (Lehne, 2012, p. 20) Still, neither the European Commission nor the EEAS would be in a position to manage any of the vital foreign policy issues, including enlargement, without the explicit or at least tacit approval of the three most powerful members of the organization. The formal principle of unanimity stipulated as the crucial method of decision-making in foreign policy is boosting the perception that in this very heterogeneous entity all 27 members-states are equal. Although, for those familiar with the bargaining behind the scene it is clear that on most occasions the largest members are taking the lead (*Ibid*, p. 1).

In the post- Second World War period, Germany has never been ambivalent towards transferring part of its national sovereignty to the pan-European level because a long standing tenet that there was “more Europe” is inherently good for the country (Lehne, 2012, p. 10). Within this context, eastern enlargement is undisputable for Berlin with the exception of Turkey’s bid at which point the political elite is still highly polarized – the Christian democrats are against enlargement (?), whilst the Social democrats are in favor, having in mind, among others, the integration of Turks living in Germany. The inclusion of the Western Balkans, Croatia in particular, was a high priority on the German foreign policy agenda since the fall of communism. Rare statements voicing skepticism about Croatia’s level of preparedness (EurActiv, 2012) are more akin to the pre-election juggling with the sentiments of the electorate than any real political strategy to counter EU accession to the main German ally in the region.

From a historical perspective French foreign policy has been recognizable by the protection of national sovereignty and opposition to any accumulation of power outside of France’s borders. Historically,

French politicians have always been against “broadening” without the “deepening” of the EU, afraid of progressively losing influence in a growing Union (Brincker, 2009, p. 1). At the same time, all relevant political parties, with the exclusion of the far right have been in favor of a broader Europe, but, all politicians would have assumed a leadership role for France in the occasions of a common external endeavor. Wide-ranging and frequently unspoken consensus does exist against the fully-fledged membership of Turkey, but, the integration of the Western Balkan countries is not contested, of course, in due procedure and without any shortcuts. The French media are from times to time “obsessed with Turkey”, but, the paradox is that the French people are not obsessed by the eventual inclusion of the Western Balkans countries despite the fact that they know less about the Balkans than about Turkey (EurActiv, 2010).

The United Kingdom has always been bestowed with partial legitimacy in the debates about the future of the EU because London has commonly been perceived by other member states as the mouthpiece of Washington D.C. Therefore, London’s commitments in favor of enlargement have been interpreted more as conveying an American agenda, then as any genuine desire to strengthen the Union. Anyhow, the UK has been a strong supporter of enlargement and the neighborhood policy which are considered useful instruments to stabilize the European periphery (Lehne, 2012, p. 17). Even in a period when contemplating a potential exit strategy, London is advocating enlargement in the belief that the EU will remain strong only if it is outward looking and continues to grow (Lidington, 2012).

Anyway, the UK debate on Europe in the last year has shifted significantly, motivated by the official announcement of Prime Minister Cameron on the referendum about the UK’s future relations with Brussels. The United Kingdom’s contributions to European foreign policy is so important that their eventual decision to leave the Union would seriously hurt the European project (*Ibid*, p. 18). If such a scenario were to happen, new political and institutional arrangements would certainly follow and they might redefine many of the basic EU categories, including the very notion of enlargement. While waiting for that moment to eventually come, it is apparent that enlargement

fatigue among the “big three” is not a paralyzing factor to the current enlargement processes concerning the Western Balkans.

## The United States and EU Enlargement

On both shores of the Atlantic a number of articles have been published about the endurance of the Western alliance after the fall of communism and most of them are predicated on the gradual downfall of the partnership. In the last few years pundits delivered projections with a similar intensity about the influence of the prolonged financial crisis which started in the USA, but, mostly embraced Europe. On both ends of the field two opposing camps are as vibrant as before: in the first group there is a degree of certainty about the “end of Atlanticism” and a strategic drift that allegedly could result in separation (Daalder & Kagan quoted in Kupchan, 2012, p. 60). In the second one scholars strongly emphasize the axis of values and interests that the trans-Atlantic alliance is laid upon which has not lost any significance in an era of “ongoing diffusion of power from the West to the rising rest” (*Ibid*).

Concerning the level of EU unity and enlargement policy Moravcsik argues that the process of European integration is reaching a natural plateau at least for the foreseeable future. The movement towards an ever-closer Union has to stop “at some point”. Yet, despite all the predictions of the doomsayers the EU does have a future and according to him, even the collapse of the euro would not threaten the very existence of the EU (Moravcsik, 2012, p. 68).

In the group of countries which are concerned about the EU’s future in the fallout of the crisis the position of the USA is by far the most important one to be reckoned with. The United States of America has permanently supported the project of a “United Europe” embracing ever more countries with the key argument that it serves the US national interests by advancing democracy and stability in the euro-Atlantic area (Archick, 2013, p. 14). The enlargement was strongly endorsed with an additional set of arguments coming for years from both sides of the highly polarized US political scene. First, it was seen as being beneficial for the US since most of the new member-states have been considered as more pro-American than the old ones. Also, the US

business community has generally favored enlargement, believing that their commercial interests would be better served by a larger and more integrated market (Ibid, p. 15). Although there were sporadic concerns that a bigger EU with the total GDP equivalent to that of the US could question the global supremacy of Washington D.C. many within the political circles and expert community have been very critical at the slow pace of enlargement, particularly with regard to Turkey (Ibid).

## **Future Scenarios for EU Foreign Policy and Enlargement**

It sounds paradoxical, but, the main factor for shaping the future of EU foreign policy is not placed outside the foreign policy realm. Yet, if the problems within the euro zone are not resolved, the EU's foreign policy is going to be a collateral damage (Lehne, 2012, p. 23). Basically, experts do not significantly differ when projecting the possible course of developments in this domain. Lehne has described three broad scenarios and in the first one he predicts that permanent crisis management will continue to absorb most of Brussels' attention focusing the political elite away from executing foreign policy. Centrifugal tendencies will be strengthened in a more fragmented Europe so that a stronger leaning towards the renationalization of foreign policy would be unavoidable. The loss of coherence will marginalize the whole area, the EEAS probably will not be given the necessary resources and political support, and the EU would lose its relevance as a global actor, as well (Ibid, p. 24). In the second scenario, the EU would succeed in resolving the crisis without implementing profound changes in foreign policy structures. Member-states, especially the most powerful members would maintain their presence and activities on the international scene, but, an increasing part of foreign policy would be realized within the framework of the common EU institutions. In the last scenario the EU would undertake deep structural changes transferring substantial fiscal and economic competencies on a supranational level which would lead to the formation of a "federalist circle" in the middle of the Union. In such a scenario the EU institutions would be gradually sidelined while the federalist core would reach the level of political and economic integration similar to that of the federal states (Ibid, p. 25).

Out of the three projected situations only in the first one would EU foreign policy suffer on some scale: the EU's overall capacities for external activities would be downgraded, moderately affecting the enlargement process. However, the remaining capacities and political will on the part of the EU as a whole would be sufficient for absorbing the Western Balkan countries and potentially further afield to include the absorption of Turkey and starting the process of integrating Ukraine. Also, there are some specifics in the third scenario when the EU would develop a stronger strategic vision and more efficient decision-making procedures (*Ibid*, p. 26). The enthusiasm for enlargement would probably stay the same on both sides, but, the ambition to enter into the so-called federalist core would be hardly achievable due to the more complex accession criteria.

The scenarios offered by Fagersten (2012) are similar with minor modifications in the phases the whole process is expected to move through. In his first variant the Eurozone "muddles through, but, foreign policy is left to decline", new political structures and procedures are not introduced and the EU is facing problem to act as a Union (Fagersten, 2012, p. 22). In the second alternative the euro zone fails with more than a certain negative impact on EU foreign policy. According to the last scenario the monetary union would be successfully re-designed and positive effects spillover into the foreign policy field. Higher levels of political unity would be within reach in the mid-term with elevated public support for the EU to speak with one voice in international affairs (*Ibid*, pp. 23-24). Within the overall general framework that has been presented it is obvious that with the exception of the second scenario the enlargement policy should not be put on hold under any circumstances.

## Conclusion

In the past five years European politicians and citizens alike have been preoccupied with forging practical solutions for the dire economic challenges which had not previously been experienced by the organization in its five and a half decades of existence. Concrete financial and economic circumstances have forced all of them to be continually in

the operational mode characteristic for daily politics. Nevertheless, it is clear that the longevity of the European project could be assured only by the infusion of a set of fresh ideas and initiatives of strategic proportions. Long ago designated as the “grand ideas” of the 20th century - peace, stability and prosperity remain valid even nowadays, but, these success stories are mostly associated with the past (Emmanouilidis & Janning, 2011, p. 12) and do not bear the same mobilization strength and attractiveness for contemporary generations. Despite the enlargement fatigue in many member states and the increasing accession fatigue among the current and potential candidates, EU enlargement has always been considered as one of its major assets (Ibid, p. 15). Beyond doubt, each round of enlargement since the 1970s has been a source for the kind of EU political and economic dynamism necessary to overcome the challenge of expanded membership and transform and improve its institutional setting (Ibid, p. 10). Moreover, in the period after 1989 the integration of the former communist countries has stretched out the zone of stability and prosperity in Eastern Europe with, in return, a positive influence to the western parts of the continent.

A very similar set of reasons might be used for the promotion of the prospective EU membership of the Western Balkan countries with an added argument in favor of their admission: as members they cannot significantly alter the embedded internal distribution of power or overburden any paragraph of the EU financial perspective. Obviously this was the prime reason why during the deep financial crisis the most influential EU members have not obstructed the activities of the EU Commissioner for Enlargement and the High Representative for foreign affairs and security policy regarding the region. Therefore, if Brussels is observing its obligations in a time of crisis it is up to the local elites to redouble their integration efforts and bear the responsibility for the better future of their citizens staying for so long in the transitional corridors.

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## **E-democracy Strategy in the Republic of Macedonia in the Context of E-democracy Strategies in EU Member States**

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### **Abstract**

*E-democracy refers to using new Information and Communication Technologies in order to increase and enhance citizen engagement in democratic processes. Different e-democracy tools provide different levels of citizen involvement, such as: informative, consultative and cooperative public participation. This paper will evaluate the e-democracy strategy and levels of citizen involvement in the Republic of Macedonia while attempting to compare the Macedonian case with e-democracy strategies and citizen involvement that may be found in EU Member States today. The questionnaire used in the EPACE project (Exchanging good practices for the promotion of an active citizenship in the EU) served as a basis for our research and it was distributed to all the ministries within the Government of the Republic of Macedonia, focusing on the following issues: strategies related to e-democracy and their main objectives; and, e-participation tools and projects for the future. Relevant officials from the Macedonian Ministry of Information Society and Administration were contacted for more detailed information about strategy and cases. In order to gain an insight into e-democracy at a local level, we analyzed the web portals of local governments, with a special emphasis on the e-tools used. As the findings suggest, both EU Member States and the Republic of Macedonia have a document which can be considered as part of a National Strategy which refers to the development of an Information Society as a whole whilst paying only modest attention to e-democracy.*

*In contrast to the EU Member States, where more or less all three levels of citizen involvement are present, the findings in the Republic of Macedonia suggest that only citizen involvement at an information and consultation level is currently in existence. Further research on this topic should be undertaken in order to investigate the extent to which the applied e-tools in the Republic of Macedonia provide communication and feedback in both directions.*

*Keywords: e-democracy, e-tools, e-democracy strategy, levels of citizen involvement, Republic of Macedonia, EU Member States.*

## **Introduction**

Democracy is a form of government in which power is held directly or indirectly by citizens under a free electoral system. Yet, in political theory, democracy is described both as a form of government and a political philosophy. Even though there is no universally accepted definition of 'democracy', there are two principles that any definition of democracy must include. The first principle is that all members of society (citizens) have an equal access to power and the second that all members (citizens) enjoy universally recognized freedoms and liberties. In some countries, democracy is based on the philosophical principle of equal rights. The term "democracy" is also used as a shorthand for liberal democracy, which may include additional elements such as political pluralism, equality before the law, the right to petition elected officials for redress of grievances, civil liberties, human rights, and elements of civil society outside the government. However, political theory highlights three pillars that underpin democracy: transparency, accountability and the right to participate.

E-democracy, as stated in the Recommendation on e-democracy, adopted by the Council of Europe (CoE Recommendations in text) in February 2009, is nothing more than the support and enhancement of democracy, democratic institutions and democratic processes by means of technology. This document presents a set of principles and guidelines on e-democracy. According to this document, e-democracy

concerns all sectors of democracy, all democratic institutions, and all levels of government. Hence, e-democracy cannot be isolated from traditional democratic processes. It is additional, complementary to, and interlinked with traditional democratic processes, so as to widen the choices available to the public for taking part in political processes. The CoE Recommendations underline the main goals of e-democracy which are similar to those of good governance, such as: transparency, accountability, responsiveness, engagement, deliberation, inclusiveness, accessibility, participation, subsidiarity, trust in democracy, democratic institutions and democratic processes, and social cohesion.

According to Caldow (2004: 1) e-democracy has both a tactical side and a strategic side:

On the tactical side, information technology has advanced communication and the access to information arguably better than any known medium. But, the underlying core principle of democracy is an informed and engaged citizenry. Most governments get passing marks for “informing” citizens via digital communication. But the vast majority has a long way to go to “actively engage” citizens or to effectively exert global influence using digital media. These elements comprise the most overlooked dimension of e-democracy – the strategic side.

Reinsalu (2010) points out that e-participation is a necessary component or even, more precisely, a prerequisite of e-democracy. It refers to the means of ICT-supported participation in processes concerning a raft of areas such as: administration, policy making, decision making, service delivery, information provision, consultation, and deliberation.

According to Mahrer and Krimmer (2005) e-democracy is not only about technology (and involves both so-called e-participation and e-voting) but also impacts every aspect of an organization involved. In addition, it captures the behavior of members of society (citizens, lobbies and opinion leaders), the media (media, agencies and market researchers) when interacting with, and attitudes towards, government agencies and representatives.

E-democracy can also be considered as a set of tools i.e. applications by means of which the goals of democracy can be achieved, in other words to improve the connectivity (information-communication) between government, stakeholders and citizens, raising engagement and participation in democratic processes. Some of the most commonly used e-democracy tools are the following: e-discussion, e-consultation, e-initiative, e-petition, e-polls, e-voting, and webcasts. Different e-democracy tools provide different levels of citizen involvement. The levels of involvement can be categorized as: information (informative public participation), consultation (consultative public participation) and cooperation (cooperative public participation).

In this study we evaluate the e-democracy strategy and levels of citizen involvement in the Republic of Macedonia while attempting to compare with the e-democracy strategies and levels of involvement in the EU Member States, presented in the publication *Handbook on E-democracy*. This Handbook was published within a framework of the EPACE project, which was produced with the financial support of the European Commission's Fundamental Rights and Citizenship Programme (2007–2013). The project partners include the Ministry of Justice in Finland (coordinator), the State Chancellery of the Republic of Estonia and the Ministry of Integration and Gender Equality in Sweden. The questionnaires were distributed to the central governments of all EU Member States, plus Norway and Switzerland, and the response rate was 63 %. These EPACE questionnaires served as a basis for our research, and for the purposes of this study, we have asked for the following information:

- Information about strategies related to e-democracy/e-participation and their main objectives
- Information about e-participation tools (The respondents were given a long list of e-tools where they could mark all e-tools used in our country. In the interest of common understanding, a short definition for each tool was presented below the list)

- Information about projects or guidelines for the future.

Relevant officials and experts from the Ministry of Information Society and the Administration in the Government of the Republic of Macedonia were contacted for more detailed information about strategy and cases. In order to gain an insight into e-democracy on a

local level, we analyzed the web portals of local governments, placing a special emphasis on the e-tools used.

## The EPACE Project

The main objective of this project was to elaborate and exchange good citizen participation practices in order to increase and promote participatory opportunities within the European Union member states. The following aspects of e-democracy were the analysis of subject matter in this project referring to: strategic policy planning, the administration of e-democracy and e-participation.

**E-democracy Strategies.** As stated in the CoE Recommendations, when introducing, implementing and reviewing e-democracy, it is important to ensure that e-democracy 'is embedded in balanced, citizen-oriented rules and regulatory frameworks, including regulations adopted by public authorities, co-regulation and self-regulation.' For the purposes of the EPACE project the questionnaires were distributed to all EU member states, and based on the answers it was found that 71% of the respondent countries have a document which can be considered more or less as a National Strategy.

According to the collected answers from the questionnaires, strategic documents featuring e-democracy in EU Member States were divided as follows: a) E-democracy as part of the Information Society Strategy (Estonia); b) E-Government strategy with some elements of e-democracy and e-Inclusion Strategy (Hungary, Latvia, Slovakia, Slovenia); c) Special policy document for e-democracy, Whitepapers (Austria); d) Regional or local strategies (Italy, Spain, Switzerland); e) Strategies based on the CoE Recommendations, still in process, envisaged for 2010 – (Denmark, Sweden).

The study showed that strategic planning practices vary considerably from state to state. That those strategies are primarily national e-Gov strategies and e-democracy is listed as just one component among many within these strategies (for example, in Switzerland one part of the national e-Gov strategy is dedicated to citizens-public communication). Mostly, the strategies are very general, being the Information Society as a whole, and pay only modest attention to

e-democracy. However, the Estonian Information Society strategy 2013 cites citizen participation as one of its long-term goals. Many member states note that they are planning to implement a special strategy based on the CoE Recommendations in the near future (such as Sweden and Denmark).

**Levels of involvement.** In the *Handbook on e-democracy* (2010), depending on the level of citizen involvement provided by different e-tools, three categories of levels were distinguished: Information (informative public participation) – Participants receive information about planning or decisions that have been taken. However, they do not have any influence on these matters. Communication is only one-way, namely from the planning or decision making bodies to the public. Consultation (consultative public participation) – Participants can give their comments on a question asked or a draft presented. They can thereby influence the decision, even though the extent of influence may differ considerably. Communication is in both directions, from the planning or decision-making body to the public and from the public back to the planning or decision-making body, as well as, under certain circumstances, once again back to the public; for example, if the comments received are answered. Cooperation (cooperative public participation) – Participants have a say in the decisions, for example at Round Table meetings, in mediation procedures or in stakeholder processes. The degree of influence is high and may include common decision-making with the political decision-making bodies. Planning or decision-making bodies and the public communicate intensively with each other. The cases at this level should demonstrate that the contribution from citizens, guaranteed through activities at two levels of involvement, has real consequences. Not only can citizens express their opinions, they can vote for them and the voice of the majority can constitute a real proposal for changes to a legislative act.

As this study clearly demonstrated, the most commonly used e-tools (e-consultation – 94%, e-discussions – 88% and webcasts – 82%), are those that provide the consultation level of involvement (Figure 1). E-voting, as an e-tool that provides a level of cooperation, is represented by 47%, which can be considered a significant level of application. According to Reinsalu (2010), many countries state that in their strategic documents on e-elections (national or regional) e-elections will be one

of the main future activities for extending e-democracy (examples include Norway – a pilot for e-voting is planned for the 2011 municipal and country elections – and Switzerland). This is inspite of the fact that e-elections cannot be considered as the pure practice of e-democracy, since there has been too little research into e-voting to draw definitive conclusions in terms of its actual influence. Many countries have stated in their strategic documents that e-elections (national or regional) will be one of the main future activities for extending e-democracy. For other sample cases – the level of citizen involvement, the tools used and institutional levels - see Table 1.

## **E-democracy in the Republic of Macedonia**

The Republic of Macedonia is a relatively young democratic country, gaining its independence in the so-called 'third wave of democracy', that is in the year 1991 following the dissolution of the Socialist Federal Republic of Yugoslavia. The discussions concerning the relevance and significance of democracy, as a precondition for the global development of society, represent an integral part of the current political and academic debates in the Republic of Macedonia. Although Macedonian society is still regarded as a society in democratic transition, serious efforts have been made to develop and enhance the information society as a whole, striving to introduce a range of tools that can usefully be applied in democratic processes and institutions.

**E-democracy Strategy.** The National Strategy for the Development of an Information Society was the first strategic document to address the issues of the information society, drafted and published by the Government of the Republic of Macedonia in 2005. This document refers to the development of an information society as a whole, with special emphasis on the following aspects: infrastructure, e-business, e-citizens, e-education, e-healthcare and legislation. In 2008 a Ministry of Information Society was established within the Government of the Republic of Macedonia. This ministry became responsible for the development of the information society as a whole, for creating and drafting policy papers, and for the coordination of the activities related to digital skills and services. Later on, the name of the ministry was changed to the Ministry of Information Society and Administration.

In the last few years several Strategies were drafted in the Republic of Macedonia: the National Strategy for Digital Communications and Digital Technologies; the National Strategy for Development of e-sectors (2010); the National Strategy for e-Government (2010-2012) and the National Strategy for e-inclusiveness (2011-2014). All of these strategies are very general, concerning the Information Society as a whole, such as: physical access to the Internet, equipment and content or digital skills and services, and some particular e-sectors.

In order to support and facilitate democratic processes in the Republic of Macedonia, the Ministry of Information and Administration created a web portal called e-democracy in 2011. As stated in the document drafted by this ministry, introducing the e-democracy web portal should be understood as a kind of continuity and modern method of public debate. This web portal solution should provide a simple and easily accessible way for citizens of the Republic of Macedonia, to give their opinion both about draft documents of the Government and adopted laws and be actively involved in decision making. In accordance with European standards, the portal solution has been designed in an open program code strengthening trust and transparency in institutions and the rule of law. The designing process of this portal solution was based on the CoE Recommendations, adopted in 2009 by the Council of Europe Committee of Ministers.

The web portal covers various activities, documents and initiatives from the following sectors of the Government of the Republic of Macedonia: ICT, administrative reform, education and science, finance, economics the interior, foreign affairs, justice, defense, the Ohrid Framework Agreement, trade, tourism, healthcare, social welfare, environment, local-self-government, culture, and agriculture. Macedonian citizens can exercise their democratic rights to participate in the democratic processes in the country by using the implemented (at this portal) e-tools: e-forums, e-initiative, e-polls and blogs.

**Levels of Involvement.** In order to determine the level of citizen involvement in the Republic of Macedonia, the questionnaires were distributed to all the Macedonian ministries within the Government. The response rate was 50%. The findings, based on collected answers show that the most commonly used e-tools on their web portals are e-consultations (80%), feedback (70%), e-initiative (50%) and

e-complaints (50%) (see Figure 2). Particular e-tools, such as e-petitions, e-budgeting, webcasts and e-voting, are not applied at all.

According to data from Figure 3, only two ministries' web portals use 50% of all listed e-tools in the questionnaire and shown in Figure 2.

The overall results from the collected answers indicate that there is no cooperation level of citizen involvement at a central governmental level. Further on, according to the Ministry officials and experts, the application of e-polls, e-services and e-taxes were reported as one of the main future activities for extending e-democracy.

**Local e-democracy.** The development of democracy at a local level is of significant importance for the development of the overall democratic processes within society. In this sense and in order to facilitate, improve and ultimately extend the exercise of democracy as well as to provide accountability, transparency and participation at a local level, local democracy should be supported and enhanced by the means of the tools of digital information technology.

Furthermore, in accordance with the Ohrid Framework Agreement, the official language throughout Macedonia and in Macedonia's international relations is the Macedonian language. But - as stated in the Agreement - with respect to local self-government, in municipalities where a community comprises at least 20 percent of the population of the municipality, the language of that community will be used as an official language in addition to Macedonian. With respect to languages spoken by less than 20 percent of the population of the municipality, the local authorities will decide democratically on their use in public bodies. Subsequently, these principles should be applied accordingly on the municipalities' web portals.

In the Republic of Macedonia there are 83 local government units plus the City of Skopje. As shown in Pie chart 1, 29% of the local units do not have a web portal or they do not function.

The analysis of the portals (71%) demonstrates that there is a wide range of e-tools that are not listed in the questionnaire. These tools, such as e-forms, e-applications for urban planning, or e-advertisement for tenders & public procurement, are categorized as e-services tools. Bearing in mind that one of the main tasks of local government is to meet the citizens' needs at a local level, then the significant level of their representation becomes quite clear and understandable (see Figure

4). On the other hand, many of the listed e-tools in the questionnaire (e-petitions, e-consultation, feedback etc) are not applied at all.

The study indicates that on both levels, central government and local, the applied e-tools provide only information and consultation level of citizen involvement. Particular e-tools, such as e-petitions, e-budgeting, webcasts and e-voting, are not used at all. In contrast to these findings the Espace project clearly demonstrated a significant level of application of the same e-tools: webcasts (82%), e-petitions (53%), e-voting (47%) and e-budgeting (29%).

**Study limitations.** To the best of our knowledge, this is the first study addressing the issue of e-democracy with a special emphasis on the level of citizen involvement in the Republic of Macedonia. In this sense, the study has some limitations. A major limitation is the fact that we only did mapping of the e-tools used on the official web portals of the ministries and local government units. We did not gain any insight into the functionality of those e-tools that are supposed to provide a consultation level of involvement. In other words, the extent of the communication and feedback provided in both directions, from the planning or decision-making body to the public and from the public back to the planning or decision-making body, was not measured. Also, we did not analyze the linguistic aspect of the web portals at a local level which should be in line with the Ohrid Framework Agreement regarding language issues.

## Conclusion

This study has evaluated the position of the Republic of Macedonia regarding e-democracy strategy and levels of citizen involvement in the context of strategies and levels of citizen involvement among the EU Member States.

As the findings of the EPACE project suggest, the vast majority of EU Member States possess a document that can be considered as a National Strategy. In the Republic of Macedonia there is also a document which can be considered as a National Strategy. In both cases, these strategies refer to the development of the Information Society as a whole, paying modest attention to e-democracy. In contrast to the EU

Member States, where more or less all three levels of citizen involvement are present, the findings in the Republic of Macedonia suggest that only the information and consultation levels exist.

The empirical findings in this study enhance our understanding of the importance of e-democracy as a precondition for the development of democratic processes and democratic institutions within society. Also, these findings provide a profound understanding of the relationship between different e-tools and levels of citizen involvement.

An issue that was not addressed in this study is whether e-tools used and listed in the answered questionnaires provide real communication and feedback in both directions, in other words- at the consultation level of citizen involvement in the Republic of Macedonia.

However, further research on this topic should be undertaken in order to investigate the functionality of the applied e-tools, in other words, the extent to which communication and feedback is provided in both directions, from the planning or decision-making bodies to the public and from the public back to the planning or decision-making bodies in the Republic of Macedonia.

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## Tables

Table 1.

Sample cases – level of citizen involvement, tools used and institutional level

Levels of involvement	Case	e-tools used	institutional level
Information	Case 1: Austrian participation portal	e-information	national
	Case 2. Latvian Public policy website	e-information	national
Consultation	Case 1: Austrian Wahlkabinet.at	e-initiative, e-discussions, feedback, e-consultations, e-polls	national
	Case 2: Finnish Discussion Forum Otakantaa.fi	e-information, e-discussions, e-consultation	national
	Case 3: Danish Odder Nettet	e-information, e-discussions, e-consultation	local
Cooperation	Case 1: TOM in Estonia	e-consultation, e-initiative, e-voting	national
	Case 2: Estonian Portal osale.ee	e-participation, e-discussions, feedback, e-consultation	national
	Case 3: ROSTRA in Denmark	e-participation, e-discussions, e-voting, feedback, e-consultation	national
	Case 4: Interactive City Council (Issy-les-Moulinex) in France	e-participation, e-discussions, e-voting, feedback, e-consultation	local
	Case 5: Spanish Madrid Participa	e-participation, e-discussions, e-voting, feedback, e-consultation	local

Source: Handbook on e-democracy

## Figures

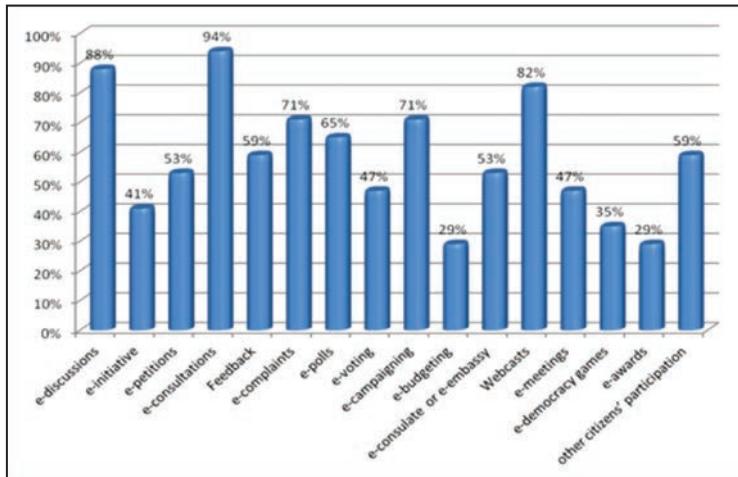


Figure 1: Use of different e-tools in EU Member States based on information collected from questionnaires (Source: Handbook on e-democracy, 2010)

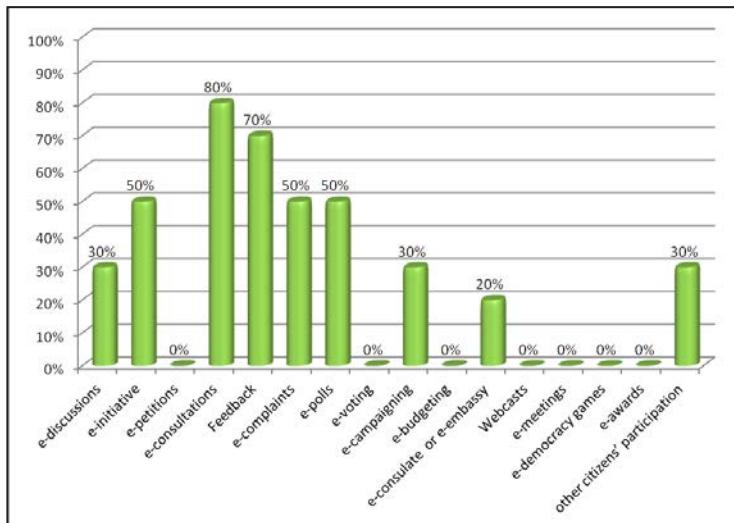


Figure 2. Use of different e-tools from the Macedonian ministries' web portals based on information collected from questionnaires

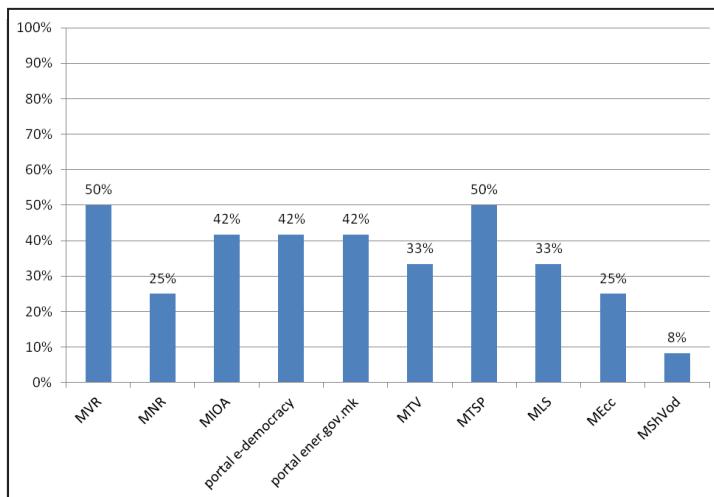
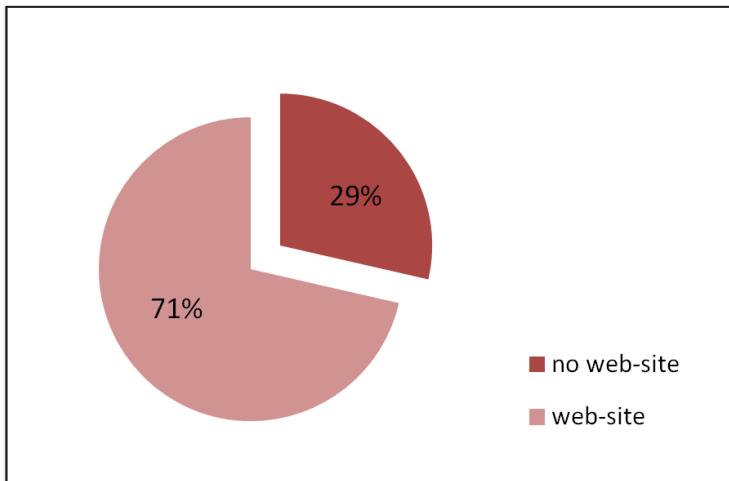


Figure 3: Use of e-tools in the Macedonian ministries' portals listed in the questionnaire



Pie chart 1. Percentage of existing portals at local level in the Republic of Macedonia

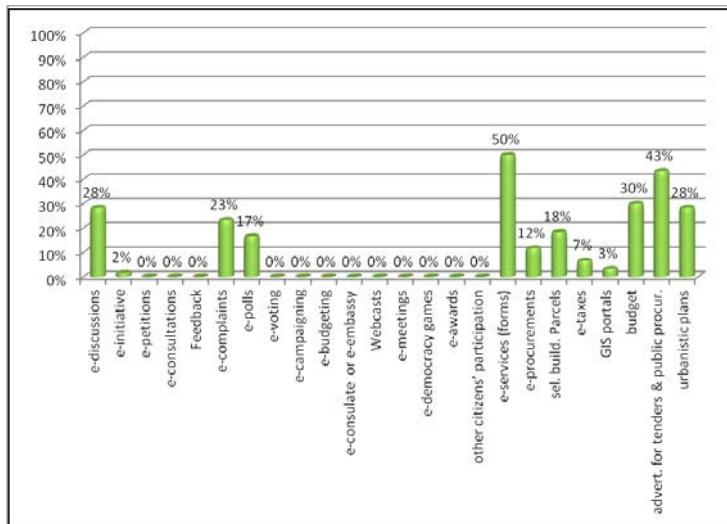


Figure 4: Use of different e-tools on the local units' portals in the Republic of Macedonia

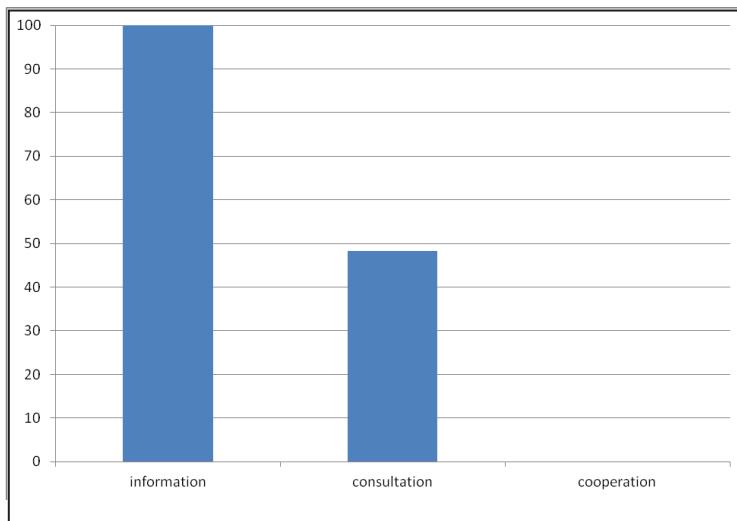


Figure 5: Levels of involvement at local level in the Republic of Macedonia

## **The Constitutional Principle of Voting Equality Viewed through EU Standards – the Case of the Ex-Patriot Vote**

*Natasha Gaber-Damjanovska*

### **Abstract**

*Election systems in modern democracies are continuously remodeled and adjusted to meet the needs of societal changes. One of the recent issues regarding elections, attracting the attention of comparative politics 'concerns' the mechanisms countries adopt in order to allow the nationals of countries' who have moved out of the country to be able to vote. The topic raises various, often opposed opinions on the manner in which this right ought to be accomplished, the type of elections on which ex-patriots would be able to vote (such as national elections, presidential elections and referendums), the number of seats reserved for the representation of ex-patriots' compared to the national seats, the election model selection and adjustments, and other issues. According to international documents and conventions, expert recommendations as well as the Macedonian Constitution, one of the election principles that by all means ought to be respected while creating the election model of the country is to consider the principle of the voting equality. This indispensable and essential democratic rule is built on the equality of citizens and ought to be respected for all types of elected political representation, including the seats assigned for the ex-patriot voters. This paper intends to analyze whether in legal and practical terms the principle of the equality of voting is respected in the case of domestically elected members of Parliament in Macedonia, compared to the elected ex-patriot*

*MPs, considering comparison with the experiences of other countries. Included are the OSCE/ODIHR recommendations on the Macedonian Electoral Codex, the Venice Commission recommendations, as well as studies and comparative papers from IDEA, IFES and other organizations and authors.*

*Keywords: elections, equality of vote, political representation, ex-patriot vote, out-of-the-country vote*

## **Introductory Remarks**

The democratic establishment of political authorities as laid down in the constitution, especially the elected parliament as a representative body of the citizens, makes together with the freedom of speech and the freedom of association the most important triad of contemporary states, which are considered to be democratic. In practice, the first listed prerequisite is founded on the recognition and application of the general, equal, direct and secret right to vote, while elections represent the essential tool for achieving this right in every country. By freely and democratically electing political representatives, citizens accomplish the very essence of a process through which is transferred, expressed and confirmed their opinion, will, authority and legitimacy to the elected representatives and further, through, them, to the executive power of state. Acknowledging the value and significance of the right to vote, the fathers of the American Constitution, stressed the importance of the free expression of the will of the people through voting, viewing it as an immanent possession or property of free citizens. As such, they rightly emphasized the:

Personal rights, of which the right of voting for representatives is one - *a species of property of the most sacred kind*: and he that would employ his pecuniary property, or presume upon the influence it gives him, to dispossess or rob another of his property or rights, uses that pecuniary property as he would use fire-arms, and merits to have it taken from him.

In modern states, the election system itself is the mechanism by which citizens' votes are translated into seats. It has the task of ensuring that the will of citizens is correctly transferred in the elected legislature, in a manner in which universal civil and political freedoms and rights such as: freedom and fairness of elections, guaranteed secrecy of the vote, universal right to vote, and the equality (the equal weight) of votes are operatively applied and respected in practice.

Historically observed, voting universality and equality have not been initially granted in the form that is widely perceived in contemporary societies. Older democracies have transited through a long battle of at first gradually including into the electoral process various society groups by obtaining the right to vote (like the working class, poor rural population, women, non-white voters), and secondly, the design of election systems which slowly progressing towards ensuring equality (equal value or weigh) of the vote. Consequently, the promotion slogan of the then progressive forces was: "one man, one vote, one value".

There was a country to country variety of experiences in the past for achieving these two main goals, while the historical cases of misuse may today serve as examples to be avoided: in political science jargon is widely known the expression "gerrymandering", named after the Boston candidate Governor Elbridge Gerry who in 1812 drew the constituency *boundaries* in which his Democratic-Republican party was favored, a success secured according to his calculations of the votes support from the included population. Similar examples are provided by the drawing up of constituency boundaries in France, during the Fifth Republic when political bias favoring de Gaulle was created intentionally mixing urban and rural population in one constituency, in order to diminish left-wing influences in urban areas.

Another parallel problem is the *average number of votes obtained per candidate*, which has indicated many significant breeches of the equality of the voting principle in the past (see Table 1). Realizing the serious issues that may occur in practice, especially considering its electoral first-past-the-post majoritarian model in single member constituencies, Great Britain founded the Boundary Commission in 1917 (which currently functions as four permanent Commissions for England, Wales, Scotland and Northern Ireland). The Boundary Commission serves as a strong independent body, that follows population movement

in the set constituency boundaries and makes sure that there is a similar average number of votes per Member of Parliament (MP) seat in every constituency, in accordance with the population figures and migration. In all countries in the meantime, the situation from this perspective has significantly improved, while the newly established democracies have more rapidly grasped the experience and made efforts to speedily overcome these potential problems.

However, even today, the fight for the equality is not over. Although set in all relevant international documents, stated in many national constitutions and election laws, this principle may not be entirely met in some cases, especially when considering various criteria which are applied while shaping a country's electoral model, or drawing constituency boundaries and determining the average number of potential voters or votes cast in it for electing one political representative or MP.

## **A Theoretical Background to the Voting Equality Principle**

There are numerous political theories and ideologies throughout the development of human thought that strive to define and practically implement the concept of democracy. Although it is still seen as a valuable principle or an idea that is very difficult to apply in its entirety in a political system, there is an ongoing effort for the ideal to be reached as closely as possible. Robert A. Dahl in his work *Democracy and Its Critics* estimates that although democracy is perceived as a utopian idea, it can still be reached through meeting five criteria: (1) citizens should have effective participation through adequate and equal opportunities to form their preference, place questions on the public agenda and express reasons for one outcome over the other; (2) voting equality should be secured at a the decisive stage - each citizen must be assured his or her judgments will be counted as equal in weight to the judgments of others; (3) achieving enlightened understanding – citizens must enjoy ample and equal opportunities for discovering and affirming what choice would best serve their interests; (4) there should be control of the agenda - people must have the opportunity to decide

what political matters actually are and what should be brought up for deliberation; and (5) there should be inclusiveness – equality must extend to all citizens within the state, as everyone has a legitimate stake within the political process.

Linked with the above mentioned criteria, it is determined that the basic characteristics of any system of elections are: the defining of constituency boundaries (including the aspect of territorial division, the number of inhabitants, the number of voters, number of mandates per constituency), rules for conducting the election race, voting procedure and the way of translating votes into seats. The principle of equality, working through these systemic instruments is at its best described in the Oxford Dictionary of Politics, “Equality is a factual and/or normative assertion of the equal capacity of equal standing of persons, generating claims about distributive justice...The normative claim involves four main “applications” which are not wholly separable: (1) equal consideration within a scheme of (moral) decision-making. In this sense, the claim to be taken equally into account, as in the “utilitarian” concern that each count for one in the aggregation procedure. (2) even-handed treatment - claiming that similar cases are to be treated alike; (3) equality in distribution - here equal treatment requires that each person receives an equal amount of a “good” And (4) equality in outcome – meaning that all persons should end up in the same conditions, taking account of their situation before distribution and adjusting the amount to be distributed to each accordingly” (McLean & McMillan, 2003, p. 173).

Even more simply described, according to Dieter Nohlen, “equal election rights as a rule demand that the weight of the vote of all persons that have the right to vote be equal and not be differentiated by property, class, taxation, income, religion, race, gender or political position... While drawing up the boundaries must taken into account the necessity of having an approximately *equal number of voters* in every constituency giving the same number of representative seats in the parliament” (Nohlen, 1992, p. 26).

The referred theoretical positions create a strong support of the understanding of the equality of the right to vote through the idea of the equitable (fair) representation of all individuals obtaining such a right with special attention to the weight of votes (equal numerical value of votes). What’s more, voting equality is clearly relevant to the practical

operational tailoring of the election model, above all when drawing up the constituency boundaries in a country, in the sense of having an approximately equal number of potential voters for each parliamentary seat in all constituencies throughout the country, regardless of how many mandates each constituency elects. Numerous theoreticians and psephologists emphasize that this rule is practically the most important one of all the principles of the electoral process.

Sticking to this principle, the legal determination of the average quantity or “value” of the number of voters that covers a single mandate in a country is anticipated beforehand. In this sense, in election practice two procedural possibilities are understood: 1. determined by as many single-member constituencies as there are mandates to be distributed, while in each constituency there is an average number of voters that belong to that constituency, with a small range of variability of that average number, depending on the configuration of settlements. The drawing up of boundaries is of inherently special importance for those single-member districts, in which candidates are elected by the use of the majoritarian electoral system; or 2. it is calculated how many mandates should be allocated per constituency (in this case there are multi-member constituencies and the use of the proportional representation election model-PR model) whose number depends on the number of potential voters per constituency, divided by the national average “value”, which the result offers to the adequate number of mandates per constituency.

In principle, electoral constituencies should be structured initially and as stable as possible on longer terms, in order to avoid suspicion of potential fraud thereby inducing political instability. When drafting constituency boundaries, there should be an obligatory consensus, that is to have higher level of social cooperation and acceptance in the state, encompassing all significant political actors in society. By reaching such an agreement the legitimacy of the elected candidates can be secured. However, once set, constituency boundaries are not determined for an indefinite amount of time, making it necessary to be continuously followed and re-examined, in order to adjust them to the migrational, demographic and other population changes that occur in relation to the number of mandates such a constituency gives. It is a widely applied standard that, the determined “mean” or “average” of the number of voters covering one mandate should be re-examined about every

ten years, thereby allowing for a constant rather small numerical swing depending on the characteristics of the geographic settlement distribution existing in the constituency.

The same principles of the equality of the vote are clearly formulated as practical recommendations by the Venice Commission (European Commission for Democracy through Law, 2002) for countries to follow. They are that: the right to equal voting is understood as each voter has in principle one vote, whilst when the electoral system provides voters with more than one vote, each voter should have the same number of votes; the equal voting power is defined through seats that must be evenly distributed between the constituencies. The principle must at least apply to elections to lower houses of parliament and regional and local elections; and should entail a clear and balanced distribution of seats among constituencies on the basis of one of the following allocation criteria: population, number of resident nationals (including minors), number of registered voters, and possibly the number of people actually voting. While drafting constituency boundaries, the geographical criterion and administrative, or possibly even historical, boundaries may be taken into consideration; the permissible departure from the norm should not be more than 10%, and should certainly not exceed 15% except in special circumstances (such as the protection of a concentrated minority, or a sparsely populated administrative entity); in order to guarantee equal voting power, the distribution of seats must be reviewed at least every ten years, preferably outside election periods. With multi-member constituencies, seats should preferably be redistributed without redefining constituency boundaries, which should, where possible, coincide with administrative boundaries. When constituency boundaries are redefined it must be done impartially, without detriment to national minorities and taking account of the opinion of a committee, the majority of whose members are independent.

### **Relevant International Documents on Voting Equality**

The importance of the principle of voting equality is reflected in many international documents, such as the Universal Declaration of Human Rights, which in Article 21 paragraph (1) states that “Everyone

has the right to take part in the government of his country directly or through freely chosen representatives" and in paragraph (3) emphasizes that "The will of the people shall be the basis of the authority of the government; this will shall be expressed in periodic and genuine elections which shall be by universal and equal suffrage and shall be held by secret vote or by equivalent free voting procedures". Similarly, Article 3 of the Protocol of the European Convention of Human Rights (1952), determines the right for free elections: "The High Contracting Parties undertake to hold free elections at reasonable intervals by secret ballot, under conditions which will ensure the free expression of the opinion of the people in the choice of the legislature". Of special importance for the elections is Article 7 of the Document of the Copenhagen Meeting of the Conference on the Human Dimension of the CSCE in 1990, by which participating states in order to ensure that the will of the people serves as the basis of the authority of government will among other things: "(7.3) - guarantee universal and equal suffrage to adult citizens; (7.4) - ensure that votes are cast by secret ballot or by equivalent free voting procedure, and that they are counted and reported honestly with the official results made public". None of the mentioned documents deals with the vote of citizens abroad in particular, but it is understood that the same rules and principles that are applied with the national voting rights and principles should equally apply to out-of-country voting. In this sense, the Parliamentary Assembly of the Council of Europe encourages member states to allow their citizens living abroad to participate to the fullest extent possible in the electoral process (Resolution no 1459 (2005) (paragraph 7) and Recommendation no 1714 (2005); Recommendation no 1410 (1999).

How this principle concretely applies to specific issues linked to elections in the Republic of Macedonia and can be detected through the position of the relevant international bodies that monitor elections and comment on the specific legal solutions on the matter, namely the ex-patriot seats. The 2009 Joint OSCE/ODIHR and Venice Commission Opinion on the Electoral Code of Macedonia, commenting specifically on out-of-country voting and the new parliamentary districts set for that purpose, emphasizes: "while there is no legal standard for measures to vote abroad, and the procedures vary widely in scope and approach, the election should generally meet the same standards for democratic

elections as in-country procedures. It appears that the method outlined in the current legislation does not achieve such a standard and it is recommended that a new formula is considered.” It is also noted that “the Code provides a proportionally-based system for the parliamentary elections (with six districts of high magnitude, 20 seats each) but the three single member constituencies break with this principle, as a single mandate district cannot be proportionally distributed (....) it should be noted that while the domestic districts are designed to produce approximately the same number of votes per seat, the three districts abroad are predefined to one seat each regardless of the number of registered voters.... Therefore, the number of voters electing each of these mandates will likely differ considerably amongst themselves, as well as from the in-country constituencies. This risk compromises the principle of equal suffrage, and more precisely the principle of equal voting power”. Further, the report advises that: “While the creation of a virtual district is a viable option for voting abroad, assuming that a large enough number of voters would participate to allow equal suffrage, mandates should be allocated in such a way as to allow for a proportional system to be effective (in this case by having more than a single mandate). In the absence of such, it is recommended that votes cast from abroad are counted in the domestic districts of the voters’ last residence.”

After the completion of the Macedonian early parliamentary elections of 2011, the OSCE/ODIHR Election Observation Mission Report followed in which was reaffirmed the same position on the matter of the ex-patriot vote, as had been elaborated previously. It was said that the legal framework provides for the fundamental civil and political rights and freedoms necessary for the conduct of democratic elections, however the position is that it still requires further improvement in order to fully comply with OSCE commitments and other international standards. Among other things, remarks have been given on the *speedy introduction* of the ex-patriot vote, which is not in compliance with good electoral practice and has affected the timely and consistent implementation of the law. What's more, the Mission repeated the deep concern it has regarding the small number of voters who ultimately registered to vote abroad and raised questions about the equality of the in-country and out-of-country votes; emphasizing that the small number

of voters who registered abroad underlines concerns about the equality between in-country and out-of-country vote; and that any deviation from the equality of voting should be minimal. In the recommendations following these findings, the Mission suggests that the authorities should review the current system of the allocation of mandates in out-of-country electoral districts to ensure that the number of votes needed to elect MPs does not significantly diminish the equality of the vote, as guaranteed by the Constitution and Electoral Code.

## **Out-of-Country Voting Comparative Experience**

A thorough analysis and a summary comparing of the experience of various countries comprised in the Report on Out-of-Country-Voting prepared by the Venice Commission (European Commission on Democracy through Law, 2011) shows that the right of persons voting abroad is a very complex issue. On the one hand it is a question of principle, whether to grant the right to vote to this particular category of citizens, whilst on the other hand however, specific questions with regard to different modalities of the execution of this right, including the dilemma of how persons living abroad can benefit from this right, are raised. With respect to democratic openness, each state may give a different response to this problem depending on circumstance, as it is within the state's own scope of sovereignty to decide whether they wish to grant the right to vote to their citizens residing abroad or not. The Report notes that: "no precise international standards exist for implementing such measures, but elections abroad should generally meet the same standards for democratic elections as in-country procedures. The design of a system for voting abroad depends on the particular circumstances of a country, including its administrative, infrastructure, budget constraints, in-country election arrangements and level of public confidence".

As the report points out, there are three categories of citizens living abroad: those who may be abroad on election day for business or personal reasons; citizens who for academic or employment purposes spend a definite or temporary amount of time in another country, where they will reside for a given period; and citizens residing abroad for a much longer period of time, who may sometimes have

double nationality and who settle down in the host country in a more permanent manner. For example, groups of people staying or residing abroad who are entitled to vote may be: migrant workers, refugees, internally displaced persons (IDPs), individuals in certain professional groups, such as military personnel, public officials or diplomatic staff (and their families) and all the country's citizens living or staying abroad, on a temporary or permanent basis. Inevitably, bearing in mind the differences between these three categories, the voting process demands a different approach to enjoying the right to vote. At the same time and even more importantly, there should be a clear "definition of the electoral college" in the sense that it should be distinguished which group votes in which constituency and for which candidates (in-country candidates or ex-patriate candidates), or what proportion of out-of-country voters per MP seat should be the equivalent to the proportion of in-country voters, linked to the type of election concerned and the election system of the given state.

Similarly, the IDEA handbook (2007) presents three main structural problems which are typical for out-of-country voting which should therefore be considered in political debates while introducing it. These are: (a) the problem of the political representation of citizens living abroad; (b) the problems of organizing free and fair elections, the transparency of external voting procedures, and the freedom and fairness of party competition, and (c) the problem of the judicial review of elections held. The IDEA Handbook states: institutional provisions for the assignment of external votes are politically important because they define how external votes are translated into parliamentary seats. In other words, these regulations will largely decide the extent to which external voters can influence domestic politics." In practice, there may be two basic options: creating extraterritorial electoral districts for external electors *or* to assigning these votes to existing electoral districts inside the country, (possibly in the electoral district in which the external elector was last registered). Each of the two options may create a different political effect domestically: The first has a great influence in the case of the need to create a majority government, or in giving greater strength to an existing ruling party or pulling at times conservative trends in domestic policies. The second influences the election results in domestic constituencies so that as a consequence the country's politics may be "externally" determined.

Table 6 gives a very informative approach to the types of elections ex-patriots can vote in forty-one countries, indicating that various countries, depending on their social characteristics, historical heritage, political circumstances and diasporic specificities have adopted a variety of possibilities regarding the out-of-country vote. In only five states – Austria, Bosnia and Herzegovina, Denmark, Iceland and Norway are citizens allowed to vote in all types of elections. At the same time, there are 12 countries (Albania, Andorra, Armenia, Chile, Cyprus, Greece, Ireland, Israel, Malta, Montenegro, San Marino and Turkey) where no legal provisions have been enacted to organize voting for their nationals abroad or where the right to vote from abroad has only been granted to a very restricted category of people.

The legal basis under which a person obtains the right to vote in a particular country is based on the principle of nationality, that is citizenship. Out-of-country voting enables citizens living outside their country of origin to continue participating in the political life of their country of origin. There are even some countries that have special seats for MPs who are dedicated to representing their ex-patriots, like Croatia, France, Italy, Portugal, Romania, Macedonia and others (see Table 5) for which the design of the national election systems had to undergo some changes. In these cases, it is interesting to observe to what extent, according to the number of reserved seats in the parliament the diaspora is able to influence domestic politics, even reaching the majority decision on national policies and laws, as well as being able to assist in forming a government. Bearing in mind these possibilities, there is an additional reason why the ex-patriot MPs should guarantee the same voting representation, support and legitimacy that “domestic” MPs enjoy.

At this point, it is interesting to mention the Croatian experience in drafting the electoral model for the Croatian diaspora seats. The Law on parliamentarian elections in Croatia of 1995 created a special, single constituency, at that time providing 12 parliamentary seats, in order to represent the considerable Croatian diaspora (estimated at about 400.000 voters). The number of seats was the same with 12 seats for each of the domestic 10 multi-member constituencies. As a result of fierce criticism, the law was reformed. Currently, the maximum number of seats from the diaspora can be up to 14 but firstly it is computed

according to the “price in votes obtained” for an average domestic parliamentary seat, whose number is then divided by the total of the votes cast out of the country. The quotient obtained determines the number of seats that are going to be allocated for the diaspora in that particular election. In that way, Croatia secures the equality of principle of voting equality in both the domestic and out-of-country vote.

Other interesting examples are provided by Italy and Portugal. The Portuguese abroad have been represented in the House of Representatives since 1976. For this purpose, voters abroad also make up two electoral districts, one for Europe and the other for the rest of the world. Two deputies are elected in each of these districts, but only if a minimum of 55,000 electors cast a vote within the district. If fewer voters cast a vote, only one seat is assigned to the corresponding district. In the parliamentary elections of February 2005, both districts obtained their two seats. In addition to providing for the external vote for elections to the legislature and referendums, the constitutional reforms approved in Italy in 2000 stated that citizens abroad are provided with representation in both parliamentary chambers —12 seats in the House of Representatives and six in the Senate.

## **The Macedonian Example**

An overview of national elections in Macedonia may serve as an example of the manner in which the principle of voting equality was initially applied and is still in use. At first, in the national elections of 1990 and 1994 a majoritarian two-round election model was employed, for which the whole country was divided into 120 constituencies, each producing 1 parliamentary seat; in the national elections of 1998 the model changed, as 2/3 or 85 parliamentary seats remained to be elected by the majoritarian two-round election model for which the country was retaillored into 85 single-member constituencies, while the remaining 35 parliamentary seats were distributed by use of the D'Hondt PR formula, based on nationwide closed party lists.

For the 2002 national elections in Macedonia the regional-proportional election model was introduced for the first time, where each of the set six multi-member constituencies elected an equal number of parliamentary seats (20 seats in total) in the Macedonian

Assembly. Constituencies have been tailored to represent approximately 276.000 voters on average (see Table 2) indicating that there was great consideration for respecting the equality principle. Since then, as the population numbers changed, there were some corrections in the constituency boundaries in order for this principle to be maintained correctly and in terms of the Election Codex and the Constitution. However, compared to the regulation that has been applied to these "domestic" constituencies, it cannot be said that this principle has been equally applied to the newly established ex-patriot constituencies and consequently to the number of parliamentary seats. Facts show that the current legal framework on these particular three parliamentary seats differs greatly from the other 120 domestically elected seats, seriously questioning the legitimacy of the elected ex-patriot MPs.

According to Article 22 of the Constitution of the Republic of Macedonia (1991, 2001), every citizen on reaching 18 years of age acquires the right to vote. The right to vote is equal, universal and direct, and is exercised at free elections by secret ballot. Article 62 determines that the Assembly of the Republic of Macedonia is composed of 120 to 140 Representatives. They are elected at general, direct and free elections and by secret ballot. This constitutional provision practically determines the minimum and the maximum number of seats the Macedonian Assembly can have (from 120 to 140) thus leaving space for the law to further set the definite number of seats, which can vary within this range, and the election model that will be applied.

In Article 4 paragraph 2 of the Electoral Codex (2006, 2008, 2011) it is foreseen that in the Assembly of the Republic of Macedonia 123 Members of Parliament are elected of whom 120 MPs are elected by the proportional representation model, for which reason the territory of the Republic of Macedonia is divided into six constituencies (electoral districts) whose boundaries are determined by law, and in each constituency 20 MPs are elected. This article has been amended and now sets three other constituencies (no.7-Europe and Africa, no.8-North and South America and no.9-Asia and Australia) where each gives one parliamentary seat by application of the majoritarian first-past-the-post election model for the Macedonian Assembly. Article 4 paragraph 3 anticipates that the number of voters in the domestic PR multi-member constituencies may differ at most +5% from the average number of voters. These constituencies are tailored to contain a certain

number of potential voters which allows for an acceptable swing in voting support per parliamentary seat in a district without distorting the constitutionally determined rule of vote equality. However, these three out-of-the-country constituencies do not abide to this rule, that is, by law they are exempt from this principle. Article 127-a paragraph 2 (Electoral Codex 2011) determines that for these three constituencies the candidate who is elected won more votes than the other candidates, under the condition that he obtained not less than 2% of the voters inscribed in the voters' list, whose threshold is an extremely low one and does not provide the required voting equity.

In practice, the effect of these legal provisions demonstrates that in the 2011 national elections nationwide 1.156.049 persons voted (out of which there were 1.124.064 valid notes and 31.985 votes were invalid), showing a turnout of 63,48%. By dividing the number of votes cast by the 120 domestically distributed seats, it can be seen that the average "value" of one parliamentary seat in the Assembly in 2011 is 9.633 votes. However, in that same year, Macedonian ex-patriots had the opportunity for the first time to cast their votes, for which in the three new election districts (7, 8 and 9), in total 7.213 voters were registered, out of which 4,088 people voted (valid ballots 3.972, invalid 116). The turnout in these three districts averaged to 56,67% (See Table 4). All three winning candidates belong to the same party – VMRO-DPMNE.

Comparing through time the "value" or "weight" in votes of these three parliamentary seats with the average "weight value" of the other 120 domestic parliamentary seats, observed through all national elections since 2002, it can be seen that the average number of votes per national parliamentary seat varied from 9.965 in 2002, to 8.124 in 2006, 8.459 in 2008 and 9.633 in 2011 (see Table 3), but was never that low like the number of votes by which these three candidates had been elected. Namely, the candidate from the European and African constituency got six times less votes than any other domestic candidate, while the two that had been elected in the Americas and Asia-Australia got seventeen times less votes than any domestic candidate. Data make it clear that there is an explicit breach of the constitutionally guaranteed equality of voting principle. Practically, there is six or seventeen times ponderation of the out-of-country vote towards any domestic voter, resulting in the creation of deep political inequality among the citizens and seriously questioning the legitimacy of the elected MPs.

Other than this particular fact, the law does not make a clear distinction between citizens who are temporarily residing and working abroad and those who have permanently left the country, but who still keep their Macedonian citizenship and are interested in voting. This distinction ought to be made, because the first group of persons would be voting for the 120 domestic parliamentary seats, while the second would be expected to vote for the three parliamentary seats allocated to the ex-patriots. The possibility of having a double listing in the country and abroad of the same persons should be avoided, and a clear definition of what an ex-patriot is should be set in the law. What's more, there is no determined time limit, after which a Macedonian national would be considered as a person that has permanently moved abroad. In this sense for example, Great Britain determines that time-frame on 15 years during which time a person would be living out of the country.

## **Conclusions**

The right to vote is connected with the possession of a country's citizenship, as it belongs to the gamut of legally guaranteed political rights, representing one dimension of the universality of voting rights. Undoubtedly, the Macedonian state has the freedom of deciding how this right is to be operated, and which election model shall be adopted; but, at the same time the state must make sure that the principle of voting equality guaranteed by the Constitution is respected. The basic electoral model carefully considers the application of this right, while this is not the case with the three elected ex-patriot parliamentary seats, as the Election Codex does not instrumentalize correctly the set principle. Critical voices were heard not only by the domestic experts and some political forces in the country but also by the relevant international organizations in charge of harmonizing domestic legislation with international legal documents and best practices. It should be borne in mind that comparative international experience shows how such voting practices create problems, especially when younger democracies are in question which have difficulties in electoral administration and/or have a certain history of electoral fraud. Therefore, the Republic of Macedonia should urgently abide by the constitutionally guaranteed

principle and correct the electoral model concerning the election of the three ex-patriot parliamentary seats.

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## Appendices and Tables

Table 1: Number of voters by mandate in several countries  
(Dieter Nohlen, 1992, p. 49)

Country	Year	Final mandates (votes per seat)	Type of constituency
Brazil	1962	From 2100 to 53.500	Multi-member constituency
Brazil	1986	4.663 – 499.800	Multi-member constituency
Chile	1969	28.000 – 296.000	Multi-member constituency
France	1973	9.520 – 60.000	Single-member constituency
Germany	1907	18.800 – 220.000	Single-member constituency
Spain	1977	35.500 – 141.200	Multi-member constituency

Table 2: Average number of voters per constituency in 2002  
 (State Election Committee of the Republic of Macedonia)

Constituency number	Number of voters in the voter's list	Votes cast
1	277.782	180.806
2	272.842	187.265
3	277.126	211.498
4	277.236	206.173
5	279.717	203.011
6	279.593	207.134
<b>Total</b>	<b>1.664.296</b>	<b>1.195.887</b>

Table 3: Comparative overview of the average “cost” of one MP seat in national elections since 2002 (State Election Committee of the Republic of Macedonia)

Year of elections held	Total number of voters inscribed in the Election List	Total number of votes cast	Average number of votes obtained per one seat in the Assembly
2002	1.664.296	1.195.887	$1.195.887 : 120 = \mathbf{9.965}$
2006	1.741.449	974.891	$974.891 : 120 = \mathbf{8.124}$
2008	1.779.116	1.015.164	$1.015.164 : 120 = \mathbf{8.459}$
2011	1.821.122	1.156.049	$1.156.049 : 120 = \mathbf{9.633}$

Table 4: Number of votes by which the ex-patriot candidates have been elected in their constituencies (State Election Committee of the Republic of Macedonia)

Constituency number	Total number of voters inscribed in the voter's list	Total number of votes cast	Number of votes by which the candidate has been elected in his constituency
7	4.591	2.494	<b>1.578</b>
8	1.824	994	<b>560</b>
9	798	600	<b>548</b>
	7.213	4.088	

Table 5: Model of ex-patriot political representation (number of seats) compared with the total number of parliamentarian seats in the country

Country	Number of MP seats (percent of the total number of seats in the national assembly)
Algeria	8 (2% of 389 seats)
Angola	3 (1,4% of 220 seats) this kind of voting has not been yet implemented
Cape Verde	6 (8,3% of 72 seats)
Colombia	1 (0,6% of 166 seats)
Croatia	6 (3,9% of 152 seats) for maximum of 14 seats*
Ecuador	6 (4,6% of 130 seats)
France	12 (3,6% of 331 seat) only for the Senate
Italy	12 (1,9% of 630 seats)
Mozambique	2 (0,8% of 250 seats)
Panama	6 (4,6% of 130 seats)
Portugal	4 (1,7% of 230 seats)

Table 6: Country comparative overview of the types of elections ex-patriots vote

PRESIDENTIAL	PARLIAMENTARY	REFERENDUM	EUROPEAN	LOCAL
Algeria	Algeria	Algeria		Algeria
Azerbaijan		Azerbaijan		
Belarus	Belarus	Belarus		Belarus
	Belgium		Belgium	
Brazil		Brazil		
Bulgaria	Bulgaria			
Croatia	Croatia	Croatia	(Croatia)	
	Czech Republic			
	Estonia	Estonia		
Finland	Finland			Finland
France	France	France	France	
Georgia	Georgia			
	Germany		Germany	
	Hungary	Hungary	Hungary	
	Italy	Italy		
Korea	Korea			
Kyrgistan	Kyrgistan	Kyrgistan		
	Latvia	Latvia		
	Liechtenstein	Liechtenstein		
	Lithuania	Lithuania	Lithuania	Lithuania
	Luxembourg	Luxembourg	Luxembourg	
		Morocco		
Mexico				
Moldova	Moldova	Moldova		
	Monaco			
	Netherlands		Netherlands	
Peru	Peru	Peru		
Poland	Poland	Poland		
Portugal	Portugal	Portugal	Portugal	
Romania	Romania	Romania	Romania	
Russia	Russia	Russia		
Serbia	Serbia			
	Slovakia			
Slovenia	Slovenia	Slovenia		
	Spain	Spain		Spain
	Sweden	Sweden	Sweden	Sweden
	Switzerland	Switzerland		Switzerland
Macedonia	Macedonia			
Tunisia		Tunisia		
Ukraine	Ukraine	Ukraine		
	United Kingdom		United Kingdom	

Table 7: Overview of the arguments “for” and “against” the introduction of external voting

	For	Against
Theoretical arguments	Full implementation of the <i>universal suffrage</i> as a part of human rights	<i>Residency</i> as a central criterion of suffrage and of political representation
	Increased <i>political participation</i>	Problematic <i>transparency</i> of external election process
		Problematic <i>dispute resolution</i> of external voting
Historical and empirical circumstances	Small number of permanent external electors in relation to domestic electors	Large number of permanent external electors in relation to domestic electors
	Equal distribution of political preferences of external electors	Uniform ideological orientation of external electors
	Democracies with long experience of elections and a well-established electoral organization	New democracies with problems of electoral administration and/or a history of electoral fraud

## **Economic Diplomacy as a Strategy for Sustainable Economic Growth**

*Krum Efremov*

### **Abstract**

*The focus of this research is to assess how economic diplomacy as a state policy could achieve better economic results. This research is theoretical, drawing empirical evidence on the implementation of economic diplomacy in two small EU countries, the Republic of Slovenia and the Kingdom of Denmark, and the Republic of Macedonia. The research is based on qualitative analyses, as well as recommendations and results, which could be of interest for policy makers in public administration and in academic circles. The paper examines the concept and experiences of economic diplomacy in the Republic of Slovenia and in the Kingdom of Denmark, as small countries with populations between 2 and 6 million citizens. Special attention is paid to the role of the Ministries of Foreign Affairs in the selected countries and on the coordination with other national institutions. Next, we investigate whether the economic diplomacy in the two countries is in accordance with their policy of sustainable economic growth? Western economies, especially EU countries, are facing significant economic and fiscal challenges. Economic diplomacy is an alternative tool to overcoming global threats and to increasing influence in important and vital markets. The future challenge is a strategy that through economic diplomacy is to increase the sustainable economic growth of EU countries. Finally, we look at the position of economic diplomacy in the Republic of Macedonia. The promotion of economic interests and priorities abroad is one of the most important operative tasks of the Government of the Republic of Macedonia. The purpose of these activities is to*

*present the Republic of Macedonia as an attractive destination for foreign investments, through the promotion of business advantages, giving incentives to Macedonian exports, as well as strengthening the country's position as a reliable business partner and an attractive tourism destination.*

*Keywords: economic diplomacy, export promotion, investment promotion, globalization, sustainable development.*

## **Experiences in Different Countries, Small Economies in the EU in Pursuing Economic Diplomacy**

The connections and interdependence of national economies encourage Sovereign States to make economic diplomacy an important part of their foreign policy (Lee & Hudson, 2004). Bayne and Woolcock (2007) elaborate that economic diplomacy is not just a subject for academic study. It is an activity pursued by state and non-state actors in the real world of today. In some respects economic diplomacy is like sex: easier to describe if you have practised it yourself.

The economic situation in the EU today increases the role of economic diplomacy, but still there are different approaches to its pursuance in various countries. Our focus will be on the pursuance of economic diplomacy in two different countries, both small economies in the EU: the Republic of Slovenia and the Kingdom of Denmark. The globalisation process has significantly raised the importance of economic diplomacy. The circulation of relevant information to companies about investment and trade opportunities and facilitating greater direct, practical dialogue between business partners who would be able to identify new areas of cooperation are practical activities in the field of economic diplomacy (e.g., Monteferrand 2009).

Many countries develop their own strategy for economic diplomacy depending on the sources and positions of policy makers. In this paper we will focus on the experience of two small European countries with population between 2 and 6 million citizens (Thorhallsson, 2006). For example, Panke (2008) elaborates that smaller states have lesser administrative capacities, but a newer form of economic diplomacy

today develops a strategy for marketing a nation, based on the analysis of the state of its economy. The marketeers of the nation would most likely be diplomats assigned both abroad and at home. The process is subjective and individual, varying from country to country.

Saner and Yiu (2003) recognize that the adaptation of traditional diplomacy to the reality of post modern diplomacy has become an urgent necessity. Using for example, for investment promotion purposes, the nation's high unemployment rate becomes less of a detriment than it is an asset providing a ready and willing work force to new investors. That strategy then becomes the core of a marketing efforts made by the nation's diplomats. They would attend trade shows, visit potential investors, organize trade events and seminars, and otherwise be proactive in marketing the advantages of their nation. Economic diplomacy, as a form of public diplomacy, promotes investment, export and trade cooperation, and puts the nation's economic interest at the top of its foreign policy. For example, Svetličić (2011) recognized that in small countries, economic diplomacy has a relatively higher importance than for large countries, firstly because they have to be much more intensively integrated in the global economy, and their companies are much more internationalized.

### **Economic Diplomacy in Accordance with the Policy of Sustainable Economic Growth**

Western economies, especially the EU countries, are confronted with significant economic and fiscal challenges. In a changing world, the EU focus is to become a smart, sustainable and inclusive economy. Barroso (2013) elaborates these three mutually reinforcing priorities that should help the EU and the Member States deliver high levels of employment, productivity and social cohesion. When the Lisbon Strategy ended in 2010, a decade after its introduction, and Europe was confronted with the biggest economic crisis since the Second World War, European decision-makers decided to develop an exit strategy that was meant to help guide the Union out of the crisis. It was in this context that the Europe 2020 Strategy was devised in order to create more jobs and lead to smart, sustainable and inclusive economic growth. European

targets in five areas, which Member States of the European Union have promised to achieve by 2020 are to: 1) Strive to reach an employment rate of 75% for women and men between the ages of 20 and 64; 2) Improve conditions for research & development, more specifically with the aim of increasing the combined public and private investments in this sector to 3% of GDP; 3) Reduce the emission of greenhouse gases by 20% as compared to the levels in 1990; increase the share of renewable energy sources to 20% of the ultimate energy consumption levels; and work towards improving energy efficiency by 20%; 4) Increase educational levels, especially through the aim towards reducing school drop-out rates to below 10%, and to increase the amount of people in the 30-34 years old age group who have completed third level or similar education to at least 40%, 5) Promote social inclusion, particularly through the reduction of poverty, by aiming to provide at least 20 million people with a solution reducing their exposure to the risk of poverty and social exclusion (see Europe 2020 targets). Economic diplomacy facilitates contacts with foreign institutions, businesses and international organizations: to advance economic interests, to resolve bilateral trade disputes and negotiate with trading partners to liberalize trade, to formulate an official policy for development and recommendations, to facilitate negotiations on trade-related agreements and treaties and to identify and coordinate financial assistance to troubled areas. Furthermore, economic diplomacy engages development partners to raise the standard of living, to coordinate trade policy, to promote open markets and promote interests in the international and bilateral scientific, environmental, and technological arena (Bayne & Woolcock, 2007). Economic diplomacy is an alternative tool to overcome global threats and to increase influence in vitally important markets. The challenge is attaining future growth of EU countries in line with the EU Strategy 2020.

## **The Position of Economic Diplomacy in the Republic of Slovenia**

The main institution for economic diplomacy, the Ministry of Foreign Affairs of the Republic of Slovenia protects, pursues and

promotes the interests of the Slovenian economy abroad through its network of diplomatic missions and consular posts. Economic diplomacy includes all relevant activities of the Ministry of Foreign Affairs and the 56 Diplomatic Missions and Consular Posts of the Republic of Slovenia with their 26 Economic advisors. Before 2011, economic advisers were representatives from the Ministry of Economy, but now the Ministry of Foreign Affairs has taken over that role. It is one of the top priorities of the Ministry, which therefore on 1 October 2009 established the Directorate for Economic Diplomacy and thus acquired exclusive competence for the management of economic diplomacy. Tasks and competences of the Directorate include activities in economic diplomacy, bilateral economic cooperation and promotion carried out by two of its departments. The two basic functions of the Department for Bilateral Economic Cooperation are the direction and the coordination of Slovenia's bilateral economic cooperation with third countries. The two basic functions of the Department for Economic Promotion are to provide assistance to Slovenian companies when entering foreign markets and to stimulate the further internationalisation of the Slovenian economy with a view to increasing Slovenian exports and achieving better geographical diversification (Šušteršič, Rojec & Korenika, 2005).

The basic task of the Directorate is to ensure the efficient work of economic diplomacy through coordination and management within the broader system of Slovenian foreign policy. In this context, the Department cooperates with other government and non-government institutions dealing with the internationalisation of the Slovenian economy, especially with the Ministry of the Economy, Agency for Entrepreneurship and Foreign Investment, the Chamber of Commerce and Industry of Slovenia, the Chamber of Craft and Small Business of the Slovenian Export and Development Bank, the Slovenian Tourist Board and Slovenian business clubs, as well as honorary consuls of the Republic of Slovenia abroad.

The Ministry of Foreign Affairs and its network of diplomatic missions and consular posts in regard to economic diplomacy: organise meetings of intergovernmental commissions on economic cooperation; make all the necessary arrangements for business delegations during visits of senior national representatives; promote Slovenia as a location for foreign direct investments; support Slovenian businesses in entering and expanding foreign markets, and in solving problems through

various forms of free of charge services; support foreign businesses in establishing contacts with Slovenian businesses; and coordinate economic activities related to the EU and international organisations.

Diplomatic missions, consular posts and economic advisers offer Slovenian businesses: assistance in establishing contacts with ministries and other state institutions, chambers of commerce, business associations, and media at national and regional levels, as well as in connecting these with similar institutions in Slovenia; services to boost exports; assistance in tackling problems indicated by ministries, other institutions and businesses; and organisation of, and participation in business meetings, fair presentations and other presentations, seminars and conferences as well as other promotional events; information on business opportunities, international tenders; advisory support in entering a foreign market; assistance in establishing contacts with potential business partners; and advice and information support for potential foreign investors.

In addition to direct support for businesses, diplomatic missions and consular posts provide: a review and analysis of the macroeconomic situation in countries of accreditation; coordination of institutional bilateral economic cooperation between Slovenia and countries of accreditation; and coordination of economic activities related to the EU and international organizations (*Economic Diplomacy*, 2013).

Another important aspect is cooperation between all governmental and nongovernmental organizations which are involved in economic diplomacy. A Strategic Council for Economic Cooperation with Foreign Countries has been established in Slovenia, which includes ministers and directors (*Establishment of the Strategic Council*, 2013). But a more important aspect is the Protocol for direct cooperation of experts for purposes of solving the problems and exchanging of information about effective economic diplomacy of the Republic of Slovenia.

## **The Position of Economic Diplomacy in the Kingdom of Denmark**

The Trade Council under the Ministry of Foreign Affairs of Denmark is the main governmental organisation for export and

investment promotion. The organisation comprises all governmental activities designed to promote Danish export and foreign investments in Denmark under one roof. The Trade Council has approximately 100 employees in Denmark and 300 employees abroad located at more than 100 embassies, consulates general and trade commissions in 60 countries around the globe. The Trade Council has established a Board of Directors to ensure that the activities are always rooted in the needs of the business community. The Board of Directors consists of active business professionals with practical international experience, industrial and social insight, which represent a variety of sectors, as well as small and medium sized enterprises. The aim is to ensure a close partnership between Danish business and the Trade Council and in this context help to promote the export and internationalisation of the Danish companies. The Board of Directors is composed in order to represent a broad spectrum of business and export interests. The Board of Directors also advises the Minister of Foreign Affairs on questions related to the Government's export and investment promotion policies. The Trade Council focuses on offering Danish companies individual advice on all issues important for their international activities. It is a professional and innovative organisation, which aims to secure the best possible conditions for taking part in the increasing globalisation for the Danish industry. Moreover, it is an organisation which can act as a sparring partner for companies at all levels. The Trade Council is in a position to offer substantial and discernible benefits to both new and experienced exporting companies. The goal is to offer the Danish business community the opportunity to enter into a close partnership, which will enhance the professional analysis of foreign markets and thereby increase the competitiveness of the companies. The Trade Council is a customer-oriented export and investment promotion organisation, and creates results through individual approaches based on customer needs. This applies to both export promotion and efforts to attract foreign direct investments in Denmark.

The Trade Council goals are as follows: solid economic growth is a precondition for Denmark to be among the world's 10 wealthiest countries by 2020. The world is changing rapidly and Denmark needs to think along new and innovative lines. Approximately half of Denmark's GDP is based on exports. Increased export is a precondition for bringing

Denmark back on the growth track and for reaching the Danish 2020 target. The Ministry of Foreign Affairs stands ready as Denmark's growth ambassador with the entire Ministry as Denmark's growth agent. The Ministry of Foreign Affairs will contribute to growth and employment for Danish companies through targeted efforts and sharper prioritisation.

Bukovskis (2010) elaborates that role of a coordinator and technical administrator of interstate activities is also the task that the Ministry of Foreign Affairs acquires in external economic sphere. This applies to both export promotion and efforts to attract foreign direct investments in Denmark and increase the level of competence and knowledge.

The Trade Council is focused on: helping companies with new businesses or helping to expand already existing ones; providing companies with access to key decision makers and helping identify the right partners; minimising risks through risk analysis and advice, including anti-corruption; working on creating free and fair trade relations across the world; bringing benefits to Denmark by bringing knowledge, investments and jobs to the country. The Trade Council focuses on business areas of global growth, global public affairs and global opportunities and risks.

The great number of small and medium-sized Danish enterprises constitutes a huge export potential, and the Trade Council therefore continues its special focus on these enterprises. The Trade Council has a number of programmes especially targeted at the small and medium sized companies with international potential. The aim is to promote the internationalization of small and medium-sized Danish enterprises and assist them with opportunities at export markets.

The Danish innovation centres are part of the Government's efforts to stimulate research and innovation. Innovation centres are an entry point for innovative Danish companies and knowledge institutions into world leading hotspots within science, research and innovation. Through the centres innovative Danish companies have excellent conditions for gaining access to new knowledge, research, technology, networks and international markets. Companies must compete on their ability to create innovative solutions. Denmark generates only one per cent of the global knowledge. So if Danish companies wish to strengthen their growth opportunities, it is necessary to collaborate on research

and innovation with the best research institutions and technology-leading companies globally. This is achieved through the attraction of foreign investments and through the Trade Council's three innovation centres in Silicon Valley, Shanghai and Munich, which have been set up in cooperation with the Danish Ministry of Science, Technology and Innovation.

Investing in Denmark as a national Danish foreign investment promotion agency is part of the Ministry of Foreign Affairs of Denmark and it helps in starting up a business in Denmark. The objective is to create knowledge intensive jobs and growth and further strengthen the leading Danish clusters of life science, cleantech and information communication technologies. Invest in Denmark provides a tailor-made solution for locating business in Denmark. Invest in Denmark is present in the Silicon Valley, Toronto, New York, London, Paris, Munich, Bangalore, Seoul, Shanghai, Taipei and Tokyo.

All exporters may be affected by non tariff barriers, import restrictions and other protective measures. Danish companies can notify trade barriers to the Ministry of Foreign Affairs and get help to have them removed. Assistance by the Trade Council must be paid for according to the current rates and for cases that are paid according to hourly rates and where the time spent exceeds half an hour in accordance with a written agreement between the Trade Council and the company. The written agreement must contain information about the expected time consumption, an overall price for the specified service. For assistance serving the purpose of supporting the business community's export efforts and other commercial activities abroad, a fixed price per hour or fraction of an hour or a fixed overall price for the service must be paid. There is, however, a minimum fee per individual solved case. The current price for services and consultancy provided by Trade Council is 915DKK (about EURO 123) per hour. The Trade Council collects its payment when the service has been rendered. However, depending on the circumstances a partial or advance payment may be required. Payment must be made no later than 30 days after the invoice date. A fee may be charged for late payment and interest may be charged according to the general rules ("The Trade Council Abroad", 2013).

Economic diplomacy in the Kingdom of Denmark has a holistic approach, and involves all aspects of support business interest. There is

a discussion on the payment for assistance of Trade Council by Danish companies, because economic diplomacy is a concept for support to the business communities. An additional fee for services is a profit oriented concept and maybe participation by the business sector in the cost of events and manifestation is a better alternative for mutual participation.

### **The Position of Economic Diplomacy in the Republic of Macedonia**

Under the Law on Foreign Affairs and the four-year Program of the Government of the Republic of Macedonia, as of 2006, for the first time economic diplomacy has become an integral part of the regular activities of the Macedonian diplomatic missions and consular posts abroad. In 2008, the Economic Diplomacy Directorate at the Ministry of Foreign Affairs was actively involved in the implementation of the Government Economic Program, thus strengthening the economic dimension of diplomacy. In this respect, the Government of the Republic of Macedonia has created a specific institutional structure, which reflects the dedication to this goal, as part of which the Ministry of Foreign Affairs has continuously maintained its role in the improvement and coordination of foreign economic policy and foreign economic activities. The primary goal to be achieved through the implementation of the economic program of the Government is economic growth, which would ensure a better standard of living for all citizens of Macedonia, a reduction of the unemployment rate and poverty, as well as improvement of the business climate. Working to achieve these goals, the Ministry of Foreign Affairs is taking comprehensive measures in order to attract foreign direct investments, as well as to increase the export volume to other countries. At the same time, the Ministry is actively pursuing tasks defined and entrusted respectively by the Government of the Republic of Macedonia arising from the everyday activities in the field of the economy.

The promotion of economic interests and priorities abroad is one of the most important operative tasks of economic diplomacy. The purpose of these activities is to present the Republic of Macedonia as an attractive destination for foreign investments, through the promotion

of business advantages, giving support to Macedonian exports, as well as the strengthening of the country's position as a reliable business partner.

Initially the idea of appointing economic promoters of the Republic of Macedonia abroad grew out of a pilot project of the Ministry of the Economy in 2005, under which two trade promoters were appointed in the former Republic of Serbia and Montenegro and the Russian Federation and two investment promoters in Italy and Germany. The agreement between the Ministry of Foreign Affairs and the Ministry of the Economy was practically implemented and upon the proposal of the Ministry of the Economy three promoters were appointed (two trade promoters at the Embassies in Belgrade and Moscow and one investment promoter in the Embassy in Rome). Based on the work programme of economic promoters in 2005, they were required to make monthly plans of activities and to inform the Minister of the Economy about their implementation. The Ministry of the Economy assessed the work of economic promoters depending on the results of their operation. But due to lack of a financial structure and a budget for the coming years, this pilot programme was completed in early 2006.

In the second half of 2007, a new pilot project of the Agency for Foreign Investments and Export Promotion started. Thus, economic promoters were appointed in order to reinforce the capacity of the country's economic diplomacy in terms of implementing activities projected under the Program of the Government of the Republic of Macedonia. Furthermore, for the purpose of improving the perception of our country and highlighting its beauties, its identity, and its culture, the Ministry of Foreign Affairs, through the diplomatic missions and consular posts promotes the Republic of Macedonia as a brand, which would make our country more recognizable worldwide. Furthermore, the Ministry of Foreign Affairs coordinates the activities for the preparation and organization of Business Forums and Road Shows abroad.

The successful implementation of the program activities in the area of economic diplomacy depends essentially on the joint implementation and coordination of activities between diplomatic missions and consular posts on the one hand, and economic promoters appointed by the Agency for Foreign Investments and Export Promotion,

on the other. The Agency for Foreign Investments and Export Promotion has about 30 economic promoters abroad. In addition, the Government of Macedonia has appointed two ministers responsible for investment promotion and has enhanced the role of Agency for Promotion and Support of Tourism.

Based on previous experiences in the fulfilment of the obligations assumed by heads of the diplomatic missions and consular posts for visiting 10 companies a month, the Economic Diplomacy Directorate at the Ministry of Foreign Affairs has assessed that it is necessary to incorporate certain qualitative elements to this criteria, as well. The first step taken in this respect has been the classifying of foreign countries according to their economic parameters and the level of interest that they have thus far shown in cooperating with the Republic of Macedonia. As of 2008, acting through the Ministry of Foreign Affairs, the Government of the Republic of Macedonia has been issuing instructions to embassies and consular posts requiring them to send detailed information to the Ministry of Foreign Affairs on announcements of tenders in the host countries on daily basis. The Ministry of Foreign Affairs instantly electronically distributes this information to the business associations in the Republic of Macedonia, the member companies of which are interested in participating in tenders in other countries. Thus, there are opportunities opened to these companies to expand their business activities outside the borders of the Republic of Macedonia ("Economic Diplomacy", 2013).

The next step was the decision by the Government of the Republic of Macedonia to adopt a conclusion obliging the Ministry of Foreign Affairs to develop a new methodology in 2011 for all diplomatic missions and consular posts, according to the adopted criteria for the implementation of a new methodology as a pilot project in 2012. At the Annual Working Meeting in December 2012 with Macedonian Ambassadors which was held at the headquarters in Skopje there were discussions about the activities of Macedonian economic diplomacy in 2012 and about activities planned for 2013. Furthermore, Macedonian Ambassadors were introduced 'to' the methods of evaluating the economic activity over the past three quarters of 2012, as well as with the evaluation criteria used throughout the year long pilot project. In

addition, there were discussions about the priorities of Macedonian economic diplomacy in 2013, explaining the new amended methodology to be used in the impending period.

The Republic of Macedonia has adopted clear strategies in terms of identifying strong export sectors of its economy, while actively searching for developing markets for these goods and services. Governments are becoming increasingly pro-active when it comes to seeking out new markets and encouraging their own businesses to export abroad. This is particularly true when it comes to encouraging companies to seriously consider exporting to emerging markets. There is, however, an obvious dilemma as to where scarce resources are best utilized (Gotisan & Molendowski, 2012). The Macedonian economic diplomacy involves many institutions and relies on a decentralized concept, which needs strict rules about competences with a view to better cooperation.

## Conclusions

Globalization and the technological revolution have increased the speed of changes, and economic diplomacy has a perspective future. This is confirmed with the greater involvement of all countries in economic diplomacy. Today, successful bilateral visits at the highest level are always followed by news about contracts for the sale or delivery of goods or services in the interest of the economies of countries. Usually high-level official delegations include managers of the top domestic companies in order to allow economic activities to bring about the conclusion of large scale business deals.

Based on the analysis of the experiences of the three countries in pursuance of economic diplomacy, we can conclude that the most comprehensive and developed economic diplomacy is implemented in the Kingdom of Denmark. The economic diplomacy is developed in the same direction in the Republic of Slovenia, keeping in mind that it is a newer member of EU. What these two countries have in common is the central role of the Ministry of Foreign Affairs in the pursuance of economic diplomacy. The Kingdom of Denmark, in addition has a holistic structure of economic diplomacy, but the latest trend involves

charging their services with some of the companies that use support by the economic diplomacy structure. While developing its economic diplomacy, the Republic of Slovenia has opened its Embassies for study and business visits by businesspersons who want to do market research in order to prepare a strategy for performance at foreign markets. Ambassadors and promoters are required for direct assistance to businesses in their activities outside the country.

Macedonia develops its own economic diplomacy where in addition to the Ministry of Foreign Affairs, the Agency for Foreign Investments and Export Promotion has a significant role, taking into account that economic promoters are appointed by this Agency. According to the experience of the small EU countries we have analyzed in terms of evolution and better future development of the economic diplomacy of the Republic of Macedonia, we would suggest some recommendations and the following ideas:

- The Central role of the Ministry of Foreign Affairs in pursuing economic diplomacy. This example is provided by the Republic of Slovenia and the Kingdom of Denmark, where the main coordination and the main role is given to their Ministries of Foreign Affairs, which ensures full control and monitoring of all activities and policies in economic diplomacy from one central place.
- Greater involvement of the Embassies of the Republic of Macedonia in terms of business visits and study stays by Macedonian businesspersons who want to do market research in order to prepare a strategy for performance at foreign markets. This initiative has been successfully implemented by the Ministry of Foreign Affairs of the Republic of Slovenia. The Chambers of Commerce of the Republic of Macedonia will support and recommend to the Ministry of Foreign Affairs, certain exporting Macedonian companies, which would like to carry out research and design a strategy for targeted foreign markets. Embassies will be hosts to representatives of Macedonian companies for a period of 1 to 3 months. This initiative does not require a large budget, while the Ministry of Foreign Affairs will be directly involved and it will strengthen relations with business associations in the country.

- Greater multilateral economic activity and international presence. The biggest challenges in the XXI century are: greenhouse effects and CO2 emissions, the consequences of climate changes,

attainment of the UN Millennium Development Goals, finalization of the Doha Development Agenda in the multilateral trading system, and negotiation of the Framework Convention on Tobacco Control with the World Health Organization. All these issues are an important part of the multilateral economic system. Climate change and the future new deal to replace the Kyoto Protocol will cause significant adjustment needs for additional investment of the domestic industry and the energy sector. The finalization of Doha Development Agenda in the multilateral trading system will give possibilities for Very Recently Acceded Members, because of the obligation to implement a great number of concessions and commitments in the process of accession, but all members must participate in the ongoing negotiation of the World Trade Organization, because nothing is agreed until the entire package is agreed. The Framework Convention on Tobacco Control provides long-term deal with tobacco producers because of the harmful effects on human health. The final goal is the abolition of the production of tobacco products in a transition period, maybe of 20 years or more. This process will produce commitments for restructuring domestic polices in the agricultural sector. The Republic of Macedonia should be more active in the multilateral economic activity in order to protect its economic interests.

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## **Green, Greener, the Greenest: The Western Balkan Countries on Test – Lessons for Macedonia**

*Ana Stojilovska*

### **Abstract**

*The economic crises may have challenged the EU in many ways, forcing it to rethink its policies; however one thing the Union remained true to is the idea of promoting renewable energy and energy efficiency as a means for achieving sustainable growth and a low-carbon society. In fact, by setting its 2020 and 2050 policies, the EU sees the crisis as an opportunity for investment in its own competitiveness and growth, and therefore continues to present a “green” role model. In this line, being an essential part of the EU enlargement policy - the Western Balkan countries – play an important role in contributing to a greener Europe since they are to implement these EU energy and climate change policies. This paper will assess the level of adoption and implementation of EU energy efficiency and renewable energy policies in the region by comparing the case studies of Macedonia, Montenegro and Albania for the purpose of stating whether Macedonia as the country with longest experience of candidate status is the most advanced; and this paper will also draft recommendations for Macedonia. From the analysis that has been conducted it is clear that the least successful state is Albania, which is still a potential candidate for EU membership, while the level of successfulness in the area is almost tied between Macedonia and Montenegro, however Montenegro proved to be the greenest country. Concrete recommendations for Macedonia are that Macedonia should follow Montenegro’s example for having a green leader as a Deputy Minister; and should establish an Energy Efficiency Fund. Further recommendations which*

*Macedonia should undertake are having a separate Energy Efficiency and a separate Renewable Energy Law; strengthening the capacities of its implementing institutions; introducing energy awareness raising campaigns which include wide inter-sector cooperation; as well as introducing many incentives and implementation tools leading towards reaching the EU goals for 2020 and 2050. Methodologically, the paper considered relevant regional studies on the topic, EU documents, the EU progress reports and similar.*

*Keywords: Western Balkan countries, Macedonia, renewable energy, energy efficiency, EU energy acquis*

## **Introduction**

The economic crises may have challenged the European Union (EU) in many ways, forcing it to rethink its policies; however one thing the EU remained true to is the idea of promoting renewable energy and energy efficiency as a means for achieving sustainable growth and a low-carbon society. In fact, by setting its 2020 and 2050 policies, the EU sees the crisis as an opportunity for investment in its own competitiveness and growth, thereby continuing to present a “green” role model. In this line, being an essential part of the EU enlargement policy - the Western Balkan countries – play an important role in contributing to a greener Europe. In fact if they were to implement these EU energy and climate change policies, they would be provided with the opportunity to seize the region’s untapped renewable and energy efficiency potential, thereby increasing their energy security and helping to fight climate change. However, although the countries are put under the same energy framework, they differ in their state of compliance with EU energy policies and more importantly they are significantly challenged in its implementation.

This paper will try to assess the level of adoption and implementation of EU energy efficiency and renewable energy policies in the region by taking the case studies of Macedonia (an “older” candidate), Montenegro (a “younger” candidate) and Albania

(a potential candidate). It will focus on the capacities of their energy institutions, the level of legislation adoption, energy policy planning at local level, the availability of financial means for energy projects, promotional and awareness raising activities as well as support schemes for implementation in the areas in the three countries. The paper will not present all the developments and projects in detail, but rather it will try to give an overall impression of the progress of EU energy efficiency and renewable energy adoption and implementation. The main idea is to compare the three countries in the light of the state of adoption and implementation of EU energy efficiency and renewable energy policies by using regional studies and reports for the purpose of stating whether Macedonia as the country with longest candidate status experience among the three is also the most advanced in this area; and for drafting recommendations to the respective Macedonian authorities for better performance in the area for Macedonia. The overall aim is a contribution to the better implementation of EU energy efficiency and renewable energy policy in Macedonia. The importance of this research lies in the need to answer the dilemma whether Macedonia as the oldest candidate country in the Western Balkans has slowed its tempo regarding its work on the EU energy related agenda and whether by doing it is no longer the leader in EU renewable energy and energy efficiency policy implementation. Therefore, the need arises to face the facts by utilizing regionally comparable assessments for Albania, Macedonia and Montenegro in order to present the level of progress in the last few years regarding the countries' performances in implementing EU energy efficiency and renewable energy policies.

The paper will be structured in such a way that at the beginning EU energy efficiency and renewable energy policies will be presented as well as the legal framework that serves as the basis for EU integration in the area of energy for the Western Balkan countries. The next section will briefly present the EU integration history of each of the three countries, along with the relevant legal framework, and the institutional set-up, whilst a major part will be devoted to the state of implementation of these policies. The final section after summarizing and comparing the performance of the three countries will conclude by answering the research question whether or not Macedonia is the most advanced country in adopting and implementing EU energy efficiency

and renewable energy policies; and will draft recommendation for Macedonia based on inter-state comparison. The methodology will include primary and secondary resources as relevant regional studies on the topic, EU documents, information from websites of the relevant institutions, EU progress reports and the like.

## **EU Energy Efficiency, Renewable Energy Policies and the Western Balkans**

The EU has marked its future with green policies and very ambitious goals. One of the main documents with regard to this is *Europe 2020*, which will serve as the EU's growth strategy till 2020. It was prepared as an answer to the challenges the EU faces as a result of the economic crisis and ever pressing matters such as globalisation, the scarcity of resources, and the impact of the ageing of the society impact upon Europe. The three priorities in *Europe 2020* are: smart, inclusive and sustainable growth, the latter of which will be achieved by promoting a resource efficient, greener and more competitive economy. Among the set targets in this document are the "20/20/20" climate/energy targets (including an increase to 30% of emissions reduction if the conditions are right) by 2020 (European Commission, 2010c). The EU's 20/20/20 energy and climate change policy targets include: a 20% reduction in EU greenhouse gas emission from 1990 levels, a 20% renewable energy share in EU energy consumption and a 20% improvement in the EU's energy efficiency (European Commission, 2012b). However, the EU went even further than simply drafting its green policies until 2020 when in 2011 the European Commission adopted the very ambitious Communication "Energy Roadmap 2050". By doing so, it has committed itself to reducing greenhouse gas emissions to 80-95% below 1990 levels by 2050. In the Energy Roadmap 2050 the scenarios aim to explore routes towards decarbonisation of the energy system while at the same time ensuring security of energy supply and competitiveness (European Commission, 2011b). It is important to mention that energy efficiency and renewable energy remain to be one of the main means for achieving the EU's 2020 and 2050 goals.

In line with the commitment of the Western Balkan countries to join the EU, by signing the Energy Community Treaty, they obliged

themselves to adopt and implement the *acquis communautaire* on energy, environment, competition, energy efficiency and renewable energy. The Treaty, which entered into force in 2006, represents a legally binding framework extending the EU internal energy market to South Eastern Europe and beyond. It has the general objective of creating a stable, regulatory and market framework in order to attract investment in power generation and networks for the purpose of ensuring a stable and continuous energy supply; creating an integrated energy market allowing for cross-border energy trade and integration with the EU market; enhancing the security of supply; improving the environmental situation in relation with energy supply in the region; and enhancing competition at regional level and exploiting economies of scale (Energy Community, 2013).

Bearing in mind on the one hand the legal obligation of the Western Balkan countries to adopt and implement the EU energy policies and on the other hand the EU determination to increase its renewable energy share and improve its energy efficiency, it is evident that the Western Balkan countries will have to shape their green future through energy efficiency and renewable energy policies.

### **Adopting and Implementing EU Energy Efficiency and Renewable Energy Policies – the Macedonian Case Study**

From all three countries taken into consideration in this paper, Macedonia is the oldest candidate country for EU membership, which was granted this status back in 2005. Further highlights include the recommendation for opening the negotiations as stated by the European Commission in 2009 and the launch of a High Level Accession Dialogue in 2012. Regarding the institutional set-up, the main institutions are the Ministry of Economy, responsible for energy policy making, including policies on renewables and energy efficiency; and the Energy Agency, set to support the energy policy implementation with focus on renewables and energy efficiency. In addition, energy efficiency is being developed on a local level as a responsibility of the local authorities. As the capacities of these institutions affect policy adoption and implementation, it is vital

to understand the state of their development. An earlier study (USAID, 2008) assessed the Macedonian Ministry of Economy's capacities to be set in place, thus representing a fully implemented area and the best example among the three countries; in comparison with the Montenegro's and Albania's respective ministries which were assessed that both need strengthening as can be seen in Table 1. The same study (USAID, 2008), also as illustrated in Table 1, assesses Macedonia and Albania in the area of the capacities of energy efficiency agencies to be a better example than Montenegro, the latter of which had no capacities set in place. However, a later study by the World Bank (2010) states that the weak implementation of energy efficiency policy in Macedonia is due to the understaffing of the energy institutions responsible for its implementation. The World Bank (2010) also showcased the Albanian implementing agency to be of good quality as seen in Table 2 and the best among the three; while in this area of capacities of an implementing agency Macedonia was assessed to be of medium quality together with Montenegro. With regards to the Macedonian Energy Agency, several subsequent EU progress reports (2009, 2010, 2011, and 2012) repeat that its capacities are insufficient.

Regarding the legal framework of the country, the legal basis for the energy policy in Macedonia is the Energy Law of 2011. On a strategic level, Macedonia has three major state strategies in the energy domain— one on the development of the energy sector as a whole, the second on energy efficiency and the third on renewable energy – all adopted in 2010, while in 2011 the country adopted an Energy Efficiency Action Plan. When compared in the area of legislation, according to the USAID study (2008) and graphically presented in Table 1, Macedonia turned out to have it partially set together with Albania; Macedonia got the same assessment regarding the area of municipal energy planning together with Montenegro, both being better examples of policies than the Albanian one. Later, according to the World Bank (2010) and as can be seen in Table 2, Macedonia in the area of policy framework which included *inter alia* administrative responsibilities, the legal basis and policy goals for energy efficiency, regulations, strategies and action plans on energy efficiency and supporting policy tools, was assessed to be of predominantly medium quality, the administrative responsibilities being the only sub-area of the policy framework to be of good quality. In

this area, Table 2 clearly shows that Macedonia is the weakest example of all three regarding the policy framework.

Implementing energy efficiency and renewable energy policies also requires sufficient financial means. In Macedonia there is donor funding for energy efficiency projects coming from the Sustainable Energy Program GEF (Global Environment Fund) and USAID (USAID, 2008), the former of which was closed in 2013. However, the Energy Efficiency Fund envisaged in the Energy Efficiency Strategy as one of the main tools for implementing the energy efficiency projects, and which had been planned back in 2004, is still missing as is also pointed out by the Energy Community Secretariat (2011, 2012). Furthermore, the World Bank (2010) noted that in general many energy efficiency incentives are lacking. To get a more visual picture regarding the progress of Macedonia in adopting energy efficiency policies and strategies, Table 1 shows that in this area Macedonia was assessed as to having had it partially implemented in the same way as Albania, with both lagging behind Montenegro; and with regards to the Energy Efficiency Fund, Macedonia was assessed according to the fact that it had it envisaged but had not yet implemented it (USAID, 2008). The important part of the energy efficiency policy implementing, the support schemes as seen in Table 2, were assessed to be of low quality for Macedonia, as in the case of Montenegro (World Bank, 2010).

Awareness raising activities have also been undertaken in Macedonia, but the Macedonian government's public information capacity for energy efficiency needs strengthening (World Bank, 2010) and awareness raising activities have been planned in all strategic documents despite the lack of capacity and funds for wider implementation (EU Build, 2012). In comparative terms as presented in Table 1, Macedonia was assessed as having planned but not having implemented programs for promoting energy efficiency in the public sector at the national level similar to Montenegro; whilst public information campaigns promoting energy efficiency were assessed as having been partially implemented thereby leaving the other two countries worse off by comparison (USAID, 2008).

In order to get a more general impression about the EU energy efficiency and renewable energy policy implementation in Macedonia over the years (2006-2012), EU progress reports have assessed

Macedonia's performance as having achieved from limited to good progress; the term of some progress is most frequently used for general assessment as is also used in the latest report of 2012 to describe the progress under renewable energy and energy efficiency policy.

### **Adopting and Implementing EU Energy Efficiency and Renewable Energy Policies – the Montenegro Case Study**

Montenegro in this paper is the younger candidate country which was granted EU candidate status in 2010. It moved very quickly towards the accession negotiations which started in 2012 when also the first chapter (Science and Research) was provisionally closed. The institutional set-up of Montenegro is slightly different to that of Macedonia since it has only a Ministry of Economy as the institution responsible for energy policy, but does not have a specialized implementing agency (Energy Community Secretariat, 2012), which the World Bank (2010) recommends establishing since the Energy Efficiency Unit within the Ministry has staff shortages, having as a result only a limited ability to provide support and advice. However, despite the limited staff capacities, Montenegro chose to show leadership in the area by introducing a new position - the Deputy Minister for Energy Efficiency who heads the Energy Efficiency Unit within the Ministry of Economy, which is assigned for the monitoring role for the implementation of the Energy Efficiency Law (Energy Community Secretariat, 2010). Regarding the Ministry's capacities, Montenegro was assessed as being an area which needs further strengthening, being in this case in comparison together with Albania the poorer example as is demonstrated in Table 1 (USAID, 2008). Also due to the non-existence of an Energy Agency, Montenegro was presented as the worst example in this regard from all three countries as seen in Table 1 (USAID, 2008). Other actors in the energy area especially in energy efficiency are the local authorities. In fact, in Montenegro's Energy Efficiency Action Plan up to 2012 and the Energy Efficiency Action Plan for the Public Sector (2008-2012) envisaged the project "Promotion of Energy Management Schemes at local level and capacity building" which includes a variety of activities, such as preparing brochures for

energy efficiency measures, organizing decentralized training courses, and energy efficiency demonstration projects (USAID, 2008). Montenegro managed to improve its performance a little regarding the capacities of an implementing institution in the area by having this area estimated to be of medium quality; being however together with Macedonia second best after Albania as shown in Table 1 (World bank, 2010).

The important strategic documents in the area are the Energy Efficiency Strategy, the National Action Plan for Energy Efficiency and the Strategy for Energy Development, the latter which is under preparation (EU Build, 2012). Unlike Macedonia which has a single Energy Law; Montenegro has a specific Energy Efficiency Law (EU Build, 2012) and also an Energy Law which also contains a separate chapter on renewables (Energy Community Secretariat, 2010). In order to sum up Montenegro's performance regarding its progress in adopting the legislative framework, Table 1 shows that Montenegro is a leader among the three countries analyzed which has been assessed as having fully implemented this legislative assignment (USAID, 2008). With regard to municipal energy planning, Montenegro has been assessed as having partially implemented this policy, together with Macedonia being the better examples (USAID, 2008) as shown in Table 1. The World Bank study on energy efficiency (2010) regarding the policy framework addressing the administrative responsibilities, the legal basis and policy goals for energy efficiency, and regulations, strategies and action plans on energy efficiency and supporting policy tools, shows Montenegro as the best example among the three countries given that all but two areas of its policy framework are considered to be of good quality as is shown in Table 1.

Obtaining sufficient financial support and introducing attractive incentives for energy projects is always a challenge. The World Bank (2010) noted that Montenegro lacks many energy efficiency incentives. However, regarding financial support, Montenegro managed to merge as a leader by establishing its own fund for financing energy projects unlike Albania and Macedonia. In fact, the Fund for Energy Efficiency was established by the Budget Law in 2006 as an independent item under the state budget for the Ministry of Economy; the Fund manages projects supported from the state budget, donations, loans and other financing mechanisms (Energy Community Secretariat, 2011, 2012). This Fund

was established for the purpose of implementing the Annual Energy Efficiency Action Plans (USAID, 2008); although one analysis claims that the Fund has not been implemented (EU Build, 2012). Compared to Albania and Macedonia, Table 1 presents Montenegro as the best example in the area of energy efficiency policy and strategies compared with the other two countries; as with the Energy Efficiency Fund (USAID, 2008). As implementation remains a challenge, Montenegro's support schemes for implementation showcased the performance to be of a low quality as seen in Table 2, however it had the same assessment as Macedonia, both being better off than Albania (World Bank, 2010).

Montenegro was performing well in the area of awareness raising. Earlier reports stated that Montenegro has begun planning a public awareness campaign on energy efficiency (USAID, 2008), but that there is a need for a further strengthening of the Government's public information capacity for energy efficiency and that there are no comprehensive programs promoting energy efficiency in the public sector (World Bank, 2010). A more positive assessment was noted by the Energy Community Secretariat (2010) which highlighted Montenegro's activities in this regard as the national project "Year of energy efficiency" has given good results. Furthermore, the Energy Community Secretariat (2011, 2012) noted that for two years in a row Montenegro's awareness raising activities coordinated by the Ministry of the Economy included a variety of different stakeholders, such as donors, local institutions, NGOs, academia and the media, and that a National Awareness Raising Plan for 2011 has been implemented. The overall comparative impression puts Montenegro among the more successful examples regarding promoting energy efficiency together with Macedonia, although the exact assessment of this area was – a planned policy which had not yet been implemented; the same assessment was also given to the area of information campaigns promoting energy efficiency, making Montenegro in this specific area second best behind Macedonia as shown in Table 1 (USAID, 2008). The EU progress reports on Montenegro regarding its EU energy efficiency and renewable energy policy implementation over the years (2006-2012) assesses this country's performance as having achieved from little to good progress, mostly achieving some progress, as stated for the area of renewables in the last progress report of 2012.

## **Adopting and Implementing EU Energy Efficiency and Renewable Energy Policies – the Albanian Case Study**

Unlike Macedonia and Montenegro, Albania is still only a potential candidate for EU membership as identified together with the other Western Balkan countries at the Thessaloniki European Council Summit in 2003. In 2012 the European Commission recommended Albania be granted EU candidate status subject to the completion of key measures in a few areas. Regarding the relevant stakeholders, the Albanian Ministry of Economy, Trade and Energy is the institution responsible for energy policy. There is also an agency called the National Agency of Natural Resources which has more competences in the area of renewables (National Agency of Natural Resources, 2013), but which was assessed as having an unclear division of responsibilities regarding energy efficiency with the Ministry of Economy, Trade and Energy, what tends to be one of the main barriers to the successful implementation of the country's Energy Efficiency Action Plan (Energy Community Secretariat, 2012). As can be seen in Table 1, Albania with regard to the capacity of both its Ministry and the Agency of Natural Resources was assessed as having started developing this area with a need for further strengthening, so in regard to the institutional set-up Albania turned out to be the second best example after Macedonia (USAID, 2008). According to a later study, the assessment for the energy institutional capacities seemed to have improved for Albania since its implementing agency was assessed to be a policy with good quality, thereby presenting the best example of all three countries regarding the Agency's capacities as is shown in Table 2 (World Bank, 2010).

The country has a draft Energy Efficiency Law, a draft Renewable Energy Law and a strategy titled National Strategy of Energy (EU Build, 2012) and a National Energy Efficiency Action Plan the latter adopted in 2011(Energy Community Secretariat, 2012). Concerning the drafting of legislation and local energy planning, Albania, as shown in Table 1 turned out to be the worst off of the three countries concerned, by having only partial legislation set in place and no energy planning at all at the local level (USAID, 2008). Furthermore, as shown in Table 2, Albania manages to get good quality marks for its administrative responsibilities,

for the legal basis for energy efficiency and for the regulations; and medium quality grades for the policy goals for energy efficiency, energy efficiency strategy, energy efficiency action plans and supporting policy tools, regarding this set of policy framework in comparison turning out to be the second best example after Montenegro (World Bank, 2010).

As for concrete implementation, Albania has envisaged *inter alia* a national energy efficiency program and an Energy Efficiency Fund in its Energy Efficiency Law, and the Energy Community Secretariat has noted in two subsequent reports (2011, 2012) that this Energy Efficiency Law had not been properly implemented, since among other things the envisaged Energy Efficiency Fund had not been created due to budgetary constraints. The World Bank study (2010) also concludes that Albania is challenged on the implementation level since it was noted that it is lagging behind in implementing existing laws and adopting secondary legislation and supportive policy tools. When analyzing concrete financial means for the purpose of implementing energy policies, Albania was found back in an earlier study to be in a desperate need of energy efficiency investment but that it did not have the appropriate funds (USAID, 2008). In a later study the World Bank (2010) repeated that the country had not yet introduced financial incentives to promote energy efficiency. Furthermore, from concrete incentives, tax reduction is poor in practice (EU Build, 2012). Regarding the area of energy efficiency policy and strategies, Albania was assessed as having begun to develop this area with the need to further strengthen it thereby turning out, together with Macedonia to lag behind Montenegro as is evident from Table 1 (USAID, 2008). However, Table 1 showcases Albania's Energy Efficiency Fund with regard to legislation that has been put in place for a substantial amount of time, but the implementation failed, making the Albanian case the worst example when compared with Macedonia and Montenegro (USAID, 2008). As can be shown in Table 2, Albania was the worst example regarding support schemes for implementation, having been assessed to have none (World Bank, 2010).

On the subject of awareness raising, an earlier study USAID (2008) assessed Albania to be the worst example compared with the other two countries by having neither programs for promoting energy efficiency nor public information campaigns on the subject as shown in Table 2. Later the country has undertaken information campaigns

on energy efficiency in buildings and energy labelling which included builders, architects, producers of construction materials , consumers, and representatives from small banks, municipalities and the like (Energy Community Secretariat, 2010). However, the World Bank (2010) noticed that the Government had not yet developed a public information capacity to promote energy efficiency benefits and technologies and those programs were needed to demonstrate and promote energy efficient measures in schools, hospitals, and other public buildings. Albania's overall impression on the progress it achieved on EU energy efficiency and renewable energy policy implementation over the years (2007-2012) shows either some or no progress has been achieved, the latter being the state of development in the last two progress reports of 2011 and 2012.

## **Conclusions and Recommendations**

This paper aimed to assess the level of adoption and implementation of the EU energy efficiency and renewable energy policies in the region by comparing the case studies of Macedonia, Montenegro and Albania. This was done by utilizing regionally comparable studies in the areas of the capacities of their energy institutions, the level of the adoption of legislation, and energy policy planning at local level. Also, under review was the availability of the financial means for energy projects, and promotional and awareness raising activities as well as support schemes for implementation regarding their energy efficiency and renewable energy policies. The objective was for the purpose of stating whether Macedonia as the country with the longest candidate status experience is the most advanced; and for drafting a recommendation to the respective Macedonian authorities for better performance in the area for Macedonia.

As for the institutional set-up of these countries, all three have a ministry which among other things, tackles the energy matters including renewables and energy efficiency, Montenegro is the only state without a separate Energy Agency, the Macedonian Agency however lacks the adequate capacities for performing its duties. It is important to mention that the Deputy Minister of the Economy in Montenegro is also

directly responsible for energy efficiency policies, showing institutional leadership in the energy area, thus presenting a good example to learn from. Further good examples are demonstrated by the well staffed Albanian implementing agency in the area, making the country the best example among the three regarding the respective energy implementing capacities according to more recent assessments, although the matter of unclear responsibilities with the Ministry remains.

Moving to legislation, drafting energy laws and strategies has also been set differently in each of the three countries, while the strategic planning of energy efficiency, renewable energy and the development of the energy sector is also present. While Macedonia has a single Energy Law in which there are separate chapters on energy efficiency and renewable energy, Albania and Montenegro have specific energy efficiency laws, Albania is drafting a separate Renewable Energy Law as well. As presented, the regional studies' assessment of the overall policy framework of these countries addressing mostly the adoption of specific legislation showcased Montenegro as a clear leader among the three, with Macedonia as the weakest example.

In the area of implementation, all three countries have made efforts and implemented reforms and projects in the area and are still generally challenged on the subject since they all lack sufficient incentives. However, some performed better than others in the area. Bearing in mind the importance of having sufficient financial means for implementing energy projects, it was a big step in the right direction for Montenegro to establish the Energy Efficiency Fund, unlike the other two countries. Of special concern is the fact that the Macedonia's Energy Efficiency Fund had been envisaged almost ten years ago. The comparable regional assessment regarding the energy efficiency policies establishing energy goals and having support schemes for implementation with a highlight of having an Energy Efficiency Fund, presented Montenegro as the best example out of the three countries concerned. Regarding awareness raising, all three countries need further strengthening in this area, however the regional comparative studies presented Macedonia as the most successful and Albania as the least successful case. Some promotional activities of Montenegro in the area however caught the eye of the Energy Community Secretariat, highlighting the results and the effectiveness of this country's campaigns.

The overall impression as presented in the EU progress reports is that the progress of Macedonia and Montenegro is almost identical in terms of overall statements on the level of EU energy efficiency and renewable energy adoption, Albania being a clearly less successful case. From the analysis conducted, it is clear that the least successful in adopting and implementing the EU energy efficiency and renewable energy policies is Albania, which is still a potential candidate for EU membership. On the other hand, the level of successiveness in the area is almost tied between Macedonia and Montenegro, Macedonia being an older candidate country – bearing the title since 2005, when Montenegro was still part of Serbia and Montenegro, but bearing in mind that one additional obstacle for Macedonia regarding starting the negotiations for entry into the European Union is the matter of high politics, namely the name dispute with Greece, which has nothing to do with Macedonia's progress in the area of renewables and energy efficiency. Strictly regarding the progress under the energy efficiency and renewable energy part and having in mind Montenegro's more recent experience with the EU candidate status, it can be concluded that Montenegro is the greenest country having achieved best progress in adopting and implementing EU renewable energy and energy efficiency policies compared with Macedonia and Albania. Highlights include the leadership Montenegro shows with having a Deputy Minister in charge of energy efficiency and the determination to establish a key implementing mechanism, the Energy Efficiency Fund. Further positive examples include having a separate Energy Efficiency Law which could facilitate the adoption of secondary acts and their implementation, as well as successful awareness raising campaigns.

Concrete recommendations for Macedonia are that the state should follow Montenegro's example in establishing an Energy Efficiency Fund. Next that Macedonia should consider is Montenegro's but also Albania's practice of having a separate Energy Efficiency Law and even possibly a separate Renewable Energy Law. Furthermore, although not shown as the best example, but nevertheless demonstrating leadership in the area, having a Deputy Minister for Energy Efficiency and Renewables should be considered. Moreover, strengthening the Energy Agency's capacities is a must looking up to the Albanian example of a properly staffed implementing institution. Also, some good examples of

Montenegro regarding energy awareness raising using catchy titles such as 'year of energy efficiency' and more importantly including wide inter-sector cooperation is highly recommendable. Finally, as in common with all three countries, it is recommendable to introduce as many incentives and implementation tools as possible to serve the purpose of supporting implementation, such as tax incentives, taxes, funds, credits, grants, or pilot projects. By implementing these policies, Macedonia can regain the title of green leader among the EU candidate countries and potential candidate countries and by doing so can contribute to reaching the EU goals for 2020 and 2050, which in turn will contribute to improving the standard and quality of living of its citizens.

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## Appendix

**Table 1:** Laws and regulations concerning energy efficiency and heat, policies and programs for implementation of energy efficiency projects and institutions and authorities responsible for promoting energy efficiency (selection)

Area/ Country	Macedonia	Montenegro	Albania
Legislation	+	++	+
Requirements for municipal energy planning and restrictions on use of heat sources not consistent with the plans	+	+	-
Energy efficiency policies or strategies establishing energy savings goals for the country as a whole and by sector	+	++	+
Energy efficiency funds	+-	+	!
Programs and provisions for promoting energy efficiency in the public sector at the national government level	+-	+-	-
Public information campaigns promoting energy efficiency	+	+-	-
Ministries with energy efficiency department	++	+	+
National energy efficiency or energy conservation agencies	+	-	+

Explanation: ++ means full implementation (development is advanced and capacities are in place), + is partial implementation (development has started, legislation and some capacity is in place, need of further strengthening), +- is planned but not implemented (legislation is in place and implementation is pending), -nothing (no legislation and/or capacities in place), ! means legislation has been in place for a substantial amount of time, but implementation failed  
Source: USAID, 2008.

**Table 2:** Institutional framework (selection)

Area/ Country	Macedonia	Montenegro	Albania
Administrative responsibilities	1	1	1
Legal base for energy efficiency	2	1	1
Regulations	2	1	1
Policy goals for energy efficiency	2	2	2
Energy efficiency strategy	2	2	2
Energy efficiency action plans	2	1	2
Supporting policy tools	2	1	2
Implementing agency	2	2	1
Support scheme for implementation	3	3	4

Explanation: 1 is good quality, 2 is medium quality, 3 is low quality, 4 is none existing

Source: World Bank (2010) based on information from the Austrian Energy Agency

## **EU Consumer Protection and the Implementation in Macedonia and Countries of Former Yugoslavia: Focus on Liability for Defective Products**

*Kimo Cavdar, Zoran Sapurik*

### **Abstract**

*Consumer protection is one of the core European Union values. The harmonization of consumer protection legislation aims toward the improvement of the consumer's rights. Apart from EU member states, those countries with those countries who aspire to membership of the EU are also obliged to transpose this common legislation into their national legislation. The EU Directive on consumer rights and the Directive on the liability for defective products are an important part of common consumer protection. Macedonia and other countries of the Former Yugoslavia, on their way to approaching the EU have implemented the European Union's consumer protection legislation in a similar way. This paper tries to put more light on the process of the harmonization of consumer protection legislation in the countries of Former Yugoslavia. It focuses on the liability for defective products.*

*Keywords: EU, legislation, consumer, liability, product, producer.*

### **Introduction**

The European Union as a political and economic community has been acting permanently in the field on harmonization of legislation. The harmonisation of legislation often opens up the debate between those arguments in favor of a futher strengthening of the EU common legal framework and those against such a process. One of the first EU

efforts in the harmonization of common legislation in the sphere of consumer protection and liability for defective products is Directive 85/374 on the approximation of the laws, regulation and administrative provisions of the Member States concerning the liability for defective products, known as the Directive on liability for defective products. The Directive was adopted in 1985 and amended in 1999 (Directive 1985). The Directive is consumer protection oriented and makes efforts to establish the first steps of harmonization of the liability for damage caused by defective products. It is important to stress that there is a need to connect this Directive with other consumer protection oriented EU legislation, especially with Directive 2011/83/EU on consumer rights, which supplement the overall liability for defective products with the aim of protecting the consumer rights of EU citizens (Directive 2011). The aim of the common consumer policy is to ensure that the EU consumer can draw maximum benefits from the existence of an internal market ( Moussis 2006 ). We can clearly recognize the EU commitment to harmonize the activities in the area of consumer protection, including protection from the damage caused by defective products in the Treaty on the functioning of the European Union. In article 169 of this Treaty it is determined that in order to promote the interest of the consumer and to ensure a high level of consumer protection the European Union will contribute to protect health, safety and the economic interest of consumers as well promoting their right to information, education and to organize themselves in order to safeguard their interests. The measures taken by the member states must be compatible with the Union treaties (Treaty 2010). The legislation on the European Union level and the legislation on the national level must be in compliance with EU treaties, which have constitutional importance.

The countries of the Former Yugoslavia: Macedonia, Serbia, Montenegro, Bosnia and Herzegovina, which aspire to full membership of the EU, have numerous obligations for transposing and implementing EU legislation. This is also the case for Croatia, which joined the EU in 2013. One of the important areas of EU legislation is the area of consumer protection legislation, including the liability for defective products. This liability produces an obligation for compensatory damage for defective products, by the producers and traders. The liability for defective products is a significant part of consumer protection legislation. Shortly

after the dissolution of the Former Yugoslavia, Macedonia, Bosnia and Herzegovina, Serbia, Montenegro and Croatia undertook the provisions from the Law on obligations of the former Yugoslavia adopted in 1978, which regulates some issues related to liability on defective products, as their national laws (Law on obligation 1978). The Law on obligation was very progressive for that period. Later those countries adopted their national laws on obligation, where they regulated the issues relating to liability for defective products. According to the harmonization of their legislation, many of them later regulated this liability in their consumer protection laws.

## **EU Consumer Protection Legislation and Liability For Defective Products**

The EU has been acting permanently in the direction of building common legislation. One of the spheres where the EU has been making big efforts for harmonization is the sphere of consumer protection and in the framework of this the issues related to the liability for defective products. The harmonization of EU legislation has led to a debate on the support or rejection of the strengthening of common legislation. The Eurosceptics emphasize that strengthening harmonization affects the sovereignty of member states. The supporters of the stronger cohesion of the EU underline the needs for a further strengthening of the common legislation as a basis for the performance of common activities, which provides for a more efficient and effective realization of the interests of citizens. The existence of EU law is crucial with the policy implementation (Nugent 2003). In this direction is the standpoint that the Union provisions have precedence over national legislation in the case of conflicts (Mathijsen 2010). However besides the arguments of eurosceptics, especially from the United Kingdom, the process of the harmonization of EU consumer protection legislation continues and provides positive effects, especially in the field of more effective protection of the consumer overcoming the border barriers and strengthening the EU single market. It is important to stress in this part of the paper that in the countries of Former Yugoslavia the harmonization of national legislations with the EU legislation is not really

being addressed. Those countries accept that EU accession means the harmonization of the activities in different areas including the consumer area.

The Directive on the approximation of the laws, regulation and administrative provisions of the Member States concerning liability for defective products, known as the Directive on Liability for Defective products was adopted in 1985 and it was amended in 1999. This Directive determined the principle of liability without fault, applicable to all EU producers. According to the Directive if a defective product causes damage to a consumer, the producer may be liable. It means that for the first time at an EU level (at the time of adoption the Directive, European Economic Community), the obligation that the producer is liable for damages caused by defects in his product was established. The producer is defined as: the producer of a raw material, the manufacturer of a finished product or of a component part; the importer of the product: any person putting their name, trade mark or other distinguishing feature on the products; any person supplying their name and any person supplying a product whose producer or importer cannot be identified. It is important to stress that the extensive determination of the term producer, strongly emphasizes the importance of consumer protection in the single EU market. A product is specified as defective, when it does not provide the level of safety which an individual is entitled to expect, taking all circumstances into account including the presentation of the product, the reasonable use of the product, and the time when the product was put on the market. Besides the extensive liability of the producers, the consumers, as the damaged party must prove the actual damage, the defect of the product and the causal relationship between the damage and the product defect. But the consumer does not have to prove any negligence or fault of the producer or importer, which enables consumers to compensate the damage caused by defective products in a relative easy and simplified procedure. It confirms the assumed liability of the producers. The producer does not have any liability if he proves that he did not put the product into market circulation; the product is not produced to be sold or distributed for profit; the product is not produced and distributed in the course of his business and if the defect appeared after the product was put into circulation. However the

burden to prove the product defect is not the obligation of the consumer. It is the obligation of the producer which gives the consumer a better position and protects them from any deception by the producers. This is completely in compliance with the EU determination for strengthening the rights of consumers and, concomitantly, the responsibility of the producers.

The term product, means all movables, with the exception of primary agricultural product, even though this may be incorporated into another movable or into an immovable and the term also includes electricity. The Directive does not apply to injury or damage arising from nuclear accidents regulated by international convention ratified by the EU as a community and its member states. The Directive limits the period to apply for compensation so that the injured consumer must seek compensation within a period of three years. This period starts from the date when the consumer became aware of the damage of the defect and the identity of the producer. The general producer's liability is limited for a period of ten years after the date when the product was put on the market. The liability of the producer in relation to the injured person, arising from the Directive cannot be limited by other provisions and the member states can not shorten these time limits in their own national legislations. This provision clearly confirms the determination of the EU for the harmonization of legislation. The Directive has applied in the EU already for a period of eighteen years, which confirms the value of these determinations. It has a great significance for the regulation of relations between the consumer as a buyer or end user and the producer as a seller. The Directive has been implemented in the national legislation of EU member states in three ways (Ivancevic 2012). The first one provides the adoption of specific legislation on liability from damages caused by defective products. As is the case in: Austria, Belgium, Denmark, Finland, Ireland, Italy, Germany, Portugal, Sweden, Spain, Luxemburg, the Czech Republic, Slovakia, Estonia, Cyprus and Latvia. The second way is the implementation through the provisions in the civil codes of : France, the Netherlands, Poland and Lithuania. The third way is one that is applied in Greece, the United Kingdom, Malta, Slovenia and Bulgaria, where the Directive has been implemented in consumer protection laws. We want to underline

that a different way of transposing – implementing the provisions of the Directive does not prevent the achievements of the objectives of the Directive. The directives as an important part of EU secondary legislation are characterised with the primary goal of meeting their targets and that could be realized in the national legislation of member states in different ways. The Directive on Liability for Defective products is a typical example of the implementation of the Directive's provisions in a different way. Alongside the regulations, which are also the parts of the EU, secondary legislation is automatically applicable in the national legislation, without transposing any of the provisions.

It is very important in the context of EU consumer protection legislation to elaborate the Directive on consumer rights (Directive 2011). This Directive significantly strengthens and expands consumer protection rights in the EU. The Directive makes serious efforts toward further harmonization and the simplification of common legislation in the field of consumer protection. It enables the free movement of goods and services within the EU single market, eliminating the barriers between member states. It should not affect national legislation for aspects of contract law that are not regulated by this Directive. The Directive regulates distance contracts and off premises contracts. A distance contract is defined as any contract concluded without the simultaneous physical presence of the trader and the consumer by using one or more distance communications. An off premises contract is determinated as a contract that is concluded in a place which is not the business premises of the trader. Despite that this Directive determines the term trader, instead of the term producer in the Directive on Liability for Defective Products, it is clear that both directives are closely related and that they are aimed at strengthening and harmonizing consumer rights in the EU. Furthermore the Directive on consumer rights regulates the consumer's right to withdraw from a distance or, off – premises contract without giving any reason. It includes the possibility of withdrawing in the case of a defective product. This clearly shows the determination of the European Union to continue with the further harmonization of common consumer protection legislation, with a goal to provide for the better protection of the interests of consumers.

## **The Implementation of EU Consumer Protection Legislation in the Countries of the Former Yugoslavia**

Any country aspiring to membership of the EU has an obligation to harmonize its legislation with EU legislation according the treaties for stabilization and association with the EU on the basis of their national programs. After the dissolution of the Former Yugoslavia, Macedonia, Bosnia and Herzegovina, Serbia, Montenegro and Croatia, regulated the liability for defective products by directly undertaking the provisions from the Law on obligations of former Yugoslavia.

**Croatia** became a member of the EU in July 2013. In the process of the harmonization of its legislation the Law on obligation (Law on obligation of Croatia 2005) was adopted in 2005. The provisions of the EU Directive on Liability for Defective Products were transposed in chapter five which regulates liability for defective products. In this Law the liability for defective products was separated from the liability for damage caused by dangerous objects (products) and dangerous activity. It was made, due to the fact that these two liabilities are separate types of liability which are based on different assumptions and charged against different individuals. Also changes in terminology were made and the term 'defective product' was introduced. With this change the identification of liability for defective products was made, as opposed to liability for material shortages. Croatia adopted the Law on consumer protection as an obligation for the implementation of the EU Directive on consumer rights, but the liability for defective products is regulated primarily in the Law on obligation.

Croatia's Law on obligation imposes the strict liability on producers of defective products. The burden to prove damage and the nature of the defect are placed upon the injured party. The producer cannot exclude liability for defects. The provisions on product liability refer to material damage such as death or personal injury and damage to the other property. It can be concluded that Croatia completely transposed EU legislation in the field of consumer protection and liability for defective products before joining the EU, as the twenty eighth member state.

In **Montenegro**, liability for defective products and the responsibility for defective products is determined by the Law of

Obligation (Law on obligation of Montenegro of 2008). This Law transposes EU Directive 85/374, and stipulates that the individual who has suffered damage is obliged to prove the defect of the product and damage in the context of a causal relationship between the defect product and the damage. The obligations of the producer's liability for defective products are also transposed in the Law on consumer protection (Law on consumer protection of Montenegro 2007), where the terminology defining the terms product and producers are defined according to the EU Directive.

In **Bosnia and Herzegovina** in many spheres there is a duality in legislation, given that there is a parallel legal system operating in the Federation of BiH and in the Bosnian Serb Republic. These two legal systems also operate in the sphere of consumer protection and liability for defective products in Bosnian and Herzegovina. The Law on obligation (Law on obligation of Bosnia and Herzegovina 2003) has transposed the provisions from the Directive on Liability for Defective Products by determining the obligations in the case of damage caused by defective products. Bosnia and Herzegovina has adopted the Law on consumer protection (Law on consumer protection of Bosnia and Herzegovina 2006). This Law regulates that the producer is liable for any damage caused by defects in his product in accordance with the provisions of the law, which regulate the obligations. In this way the Law on consumer protection connects the liability for defective products with the Law on obligations. Besides the existing of two legal systems in this sphere, completely is the same situation in Bosnian Serb Republic, where the Law on obligation (Law on obligation of *Republika Srpska* 1993) and the Law on consumer protection (Law on consumer protection of *Republika Srpska* 2012), regulate consumer protection from the damage caused by defective product.

In **Serbia** the producer's liability for defective products is regulated under the Law on consumer protection (Law on consumer protection of Serbia 2010). The Law defines the basic rights of consumers and the safety of products and services. Consumer protection is linked with the protection of health and the protection of the environment. The Law also regulates distance contracts and off premises contracts, with full implementation of the Directive of consumer rights. The Law determines the liability of the producers for damage caused by defective products.

The injured person has the right to compensation from the producer of the damages if he can prove the relationship between damage and the defective products. The limit for the right to apply for compensation for damages is within three years of the date when the consumer first became aware of the defects and the identity of the producers. Otherwise, liability ceases after a period of ten years from the date of placing the product on the market. This means that the Directive on Liability for Defective Products is fully transposed in Serbian legislation. The Directive on consumer protection and the Directive on liability for defective products, as the most important part of EU consumer protection legislation are implemented in Serbia in an integrated way in the Law on consumer protection, which in our opinion is the most favorable way for the implementation of EU consumer protection legislation.

## **Implementation in Macedonia**

Macedonia as a country with candidate status for membership of the EU, has been expecting the date for the beginning of negotiations and has obligations to harmonize its national legislations with EU legislation. Macedonia over the past few years has been making serious efforts for this harmonization. One of the obligations for harmonization lies in the sphere of consumer protection including the producer's liability for damage caused to consumers by defective products. The last EU Commission 2012 Progress report, related to Macedonia in chapter 28, where it emphasizes some progress in the sphere of consumer protection (Progress Report 2012). The Report underlines the importance of further activities in progress with regard to the practical implementation of the Law on consumer protection which transposes the Directive on Consumer protection (Law on consumer protection of Macedonia 2004). This report stresses the importance of the harmonization of national legislation with EU legislation in the sphere of consumer protection. Also the Report provides that consumer organizations continued organizing awareness raising, education and campaigns. It is noted that the financial support gained by consumer organizations remain insufficient. In this part of the chapter we want to

emphasize that the dialogue between consumers, the business sector and the authorities is an important part of building and implementing consumer protection legislation, but unfortunately in Macedonia it is still only concerns a very small number of consumer organizations. In our opinion this means that the non-governmental sector in the sphere of consumer protection is still not fully developed enough. Furthermore some consumer organizations almost have a monopoly in this area. In this way besides stronger financial support from the central government and local government, there is a need for the further development of consumer organization and the establishing of competitiveness between consumer organizations. This in turn produces a need for amendments of the Law on consumer protection.

The Law on consumer protection regulates the rights and obligations of the trader and the producer. But there is a need to make a clear distinction between the definitions of the terms of trader and producer in this law and also in the other laws which regulate some aspects of consumer protection. Existing definitions could introduce doubt and a lack of precision. Furthermore, the Law regulates the methods of payment, warranties and services, product safety and liability for product safety and liability for defects and shortcomings of the products. According to the Law, when the consumer purchases a product with a shortcoming, he has a right to apply for: a reduction in the selling price; the replacement of the product with a correct product, the cancellation of the contact, the refunding of payment and compensation for any damage caused.

The liability for the defect of a product is regulated by the Law of obligation (Law of obligation of Macedonia 2001). According to this Law the producer who placed the product on the market is responsible for any damage caused, and the production of a defective product, regardless of the producers' fault. The injured person can apply for compensation for non-pecuniary damage, only in accordance with the general rules of liability for damage from this Law. This is not related to the damage caused by nuclear disasters. The injured person is obliged to prove the damage. The Law on obligations in compliance with the Directive on Liability for Defective Products defines the named product, the defective product and the producer. The question of the definition of the product was widely discussed and so far the product is defined by covering all

movable goods including autonomous parts, which may have been fitted to the product. The definition of a product includes electricity and other types of energy. A product is specified as defective when it does not provide the safety which a person is entitled to expect, taking all circumstances into account including the presentation of the product, the reasonable use of the product, and the time when the product was put onto the market. Furthermore, the Law defines the producer and equates the liability of the importer with the liability of the producer. The producer is not liable if he can prove that he did not put the product into circulation on the market; if the product is not produced to be sold or distributed for profit; if the product is not produced and distributed in the course of his business and if the defect appeared after the product was put into circulation, which means completely and directly transposing the provisos from the Directive on Liability for Defective Products. Apart from some obstacles to the practical implementation of the above mentioned legislation in Macedonia, this harmonization shows the first positive effects. Towards this end, the activities of the state inspection authorities for the protection of consumer rights and interests are much more intensive. Also the reactions of consumers have a greater intensity in the case of the violation of their rights by defective products.

## **Conclusion**

The European Union, as a community with one of the largest single markets has been acting permanently to improve the quality of health and the quality of life of its citizens. In this context one of the core pillars has been the issue of consumer protection, whereby consumer protection activities and legislation have been introduced, which strengthen the EU single market. In this direction the EU has been making positive steps to harmonize consumer protection legislation, including the liability for defective products as an important part of consumer protection legislation. This harmonization demonstrates the positive effects of EU policy, despite the existence of opponents to the strengthening of this harmonization.

The Yugoslav successor states have expressed their desire for membership of the EU. On their way towards entry into the EU they have had to fulfil a number of obligations. The obligation for the harmonization of their national legislations with the European Union's legislation is very important. Each of these countries finds itself in a different phase of approaching the EU. Croatia has just become a member state of the EU. Montenegro as a candidate state has started negotiations with the EU and Serbia gained candidate status in 2012 and expects to begin negotiations in January 2014. Bosnia and Herzegovina has signed a Treaty for stabilization and association and is expected to gain candidate status in the longer term. Macedonia, by contrast gained candidate status in 2005, and even though it has a recommendation from the European Commission to start negotiations with the EU, has not as yet started negotiations because of a well known problem of being opposed by one particular EU member state.

An analysis of EU legislation and the legislation of the Yugoslav successor states shows that despite the fact each state is at a different phase on the way toward EU entry, generally they have transposed into their national legislation the provisions of EU consumer protection legislation and the most important part of this legislation Directive 85/ 374 on the approximation of the laws, regulation and administrative provisions of the Member States concerning liability for defective products and the Directive 2011/ 83 on consumer rights. These countries have all transposed consumer protection and liability legislation in a similar way. Some of them such as Serbia transposed the EU legislation in an integrative way in the Law on consumer protection. The other countries transposed those directives in Law on the obligation and Law on consumer protection. None of these countries failed to implement these directives by transposing into civil codes, as is a case in some EU member states. This transposing of EU legislation strengthened the position of the consumers in those countries, but there is a need for further activities and the practical implementation of EU consumer standards and a further strengthening of consumer rights. Also in the near future they have to work on the equalization of terminology, especially in relation to the other special laws which regulate some aspects of consumer protection. Taking into account that EU legislation is very dynamic, they have to follow the development

of EU legislation. After becoming a member state of the EU, Croatia has different obligations, from the other countries and regulations, as a part of secondary EU legislation it will automatically become a part of national legislation, without transposing.

Macedonia has transposed Directive 85/374 and Directive 2011/83 into national legislation. It strengthened the position and rights of the consumers in the market, but also contributes towards a stronger competitiveness of Macedonia's products in the EU single market. In the future there is a need for strengthening a dialogue between the authorities and the business sector and consumer organizations. This will contribute towards the better practical implementation of consumer legislation, including the producer's liability as opposed to that of the consumer. Apart from some problems in practical implementation, the harmonization of national consumer legislation contributes towards more effective consumer protection and the acceptance of common EU values in this area.

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## **The Economic Rationale behind Investments in Education and Human Capital**

*Emilija Tudzarovska - Gjorgjevska*

### **Abstract**

*This paper evaluates the efficiency of education and human capital investment practices in the Republic of Macedonia, as a key stimulant in providing the necessary equilibrium between the structures of the labor market, the quality of education and economic growth. The development of higher education is seen as a key stimulator of the vital policy-making strategies which aim to affect a growth in employment. Moreover from the perspective of knowledge accumulation, the internationalization of higher education is seen as both an educational and an economic tool which can be used for increasing the functionality of the Macedonian market economy. Comparisons with Croatia and Germany, aim to address the 'knowledge based' economic outcomes of the contemporary management approach towards investment in knowledge and education. In conclusion, bridging the gaps between the government, the universities and the business sector as well as the students is seen as a key stimulator of the rationale behind investments in education and human capital. Hence, the suggested shift in management practices focuses on the 'bottom-up' management approach, in interaction with 'top-down' management, as a recommended tool for reaching better 'knowledge economy' outcomes.*

*Keywords:* *human capital, investments, labor market, internationalization of higher education, management, economic growth, wage structure, management*

## Introduction

The process of globalization and the increased demand of market forces, innovations, progress in technology and skilled human capacities, has shaped contemporary labor markets and stimulated the rise of competitiveness among national economies. The awareness of the need for a new, agile and innovative economy has arisen alongside the need for a pragmatic and economic rational environment, which stimulates investments in human capital, increases the quality of education and produces adjustable 'employability' skills and qualifications. The access to quality education and the rationale behind investments in human capital became vital elements of labor market policies, with a huge potential for alleviating the problems of unemployment, a reduction of poverty, and social exclusion. In such a global context, the post-transitional societies such as those of the former Yugoslav countries and their historical background of egalitarian wage structures and reduced wage premiums on education, faced with the challenges of transcendental political capacities which led to the stagnation of proper investments in education and human capital. In the post-Yugoslav period, the Republic of Macedonia, as a post-transitional society, also faced the need to find the most effective ingresses for bridging the gaps between the labor market structure and an adequate human capital. Bridging these gaps is still one of the biggest challenges of the Macedonian market economy and its relevant economic growth. Therefore, the comparative aspect with another post-Yugoslavia state and current EU member state, such as Croatia, sets out to detect the current and future challenges of the problem-solving approach.

Hence, the first part of this paper offers a theoretical background of the development of the education and human capital theory. It focuses on its direct tie in to the 'knowledge based' society and its impact on the reduction of long-term unemployment. Moreover it offers perspectives of the active role of higher education in strengthening the link between the human accumulated knowledge, skills and competences with the market-absorbing capacities aiming to stimulate long-term economic growth and a functional market economy. The proactive and innovative development of higher education practices provides the key potential to shape the vital national and policy-making strategies which aim to

address the problems of high unemployment, the reduction of poverty and to increase the competitive potential of human capital. However, in order to realize positive outcomes, transparent and effective dialogue should be reached between the three key influencers: the university, the state and the business sector, for an efficient approach to overcome all existing gaps. Moreover, with the inclusion of the fourth key influencer: the students, we expect to reach a raft of practical and applicable outcomes that can foster further higher (formal and informal) education development. In addition to this, we will consider the tangible connection between education and the impact of human capital investments in education, training and employment schemes on attracting quality human capital, which foster economic growth and sustainability.

Hence, the general hypothesis suggests that more effective and transparent dialogue between the state, the universities, the business community and students can impact on the quality of education and the application of knowledge which can foster an increase in the quality of human capital and its relevant implications on employment schemes. This can increase productivity, knowledge competitiveness, business and entrepreneurial opportunities and in turn impact upon economic growth. Moreover, by choosing the most efficient management approach and strengthening the relevant management capacities, the efficiency behind the investments in (higher) education and human capital will increase, as well. In order to apply the best management approach which stimulates economically rational investments in education and human capital, sharing open collaboration and diverse knowledge input is highly recommended. The contemporary challenges of the national, EU and global labor market, the requests of educational background, skills and applicable qualifications and the impact of long-term unemployment should be a joint subject of interest to all relevant stakeholders. Hence, the question is which improvements might have an impact on the development of (higher) education and the production of human competences, and moreover, what is the role of the internationalization of higher education in addressing the challenges of rationalization towards the investments in education and human capital?

The second part of the paper offers a comparative, cross-country analysis of the key-indicators of 'knowledge economy' indexes such as

the (long-term) unemployment rankings in three selected case studies: Macedonia, Croatia and Germany. The comparative indicators aim to address the current and future challenges of the countries' economic developments, based on their rationalization of investments in education and human capital.

The final part of the paper focuses on the possible decision-making options for encouraging the processes of rationalization behind investments in education and human capital. The recommendation for improving the dynamics of economic growth and stability, emphasize the need for increasing the quality, attractiveness and compatibility of higher education, as a key stimulator of the return to human capital. The enforcement of 'bottom-up' management, alongside the 'top-down' management approach is considered as a highly pragmatic and effective approach to micro and macro-economic challenges.

## Theoretical Background

The first conceptualization of education and human capital' potential was offered several centuries ago when Sir William Petty (1623-1687) and Adam Smith (1723-1790) cultivated the human capital theory (Kern, 2009). Although Sir William Petty was the one who "examined the role of the state in the economy and touched on the value of labor" (Ibid.) it was Adam Smith who first established the basis of the economics of human capital, "making the first connection between the skill of the worker and higher wage levels, as he conceptualized these arguments in his famous book *The Wealth of Nations* (Kern, 2009; Becker, 1992). Human capital theory came back into fashion in the early 1960s, when it became one of the most influential economic theories of Western education, setting the framework of government policies. (Fitzsimons, 1999; *Encyclopedia of Philosophy of Education*, 2009) Amanda Kern in her work on human capital development theory points out that during this period, "the American economists Theodore Schultz (1902-1998) and Gary Becker (1930- ) began to make tangible connections between education and its impact on the ability of human beings to earn higher wages" (Kern, 2009). "Schultz identified people as a source of the economic growth when other economists were

attributing national growth to improvements in technology" (Kern, 2009; Fitzenz, 2000). However, the significant contributions to human capital theory during the last half of the twenty-first century, were made by the work of two contemporary economists Samuel Bowles and Gary Stanley Becker, due to their point that "human behavior is based on the economic self-interest of individuals operating within freely competitive markets and second, education increases worker productivity" (Ibid.) In her paper Angela Kern emphasises that "it was Bowles who first challenged the conventional economic assumptions that people are motivated entirely by self-interest. In Bowles' view, wage structure, the individual attributed value on the labor market, and the social relations of the educational process can only be explained through an analysis of class and class structure" (Kern, 2009; Bowles, 1975). In contrast, "Becker asserted that every worker is a capitalist, acting in their own best interest. Becker has expanded human capital theory with his research on the relationship between earnings and human capital and he is responsible for developing a systematic framework for studying the return on education and on-the-job training, in addition to wage differentials and wage profiles over time" (Ibid.).

Moreover, Patrick Fitzsimons defined the modern human capital theory as "the basis for nation state structural policy frameworks [based on] the enhancement of labor flexibility through regulatory reform in the labor market, as well as raising skill levels by additional investment in education, training and employment schemes, and immigration focused on attracting high quality human capital". (Fitzsimons, 1999)

Unquestionably, attracting high quality human capital has been and is one of the most demanding educational as well as economic tasks. Moreover, with the adoption of the Bologna reforms, the rise of mobility and competitiveness, the interaction between human capital and the 'knowledge economy' has increased as well. As a result, investments in education have increased in correlation to the quality of human capital. Leroy Almendarez in his paper "Human Capital Theory: Implications for Educational Development" considers education both as a consumer and a capital good (Almendarez, 2001). According to the author, "education [offers] utility satisfaction to a consumer and it also serves as an input to develop the human resources which are necessary for economic and social transformation" (Ibid.) Therefore, the focus on

education as a capital good is related to the concept of human capital, emphasizing the fact that “the development of skills is an important factor in the production activities of people” (Ibid.) The human capital theory emphasized the tangible connection between the education, human capital investments and economic growth. Bridging these key aspects of the market economies, can impact further on the economic development of the countries.

## **Lessons to be Learned: Bridging the Gaps between Past and Present Experiences**

The political and social context in the former Yugoslavia (1945-1991) fostered the adoption of egalitarian programs designed to promote general access to health care and education. However, Boris Vujčić and Vedran Šošić in their work on investing in education in Croatia point out that “The exceptionally egalitarian wage structure in the former Yugoslavia reduced the wage premiums of educated workers and resulted in insufficient investment in higher education, compared to the parallel excessive investment in secondary-level vocational training” (Vujčić & Šošić, 2007). In such a historical framework, planners in the former Yugoslav countries such as Macedonia and Croatia “preferred secondary schooling, especially vocational training, over higher education and as a consequence of vocational training the share of proletarians in the labor force increased, which was considered to be the stronghold of the communist party” (Ibid.) Hence, the reasons for promoting the secondary-level vocational training at the expense of investments in higher education were rather ideological and “skills acquired under communism were excessively specialized and non-transferable from specific, outdated technologies. This rendered much of the human capital obsolete with the advent of the transition” (Campos & Jolliffe, 2004; Vujčić & Šošić, 2007). Such a characteristic egalitarian wage structure affected productivity and created a gap of “insufficient higher education potential at the expense of secondary-level vocational training investments” (Ibid.) This gap has affected the following outcomes both in Macedonia and Croatia, and it created additional challenges and

regressions, once global circumstances and technology demands had emerged rapidly in the global multi-polar world.

Back in the 1990s, with the end of the Cold War and the fall of the Berlin wall, the German economic unification of West and East Germany emerged, so new lessons could be learned, as well. Before German unification, the West German structure and dynamics of wages and mobility for different kinds of jobs in plants under private ownership, during the 1990s were different from those in East Germany". (Holger, Lutz, & Gartner, 2005) One of the reasons for such an imbalance was the fact that "during the 1970s and 1980s, the unions were pursuing an excessively egalitarian wage policy in West Germany" (Fitzenberger et all, 2001) At the same time, East German markets created gaps of applicable skill qualifications. As a consequence, "the unification shock in 1991 has led to a massive depreciation of human capital and wage dispersion, suggesting convergence in the wage levels between East and West Germany" (Kohn, 2006).

Since then, many challenges have been overcome and new ones have arisen, however the lessons of these past experiences are worth acknowledging as they have bridged the gap between recent political and economic challenges. The effort of the German policy-makers to consolidate the two different systems, their markets and populations which had grown apart and were unequally based, can be seen as an indicator of the strength and potential of joint action and comprehensive decision-making. Moreover, this included the potential of citizens in key policy-making processes with respect towards their 'capital' as human beings. The effects of such synergized management can be highly applicable, and can influence the rise of a productive workforce and an increase in employment, as well.

The experiences of the recent past have demonstrated that at the end of 20th and beginning of 21st century, there was an imbalance between educational structure, knowledge competences, qualifications and labor market demands which created new gaps and economic difficulties. Although the convergence of egalitarian wage structures was fostered, new challenges were created concerning the return of investment in education. Within a previously created transitional environment, once the higher education Bologna reforms were adopted and started to be implemented, the gap between the 'old' and 'new'

educational systems, the compatibility of qualifications and the lack of relevant interpretation of the re-structuring processes, affected the Universities as well as the State capacities to cope with competitive pressure and market forces on the global market.

Within the new Bologna transformative concept, the role of the universities as the main transmitters of knowledge and human capital have increased and shifted their responsibilities and tasks towards wider national, labor and economic challenges. Furthermore, the position and the role of the universities and their cooperation with the state and the business community gained a new perspective once the definition of Burton Clark's triangle of the three coordinating forces of the university system: academic, state and the market (Clark, 1983), came into force. According to Clark's triangle, (Figure.1) the higher education systems resulted from a triangle of forces: professional-collegial; governmental-managerial and market (Kogan et al. 2006).

Burton Clark suggests that three kinds of stakeholders play important roles in the university system: one is the university itself (academia); the second is the market (society) or the general public and the third stakeholder is the government (state) (Yamamoto, 2004). As a result, Burton Clark's triangular model attempts to illustrate the relationship between the state, the market and the academy, estimating the influence of these three factors, according to their interests and pressures, whereby: "1) state priority reflects public needs and desires for higher education programs and services, often as expressed by state officials, but also by civic leaders outside government; 2) academic concerns involve the issues and interest of the academic community, particularly professors and administrators; 3) market forces, cover customer needs and the demands of students, parents and businesses, as well as other clients of colleges and universities" (Burke, 2004). State priorities represent political accountability; academic concerns reflect professional accountability and market forces push market accountability (Ibid.) In such a framework, "social change impacts on the university, and at the same time works through the national government, the market and science. Hence, in the face of such pressure and demands, the university is expected to use its expert knowledge to coordinate its various functions" (Kogan & Teichler, 2007).

Within this position, the role of the universities attached equal importance to the decision-making process concerning business and economic developments. Moreover, its importance has rapidly increased with new global economic shifts, market forces and knowledge accountability on the global market. In addition, the lack of a dialogue between the state, the universities and the market is demonstrated as being a key influence in higher educational systems, as well as models of salary structure which impact on economic growth in general. The lack of a dialogue and cooperation between the state and its citizens within the former Yugoslavia or the separation of East and West Germany had created imbalances which were difficult to overcome. However, once the importance of the dialogue was acknowledged, joint and comprehensive decision-making could be practiced in order to reach positive results concerning state priorities. This acknowledged the fact that an open and effective dialogue and cooperation between all relevant participants – the state, the universities, the market and business communities and moreover: the students are rather a necessity than just a concept. Without doubt, these practices can generate relevant analyses of contemporary outcomes, can offer different perspectives of ‘dealing with the past’ models and can deliver a variety of interpretations, ideas and solutions to contemporary challenges. Furthermore, putting the Burton Clark triangle into practice can support the academic transmission of power from local to national or state levels, to enforce the research exchange and to design internationally attractive curriculums (Clark, 1983). In addition, acknowledging the role of student participation in decision-making processes concerning the design of attractive curriculums and further higher education’ development, can be an addition to the “triangle” of cooperation. Putting these mechanisms into practice is a challenging and demanding responsibility and good management practices of key importance for delivering positive outcomes.

## **The Internationalization of Higher Education as a Rationale Investment in Human Capital**

In order to understand the potential of human capital as a stimulant of economic development, it is important to understand

that each investment in individual human capital has the potential to facilitate positive outcomes. Ogunade Adeyemi has commented that human development in economic terms largely depends upon the physical and human capital stock. (Ogunade, 2011) Moreover, Ogunade suggests that “human capital represents the assets that each individual develops to enhance economic productivity. As such, human capital is concerned with the wholesome adoption of the policies of education and development. In such a framework, the provision of formal education is seen as a productive investment in human capital, which sometimes is considered as equally or even more equally worthwhile than that of physical capital” (Ibid.).

Furthermore, the Organization for Economic Co-operation and Development: OECD, defines human capital as: “the knowledge, skills, competencies and attributes embodied in individuals that facilitate the creation of personal, social and economic well-being” (OECD, 2001). Hence, human capital is applied to gain an understanding of individual productivity and economic gain at a national, state, regional, community and company level. “In addition to knowledge investments, knowledge distribution through formal and informal networks is essential to economic performance. Also required is tacit knowledge, including the skills to use and adapt codified knowledge, which underlines the importance of continuous learning by individuals and firms” (Ibid.).

Due to the need for qualified, applicable and compatible human capital resources in the modern, innovative and ‘knowledge-based’ global environment, the universities, the state and the market need to place an equal amount of respect to previously accumulated knowledge as well as to the contemporary development of formal and informal education, skills and qualifications. The economic impulses of both the private and public sectors, which correspond with national decision-making processes implies the need for relevant and adjustable market qualifications and skills. In this regard, joint strategic actions can increase the population’s productivity and accelerate the decline of the unemployment rate. One of the key facilitators of these challenges with a necessary potential to address a variety of challenges is the internationalization of higher education.

“Albach, Reisberg and Rumbley stated that Globalization, a key reality of the 21<sup>st</sup> century, has already profoundly influenced higher

education. We define globalization as the reality shaped by an increasingly integrated world economy, new information and communications technology, the emergence of an international knowledge network and the role of the English language, and other forces beyond the control of academic institutions. Internationalization is defined as the variety of policies and programs that universities and governments implement to respond to globalization" (De Wit, 2011).

The internationalization of higher education can be a valuable tool for bridging the gaps between the state, the universities and the market, due to its role as being considered as a joint academic and economic process. As an outcome of the process of the convergence of higher education systems across Europe, which was initiated both with the Bologna process reforms and the European market economies, the internationalization of higher education is seen as a "positive development: more explicit, coordinated, interactive and proactive; more strategically focused on multilateral partnerships; continuing professionalism; more focused on the world outside Europe; more attention given to internationalization of the curriculum; and more attention towards to the quality assurance of internationalization" (De Wit, 2011). Furthermore, Roger Dale and Steve Robertson pointed out that the internationalization of higher education should be transmitted through the national sector and institutional level as a process of the integrating international, intercultural or global dimension (Dale & Robertson, 2009).

The internationalization of higher education is even more relevant since it addresses the process of globalization and enables us to see higher education development above its national context. This can be an additional motivation for universities to shape the development of formal and informal education skills, knowledge and qualifications which increase the productivity and international competitiveness. "International mobility programs are increasingly used to boost the economy without losing sight of their traditional objectives. As a result, the European Higher Education Area targeted by the Bologna Process is more than just a regional variation of internationalization. It has increasingly becoming a response to the challenges of globalization" (Isserstedt & Schintzler, 2005).

Furthermore, the internationalization of higher education respects previously accumulated knowledge. However, this interaction and fusion between 'past' and 'currently' gained experience, knowledge qualifications and skills can be a big challenge. In this rapidly shifting and progressive political and economic world, the integration of the "old" positive aspects as well as previously accumulated qualifications and skills into the 'new' modern post capitalistic system, can be considered as an attempt to fill the gap between the generations, to assimilate the education of all citizens and to foster their inclusion in the employment market.

One of the key UN Millennium goals also addresses this challenge. The global focus to "achieve universal primary education" not only set the basis of further educational development from primary up to higher education, but also emphasized the role of all relevant key influences: the policy-makers, civil society, and private sector, thereby: "Removing barriers, outside and within education systems, so as to provide equitable educational and learning opportunities for all children, since knowledge and education are key factors for sustained, inclusive and equitable economic growth and for the achievement of all the Millennium Development Goals, through continued political emphasis on education and by promoting, with the support of the international community, civil society and the private sector..." (UN Resolution, 2010)

With this in mind, education from early childhood to the training of an ageing workforce and its labor market adaptability which stimulates investment in human capital is a challenging process for post-transitional or developing societies such as Macedonia and Croatia as well, (although, Croatia recently became the 28<sup>th</sup> EU member state). The rationalization behind investment in education and human capital is a challenge for a developed economy and an EU member state such as Germany, too. But since Germany marks progressive economic growth and manages to deliver a stable market economy, which impacts on the reduction of unemployment, a comparative approach towards these three countries aims to detect the key challenges and perspectives for reaching measurable and visible economic growth as well as a functional market economy. This comparative approach aims to emphasize the role of management in addressing the key national and international challenges, such as: the decline of the unemployment rate, the

modernization of higher education or the increase of competitiveness in the global market. From this perspective, the modernization of educational systems, especially higher education systems is considered as key priority of the transformative processes of any market economy, which affects the EU accelerating processes as well.

### **Cross-Country Comparative Analyses: Macedonia, Croatia and Germany**

In order to examine the results of the ‘knowledge economy’ of the three countries we have chosen as our case studies: Macedonia, Croatia and Germany. We will use two composite indicators: World Bank’ rankings of the Knowledge Economy Index (KEI) and the Knowledge Index (KI). The indexes are based on the measurements of the four basic “pillars” of the knowledge economy: Economic Incentive and the Institutional Regime (EIR); Innovation and Technological Adoption; Education and Training; Information and Communications Technologies (ICT) Infrastructure; Economic Incentive Regime, Education, Innovation and ICT (The World Bank, KAM, 2012).

The data available in Table 1 shows that Croatia by 2012 had made little progress in the rankings of this ‘knowledge based’ economy, by climbing only one position higher to the 28<sup>th</sup> place. The Republic of Macedonia has progressed four places since 2000 and it is now placed 34<sup>th</sup> out of 46. Analogous to Macedonia and Croatia, Germany is ranked in 6<sup>th</sup> place in Europe, moving 5 places, due to the progress in the Innovation and ICT pillar. If we compare the latest available World Bank data for long-term unemployment (% of total unemployment, referring to the number of people with continuous periods of unemployment extending for a year or longer (World Development Indicators) available in Table 2, we will notice the different rates between Macedonia and both Croatia and Germany, with a higher percentage of long-term unemployment of 83.1 (in 2010), which was almost double the percentage of Croatia and Germany. These figures correlate with the total unemployment rate in these three countries (% of total labor force), which refers to the share of the labor force that is out of work

but available for and seeking employment (World Bank, Labor Market database). According to the figures in Table 3, Macedonia differs in its unemployment ranking, compared to Croatia and Germany. However, according to the latest available data, Macedonia registered a small decline in the unemployment rate from 32.0 to 29.90 (Table 3). In this regard, it is important to stay focused on those management practices which have been and can continue to be strengthened so that education and 'knowledge' based capacities can be improved. The quality of research and innovations activities can be stimulated, the rate of unemployment can fall, and accordingly, stable economic growth can be delivered. One of the key human capital management trends shows that "in order to meet business challenges, increase the growth of the organization, and keep customers happy, the right talent must be hired, retained, deployed, developed, and engaged" (Lombardi & Laurano, 2013). Additionally, any incompetent management of human capital can impact on the structural instability of the labor market. The lack of efficient management capacities weaken practical performance and affect the slow growth of human capital. Germany for example, faced "weak growth performance, caused by decreasing working hours and the slow growth of human capital". (Klös & Plünnecke, 2003) According to Klös & Plünnecke, two main factors for poor investment in human capital were: the low skills of German students, and low private rates of investment in education. Consequently, when market forces played a more dominant role, private rates of investment converged and consequently, international differences in skills played an important role and caused differences in investment in higher education (Ibid.). However, strengthening the management capacities towards the practical implementation of cooperation between the universities, state and the market (business community; the small and medium enterprises), encourages a diverse "triangle" of inputs concerning the design of attractive curriculums, research exchange activities, fostering mobility, endorsing practical learning, and accelerating the life-long learning agenda, which has not only affected the employment rate in Germany, but has also stimulated the country's economic growth, its global competitiveness and the functionality of its market economy.

## **The ‘Top-Down’ vis-à-vis the ‘Bottom-Up’ Management Approaches**

In one paper Dimitar Eftimoski has noted that: “economic growth is successfully converted into quality of living if it generates a higher level of employment, provides greater security of the population, makes possible a more equal distribution of income, makes the development of democracy possible and enhances human rights and freedoms” (Eftimoski, 2006). Moreover, “the access of individuals to the capital market and to information can also foster the state reallocation of funds anticipated for human development, to those activities where most individuals would benefit. In this manner, the state can create equal chances and possibilities for all individuals through an equal distribution of funds anticipated for human development” (Ibid.)

The management of human capital, good governance practices, as well as economic policies significantly affects the rationalization behind education and human capital investments, as much as it affects the business impulses and implications. In order to cope with the challenges of rationalization towards investments in education and human capital, the ‘bottom-up’ management approach in interaction with ‘top-down’ management, can be considered as a valuable addition to practical performances. The interaction of ‘top down’ and ‘bottom-up’ management might be an effective and efficient approach since it fosters a dialogue and effective cooperation between the relevant actors and participants of the decision-making processes.

The Republic of Macedonia, as an aspiring EU member state, is facing an even more demanding responsibility to address the challenges of good cooperation policies, since it was obliged to fulfill the Copenhagen economic accession criteria approved by the European Council in 1993. Due to these criteria, acceding countries are required, among other things, to be: “(i) functioning market economies, and (ii) to have, by the date of accession, the capacity to cope with competition and market forces within the EU (European Council in Copenhagen, 1993).

Therefore, choosing the right management approach can significantly affect the scope of the existing challenges. A ‘top-down’ management approach is most common and this is still very applicable within organizations, institution, enterprises, and of course the state. It

generates guidelines, information, plans and objectives which are inserted by 'top management'. The flow of information, overall goals, ideas for general growth, and adopted strategies are implemented from the top of the structure to lower levels, referring to the participants (citizens, students). However, the 'top-down' management is only effective when collaboration between top management (the state, universities and the market) and lower level participants is effective as well. Therefore, reaching the necessary quality of collaboration and dialogue is the most challenging aspect of the top-down management approach, since the 'team members of the triangle: state, universities and market should be satisfied and motivated in a respectful manner as well as the students/ citizens. Hence, the work of the universities, business or policy-makers should be highly responsible, compound and dedicated to founding the best mechanisms to amortize the gaps of unemployment as well as to reduce it. In this regard, rational investments in education and human capital should be integrated through the "top-down" management approach when the aim is to adopt and implement broader plans and strategies for reaching more effective and sustainable results and to define the key contemporary deprivations.

However, due to the need of performing effective practices which can generate national and economic growth and can meet many "quality of life" challenges of citizens, the positive aspects of the 'bottom-up' management approach can also be considered as a helpful and effective tool. The bottom-up approach "implies proactive team input in the project executing process and team members are invited to participate in every step of the management process" (Filev, 2008). In this regard, the role of students can shift from passive to active influencers or contributors to the comprehensive 'triangle' cooperation among the universities, the state and the market. The bottom-up aspects of contemporary challenges and deprivations concerning the rational investments in education and human capital can be even crucial for transparent and productive decision making which can lead to joint adopted frameworks, guidance or strategies. Better and more proactive involvement of students in the governance of higher education is recommended by the European Student Union as well (Bartolo, 2009). Moreover, students must be considered as equal partners in governance involved at all levels of decision-making (*Ibid.*)

Therefore, the interactive approach of 'top-down' and 'bottom-up' management is considered as an effective and promising approach for bridging the interests between the active participants of the 'triangle'. In this regards, it is difficult to reach these challenges. This interactive approach requires great quality of communication, collaboration, transparent dialogue, an open-minded platform and 'knowledge based' experience. We encourage such a framework for its variety of aspects, interpretations, ideas and solutions and therefore the final joint outcome will be the most effective one. Different aspects are welcomed from the civil and non-governmental sector as well: such as think-tanks, NGOs, and media representatives. The benefits of this approach affect all the actors who are involved: citizens, institutions and the state. As a result, a jointly adopted framework or strategies can significantly influence the progress of 'knowledge' based societies.

## Conclusion

The Republic of Macedonia as a post-transitional country needs to implement effective and comprehensive policies towards investments in education and human capital, in order to address the key challenge of unemployment, and foster economic growth. In this regard, all relevant actors - the State, universities, the business community as well as students have a joint responsibility to encourage the cooperative platform and to strengthen management capacities.

Croatia, although a new EU member state, faces similar challenges regarding the "lack of awareness of the effects of public policies which can influence innovation activity and the level of technological sophistication, alongside innovation, financing and scientific and technological collaboration, as links between the enterprises and the innovation infrastructure" (Švaljek, 2012). According to Švaljek, "one of the targeting key drivers for increasing the competitiveness of the Croatian economy and its macroeconomic stability is the innovative activity of the enterprises as well as the improvement of the innovation infrastructure of Croatia, with a special focus on the importance of human capital in terms of education and skills" (Ibid.). As a result, both Croatia and Macedonia are confronted with crucial challenges in developing

links between the enterprises and ‘knowledge’ infrastructures and increasing investments in innovations, as key management practice towards the decline of the unemployment rate. However, in order for the states to cope with the EU or global market economy implications, it is necessary to deliver constructive dialogues and cooperation among all relevant key influencers on the functioning of the market economy.

Germany today has a leading role in the European economy, due to its major shift towards a collaborative and comprehensive management approach which has the potential to generate economic growth and encourage innovation and research practices. Furthermore, “this increased focus on achieving economic benefits has shaped higher education policies on internationalization in Germany as well as across Europe. Globalization has even altered the Europeanization of higher education. European mobility programs once stood for encounters and reciprocal exchanges aimed at enhancing the cohesion of peripheral member states”. The key strategy of the EU is to make “the most competitive and dynamic knowledge based economic area in the world” and with regard to this priority, other aspiring or current EU member states should shape its ‘knowledge-based economic policies.

The process of the internationalization of higher education can significantly contribute to the rise of quality investments in human capital as well. It can also affect the wage structure models and its effects on educational investments. The investments in technology, research and innovations in accordance with the proper inclusion of the small and medium enterprises and their implications, can provide sustainable background for more effective development of the micro and macroeconomic policies. In line with the triangle produced by Burton Clark (Figure 1, 1983), who outlined the three coordinating forces of the university system (academic oligarchy, state and market), the changing focus in the internationalization of higher education can be illustrated in terms of actors, strategies and objectives. The laws of the market have a major influence on actors. Internationalization is no longer a marginal phenomenon, but rather an increasingly systematic approach toward achieving economic influence using marketing measures (Isserstedt & Schintzer, 2005).

Student participation in the decision-making processes is seen as another addition to the shape and adoption of best practice mechanisms

and strategies for reaching better outcomes of education and human capital investments. Moreover, an interaction between "top-down" and "bottom-up" management approaches can be an important stimulator for fostering the internationalization of higher education into practice, due to its potential to increase the engagement of students in decision-making processes and shaping the joint interests of state, the universities and the business community. Bryan Tracy stated that "Achieving the highest possible return on human capital must be every manager's goal" (Tracy, 2011). Therefore, strong and efficient management can endorse the joint responsibilities of all relevant actors who have a duty to deliver the best results and practices of a functional market economy and to strengthen the capacity of 'knowledge' based economies as a key competitive strategy on the global market.

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Figure 1.  
Illustration of the  
B. Clark triangle (1983).  
Source: Isserstedt &  
Schintzer, 2005.  
Internationalization of  
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5. Federal ministry of  
education and research.

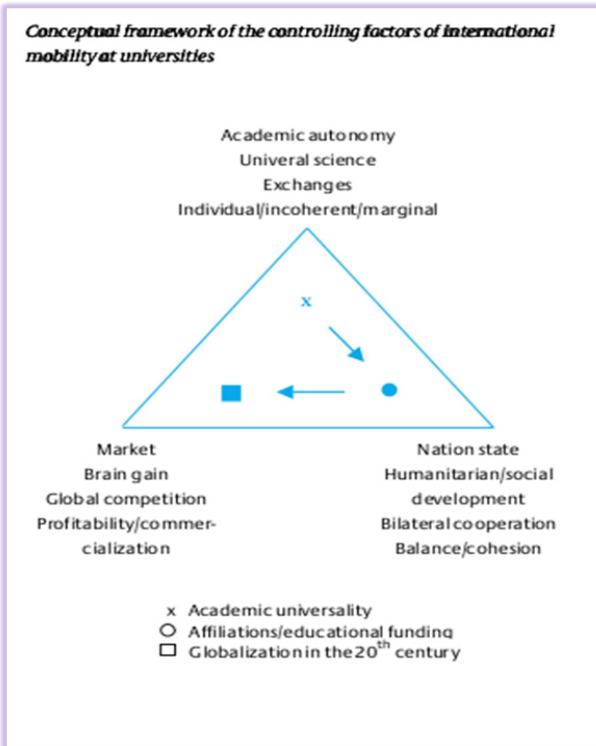


Table 1. Knowledge Economy Index (KEI) 2012 Rankings (46 total)

Rank		Country	KEI	KI	Economic Incentive Regime	Innovation	Education	ICT
1		Sweden	9.43	9.38	9.58	9.74	8.92	9.49
5		Norway	9.11	8.99	9.47	9.01	9.43	8.53
6	+5	Germany	8.90	8.83	9.10	9.11	8.20	9.17
28	+1	Croatia	7.29	7.27	7.35	7.66	6.15	8.00
33	-1	Ukraine	5.73	6.33	3.95	5.76	8.26	4.96
34	+4	Macedonia	5.65	5.63	5.73	4.99	5.15	6.74
46	-1	Tajikistan	3.13	3.33	2.55	2.18	4.66	3.14

The data is available at the official website of World Bank, KAM 2012: [www.worldbank.org/kam](http://www.worldbank.org/kam). The ranking includes 46 countries from Europe and Central Asia. The given data is not complete and it refers to the three countries which are the case study of this paper: Macedonia, Germany and Croatia

Table 2. KEI Ranking: *Long-term unemployment (% of total unemployment)*

Country name	<u>2008</u>	<u>2009</u>	<u>2010</u>
<b>Croatia</b>	63.0	56.2	44.4
<b>Germany</b>	52.6	45.5	47.4
<b>Macedonia</b>	84.9	81.6	83.1

Note: The available data is retrieved from <http://data.worldbank.org/indicator/sl.uem.ltrm.zs/countries>; The data for the long-term unemployment of the last 2 years is not available.

Table 3. *KEI Ranking, Unemployment, total (% of total labor force)*

Country name	<u>2008</u>	<u>2009</u>	<u>2010</u>
<b>Croatia</b>	8.4	9.0	11.8
<b>Germany</b>	7.5	7.7	7.1
<b>Macedonia</b>	33.8	32.2	32.0 (2013: 29.90)

Note: The available data is retrieved from: <http://data.worldbank.org/indicator/sl.uem.ltrm.zs/> countries. Additional data of the long-term unemployment from the last 2 years is not available from the same source. The data of unemployment for the Republic of Macedonia is additionally retrieved from state statistical office of [www.tradingeconomies.com](http://www.tradingeconomies.com). This data indicates 31.2 rate for 2012 and 29.90 percent in the first quarter of 2013.



# Economic and Financial Aspects of the EU Crisis



## **The Challenges of Implementation of the Fiscal Stability Treaty**

*Zoran Sapurik, Ninko Kostovski, Elena Klisarovska*

### **Abstract**

*The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, known also as the Fiscal Stability Treaty or EU Fiscal Pact, entered into force on 1 January 2013, following the successful ratification by twelve of the sixteen signatory states. The Treaty introduced new rules in the Euro Zone and into the EU as a whole. Establishing strict requirements for budget deficit, it calls for strong fiscal discipline and for real fiscal austerity in many EU member states. , which makes this Treaty one of the biggest challenges for the EU in its sixty-two years of history. From now on the budgets of the EU states will have to follow very specific fiscal objectives and criteria. The Treaty is a legally binding act that sets new pillars for building a new economic and political profile of the EU. Moreover, it will influence the countries, which have not signed the Treaty yet, such as the United Kingdom and the Czech Republic, as well as the candidate states. This paper tries to put more light on the prospects of the Fiscal Compact and the related measures and on their impact on the economic, legal and the political future of the Union. It focuses on the implementation challenges of the Treaty and the new measures that aim for stronger cohesion within the Euro zone and further afield.*

*Keywords: EU, budget, cohesion, common economic policy, member states, future challenges, EU institutions, reforms.*

## Introduction

The situation in the major European economies and the magnitude of the financial crisis call for urgent reforms of the economical, monetary and fiscal domains of the EU. The changes will inevitably entail deep cuts within the fiscal systems of states in the Euro zone and those outside it. Even the candidate countries will have to introduce similar if not the same measures in the light of their prospective membership. Academics agree that “monetary union can be a source of substantial benefits for their member countries” (Bukowski, 2011). Although, not without some drawbacks. Since the members of the Euro zone no longer have their own currencies and their respective monetary policies, their macroeconomic stabilization depends on market adjustments and on their fiscal policies. This should not present a significant problem for the developed EU states, as soon as their markets are open. Their fiscal and budgetary discipline served as benchmarks for many countries outside the EU, not to mention that one of the major objections to the faster introduction of the countries of the Western Balkans into the EU was precisely the lack of a proven record of their monetary and budgetary discipline. If this should be the case, then what happened in the meantime and why the existence of the pervasive financial crisis that threatens the very basis of the EU? Many argue that the crisis is a result of “the failure of market adjustment mechanisms and that, in fact, the EU market was never entirely opened up. The proclaimed high mobility of labour and capital, the openness of economies, production diversification and the flexibility of markets, prices and wages never happened” (Bukowski, 2011). In addition to this, without the virtues of a central bank, the governments of the states within the Euro zone had to maintain the macro-economic stability only by the means of the fiscal policy.

Pursuing the (over) ambitious Brussels programs, like that of making “Europe the most competitive and knowledge driven economy” and under the pressure of the never-ending series of election terms at all levels of government, they overextended employment in the sectors that they controlled, namely: the administration, education and social services. Consequently, the majority of the Euro Zone countries started to make huge budget deficits, financed by foreign debt. It was not a

difficult task; the euro had a better image than the dollar so investors were eager to buy their bonds. The Pandora's Box of the sovereign debt crisis was opened when the investors became suspicious that the less developed countries of the EU would not be able to repay the overdue portions of their huge debts due to the prolonged worldwide recession. The capital markets all of a sudden were very rigorous in assessing the risks related to their future debt, so they were not able to borrow at "normal" interest rates any more. Some economists argue that this was quite predictable since the only way for a monetary union to hold together long term is to have a strict and centralized fiscal policy at some supranational level. They claim that "a simple coordination of national policies is not enough" (Raluca et al. 2011). "While any good fiscal policy is expected to stimulate stable and sustainable economic growth, the crises in the second decade, in the case of the EU imposed an urgent need for consolidation of the public finances. In the case of some countries, there was also the need for slowing down their public debt and restoration of the elementary budgetary discipline and macroeconomic sustainability" (Postula, 2012).

One of the most important achievements towards the strengthening of fiscal cohesion of the EU was the adoption of The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, now known as Treaty on Stability, or Fiscal Compact. The Treaty entered into force on 1 January 2013 after ratification by twelve of the sixteen signatory states. It was good news for the euro-optimists and bad news for the euro-sceptics.

The Treaty introduced new rules and called for entirely new fiscal behaviour. Despite scepticism from the camp of the euro-sceptics, the European Council managed to pass the early measures necessary for the implementation of the Treaty. Consequently, the expectations that the Treaty will bring much stronger financial discipline seem realistic. However, the strict budgetary discipline of all actors, the private sector, the banks, the unions and the governments started to backfire in practically all EU countries. That is why this document can easily become the major source of future challenges for the entire EU. Academics and politicians, both for and against the Treaty are already entrenching their positions. They either claim the Treaty as a brave, new and modern document that will positively impact on the EU future, or

see it as just another futile step in a row that could even dangerously threaten to change the original idea of the European integration of *sovereign* constituencies. The former interpretation stresses the need for a stronger and more centralized fiscal policy and discipline and wide cost cuts in order to re-establish the competitiveness and the agility of the EU economy, without the need to create some supra-financial power. Some of them said that it is simply legally impossible and next to treason! The latter approach also stresses the need for greater flexibility in the member countries in the budget setting as the major prerequisite for the very same objective: competitiveness and the agility of their respective national economies.

### **The Challenges Arising from the Implementation of the Treaty**

The EU 2014 – 2020 Framework Budget provided the first occasion in which the numerous challenges related to the Treaty began to emerge. The first draft of the budget proposed by the European Commission was above a trillion euro and after a fierce debate in the European Parliament and with strong opposition from some states, especially from the UK, the budget was reduced to 960 billion. This was unprecedented. Moreover, in the future, the EU and its member states will have to take various additional long-term measures in response to the prolonged economic and financial crisis, mostly unpleasant cost cuts of various kinds. The future budgets will have to be orientated towards the creation of agile economies, economic growth, private investments and the creation of new jobs. However, the opponents of the budget cut, stressed that the unemployment rate among the young is already 25%, while investment in education and in other “youth related issues” is already at a meagre 0.8% of the current EU budget. They claim that the dissatisfaction of young people is already a major obstacle for further radical spending cuts by any government at any level in the entire EU. The tasks of creating new jobs to mitigate the negative social consequences arising from the crisis, together with the wide budget cuts and the better use of funds, are for many unsustainable. It can only be achieved by leaving others with a smaller piece of the budget cake.

Indeed, many electorates have rejected the statement “more quality than quantity”—which means that proponents of this idea are left with the choice of either having to abandon such a policy or to step down from power. Moreover, any serious effort towards the improvement of budget spending calls for mighty, but precise financial instruments, both monetary and fiscal, together with the free movement of labour and private capital on the open market. The protagonists have been found lacking in all these instruments. The Treaty introduced some instruments for “automatic” corrections in the case of the breaching of its provisions, but the major problems that caused the crisis: the lack of monetary instruments and locked markets have remained and have even increased. The labour market was further restricted due to the pervasive negative sentiments towards immigrants who were accused of “stealing scarce jobs”. This was an approach employed by the conservative parties in practically all of the EU countries not just in the crippled Mediterranean group. Their governments were unable to cut wages by a simple devaluation of their national currency thereby re-establishing their competitiveness and improving their damaged reputation as reliable debtors. Without their currencies, these countries were hopelessly dependent on the euro. The proposal put forward by George Soros, namely common EU bonds was rejected. Instead, Brussels and Frankfurt administered a “homeopathic” therapy based on even more sovereign debt. Moreover, Brussels and Frankfurt claimed that stepping out from the Euro zone, an option that some countries were contemplating at least as a last resort, is not an option and will only be understood as a departure from the EU. The government of Cyprus decided to undertake an unprecedented move in order to escape the bankruptcy of its banking sector by nationalizing a considerable portion of the savings deposited in the Cypriot banks. This move, masterminded and supported by the major EU players Germany and France, threatens to leave the EU out of the international capital routes for decades in the future. A number of private investors and rich celebrities started to leave the EU zone. The most notable example was that of Gerard Depardieu, the famous French actor, who left for Russia even giving up his “precious” EU citizenship when faced with a 75% personal tax rate in Belgium. Private capital has no ear for the Brussels, Paris or Berlin pro EU tirades, and many warned that radical fiscal operations could cost

the EU a lot.

Meanwhile, the proponents of the Treaty have taken entirely different positions. For them it would be a “one-time-only measure” and that the EU now introduces a variety of tools for the correction of deviations in the budgets that will bring sustainable harmonization of the fiscal policies of the various EU institutions and the member states. They stress that despite some opposition, the member states all agree to build a new budgetary policy, particularly having in mind that they will preserve some sort of freedom in “determining the level of budget reductions and the dynamics of the implementation”. They believe that the statement by the Euro Area heads of countries of December 2011 about the “reinforced architecture for new economic and monetary union” reaffirms the determination for redefinition of many aspects of the common economic activities and that the Treaty is an outcome of this determination that opens new possibilities for a new common coherence in the monetary and the economic domains. They even claim that it shows a road map for solving the numerous future problems arising from the economic crises and opens possibilities for the practical implementation of the principle of solidarity in the EU.

## **The Future of the Treaty**

Recently, in February 2013, the European Council adopted *Conclusions* that express the determination of the Council to build a new governance model that will allow structural reforms aimed at consolidating and strengthening fiscal discipline across the Union. In the *Conclusions*, the heads of the states stipulate that the meticulous and on-going observation of the fiscal, financial and economic activities in the member states and effective coordination of all stakeholders will have a crucial impact on the future macroeconomic stability of the EU and its countries. However, how realistic is the requirement that the budgets of the member states should be balanced or in a surplus? The Treaty stipulates the obligation for the total deficit to be not more than 3% of GDP and the level of structural deficit not more than 1% of GDP and that the public debt should not exceed 60% of GDP of the countries. Moreover, the one year time window given to the states to adjust their

respective legislations after the Treaty enters into force is simply not achievable, claim the sceptics. This dangerous step can throw the whole of Europe into an endless vicious recession. The pauperized electorates will then start seeing the EU idea as an obsolete and naïve daydream that threatens their personal destiny and, disappointed, will start looking for quick fixes. It is not difficult to predict what political forces will offer them. If that happens, there will be many "Golden Dawns" and red nights of fire such as those in the 2011 riots all around the Europe. Last, but not the least argument in their favour, came from the scientists who found that the main Harvard paper "Growth in a Time of Debt" that the EU used to fabricate its one-size-fits-all austerity package was based on erroneous formulae (Austerity after Reinhart and Rogoff, 2013).

## **Strengthening the Functions of EU Institutions**

It is a very unrealistic and pessimistic scenario, the World is not the same, the EU idea has already changed the people in a positive manner, argue the EU supporters. Since 1951, the cohesion of the EU has been strengthened continuously. The network of EU institutions is subject to continuous improvement and upgrading to serve as a reliable pillar of cohesion within the EU and that "institutions of the EU directly reflect its most fundamental goals" (Peterson & Shackleton, 2005). The Fiscal Treaty only continued that process, further empowering these institutions in order to better manage all common policies including those dealing with the economic and fiscal governance. This is even more important in a period of crisis. "There is almost a consensus in the EU that fundamental institutional reforms are needed to ensure that the enlarged EU could also function effectively" (Odenaren, 2005).

The Treaty promotes a further strengthening of the role of the common institutions, in the first place, the European Commission and the Court of Justice. The Commission, according to the Treaty observes the enforcement of the Treaty and plays a proactive role in the enforcement of measures and activities towards the implementation of the Treaty. The Court of Justice is entitled to impose sanctions for those member states which breach the Treaty. Despite the fact that some opposing attitudes believe that the Fiscal Stability Treaty, is not consistent with

the core EU legal framework (The Treaty on the European Union and the Treaty on the Function of the European Union), most of the EU member states generally support the new role of common institutions. However, for a better performance of the new rolls of the European Union's institutions, it would be better to make some changes to the current secondary EU legislation that would create the legal framework for a stronger position for the Commission, together with that of the European Central Bank, the Council of Europe and the European Court of Justice. The European Parliament should also get more power in the economic, monetary and financial areas. It would only improve the "transparency" and the democratic capacity of the EU in these sensitive domains. The recent debate on the budgetary framework for the period 2014–2020, clearly demonstrated that need. Many argue that these new powers of the EU central institutions could be derived from the current "constitutional" acts, mainly by interventions at the level of directives and other secondary legislation. Others think that there is a need for a radical change of the EU principals, a rather painful and unpredictable process that many would try to avoid if at all possible. No matter who is right or wrong on this legal issue, for the successful implementation of the new economic governance, the coordination between the EU institutions, especially between the EU Commission, the Council of Europe, the European Parliament and the European Central Bank is critical. The new system should not be dependent on the goodwill of the political leaders but be self-sustainable over a longer period.

## Conclusion

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union aims towards solving more effectively the numerous problems imposed by the economic crisis in the EU area. However, the number of issues and problems that arise from its implementation (such as the new EU economic governance, or the strengthening of the position of EU institutions) is sometimes overwhelming. One of the most critical issues is whether or not the new roles can be introduced based on a simple transfer of the competencies between the various players at an EU level and those at the regional and

the national level in order to quickly redefine the new roles of the EU in the monetary and fiscal domains. The current EU leaders think that the EU institutions already have enough power to undertake various urgent measures towards the re-establishment of a sustainable economic and monetary stability. The approaching federal parliamentary elections in Germany will send a clear message and will show whether or not people share the same opinions of their EU leaders. If a resounding 'yes' is registered, then the EU sceptics' camp will at least be silenced for a little while. If not, then the EU will have to deal with even harsher challenges. The management of the crisis in Cyprus confirmed that the coordination between the EU institutions could be (relatively) easy, together with the desired level of cooperation between the EU and the International Monetary Fund. On 16 March 2013, the European Commission, the European Central Bank and the International Monetary Fund agreed a ten billion Euro support package for Cyprus, making this country the latest member of the club of receivers of EU and IMF support, alongside Greece, Ireland, Portugal and Spain. The Parliament of Cyprus approved the Arrangement with the EU as a last resort to escaping from bankruptcy. However, some claim entirely different outcomes from this "Saving Private Cyprus" operation. Only time will tell who is right and who is wrong. No matter how much "freedom" is given to EU member states in the implementation of the Treaty, Germany and France will play the main roles in the implementation of the Treaty. These two countries will ultimately decide the destiny of the Treaty as well.

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## **The Potential Role of Development Banks in Solving the European Monetary Union Crisis**

*Lukasz Czernicki*

### **Abstract**

*The present crisis in the Eurozone is much more than a sovereign debt crisis. The Eurozone's southern periphery experienced strong capital inflows in the first decade of its membership in the currency union. However, these states, despite importing a large amount of foreign capital, did not sufficiently increase their export capacities in order to repay the foreign loans. Since the introduction of the euro, the economic production in Europe's peripheral countries has been excessively focused on domestic demand (non-tradable goods and services). Therefore solving economic problems in the Eurozone requires a structural shift in the peripheral states. Relying solely on austerity, as we have observed during the last two years, is not a sufficient way in which to defuse the crisis. It only concentrates on cutting the budget spending by neglecting the structural problems. In the first part of that paper we analyze the mechanism, which led to a buildup of imbalances in the European Monetary Union and its impact on the structure of production in the southern periphery. In the second part we argue that, due to problems in the private financial sector, the southern states should establish or assign new tasks for existing development banks to facilitate the change in their development model. In this connection we refer to the example of a German development bank - Kreditanstalt für Wiederaufbau - which played an important role in the reconstruction of the German economy after the Second World War. This paper, which focuses on theoretical analysis, is addressed not only to all those interested in solving the Eurozone economic problems, but also*

*to economists and politicians dealing with development and structural policy in non-EU countries.*

**Keywords:** Eurozone, euro area, EMU, crisis, imbalances, structural adjustment, development banks, Kreditanstalt für Wiederaufbau, southern periphery

## Introduction

The current crisis in the euro area is commonly associated with the sovereign debt crisis in the southern states of the EMU (Portugal, Greece, and Spain) as well as in Ireland. However, the public debt in relation to GDP rose, since the inception of the euro, only slightly in Portugal and Greece. In Spain and Ireland it was even significantly reduced. The public debt-to-GDP ratio in the afore-mentioned countries began to skyrocket first in the aftermath of the crisis (see figure 1).

In the literature another interpretation of the crisis in the EMU becomes more popular. The main problem of the Eurozone is seen in the divergent economic development in the “south” (Greece, Spain, Portugal, Italy) and “north” (among others: Germany, Holland, Luxemburg) of the EMU (see for instance: Chen et al., 2012; Sinn et al., 2012). This divergence manifests itself in two areas: first, the southern countries have been losing continually international competitiveness by experiencing at the same time a decade of strong domestic-demand led growth since the mid 1990s. Second, the decrease in competitiveness in connection with high current account deficits led to a buildup of strong negative external net positions in the southern EMU-states.

In this paper we first analyze the mechanism, which led to the imbalance between north and south countries and show up its consequences for the structure of economic production in the southern periphery. In the following section we provide an analysis of the monetary background for growing divergence in the EMU and derive two conclusions for further research. First, one of the reasons for cumulating imbalances in the EMU was the credit policy of the financial institutions in the southern countries. Second, the crisis led to strong distortions in the banking sector and the capital allocation in the southern economies has not been working properly since then. In the fourth section we

study the case of the German development bank - Kreditanstalt für Wiederaufbau (KfW). We show how KfW improved the credit access for those companies, which were excluded by the banking sector directly after the Second World War. In a further section, based on the example of KfW, we analyze how development banks in the southern states could contribute to the necessary structural change and thus to a reduction in the imbalances in the EMU. In the sixth section we summarize the results of this paper.

The following countries are commonly treated as the crisis states: Italy, Spain, Ireland, Portugal and Greece. In this paper we focus only to Portugal, Spain and Greece. They will be defined as "southern states", "southern periphery" or "PSG". These countries, while acknowledging the differences between them, have experienced strong capital inflows from abroad and, also due to this, have seriously lost their international competitiveness since the inception of the euro. Ireland's economic difficulties are mainly related to malinvestment by a strongly outsized banking sector. Italy, by contrast, has been losing its competitiveness steadily since the beginning of the 1990s but the international capital flows were not so relevant for economic development as in the case of the PSG. Its external imbalance as the share of GDP is much more modest than in the southern states (Chen et al., 2012, p. 4).

The countries, which went the opposite way in the EMU and have noted current account surpluses over a longer time and have been financing the southern periphery, are especially Germany, Austria, Holland, Luxemburg and France. They will be defined as "core countries" or "north states." However, France's current account has been mostly slightly negative since 2006, and its economic development, especially in the last few years, actually reminds one more of the economic development in the southern periphery. Nevertheless, since the inception of the euro, France has been one of the major "financiers" of the PSG-countries.

## **The Consequences of the Growing Divergence in the EMU (Real Economy Level)**

As mentioned in the introduction, the southern EMU countries had high current account deficits since the inception of the euro, which

led to a buildup of strong negative external net positions in these states. Usually, the main factor, which influences the current account, is the balance of trade.

At least since the debate about German reparations after the First World War, it was accepted, that a country (whole economy) exports capital only when it has a positive balance of trade (Cassel, 1926, p. 63); and conversely in the case of capital imports. In order to avoid crisis in connection with international capital flows (on the real economy level) the whole process must proceed in the following way: in the first phase the economy with a higher scarcity of capital (higher real interest rates) runs import surpluses. In the second phase, the economy with lower scarcity of capital has a positive balance of trade, which can be interpreted as a retransfer of former borrowed capital. Only when international capital flows follow this pattern could they be beneficial for involved countries. Foreign capital enables additional investments or consumption in the capital importing economy. The retransfer of the former exported capital includes usually interest rates, which are equivalent with additional income in the capital exporting country (Lechner, 1988, p. 376 et seq., similar by Metsel, 1999, p. 92 et seq.).

The southern EMU-states, since it was known they would join the euro, have started to run import surpluses. A substantial part of the additional import was made possible by the export surpluses of the core countries in the currency union (especially from Germany). This capital flow between north and south in the Eurozone was economically justified. In the southern states capital scarcity was larger. But, contrary to what many economists presumed, the real convergence, in order to enable the PSG-states to reduce high deficits on the balance of trade, has not occurred automatically. In the first decade of their membership in the currency union, the southern states used import surpluses to boost their consumption directly or indirectly - for additional investment in the non-tradable sector. Their export capabilities had hardly increased (see figures 2-4).

This overconsumption has also influenced the structure of production in the peripheral countries. Widening consumption was on the one hand feasible due to import surpluses, but on the other hand also national companies have responded to the growing internal demand and reoriented their output on it. Additional factors, which

played an important role for the structure of production in the southern periphery, as pointed by Chen et al. are: the nominal appreciation of the euro vis-à-vis the rest of the world, real appreciation in southern vis-à-vis northern economies, the rise of China and a deeper integration of Central and Eastern European countries with the rest of Europe or rising oil prices (Chen et al., 2012). It is well demonstrated in the comparison of GDP growth with the balance of trade data that economic development was driven by the non-tradable sector. The economies of the PSG were actually performing quite well in the first decade in the Eurozone, but their export capacities were stagnating.

As finally the economic crisis erupted, the sources, which fueled the growth, were erased. The domestic demand fell sharply due to austerity, diminishing consumption and the lack of the foreign financing. This could be also an explanation, why the current depression in the PSG is so deep. The consequence of the divergent economic development in the EMU is the, already mentioned, strong imbalance between south and north. The northern states have orientated their economies on foreign demand, and built up export surpluses, which partly flowed to the southern periphery. The opposite happened in the PSG, where producers lost competitiveness on international markets or reoriented their production on domestic demand. These countries are now unable to transfer the foreign capital that had been borrowed. The reduction of the imbalances in the currency union requires thus on one hand a reorientation on domestic demand or on new foreign markets in the northern countries – and this seems to be the easier part – but also allowing to build up import surpluses vis-à-vis the southern countries (retransfer of the borrowed capital). On the other hand – and this is more difficult – the southern countries have to switch from the consumption-led to a more export-led economic model.

## **The Monetary Dynamics behind the Crisis of the EMU**

The rebalancing of the EMU is a multi-level task and requires measures in different areas. Identifying the main problem of the southern countries in the area of weak export performance leads one

to naturally rethink, in the first place, the devaluation option. But this particular aspect will not be discussed any further in this paper. We focus here, instead, on the possible contribution of financial infrastructure to any necessary structural change. But first we study in this section how banking industry facilitates the rise of consumption in the non-tradable sector and shows up the consequences of their credit policy for financial intermediation since the outbreak of the crisis.

In a monetary economy the credit market determines mainly the aggregate production and demand for the labor force (Hankel, 1989, p. 186). Two factors were crucial for the development of credit markets in the PSG: easy monetary policy by national central banks (before the introduction of the euro) and then by the European Central Bank and capital flows from the core countries. These easy monetary conditions led to an extraordinary credit boom in the southern periphery. According to Brzoza-Brzezina, who analyzed the case of Greece, Ireland and Portugal, strong lending booms in these countries, with an annual growth of credit rates of 20-30%, began 3 - 4 years before adoption of the euro (Brzoza-Brzezina, 2005). This trend was continued in the EMU. What is not surprising, is that the rise in overall credit was connected with a massive increase of lending to households, especially housing loans. For example, in the period 2000 – 2009 the total credit to domestic households rose in Greece from 17.0 bn. to 119.6 bn. € (respectively 12,5% and 51,6% in relation to GDP). The amount of housing loans increased in that period from 11.3 bn. to 80.6 bn. € (Anthanassiou, 2007, p. 164). Therefore we can state, that a strong impulse for the reorientation of the production process on domestic demand originated from the credit market.

One can conclude that in the same way as the banking sector contributed to the swap to domestic demand-led growth, financial institutions could theoretically help to conduct, via an appropriate credit policy, the structural change in the southern periphery. But the events in connection with the crisis have affected the financial sector in two different ways. First, the capital flows from core countries reversed – an important source of credit action financing is no longer available. Second, the crisis swapped dynamically into the real economy influencing incomes and asset prices. This led to a systematic crisis in the banking sector. The actual percentage of non-performing loans, for example, in the Greek banking sector amounts to 24% (see figure

5). The deposits from companies and households in the Greek banks were reduced by almost 50% in the years 2009 – 2012 (see figure 6). The capital intermediation in the southern periphery has come to a standstill. In each of the countries considered in this paper, where we can observe a strong credit contraction. It lacks therefore the external financing for the necessary structural shift.

### **The Role of the German Development Bank (KfW) in the “German Economic Miracle”**

Directly after the Second World War, Germany descended into economic chaos. First, the monetary reform from 1948, which stopped galloping inflation, established a basis for a new economic beginning. However, the banking sector was far from working optimally. An important role in the first decade after the war in improving capital intermediation in the economy was played by the German development bank – Kreditanstalt für Wiederaufbau (KfW) (Wallich, 1955, p. 168).

The main task of the KfW was to enable access to credit for those companies, which were seen by the banks as being too risky. One of the KfW-features, which crucially contributed to its success, was the establishing of the German development bank as a refinancing instance. The KfW used the existing banking apparatus, which meant that capital intermediation took place in an indirect way. This enhanced the effectiveness of the resource allocation. KfW gave direct credit only when an investment project, which was seen as being macroeconomically important, had no access to external financing via the regular banking sector (Hankel, 1961, p. 152 et seq.).

The philosophy of KfW and its role in the German economy shows up very well as an example in export financing. Since the end of the 1950s, German companies have become continually more export oriented. But the banks were not willing to provide export credits for German companies in an adequate amount. The KfW recognized this negative development in the banking sector, which blocked the plans of expansion of German enterprises and started to refinance export credits abundantly. According to Hankel, it was recognizable, how these

refinancing operations by the KfW influenced the structure of production in the German economy (Hankel, 1961, p. 110 et seq.).

## **The Need for Development Banks in Southern Periphery**

As mentioned in section III, the banking sector in the peripheral countries is dysfunctional. Many financial institutions have been or will be recapitalized with public funds. There is a significant amount of non-performing loans and toxic assets in their balance sheets. Since 2010, the PSG has noted a sharp credit contraction. A proper capital intermediation in this financial environment is impossible.

In order to enhance the functioning of the financial sector, the southern periphery has to conduct a deep restructuration and recapitalization of the banking institutions. However, even if this process succeeds, it is doubtful, whether the banks will be willing to finance the structural change in the PSG in an adequate scale. It can be rather expected, that financial institutions would be shunning such a risk for quite a longer period of time. Therefore, it is advisable for southern countries to establish or to assign new tasks for existing development banks.

How should the development banks work in the southern periphery? In the first place, it is desirable that these institutions will enhance financing in the desired sectors of the economy in an indirect way. KfW was successfully operating in the first place as a refinancing bank. After the outbreak of the crisis many countries were enhancing the financing of small and medium enterprises, which, especially during the havoc on financial markets, have a strongly limited access to bank credit (see for that: McKinnon, 1977) by using different Credit Guarantee Schemes (CGSs) (OECD, 2013). The indirect intermediation has two crucial advantages: first, using existing banking apparatus reduces costs and improves the efficiency of capital intermediation. Second, these institutions must actually be as independent as central banks. They should be free from any political influence and from any pressure from different lobby groups. The establishing of a development bank as a refinancing or guarantee institution is the first step in ensuring

its independence. In the case of the EMU's southern periphery it is desirable, that these development banks will be additionally supervised by EU institutions. At least, many of the northern countries, in the first line with Germany, which strongly influence proceedings in the EU, are the main creditors of the southern states. It lies, above all, in their interest to ensure a successful structural change in the PSG.

As mentioned above, the economic process in the southern periphery has been strongly focused on domestic demand. A sharp decrease of domestic demand in the aftermath of the crisis, has led in turn to a skyrocketing of the unemployment rate. Coping with these two aspects is crucial for the economic healing of the southern periphery, but also for rebalancing the EMU. Therefore, development banks in the southern countries should focus on providing refinancing or guarantees for credits for these investment projects, which improve the export capabilities by demanding at the same time an over proportional additional labor force.

## Concluding Remarks

The main reason behind the economic problems in the Eurozone is the divergent development in the core states and southern periphery. The core (north) countries, since the introduction of the euro, have orientated their economies on foreign demand, and strengthened competitiveness and built up significant export surpluses. In contrast, the southern states went through a phase of consumption led growth accompanied by strong import inflows. Despite importing a large amount of foreign capital, they did not sufficiently increase their export capacities and note the currently substantial negative external net positions.

The rebalancing of the EMU requires above all, on the site of the southern periphery states, the reorientation of the structure of production on foreign demand. To accomplish the structural shift several reforms on different areas are needed. In this paper we analyzed the potential role of financial infrastructure by the redirecting of the economic process.

In section three of that paper we showed how the financial sector in southern periphery is dysfunctional and that under current

conditions capital intermediation is not working properly. In the following part we analyzed the experience of the German development bank – Kreditanstalt für Wiederaufbau (KfW). We stated that the KfW has been successfully influencing the credit policy of financial institutions by offering credit refinancing in these areas, which were seen as macro-economically significant.

In the same way as the KfW in Germany, development banks in the southern periphery could have an effect on the lending policy of Greek, Spanish or Portuguese financial institutions. Whereas the crisis in the south of the EMU was connected with a sharp decrease of domestic demand, what in turn led to a strong increase of the unemployment rate, the development banks should provide refinancing or guarantees for credits for those investment projects, which contribute to export growth and demand additionally over proportional extra labor force. Furthermore, it is advisable to establish development banks just as refinancing or guarantee banks, because this could reinforce the desired independence of these institutions.

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## Figures

Figure 1 by author (data OECD), Figure 2-6 by kind permission of “www.querschusse.de”

Figure 1. Debt to GDP-ratio in Greece, Portugal, Spain and Ireland (in percentage terms)

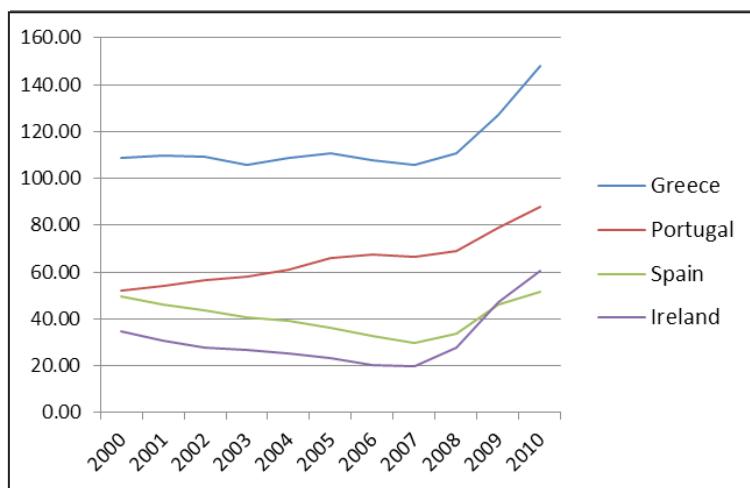


Figure 2. Unadjusted export (red line)/import (blue line) in Greece

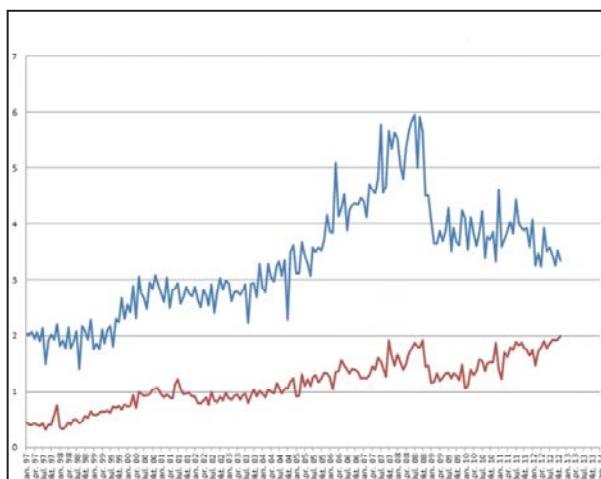


Figure 3. Unadjusted export (red line)/import (blue line) in Spain in bn. of €; (in real terms)

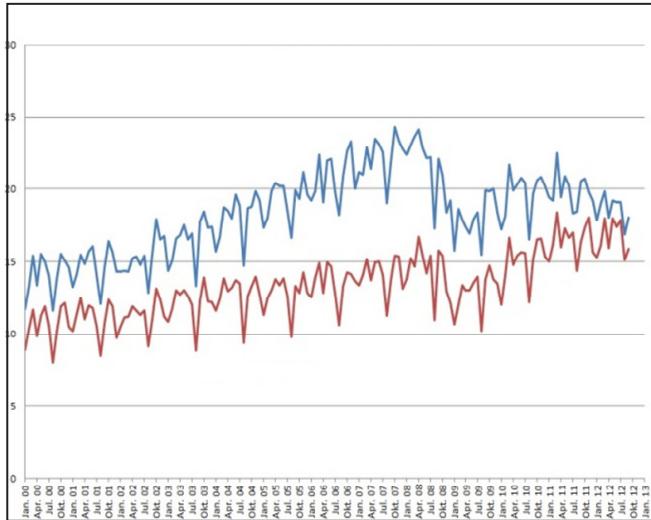


Figure 4. Unadjusted export (red line)/import (blue line) in Portugal in bn. of €;

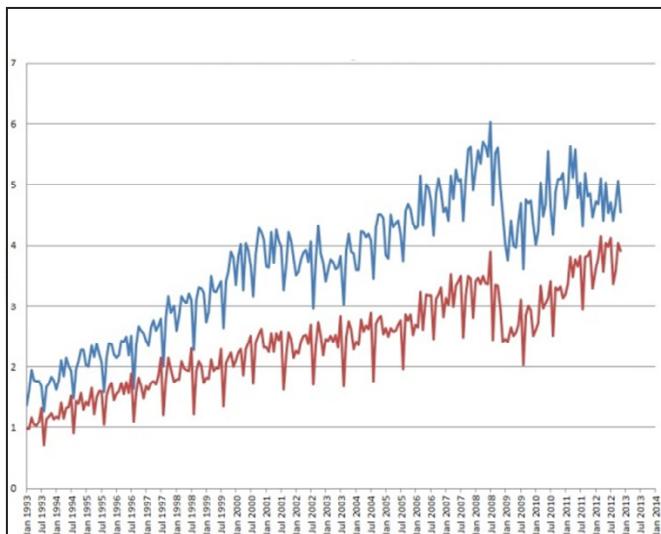


Figure 5. Non Performing Loans (NPLs) in percentage terms in Greece

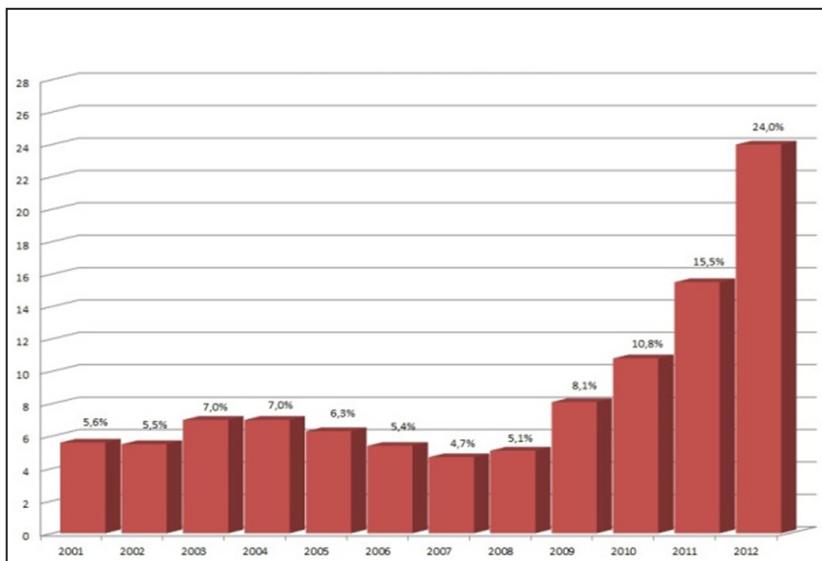
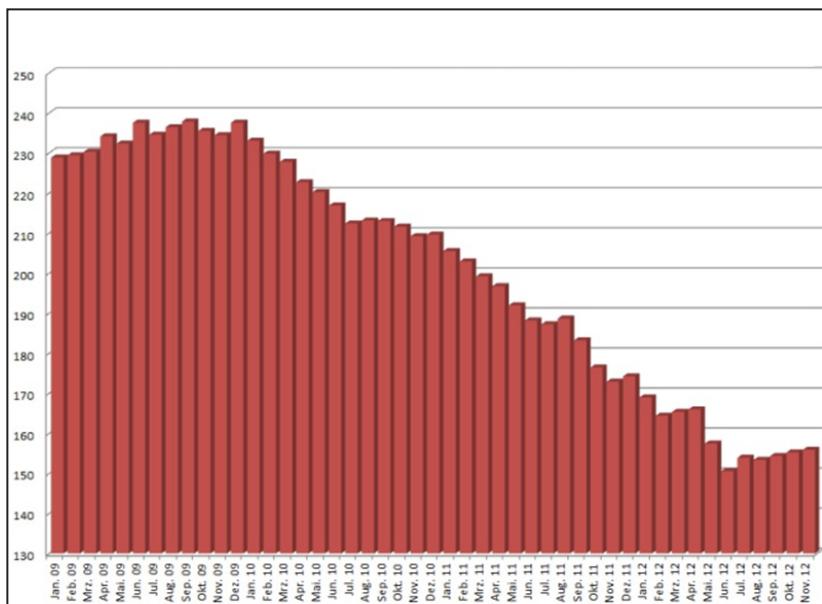


Figure 6. Deposits of households and corporate sector by Greek financial institutions



## **Assessing the Challenges to the Single European Banking Supervision**

*Evica Delova Jolevska, Jadranka Mrsik, Bogoljub Jankoski*

### **Abstract**

*The aim of this paper is to examine the challenges of the establishment of the Single European Banking Supervision. The financial crisis has powerfully demonstrated the need for a new approach to banking regulation and supervision. In fact, the Eurozone debt crisis has shown that there are weaknesses in the design of the EMU and a new architecture is needed. One of the strategic directions is to establish a regulatory and institutional framework at the European level with the aim of protecting and ensuring financial stability through the effective and consistent application of a single and uniform rulebook. The single supervisory mechanism is designed for those countries within the Eurozone, but is also open to other EU countries. Closer coordination would ensure that responses to EU-wide economic problems are coordinated and therefore much more effective. The Single European Banking Supervision will have a statutory objective to promote the safety and soundness of the EU banking system. It is one of the measures to overcome the debt crisis in the Eurozone and a decision with far-reaching implications. In this paper we will elaborate the positive and the negative consequences from the single supervisory mechanism. Critics of this idea of the Single European Banking Supervision point out the existence of a reputational risk and a conflict of interests. Also, according to critics of the current approach to making and dealing with the crisis marked as "too little, too late" creates the perception that decision is more a sign of weakness rather than of having a clear vision and plan for the future of the*

*European (Monetary) Union and to exit from the current crisis. Vision for the future of the EMU in the long run, undoubtedly lies in a deeper financial, fiscal, economic and political integration of the Eurozone.*

*Keywords: European Union, banking sector, financial system, supervision, regulation*

## **Introduction**

The crisis has made it clear that a stronger institutional framework is desirable in order to achieve a single financial market and a stable financial system. An important element in reinforcing the financial institutional framework is the creation of the Banking Union. The Banking Union aim is to build an integrated financial framework to safeguard financial stability and minimize the cost of bank failures. It consists of two central elements: Single European Banking Supervision and a common deposit insurance and resolution framework. In this paper we will focus on the single supervision that it is the main pillar and the first step towards a full banking union.

The single supervision will be placed under the aegis of the European Central Bank. The ECB will supervise an estimated 150 banks representing around 80% of the banking sector in Europe, including all institutions with balance sheets holding over €30 billion as well as the three biggest banks in each country. But the vast majority of the Eurozone's approximately 6,000 small and medium-sized banks will remain under national supervision.

The ECB would be responsible for a list of prudential supervisory tasks, including: the licensing and conducting of on-site and off-site supervision activities and the subsequent requirement for corrective action by the banks, the oversight of prudential regulation compliance, the conducting of stress tests, the approving of mergers or acquisitions as well as the right to declare an "emergency" situation, and the supervision of the implementation of the banks restructuring programs. It would potentially allow eurozone banks to recapitalize using funds from the European Stability Mechanism. Supervisors can take a euro

area-wide view of financial developments, identify early the build-up of systemic risks, and use appropriate macro-prudential tools and preventative measures to counteract them. One of the preconditions for successful supervision is respect and usage according to unique rulebooks applicable to all financial institutions in the single market. The single rulebook generally already exists by the agreement on the Capital Requirements Directive IV and Basel standards. This will contribute significantly for making the banking sector in Europe more stable and creating a level playing field.

The analysis of the creation of a Single European Banking Supervision opens many issues for discussion:

- What will be the impact on the ECB monetary policy responsibilities and its governance structure?
- Whether or not the inclusion of the supervisory function will create a significant concentration of power in one institution?
- What will be the influence on the role of national supervisors?
- What will be the influence on non-Eurozone countries?

The answer to these issues requires particular attention and deeper analysis. Their elaboration will consider the strong and weak sides of this complex and controversial decision for establishing a Single European Banking Supervision and will make appropriate conclusions.

## **The Reasons for Establishing the Single European Banking Supervisor**

The events of recent years have revealed a variety of weaknesses in the governance of the financial sector in the EU that were emphasized as a result of financial crisis. During the last period, the market integration has steadily increased in the Eurozone, witness the fragmentation of the banking system. The fragmentation within the single market arose from disparity in funding costs among businesses with similar levels of risks, sovereign debt loop fuelling fears among governments and market agents, and obstacles for the transmission mechanisms of monetary policy. Banks are increasingly withdrawing into domestic markets, as a consequence of the deeper crisis in the confidence of European financial

markets. On the other side, the sovereign debt crisis emphasized and aggravated existing structural problems in the banking systems, which cannot adequately support the necessary structural adjustments in the real economy.

Schoenmaker (2012) has called this the trilemma of financial supervision-fragmentation: similar to the famous Mundell trilemma, there is an inherent incompatibility between integration, financial stability and independent national supervision. Academic research and policy experience over the last decade has shown the gap between institutional integration and financial integration, especially for multinational banks. Subsidiaries of foreign banks effectively come under dual supervision, both home and host supervision. The home-host cooperation, based on two main principles, decentralization and weak cooperation endeavors to resolve the problem, but is most difficult in the event of the failure of a multinational bank, due to a direct conflict of interest over the distribution of the fiscal costs of bank resolution. This gap can threaten financial stability.

An important dimension on the response to the crisis is institutional integration: an attempt to build stronger supranational institutions and legal frameworks in the Eurozone. The goal is to place the responsibility for enforcing the new rules at a European level. The bank risks and supervision liability would be located in a single body under the aegis of the European Central Bank. The single supervisor would pay attention mainly to eurozone-wide stability threats, rather than to the soundness of the financial systems of each member country. It will be responsible for the recapitalization of the troubled euro area banks by using the European Stability Mechanism funds.

In the aftermath of the crisis, many suggestions arise for establishing a single EU supervisor for the largest financial institutions with cross-border operations throughout Europe. Pisany-Ferry and Sapir (2010) point out that the European supervisory infrastructure is plagued with substantial problems, as bank supervision remains under the sanction of national authority. In particular, there was poor sharing of information among policy-makers and limited transparency leading to the potential erosion of confidence. The main argument for institutional consolidation at the EU level, as per Kern (2011) is that Europe's growing internal financial market is much more integrated

and cannot be supervised efficiently because of different institutional capacities and supervisory practices. According to Kozanoglu (2011) the establishment of European financial stability is completely dependent on the efficiency of the supervision mechanism and on the maintenance of monetary stability. Hence, the national supervisors and the ECB need a clear and precise knowledge on the situation of the Euro zone's banking and financial services, and certainly on the situation of its main actors.

According to Whelan (2012), the global financial crisis has swung matters decisively back in favor of the central banks playing a key role in supervising banks because during a crisis, the central bank's lender of last resort role is crucially important. Therefore, he believes that an official role for the ECB in supervising banks will help provide a far more efficient set of procedures for diagnosing problems with banks and then diagnosing the correct mix of solvency and liquidity measures required to resolve these problems.

The advantages of the Single European Banking Supervision, according to Eijffinger (2012), are that: the ECB has an interest in a stable financial system for the transmission of monetary policy; it is responsible for the oversight of payment systems, which can also be combined with banking supervision because of informational synergies; its financial sector expertise; and, it is an independent body that is not subject to political interference.

The justification of creating a Banking Union has three interconnected objectives: (a) Maintaining financial stability on the basis of effective supervision and crisis management (b) Preserving the single market for financial services, and (c) Avoiding competitive distortions in the single market. Even the results from a numerical simulation exercise and empirical analysis in the Beck and al (2011) model show that a supranational supervisor can improve on the efficiency of the intervention decision, but only if equipped with the necessary mechanisms and information.

The Boomgaarden (EU Committee, 2012) noted that many banks would welcome central supervision as creating a level playing field and reversing the renationalization of banking that had taken place since the crisis took hold. Roubini (EU Committee, 2012) considered that the "too little, too late" approach in decision making and dealing with the crisis, created the perception that decisions are more a sign of weakness,

rather than having a clear vision and plan for the future of European monetary union and the outcome of the current crisis. In fact the nature and speed of decision making is more the result of the more democratic environment in the EU, than of any lack of vision or ignorance.

## Single European Banking Supervision Opened Issues

The EU integrated financial framework is widely recognized by critics. Although there are recognized benefits to such a centralized institutional structure, an extensive literature has emerged questioning the utility and effectiveness of the single supervisory model for Europe.

### *1. Risks from Assigning Supervision to the Central Bank*

There is a lively discussion about the appropriateness of a central bank taking on a supervisory function in addition to its core monetary policy function. Persson and Alexander (2012, Q198) noted that the ECB might be tempted to use monetary policy inappropriately, by lowering interest rates or loosening liquidity conditions, for banking system stabilization. Wieser (EU Committee, 2012) proposed as “tall, thick and impenetrable” as possible firewalls between the two functions. Constancio (2012) concludes that the idea of involving the ECB in banking supervision activities highlights the existence of reputational risk and a conflict of interest. Central banks that are also banking supervisors run a reputational risk: if they fail in their role as banking supervisor, this will tarnish their credibility for monetary policy, too (Veron 2012). On the other hand, the conflict between supervision and monetary policy in the direction that the central bank has much more weight when taking care of the banking sector and could jeopardize price stability, for example by providing liquidity or lower interest rates for banks.

Quinjón (2013) states that the argument for combining monetary policy and supervisory responsibility within the central bank stems from the natural role that it has in ensuring financial stability. Whilst, Veron (2012) finds a number of arguments against entrusting financial supervision to central banks, one of which is conflicts of interest that can arise between the mandates and objectives of monetary policy

and those of financial supervision, because the ECB would be deeply involved in three important and related areas: monetary policy, banking supervision and macro-prudential supervision. This would not only constitute an enormous concentration of powers, but would only be tantamount to the ECB controlling the impact of its own actions.

The German Council of Economic Experts (2012) argued against assigning supervisory functions to the central bank, having in mind that the ECB has no direct fiscal institution as its counterpart so that monetary policy in the Euro area differs from monetary policy in a single country. Central bank independence requires operation outside the usual democratic controls, and by contrast, a supervisory authority must be accountable to democratically legitimated bodies. The European Commission's proposal attempts to solve this conundrum by making the ECB accountable to the European Parliament and the EU Council – albeit only as regards its supervision of banks.

The solution to the problem of a monetary authority's need for independence and a Supervisory authority's need for accountability (Sibert, 2012) is to separate the monetary authority from the rest of the central bank. So, it is important to create a clear organizational separation and hierarchical mandates between the two functions within the ECB and respect the following principles:

- the need for full personnel separation between the supervisory and monetary policy tasks,
- the need to grant the proposed Supervisory Board wide decision-making autonomy,
- the need to minimize the Governing Council role in relation to supervision as far as is possible under the Treaty framework and
- the need to make clear the ultimate responsibility in a crisis of the body within the ECB.

Such a system would ensure that the supervision of banks in all EU Member States is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds. To this end, the European level would be given supervisory authority and pre-emptive intervention powers applicable to all banks.

## *2. Which Banks Would Be Supervised by a European Supervisor and What Would Be the Influence on the Role of National Supervisors?*

Although the ECB will ultimately be responsible in the conduct of its supervisory function, the ECB would be assisted by national supervisory authorities and the system would be highly decentralized. National supervisors that have the knowledge of local and regional markets and a long-established expertise in supervision would be required to follow the ECB's instructions.

The argument for applying a common supervisory mechanism to only larger banks appears to be based on the idea that the problem being solved by the common supervisor is the systemic risk to financial stability posed by these banks. Whelan (2010) does not agree with this argument because large banks are not the only threat to financial stability-the collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally present a threat.

According to Da la Dehesa (2012) keeping present national supervisors for most banks whilst leaving the ECB only supervising the "too big to fail" euro area banks does not make sense because of the following: (a) in the previous banking crises, most banks which went bankrupt were not "too big to fail" (b) Basel II has been applied with broad different levels of rigor by different euro area supervisors, (c) 75% of the ECB monetary transmission mechanism of the monetary policy is done through banks, so that the supervision of banks becomes a key factor for monetary policy as well. He found some obstacles with those Euro area Member States where the supervisor is not the central bank and will need time not only to move their supervisors to their central banks, but also for their central banks to start using them effectively.

On the word of Schoenmaker and Oosterloo (2005) a European System of Financial Supervisors could combine the advantages of a European framework for financial supervision and crisis management with the expertise of local supervisory bodies. Pisiani-Ferry and Sapir (2010) suggested that a reasonable compromise would be for the ECB to have the necessary authority to cover all banks whilst delegating supervision where appropriate. But, for Whyte (2012) it is not clear how this compromise would work in practice as there would continue to be "policies of forbearance driven by local political considerations".

National supervisors would retain some of the supervisory share not transferred to the ECB such as: consumer protection, and money laundering protection. This would be reasonable given the assumption of direct conducting of the national supervisors by the ECB, but with its ability for the immediate assumption of responsibility for the supervision of smaller banks as required. The ECB must have an opportunity to eliminate any national supervisory bias where it occurs. The proposed supervisory arrangement may produce positive results if the ECB and the national supervisors act as a single system with close cooperation, by setting out a clear demonstration of the separate authority with a strictly defined relationship. Thus, the whole supervision gains credibility and increases investor confidence.

### *3. What Would Be the Influence on Non-Eurozone Countries?*

The very important issue is how to integrate the non-Eurozone countries into the arrangement. The expectation is that the banks in countries outside the euro will be involved in the SSM, which will facilitate wider market access for banks and investors across Europe. Also, it will contribute to a more effective implementation of the supervisory practices and coordination of the failures between national supervisors. Constâncio (2013) stated that the SSM should provide an option for the competent national authorities in the non-euro area states to participate in the SSM through establishing a close cooperation with the ECB. By establishing a close cooperation, they need to adhere to the decisions taken by the ECB, if not the cooperation may be suspended or terminated.

The EBRD (2012) declared that the proposed unified bank supervision has raised concerns in several European countries, both inside and outside the eurozone and especially in emerging Europe. Some countries outside the Eurozone worry that giving banks in the euro area the possibility of direct recapitalization from ESM resources will tilt the competitive balance against banks headquartered outside. There is also a concern that national resolution authorities may not face the right incentives if fiscal losses are mutualised at the Eurozone level. Furthermore, unifying supervision in the Eurozone does little to address home-host coordination failures that affect countries outside the single supervisory mechanism or coordination failures in respect of banking resolution (which can be particularly severe).

The key issue is the banking resolution. The Single Supervisor model planned the banking resolution to remain at the national level, although within a common EU banking framework. Beside the coordination problems in the banking resolution, the lack of congruence between the supervision, resolution and ultimate responsibility could create a problem of moral hazard. Maintaining resolution authority at the national level while raising ultimate fiscal responsibility to the supranational level could produce a moral hazard and may be one of the reasons why the banking union proposal has not met with universal support in Europe.

#### *4. And on the Republic of Macedonia?*

The situations in the EU and the euro area are of interest for the Republic of Macedonia because of its strategic goal to become an EU member, its economic relations with some EU countries, and because of the economic situation in Greece as the closest neighboring country. According to the monetary strategy of the Macedonian National Bank and considering the importance of the stability of the euro for the stability of the denar, a regular and watchful monitoring of the current Euro zone situation is becoming necessarily more significant for the Macedonian economy.

The Macedonian National Bank ought to continuously monitor and make compliance with the ongoing changes in the EU supervisory legislation, caused by the redesigning of the EMU. In this respect, the Bank Union promoted the concept of supervision set within central banks, which already exists in the case with the National Bank of the Republic of Macedonia. Hence, all subsequent regulatory, procedural and organizational-technical activities for setting up banking supervision within the ECB might be used to improve the supervisory function of the National Bank of the Republic of Macedonia.

### **Conclusion**

Over the last decade it has been shown that the gap between institutional and financial integration in the Eurozone results in a number

of difficulties which can threaten financial stability. The purpose for establishing the Single Banking European Supervisor is to protect and ensure financial stability through the effective and consistent application of uniform prudential rules and practices (single rulebook), greater transparency in the application of the rules, as well as a significant reduction in the possibility of an impact on the regulator (regulatory capture). Additional arguments in favor of the idea of a supra-national regulator result in the expectation that it would overcome the problem of fragility of current economic and monetary union in times of crisis and would prevent the process of fragmentation of financial markets that is currently happening in the euro zone and would reduce the unjustified funding-cost differences.

The ultimate goal is to centralize the responsibility for enforcing new rules at the European level, thus locating the liability for bank risks and supervision in a single body under the aegis of the European Central Bank. This new regulation gives the European Central Bank additional authority to directly supervise the European banking sector. In the theoretical discussions about the prospective operation of the Single European Banking Supervision there are still many issues that question whether this measure can be a real solution to dealing with a possible new financial crisis.

The introduction of a single supervisor is already a major step forward, but there are still a lot of the steps to be taken on the path towards the completion of the Banking Union. In any case, it will take an enormous effort to end the segmentation of European financial markets. Yet, the creation of a single, credible and effective supervisor will make direct recapitalization of struggling banks by the European Stability Mechanism more politically acceptable.

The ECB Vice-President, Constancio, (2013) quoted Victor Hugo: "you can resist an invading army, you cannot resist an idea whose time is come" to emphasize the Single European Banking Supervision is exactly such an idea, but it depends how it will be turned into reality. The vision for the future of the European Monetary Union makes us expect that the long term sustainability of the monetary union is possible only with its gradual, deeper and systemic transformation to full banking, budgetary and economic union, followed by political integration.

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## **How Similar Are the CEE and SEE Countries in Terms of the Efficiency of Financial Institutions?**

*Suela Kristo, Raimonda Duka, Eri Gjoka*

### **Abstract**

*This study sets out to discover similarities regarding the efficiency of financial institutions within the CEE countries. Similarities are also required within SEE countries that are not EU members to understand better their financial development. We apply cluster analysis techniques for the period 2003-2010 in order to see the trend of homogeneity of these countries. The results show that Bulgaria, the Czech Republic and Slovakia are more integrated countries, while Hungary and Poland have fewer similarities by comparison with the other countries. Croatia, Macedonia, Bosnia and Herzegovina have greater similarities with the other CEE countries that are EU member states than with Serbia, Albania and Montenegro, which are usually classified in a separate group. Therefore, because of their position we included Greece in the cluster analysis of the SEE countries that are not members of the EU. This inclusion clarified the position of Albania, which seemed to have many more similarities with this country. Furthermore, it seems even more obvious that Macedonia and Bosnia and Herzegovina are included in the same group, while Serbia is again at some distance from the other countries. Such differences appear to be maintained during the period under consideration, leaving scope for further integration.*

*Keywords: Financial institutions, efficiency, CEE & SEE countries, cluster analysis*

## 1. Introduction

The globalisation trend on the one hand increases the financial linkages, increasing in this way the contagion effects. On the other hand, the financial systems face competitive pressure. These issues become even more sensitive for post-communist European countries as their economies have created relatively new financial systems, which are currently relatively inexperienced since becoming part of the EU. Therefore, their very survival requires them, amongst other factors, to be as efficient as possible. In such conditions, financial institutions, managers, regulators, investors as well as governments are concerned about how efficiently these institutions can perform their functions. Therefore, in this chapter, we want to answer the following three basic questions: 1) In terms of the efficiency of financial institutions how close are the CEE or SEE countries to each other; 2) how have these similarities changed during the years of the period under consideration; 3) Whether or not the CEE countries which are EU members are closer to each other than those outside EU?

We apply cluster analysis techniques to examine the degree of financial integration of these countries, focusing in particular on the financial institutions. Cluster analysis aims to find similarities between the two countries and cluster them into groups. This analysis can not impose restrictions on relationships between countries and can not find the factors that have contributed to these relationships. Such an analysis is very important as a first step toward any deeper analysis that tries to explain the relationship between financial institutions and factors affecting on these relationships.

In our analysis, we will particularly focus on the efficiency of financial institutions, although this has not fully captured all the features of financial institutions or financial systems. The paper uses this characteristic as a basis for describing, comparing, and analyzing financial institutions between CEE and SEE countries, and their evolution over time in the period 2003-2010. At first 16 CEE countries were selected to observe similarities between their financial institutions. We also tried to capture perhaps more similarities between those who are members of the EU and those outside it. The results showed differences between the EU member countries. On the one hand, we have more

integrated countries such as Bulgaria, the Czech Republic and Slovakia, and on the other hand less integrated countries such as Hungary and Poland. With regard to the countries outside the EU, some of them (Croatia and Macedonia) are closer to other countries that have been integrated into the EU. While some other countries, such as Serbia, Albania and Montenegro are far away from all other countries. Later we continue with cluster analysis of the SEE countries that are not members of the EU except Greece. We included Greece in order to look for any similarities with Serbia or Albania, because they are often in a cluster of their own and for most of the sample period, each of them is the most distant cluster. Results showed that Albania and Greece are always in the same group, strengthening the relationship between the financial institutions of these countries, however Serbia seems to stand again far away from all other countries except Montenegro, so that sometimes they are grouped together. Macedonia and Bosnia and Herzegovina were always grouped on the same cluster throughout the sample.

The paper continues with section 2, which provides a review of the literature on the financial linkages, particularly with reference to the efficiency dimension. Section 3 describes the general methodologies for cluster analysis. Section 4 explains the data and theoretical foundation for the choice of variables. Section 5 presents the results, while section 6 concludes and outlines areas for further research.

## 2. Literature Review

The importance of financial institutions in the development of any economy is widely known. Financial institutions play a significant role in economic development because they determine which firms should use a society's scarce saving (Schumpeter, 1912). Levine (2005) points out that financial institutions and financial markets exert a powerful influence on economic development, the alleviation of poverty, and economic stability. Furthermore, Aghion et al. (2005), in their cross-country comparisons have shown that the development of the financial sector has a stronger impact on growth in low and middle economies than those in high income countries.

The growing financial linkages in the globalisation trend make the financial system architecture more difficult to plan. Contagious

effects that are transmitted through financial linkages could also result in heightened cross-country spillovers of macroeconomic fluctuations (Claessens and Forbes, 2001). The potential harmful consequences of cross-border interconnectedness for the stability of the domestic banking sector have been illustrated rather dramatically during the recent global financial crisis, when shocks to one country's financial system were rapidly transmitted to many others (Čihák et al. 2011). Čihák et al. (2011) using model simulations and econometric estimates based on a world-wide dataset, which found an M-shaped relationship between the financial stability of a country's banking sector and its interconnectedness. According to them, it may be beneficial for policies to support greater interlinkages for less connected banking systems, but after a certain point the advantages of increased interconnectedness become less clear.

Many studies have supported the relationship between low efficiency and the failure of a financial institution. Banks and S&Ls with low efficiency failed at greater rates than institutions with higher efficiency levels (Berger and Humphrey, 1992a; Cebenoyan, et al. 1993). Management quality, as measured by regulatory agency assessments, is positively related to cost efficiency (DeYoung, 1997c) which, in turn, causes reductions in problem loans (past due and nonaccrual, Berger and DeYoung, 1996). As a result, efficiency measures have been shown to improve the predictive accuracy of failure prediction models and thus may represent a useful addition to current modelling efforts by regulatory agencies Berger (1997).

Although the evidence on the role of the financial system in shaping economic development is diversified, researchers do not have good cross-country, cross-time measures of the degree to which financial systems enhance the efficiency of resource allocation. Through our literature survey, we found that Sorensen et al. (2006) explain that, in the period 1998-2004, the banking sectors in the euro area countries seem to have become more homogeneous, although the results are unequivocal and considerable differences remain. Karreman (2009) examines the contemporary financial geographies of Central and Eastern Europe and argues how these may affect the established European financial centre network in the future. The results show a distinct spatial order of financial centres organised around three main city clusters: a 'south-east' cluster controlled by Athens, a 'central-east'

cluster controlled by Vienna and a ‘Baltics’ cluster controlled by both Copenhagen and Stockholm. Beck et al. (2008) use information from different databases to benchmark countries’ financial systems over time. Beck et al. (2010) introduce the updated and expanded version of the Financial Development and Structure Database and presents recent trends in the structure and development of financial institutions and markets across countries. They found a general deepening of financial markets and institutions over time, which is more pronounced in the high-income countries and more pronounced for markets than for banks. Čihák et al. (2012) use the Global Financial Development Database, an extensive dataset of financial system characteristics for 205 economies from 1960 to 2010. The authors document cross-country differences and time series trends.

Otherwise, researchers have largely—though not exclusively—relied on measures of the size of the banking industry as a proxy. However, size is not a measure of quality, nor of efficiency, nor of stability. Moreover, the banking sector is only one component of financial systems. Berger (1997) surveys 130 studies that apply frontier efficiency analysis to the financial institutions of 21 countries and finds that the various efficiency methods do not necessarily yield consistent results. Bauer et al. (1998) comparing efficiency estimates on U.S. bank efficiency from variants of all four of the major approaches -- DEA, SFA, TFA, and DFA -- and find mixed results.

There are various studies within the literature that used different clustering methods for a given classification problem and compared their results (Nanda et al. 2010). Our contribution is to try clustering CEE and SEE countries related to efficiency of financial institutions based on a newly launched Global Financial Development Database. This analysis had to confront significant gaps in information on regional financial interlinkages that are necessary to inform policy decisions regarding financial institutions.

### **3. Methodology**

The objective of cluster analysis (see Dillon and Goldstein, 1984; Everitt et al. 2001) is to determine the natural groupings (or clusters) of

observations. In our study, we have researched into the data for groups of countries, in which countries in the same group are more similar to each other than to those in other groups. We use cluster analysis as an exploratory data-analysis technique. This technique would provide a better and more accurate explanation of the observations with a minimal loss of information, because it requires no assumptions about the independence of the observations. However, this method like other methods imposes some limitations on the researcher. There are several cluster-analysis methods, where most of them allow a variety of distance measures for determining the similarity or dissimilarity between observations. Nevertheless, before applying this method, it is necessary to perform data transformations and/or variable selection. Then, it may be difficult to determine how many clusters are really in the data and how significant are the clusters that have been formed (see Korobow and Stuhr, 1991).

There are two general types of clustering methods, which are known as: partition and hierarchical. Partition methods break down the observations into a certain number of final clusters in advance. Two partition methods are kmeans and kmedians. Otherwise, hierarchical clustering is the most useful method and it consists of creating hierarchically related sets of clusters. Hierarchical cluster analysis begins by separating each object into a cluster by itself. At each stage of the analysis, the criterion by which objects are separated is relaxed in order to link the two most similar clusters until all of the objects are joined in a complete classification tree.

Hierarchical clustering methods are generally of two types: agglomerative or divisive. Agglomerative hierarchical clustering starts with single elements and aggregates them into clusters, while divisive hierarchical clustering starts with the complete data set and divides it into partitions. In this study, we chose to apply hierarchical techniques, since the number of final clusters was unknown. Furthermore, the agglomerative methods were preferred to the divisive ones because they are widely implemented in software.

The hierarchical cluster method consists of an ordered paired list  $\{t, W_t; t=1 \dots T\}$ , where  $t$  represents the different year and  $W_t$  represents  $n$  row-matrices of the observed variables for the  $n$  individuals in each year. In the case of CEE,  $n$  represents 16 countries, hence in the other

case n represents six countries. A description of variables in  $W_t$  is given in Section 3. From each  $W_t$  matrix, applied in each year, we obtain a  $D_t$  squared nxn distance matrix. For a particular t year, the initial  $D_t$  matrix is represented as:

$$D_t = \begin{pmatrix} 0 & \cdots & d_{1i} & \cdots & d_{1n} \\ \vdots & \ddots & & & \vdots \\ d_{j1} & & 0 & & d_{jn} \\ \vdots & & & \ddots & \vdots \\ d_{n1} & \cdots & d_{ni} & \cdots & 0 \end{pmatrix}$$

where  $d_{ij}$  represents the distance between the individuals i and j. In order to obtain the final dendrogram, we should do the specification of the following parameters:

*Type of distance*, which defines the formula for calculating distance, which is used to approximate the similarity of two financial institutions. The most typical and well-known distances that might be used are the Euclidean and squared Euclidean distance, the Manhattan or city block distance, the Mahalanobis distance or the Chebychev distance, among others. We decided to use the squared Euclidean measurement in this study, since it places greater emphasis on outliers to generate distance patterns (for more various levels of warnings about using different type of measures and for importance of using squared Euclidean distance, see Kaufman and Rousseeuw, 1990; Gordon, 1999; Everitt et al. 2001).

*Linkage method* defines the rules for cluster formation. The best-known linkage methods are single, complete, average, Ward's method, centroid, median, and weighted average. However, since the first three methods are more common and broadly known in most of the statistical packages, we used them to obtain the final dendograms (for examples of these methods, see Dillon et al. 1984). Overall, the complete and average linkage method led to the most consistent and stable results. We have therefore based our discussion on these methods, and the dendograms for each time period showing the cluster-relation between the different countries are presented in a condensed form in the appendix. Stata 11 package was applied to carry out the calculations.

## 4. Data and Variables Description

The paper uses the data to characterize and compare financial institutions across countries and over time. As already mentioned, this will be through cluster analysis to assign the countries into groups (clusters). Therefore, countries in the same cluster are more similar to each other than to those in other clusters. Cluster analysis implies that no restrictions or stipulated structures are imposed upon the data *ex ante*. So, it is the data itself that structures the results, therefore the selection of variables is very important.

For intermediaries, efficiency is primarily constructed to measure the cost of intermediating credit. Determinations of efficiency require different methodologies to measure it. Traditional methods of measuring efficiency are related with the analysis of various financial ratios, such as ROA, ROE, net interest margin etc. Several other studies have attempted to identify the characteristics that explain financial institution efficiency differences by means of financial institution size, form of organization, market characteristics (such as concentration), age of financial institution, loans to total assets ratio, etc. The variables described above are relatively crude measures of efficiency. For a sub-set of countries, it is possible to calculate efficiency indices based on data envelopment analysis, stochastic frontier analyses or other more sophisticated measures (see Bauer et al. 1998 for a detailed comparison of frontier efficiency methods in financial institution). However, the data required for this type of analysis are available only for a sub-set of countries. Therefore, we measure efficiency for financial institutions via traditional indicators based on the categorization of variables proposed by Beck et al. (2000, 2010). In our study, the efficiency measures will include indicators such as overhead costs to total assets, net interest margin, lending-deposits spread, non-interest income to total income, cost to income ratio, and closest related variables include return on assets and return on equity.

*The net interest margin* (see Cihák et al., 2012; Beck et al., 2010) equals the accounting value of an institution's net interest revenue as a share of its total earning assets, while *overhead cost* equals the accounting value of an institution's overhead costs as a share of its total assets. Higher levels of net interest margins and overhead costs indicate

lower levels of financial institution efficiency, as they incur higher costs and there is a higher wedge between lending and deposit interest rates. *Lending-deposits spread* is lending rate minus deposit rate. *Cost-income ratio* that measures the overhead costs relative to gross revenues, with higher ratios thus indicating lower levels of cost efficiency. *Return on Assets and Return on Equity* are computed as unweighted averages across all institutions in a given year. They are regarded as the basic indicators of financial institution profitability.

By selecting these indicators, we aim to capture one of the dimensions of financial system development. These variables are a considerable part of the factors determining the behaviour and development of efficiency in the financial institutions without imposing any causality links or structures restriction. The data for all these variables offers from a newly launched Global Financial Development Database, an extensive worldwide database combining and updating several financial data sets. The data have been selected for 16 European countries for the period 2003 to 2010 (last year offered by World Bank). We selected these from the World Bank database for the period 2003 to 2010, so as to avoid missing any variables for the countries selected.

## 5. Results

We have applied the two methods: average and complete linkage. Both of them give almost identical results, with very small differences. Results obtained from the complete methods provide a clearer idea of the similarities and differences between the banking sectors in these countries, so we decided to illustrate the dendograms of this method. Figure 1 in the appendix illustrates the results of cluster analysis and the table below gives a summary table of the CEE countries classification.

## Summary table of CEE countries classification

Country	Group 1 (years)	Group 2 (years)	Group 3 (years)
<b>Bulgaria (BGR)</b>	8		
<b>Czech Republic (CZE)</b>	8		
<b>Croatia (HRV)</b>	7	1	
<b>Macedonia (MKD)</b>	7		
<b>Slovak Republic (SVK)</b>	7	1	
<b>Estonia (EST)</b>	6	2	
<b>Latvia (LVA)</b>	6	2	
<b>Lithuania (LTU)</b>	6	2	
<b>Romania (ROM)</b>	6	2	
<b>Slovenia (SVN)</b>	6	2	
<b>Bosnia and Herzegovina (BIH)</b>	5	3	
<b>Hungary (HUN)</b>	4	3	1
<b>Poland (POL)</b>	4	3	1
<b>Montenegro (MNE)</b>	2	6	
<b>Albania (ALB)</b>	3	1	4
<b>Serbia (SRB)</b>	1	3	4

Source: Authors, based on the Global Financial Development Database

Generally, these countries are classified in three groups. The first and the bigger group include 9-12 countries. In this group, Bulgaria and the Czech Republic are always included. Croatia, Macedonia and Slovakia are included in the second group only for one year, whereas Estonia, Latvia, Lithuania, Romania and Slovenia are included in the second group for only two years and Bosnia is classified as being in the second group for three years. The second group includes fewer countries compared to the first one (2-5 countries). The countries that are more often included in this group are Hungary, Montenegro and Poland. The last group, in general, includes only one country. In this group, Serbia and Albania have been included. In 2003, Poland was included in this group, whereas in 2008 Hungary had been included. We can observe that throughout the observation period the distance of the groups has changed. At the beginning of this period (2003), the differences were relatively small compared to the years 2004–2006. There is generally an increase in homogeneity between groups during 2007-2008, but in 2009, the differences between the groups become larger whilst last year these differences seemed to be more relaxed. If we make a detailed observation of the CEE countries to understand better the similarities and the differences between them, we would have these results:

- Serbia is the country that has the biggest differences; forming a group on its own for many years (2003, 2004, 2009 and 2010), whilst in the other years it belongs to the second, smaller group. The only year that the Serbian financial institution appeared to be more similar to other countries was in 2008, when all countries seem to have had more similarities than in other years. The reason of this homogeneity between the countries might have been the financial crises that appeared strongly in this year. Serbia has a few more similarities with Montenegro and Hungary in 2006 and 2007, when they were included in the same group.

- Albania is the second country, after Serbia that appears to have the biggest differences in comparison with the other countries. For four years (2004-2007), Albania is included in the third group, due to huge differences with the other countries. It seems that during 2008 and 2009, the integration of this country increased, nevertheless, in the last year of the observation it would appear that the gap is beginning to grow again.

● Montenegro could be the third country that appears to be less integrated. Usually this country has more similarities with Bosnia, Serbia and Macedonia. This country rarely appears to have any similarities with the CEE countries that belong to the EU.

● Bosnia and Macedonia seem to be very similar to each other and to Slovenia. During the last few years, these countries seem to become more similar to Croatia. Moreover we can say that countries that are not members of the EU, (excluding Macedonia and Croatia), are less integrated than the member countries of the EU.

● Hungary is a country that is part of the EU with fewer similarities to the other countries. Greater similarity has been noticed in the early years with the Czech Republic and Latvia. However, with the passage of time the differences have become larger, even in 2008 Hungary was completely separated from other groups of countries.

● Although it seems that Poland has greater similarity with Romania, it does not seem to have that consistency that Romania has. During the study period, Poland passes from one group to another.

● The strongest relationship between groups is among Bulgaria, Croatia, Slovakia and a little less with Estonia. These countries, together with the Czech Republic and Romania stand out as the most integrated countries, regarding this dimension of the financial institutions development.

Analysis continues with the SEE countries that are not EU member states. Through this analysis, we have tried to clarify the results found above. In this classification, we have made two exceptions. The first relates to the exclusion of Croatia; a country not completely included in the SEE and that will soon be part of the EU. The second concerns the inclusion of Greece, a country that is part of the EU and has an impact on the financial systems of the SEE countries. We do so, in a bid to find a relationship between Albania and Serbia with this country, since in the above analysis they looked very separate. Figure 2 in the appendix gives dendograms of this analysis according to the complete linkage method. Generally speaking, over the years we have classified these countries into the three following groups.

● Macedonia and Bosnia are always in the same group. It is obvious how much similarity there is between the financial institutions of these two countries in terms of the efficiency dimension. In some

years, this group also includes Montenegro, which has more similarities with these two countries than the others.

- The other group includes Albania and Greece, which as was assumed, bear much more similarity with each other (except for 2003). Greece is closer to Albania than to Serbia, except in 2008 when it was closer to Serbia. Just as resulted from our analysis of the CEE countries, with the exception of 2008, in all the other years, Albania and Serbia were significantly apart from each other.

- Serbia is the only country included in the third group again for the years 2003, 2004, 2009 and 2010. In the other years, it seems to have a little more resemblance to Montenegro. However, Montenegro is actually closer to Macedonia and Bosnia than to Serbia. Although it seems that the SEE countries have become more similar in 2008; in recent years the differences between them grew even more. Serbia is the country that has the greatest differences, which at times seems to pull behind Montenegro.

## 6. Conclusion

In this study we have used the Global Financial Development Database in order to analyze the financial institutions of different countries, under the efficiency dimension. This was done through cluster analysis for the years 2003-2010. The purpose was to observe the homogeneity of the CEE countries, but not only that. We also worked towards finding the similarities between the SEE countries, as well as between countries integrated within the EU and those outside the EU.

The results showed that there are differences between members and non-EU members. Thus, with regard to the non-member countries of the EU, Macedonia and Croatia are the more integrated SEE countries. Then come Bosnia and Herzegovina, and Montenegro. Less integrated are Albania and Serbia. The last two are not only far away from the other countries, but they are far away from each other with the year 2008 being the only exception (they seem to be closer in this year). Among the CEE countries Bulgaria, the Czech Republic and Slovakia appear to be more integrated. Less integrated among these countries are Hungary and Poland, which tended to be at a long distance from the main clusters

(2008 and 2003 respectively). The tendency of homogeneity in the period under the study generally shows an increase until the year 2008, and a decrease in the last two years. Such behaviour might be due to the financial crisis that may have increased the differences between these countries. However, this requires further and more detailed analysis.

The study recognizes that financial efficiency does not capture all the features of financial systems. Rather, the paper uses this characteristic as a basis for comparing, and clustering financial systems in these countries and their evolution over the period taken into consideration. Certainly, in other subsequent studies other features of financial systems should be included in order to achieve a more comprehensive analysis. The paper also emphasizes a need for further research, including indicators measured by the most advanced methods.

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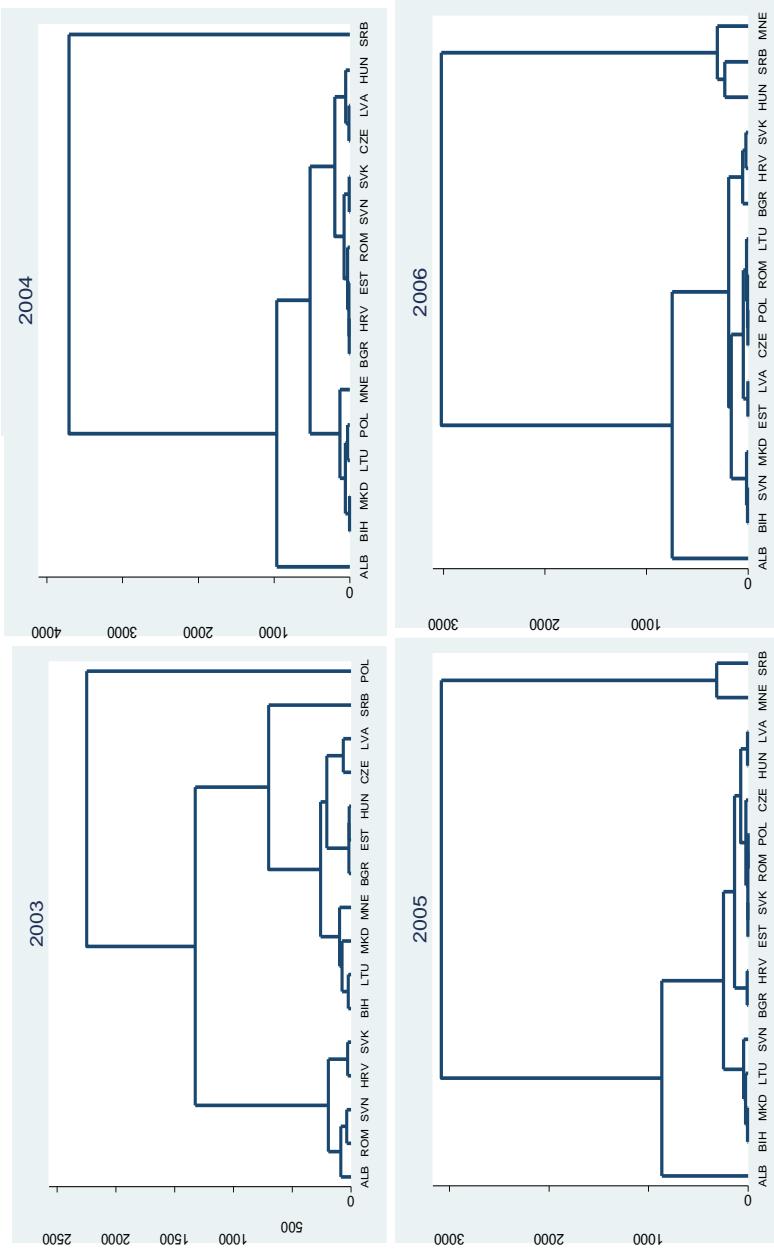
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**Appendix**  
**Figure 1: Dendograms of CEE countries classification**



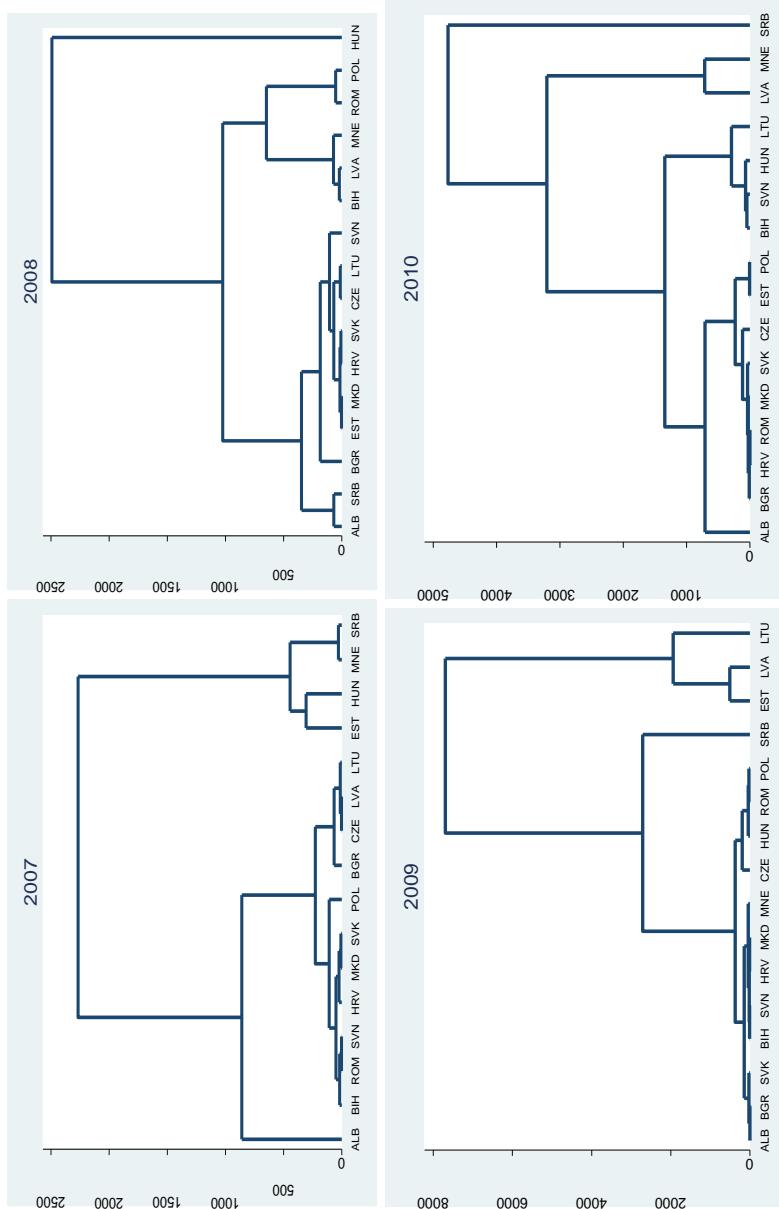
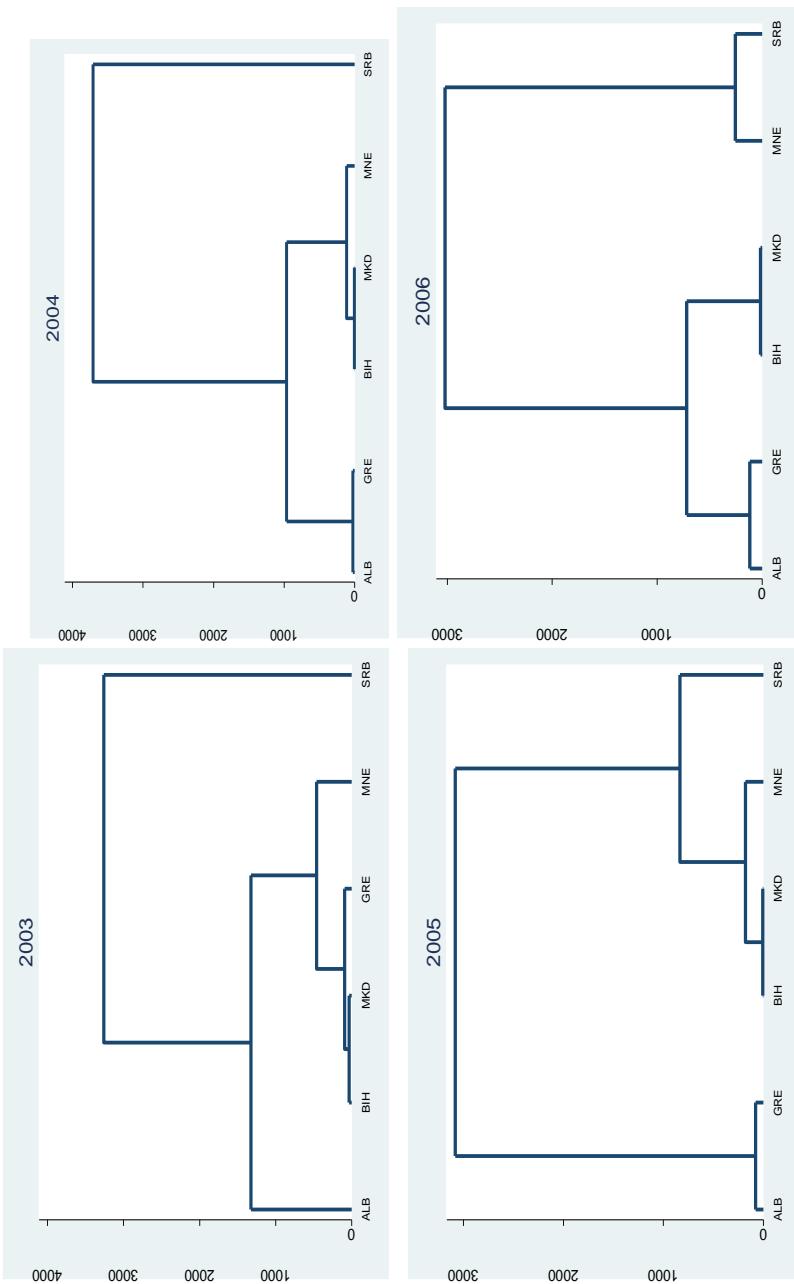
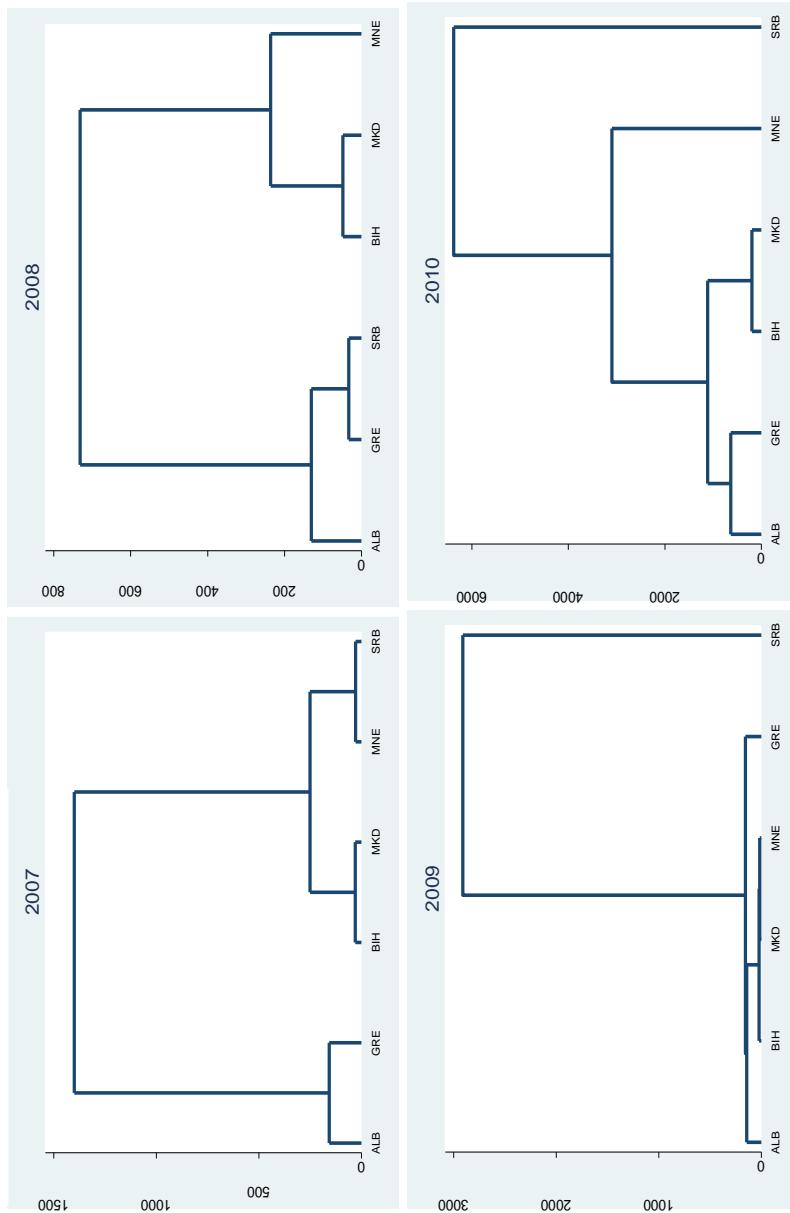


Figure 2: Dendograms of SEE countries classification





## **The Small Stock Exchanges in South - East European Countries: The Future after the Crisis**

*Dimche Lazarevski, Jadranka Mrsik*

### **Abstract**

*The aim of this paper is to identify the effects of the regional and global stock exchange mergers and integrations, and to recommend options that South-East European stock exchanges should consider in future. The global financial crisis brought considerable economic decline in 2008, and this has remained the case until today, putting the future existence of South-East European stock exchanges into question. The paper will focus on the impact that these mergers/integrations have on market liquidity, and the required rate of return. We have made a comparative analysis of selected SEE and worldwide-developed stock exchanges in terms of some market indicators. To calculate the Stock Exchanges' required rate of return we developed a modified Capital Asset Pricing Model suitable for emerging market economies. Then, we determined the breadth, depth and liquidity of the Macedonian Stock Exchange using a number of different liquidity measures. Based on the results from these analyses, we recommend several options for SEE stock exchanges: developing on their own for which aggressive policy measures for developing internal financial markets must be devised; building links with substantially larger and better developed markets to establish virtual trading venues, borrowing advanced platforms and visibility; and, to a start regional integration process (mergers/acquisitions).*

**Keywords:** *Financial markets, stock exchange, South-East Europe, modified CAPM, mergers, breadth, depth, liquidity, cost of capital, market indicators, Macedonia.*

## 1. Introduction

The aim of this paper is to identify the effects of regional and global stock exchange mergers and integrations, and to recommend options that South-East European stock exchanges should consider in future. The paper will focus on the impact that these mergers/integrations have on the market's breadth, depth and liquidity, and the required rate of return. We expect that mergers/integrations will decrease the required rate of return, and increase stock exchange liquidity, investor base and the number of quoted companies that help the development of stock exchanges, and thus the future economic development of those countries.

After more than two decades since their opening, the SEE stock exchanges did not succeed in attracting the attention of the developed European Union exchanges because of their small market capitalization and insignificant turnover. Now, as the world is coming out of the crisis and some positive trends are becoming slightly visible in SEE, it seems it is the right time to reaffirm the efforts to persuade regional or global co-operation.

This paper focuses on seven SEE security markets (Macedonia, Serbia, Croatia, Slovenia, Bulgaria, Hungary and Romania). These markets started trading in the mid – 1980s and mid 1990s with a slight number of stocks, many of which were illiquid. In spite of significant progress over the past years, there are still key challenges to ensure future growth. Liquidity in both equity and bond markets remains thin, and there is no tendency among large enterprises to make debt or equity cost-efficient issuances. The investor's protection is not yet suitable, pricing limitations still exist, while benchmark yield curves are "incomplete" and unreliable in many cases. In addition, EU accession is raising questions about the development, consolidation and integration of emerging European capital markets.

The remainder of the study is organized as follows. Section 2 reviews the related literature. Section 3 describes our Model and data. Section 4 reports the empirical results and Section 5 concludes on the main findings.

## 2. Literature Review

The first step towards merger is the Copenhagen and Stockholm stock exchange merger in 1997, (the NOREX alliance) later renamed in OMX. A few years later, Oslo, Island, Riga, Tallinn, Helsinki and Vilnius joined the OMX. The American stock exchange NASDAQ has integrated with the stock exchange from Helsinki. In 2000, a merger of the Amsterdam, Paris and Brussels stock exchange created EURONEXT. The Lisbon and London International (LIFFE) Stock Exchanges joined EURONEXT in 2001. According to Padilla & Pagano (2005), the system harmonization within the EURONEXT stock exchanges, lead to a 27% decrease in the bid-ask spread for the shares of 104 companies that are part of their research. Arnold et al. (1999) came to a similar conclusion, by examining the bid-ask prices of the shares from three regional stock exchanges that had entered into the merger process. On April 4, 2007, the first transatlantic stock exchange was created, with the merger of the New York Stock Exchange and EURONEXT, because of the coherent industrial strategy towards wide offer of securities and geographical diversification. In Central Europe, the process of the regional integration of stock exchanges started with the merger of the Hungarian, Slovenian, Czech, and Austrian stock exchanges, establishing the CEE Exchange Group (CEESEG).

During this last decade in all of the previously mentioned mergers, there is evidence of increased trading volume, an increased number of traded securities and decreased trading costs (Polato & Floreani, 2008). By contrast, Nielsson (2008) from the EURONEXT liquidity effects of mergers discovered that a merger is not in the best interest of all companies, but only of the big and international companies. Pagano et al. (2002) confirmed these conclusions. Contrary to these findings, according to OMX research (2007, p. 15), the real benefits from the mergers (increased trading volume and liquidity) belongs to the small and medium sized companies, but only if they had international sales before the merger. For Jain (2005), the improved liquidity and company performance after the merger does not depend on their size and exposure, but on the implementation of technological innovations in the merger process.

The prime aim of the linkages of stock exchanges is to reduce costs and increase liquidity. Domowitz & Steil (1999) highlight the impact

of the reduction of trading costs on turnover (as experienced in many markets), and more importantly the indirect effects of the reduction of trading costs on the required rate of return. Market size and liquidity are important factors for market efficiency, as well (La Porta et al., 1997), thus, the smaller and illiquid markets have difficulty in achieving this objective. Stijn et al. (2002) believed that most of the stock exchanges will be forced to choose between several options: developing on their own by reducing costs and increasing revenues; building larger virtual markets by establishing cross-border links of some kind with other exchanges; or merging / taking over by one or more of the other exchanges.

Claessens et al. (2002) examine three market indicators related to stock exchange development: market capitalization over gross domestic product (GDP), value traded domestically over gross domestic product (GDP), which complements the market capitalization ratio by showing whether market size is matched by trading, and value traded domestically over market capitalization. In this study, we will estimate how these market indicators for the selected SEE security markets were evolving during the last 15 years.

Liquidity and trading activity are important features of financial markets, yet we know little about their evolution over time or about their time-series determinants (Chordia et al., 2001). Their fundamental importance is exemplified by the influence of trading costs on required returns (Amihud & Mendelson (1986)) which implies a direct link between liquidity and the corporate cost of capital. Therefore this chapter examines both the liquidity and required rate of return of the Macedonian Stock Exchange in order to determine the level of development.

Chordia et al. (2001) and Alrabadi (2012) have shifted the focus of liquidity research from the individual stock level to the overall market level. The authors introduced a new phenomenon called commonality in liquidity and defined it as the co-movement between individual stock liquidity and market liquidity. Commonality is found to exist in developed markets (Hubennan & Halka, 2001; Hasbrouck & Seppi, 2001; Giouvris, 2003) as well as in emerging markets (Brockman & Chung, 2002; Sujoto et al. 2005; Qin, 2007). Launching this area of research, authors have moved toward analyzing aggregate market liquidity, (Chordia et al, 2001)

and investigating whether its variations affect stock returns (Jones, 2002; Amihud, 2002; Bekaert *et al.*, 2003; Pastor & Stambaugh, 2003; Gibson & Mousseot, 2004; Acharya & Pedersen, 2005; Liu, 2006). In our analysis, we will also calculate and analyze the aggregate market liquidity.

The models for estimating the cost of equity (required rate of return) thrive in the literature of financial economics. According to Neves & Pimentel (2011), they can follow an ex-post or an ex-ante approach. Ex-post models based on the relationship between risk and return, were first developed by Sharpe who determines the market price of risk and the measure of risk for a single asset. This is the well-known CAPM, that assumes perfectly liquid markets. In spite of the controversy and criticism of the CAPM including Fama & French (1992) and Ross (1976), this model is still a standard and the one most used by practitioners, according to the surveys of Bruner *et al.* (1998) and Graham & Harvey (2001). This is the major reason for using it as a base for the adapted model used in this chapter.

### 3. Model and Data

For our comparative analysis among SEE and worldwide-developed Stock Exchanges, we use four market indicators.

To measure the level of stock market development, we utilize stock market capitalization as a percentage of GDP, and total value of shares traded as a percentage of GDP, which complements the market capitalization ratio by showing whether market size is matched by trading. Turnover velocity, is computed as the total value of shares traded during the period divided by the average market capitalization for the period.

The cost of capital is of utmost importance in fundamentals-based models for valuing many different assets. Some conceptual problems with CAPM as pointed out by Pereiro (2002) include flaws in its professed objectivity, irrelevance and its inability to capture unsystematic risk. With the increasing interest in emerging markets throughout the 1990s, academics and practitioners have developed a number of CAPM models to compute the cost of capital in an international setting. The most used CAPM variants for business valuations in emerging markets are the global CAPM variant, local CAPM variant, adjusted local CAPM variant,

adjusted hybrid CAPM variant and Godfrey-Espinosa Model. Non-CAPM based models in use include the Estrada model and Erb-Harvey-Viskanta Model. There is no single correct model that is recommended, and the choice lies with the investor or appraiser (Pereiro, 2002).

The finance literature describes a number of empirical anomalies and suggests that, beyond the systematic risk embodied in the CAPM beta; other factors may have an influence on stock returns and should be priced as well. Pereiro outlines the following factors: the relative or absolute size of the firm's market capitalization, the ratio of price to book value, the illiquidity or lack of marketability of the stock, the trading volume, the momentum and the diversification discount,.

Since we want to investigate the required rate of return of the selected SEE stock exchange indexes, where according to our findings they characterize with low market capitalization, low liquidity, and small trading volume, it is convenient to use modification of the basic Sharp's CAPM model:

$$Re = Rf + \beta \times (Rm - Rf)$$

Modified CAPM that we create:

$$Re = Rf_L + Rc + \beta_{LG} \times (Rm_G - Rf_G) \times Rv$$

where,  $Re$  is the stock exchange required rate of return,  $Rf_L$  is the local risk free rate of euro denominated sovereign bonds,  $Rc$  is the country risk premium,  $\beta_{LG}$  is the country beta,  $Rm_G$  is the global market return,  $Rf_G$  is the global risk free rate, and  $Rv$  is the relative volatility.

We compute the country risk premium as a spread of euro denominated sovereign bonds and the German government bond – proxy for the global bonds. The country risk premium is the additional systematic risk for investing in the stock exchanges of emerging markets. Country beta we calculate as slope of the regression between the local equity market index and the DJ EUROSTOXX 600 – proxy for the global market index. We use the return of DJ EUROSTOXX 600 as a proxy for the global market return and the German government bonds as a proxy for the global risk free rate. We calculate relative volatility as a ratio between the standard deviation of the local equity market index and the DJ EUROSTOXX 600. Relative volatility represents unsystematic risk – additional risk for investing in the stock exchanges of emerging markets.

Required rate of return, the risk free rate of return for euro denominated sovereign bonds, the rate of return of DJ EUROSTOXX 600, and the risk free rate of return of the German government bonds we calculate as an annual geometric mean from the monthly rate of returns. We calculate the country risk premium as an average spread from the monthly rate of returns of the euro denominated sovereign bonds and the German government bonds.

Descriptive statistics and charts are used to describe the behavior of aggregate Macedonian stock exchange market breadth, depth and liquidity in the study period. Eight liquidity measures are employed, the absolute quoted bid-ask spread (SPR), the proportional quoted bid-ask spread (PSPR), the quoted quantity depth (DEP), the quoted denar depth (DDEP), Amihud's (2002) illiquidity ratio (AM), the number of trades (NO), the quantity trading volume (QTY) and the denar trading volume (VOL). Obviously, the study uses a number of different measures in order to reflect the different dimensions of liquidity. SPR and PSPR reflect the cost dimension, DEP and DDEP indicate by definition the quantity dimension, QTY, VOL and NO are related to the trading activity aspect of liquidity and AM is a proxy for price impact.

$$SPR_{i,t} = P_{i,t}^A - P_{i,t}^B$$

Where  $SPR_{i,t}$  is the Absolute Quoted Bid-Ask Spread,  $P_{i,t}^A$  is ask priée of stock  $i$  at time  $t$ .  $P_{i,t}^B$  is bid price of stock  $i$  at time  $t$

$$PSPR_{i,t} = \frac{P_{i,t}^A - P_{i,t}^B}{(P_{i,t}^A + P_{i,t}^B)/2}$$

Where  $PSPR_{i,t}$  is the Proportional Quoted Bid-Ask Spread

$$DEP_{i,t} = \frac{Q_{i,t}^A + Q_{i,t}^B}{2}$$

Where  $Q_{i,t}^A$  is ask quoted quantity of stock  $i$  at time  $t$ .  $Q_{i,t}^B$  is bid quoted quantity of stock  $i$  at time  $t$ .

$$DDEP_{i,t} = \frac{Q_{i,t}^A * P_{i,t}^A + Q_{i,t}^B * P_{i,t}^B}{2}$$

Where  $DDEP_{i,t}$  is the Quoted Denar Depth

$$AM_{i,t} = \frac{|R_{i,t}|}{VOL_{i,t}}$$

Where  $AM_{i,t}$  is Amihud's (2002) illiquidity Ratio,  $R_{i,t}$  is the return on stock  $i$  at time  $t$ .  $VOL_{i,t}$  is the denar volume of stock  $i$  at time  $t$ .

Aggregate market values of SPR, PSPR, DEP, DDEP and AM on a certain day are calculated by averaging their values for all the stocks that are traded on that day. However, aggregate market values of QTY, VOL and NO are calculated by summing their values for all the stocks traded on a certain day.

For the comparative analysis among SEE and worldwide-developed Stock Exchanges, we use annual data from the World Bank Database. For the stock exchange required rate of return, we use monthly data throughout the period January 2005 – December 2012 (8 years), inclusive. For each stock exchange, it includes the monthly rate of return of the 10-year euro denominated sovereign bonds, including the German government bonds used as a proxy for the global risk free rate of return. It also includes the monthly rate of return of each stock exchange index including the DJ EUROSTOXX 600, used as a proxy for the global market rate of return. We calculate the rate of return of bonds from the monthly data for bond prices obtained by the Bloomberg Data Base. For the computation of the stock exchange indexes' rate of return, we use monthly data from Budapest, Bucharest, Sofia, Ljubljana, Zagreb, Belgrade and the Macedonian Stock Exchange.

For the determination of the breadth, depth and liquidity of MSE the data set consists of daily closing trading data for all 161 stocks that are registered and traded in MSE throughout the period January 2005 – December 2012 (1.927 trading days), inclusive. For each stock, it includes the daily quantity and denar trading volume, the average prices for the day, the daily number of trades and the best quoted bid

and asking prices and their corresponding quoted quantities. All the companies that are traded in any day are included without any exception. In the calculations we exclude the shares that do not have bid-ask spread or trading volume for that day. In comparative analysis, we use the following exchange rate: 1 € = 61.35 MKD - Macedonian denar.

## 4. Empirical Results

### 4.1. Comparative Analysis

To measure the level of stock market development, as we mentioned before, we use three market indicators. The data for the first indicator, stock market capitalization as a percentage of GDP, we present in Table 1, and show that stock markets in those SEE countries grew significantly over the last 15 years.

Table 1: SEE Stock Exchange Development 1996-2011 (Market capitalization / GDP)

Country	1996	2001	2006	2011
Macedonia	2.2	1.3	16.7	5.9
Serbia	0.0	0.0	37.6	18.3
Croatia	12.7	14.4	58.2	34.9
Slovenia	3.1	13.9	39.0	12.8
Bulgaria	0.1	3.6	31.1	15.4
Hungary	11.5	19.7	16.7	13.4
Romania	0.2	5.3	26.7	11.8

Source: World Bank Database

These values are far below the levels of the well-established market economies (the total world stock exchanges ratio is 68.8%, while in the EU it is 52.7% and in Germany 32.9% in 2011). If we look at the data from 2006 (the year before the beginning of the global financial

crises) and 2011, although maybe surprisingly, we can conclude that the most developed stock exchange of SEE group is the Croatian one, followed by the Slovenian and Serbian stock exchanges.

Despite the robust growth rates, the SEE stock markets remain small in terms of market capitalization compared to the developed markets. At the end of 2011, the capitalization of all these markets together amount to 5.3% of the German and 4.0% of the French stock market capitalization.

Table 2: SEE Stock Exchange Development 1996-2011 (Trading volume / GDP)

Country	1996	2001	2006	2011
Macedonia	0.0	1.4	3.0	0.5
Serbia	0.0	0.0	4.6	0.7
Croatia	1.0	0.5	3.7	1.5
Slovenia	1.9	3.9	2.6	1.0
Bulgaria	0.0	0.5	4.5	0.5
Hungary	3.6	9.1	27.7	13.9
Romania	0.0	0.6	3.5	1.8

Source: World Bank Database

This indicator shows the other side of stock market development, and different results from the previous market indicator - very low trading volume and overvalued stock prices. From the examined countries, only the Hungarian stock exchange shows a significant level, while for the other six countries we can conclude a high level of illiquidity. These results confirm our hypothesis, that merged/integrated stock exchanges (such as the Hungarian one) have higher/increased stock exchange liquidity, and that the single SEE stock exchanges are driven to the brink of extinction with this low level of trading volume.

Table 3: SEE Stock Exchange Development 1996-2011 (Trading Volume / Market Cap.)

Country	1996	2001	2006	2011
Macedonia	0.0	177.1	22.4	2.0
Serbia	0.0	0.0	16.3	3.7
Croatia	12.8	3.9	8.7	4.1
Slovenia	82.3	29.5	8.8	6.5
Bulgaria	0.1	12.5	19.6	3.4
Hungary	42.8	43.0	83.7	83.9
Romania	7.6	16.0	16.0	12.0

Source: World Bank Database

If we look at the data in Table 3 from 2006, the turnover ratio is very high for Hungary, and the rest of the SEE countries that we examined are some way behind Hungary, which confirms the findings in the previous market ratio. This is even more evident if we look at 2011, where Hungary has 83.9%, while the others less than 12%, which is the real measure of their illiquidity. In 2011, the German stock exchange had a 134.5% turnover ratio.

In Table 4, we present the results for the SEE stock exchanges' required rate of return using the modified CAPM formula we create:

$$Re = Rf_L + Rc + \beta_{LG} \times (Rm_G - Rf_G) \times Rv$$

Table 4: SEE Stock Exchanges' required rate of return 2005-2012

Country	M-CAPM	$Rf_L$	$Rc$	$\beta_{LG}$	$Rm_G$	$Rf_G$	$Rv$	$SD_L$	$SD_G$
Macedonia	13.13	5.18	4.28	0.86	5.60	4.19	3.02	12.52	4.14
Serbia	15.23	7.57	2.81	1.30	5.60	4.19	2.64	10.95	4.14
Croatia	12.24	6.09	2.32	1.22	5.60	4.19	2.22	9.21	4.14
Slovenia	8.29	4.61	2.11	0.73	5.60	4.19	1.53	6.33	4.14
Bulgaria	8.73	2.31	1.79	1.40	5.60	4.19	2.35	9.71	4.14
Hungary	10.43	4.02	2.88	1.35	5.60	4.19	1.85	7.67	4.14
Romania	14.63	6.04	3.13	1.57	5.60	4.19	2.47	10.21	4.14

Source: Authors own calculations

From the data in Table 4, we find out that the Slovenian Stock Exchange has the lowest required rate of return of 8.29%, followed by the Bulgarian and Hungarian Stock exchanges at 8.73%, and 10.43% respectively. We must point out that the good results for Bulgaria are due to the very low risk free rate of return and consequently the very low country risk premium. However, standard deviation data correct this abnormality and place Slovenia and Hungary much farther ahead than the rest of the elaborated SEE countries. This conclusion goes also ahead with our hypothesis that stock exchange mergers/integrations decrease the required rate of return. As we point out previously Slovenia and Hungary are part of the CEE Exchange Group, and additionally they are the only ones from the elaborated stock exchanges that entered any merger process until now.

High historical required rates of return, together with the low market capitalization and turnover, are some of the reasons why the indexes of all the elaborated stock exchanges are still around their bottom in March 2009. In order to achieve these high expected rates of return, with this high level of volatility, and very low liquidity, investors ask for low prices, which keep the indexes nailed almost on their lowest historical values.

### *1.1. Breath, Depth and Liquidity of Macedonian Stock Exchange - Descriptive Statistics*

Descriptive statistics of liquidity variables are reported in Table 5.

Table 5: Descriptive Statistics of Liquidity for MSE 2005-2012

	SPR	PSPR	DEP	DDEP	AM	NO	QTY	VOL
<b>Mean</b>	1.261,33	8,25	243,87	207.615	2,98E-06	162,02	17.687,32	26.710.891
<b>Standard Error</b>	21,33	0,06	4,34	3.057,06	2,87E-07	4,26	608,76	942.639,72
<b>Median</b>	999,71	8,14	191,74	161.820	7,37E-07	100,00	9.612,00	11.750.347
<b>Mode</b>	340,39	#N/A	111,07	#N/A	#N/A	80,00	7.341,00	#N/A
<b>Sta. Deviation</b>	936,12	2,66	190,55	134.198	1,26E-05	186,90	26.722,90	41.379.629
<b>Kurtosis</b>	2,15	0,12	14,26	6,34	285,39	16,04	47,55	29,39
<b>Skewness</b>	1,62	0,13	3,30	1,91	15,19	3,46	5,48	4,28

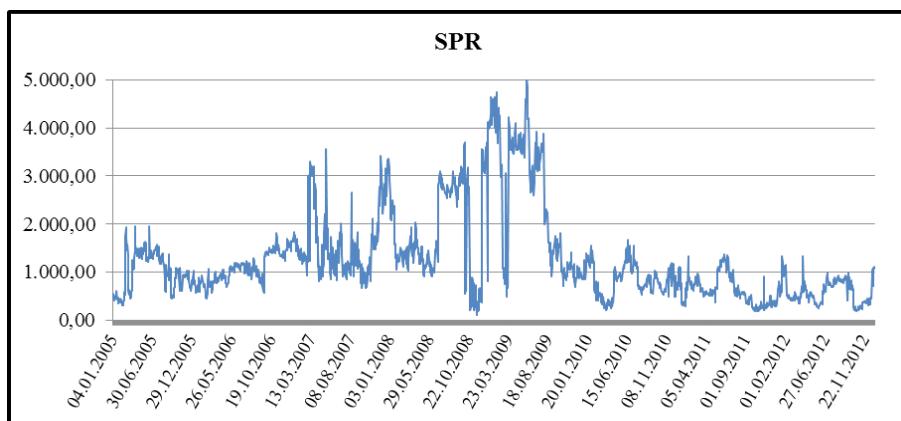
<b>Minimum</b>	107,33	0,93	36,00	63.784	2,55E-09	5,00	128,00	237.500,00
<b>Maximum</b>	5.034,26	16,52	1.533,68	1.409.743	2,72E-04	1.650,00	408.386,00	575.933,503
<b>Count</b>	1.927	1.927	1.927	1.927	1.918	1.927	1.927	1.927
<b>C. Level (95.0%)</b>	41,82	0,12	8,51	5,995	5,64E-07	8,35	1.193,89	1.848.702
<b>C of V %</b>	74,22	32,20	78,14	64,64	422,97	115,36	151,09	154,92

Source: Authors own calculations

Breadth variables SPR and PSPR as well as the depth variables DEP and DDEP, show moderate volatility, and the illiquidity and trading variables AM, NO, QTY, and VOL very high volatility indicated by the high values of the coefficient of variation. Means and medians (except for the PSPR) differ significantly, demonstrating that none of these liquidity variables is normally distributed. Furthermore, for all liquidity variables Skewness positive values show asymmetric distribution to the right. This means that all variables, most of the trading days, have negative values. AM, NO, QTY and VOL very high Kurtosis values indicates very high variability in stock exchange liquidity.

Figure 1 and 2 plot breadth variables SPR and PSPR, that reflect the cost dimension of liquidity.

Figure 1: MSE Absolute Quoted Bid-Ask Spread 2005-2012

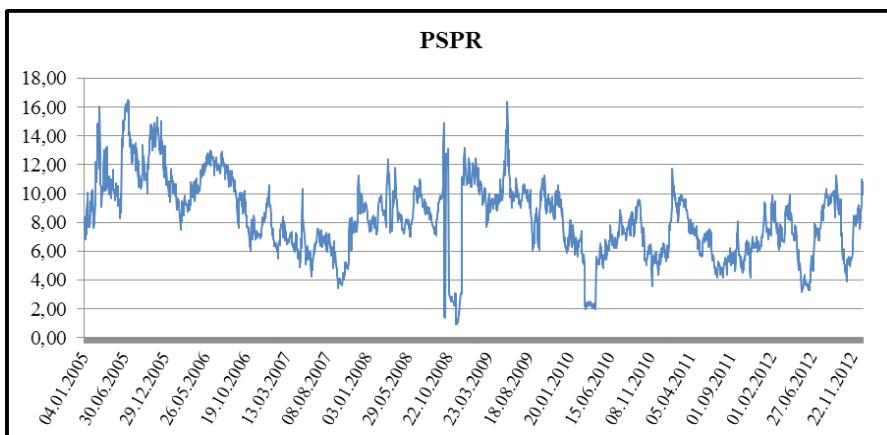


Source: Authors' own creation

SPR shows the absolute quoted bid-asking spread. The higher the spread the higher the transaction costs for the investors. From Figure 1 we can see that in 2005 and 2006 SPR is around its Mean value (1.261). In 2007 and 2008, SPR increases substantially - almost double the Mean value. The highest values and range of SPR we see in 2008 and 2009, which is understandable having in mind the start of the global financial crises in 2007 that scared all investors and thus caused a very high spread. In March 2009, when the MSE drops for more than 80% from its peak in 2007, SPR stabilized, and kept these low values until today. We explain the low level of absolute spreads by the low historical level of prices.

PSPR is the proportional quoted bid-ask spread. This measure is a more realistic picture of the stock exchange breadth and transaction costs because we calculate it as a percentage. The higher the values of this variable the lower the stock exchange breadth and the higher the transaction cost. From Figure 2 we can see that in 2005 and 2006 transaction costs were very high. The range from 8% to 16% is above the PSPR Mean. In 2007, the best year of MSE, transaction costs dropped to only 4%. After the global financial crises starts, in the second half of 2007, PSPR escalates again, reaching its peak of 16% in 2008, and then declining to the end of the sample period. This conclusion confirms our findings for SPR.

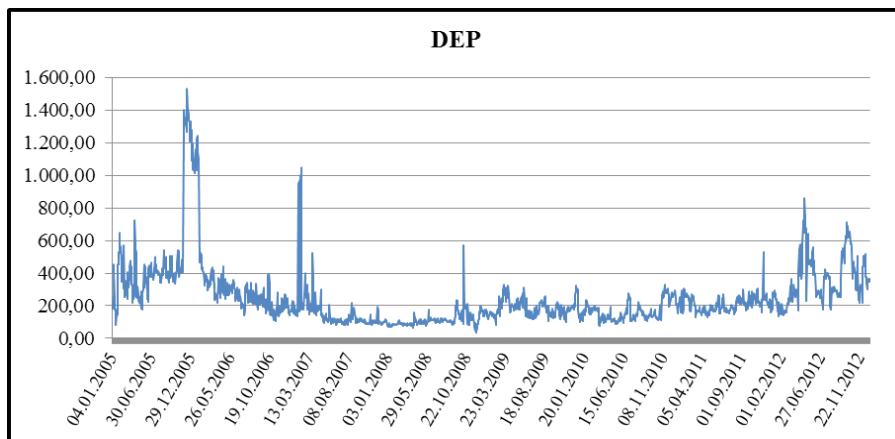
Figure 2: MSE Proportional Bid-Ask Spread 2005-2012



Source: Authors own creation

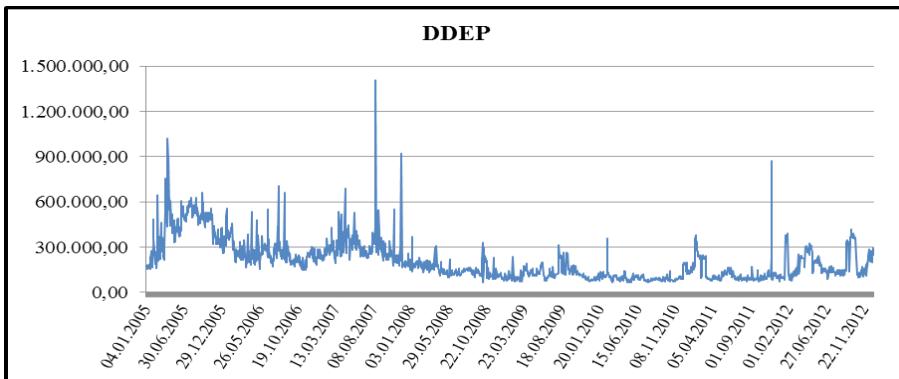
DEP and DDEP variables presented in Figure 3 and 4, indicate by definition the quantity dimension. The higher values of these variables impose higher liquidity. In 2005 and 2006 many state-owned companies were privatized , the most important of which was the ESM (National Electricity Company) in 2005, which maintained a high level of security exchange depth. In 2007, because of the stock market boom, the quoted depth reached a high level. From 2008, until the second half of 2012, the level of quantity variables was very low which explained the illiquidity and the stagnant levels of the MBI 10 index during the same period. The Mean is very low – only 207 thousand MKD or 3.500 €, which means that on average the stock exchange index can be influenced by just a small amount of money.

Figure 3: MSE Quoted Depth 2005-2012



Source: Authors own creation

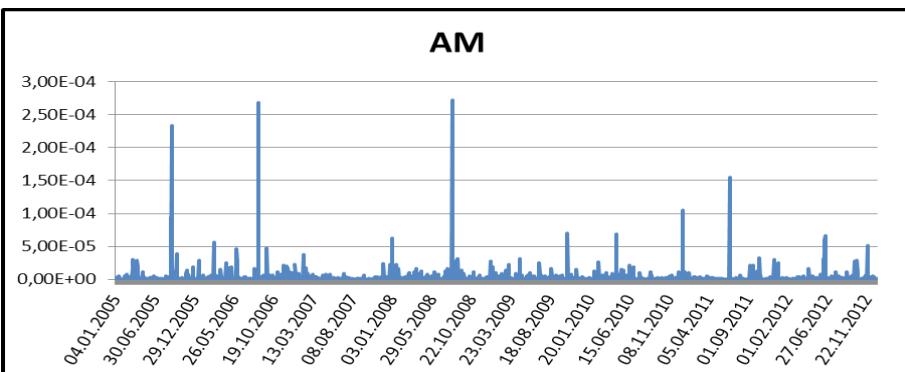
Figure 4: MSE Quoted Denar Depth 2005-2012



Source: Authors own creation

According to the findings of Amihud (2001), that are based on data on NYSE stocks for the period 1964-1997, illiquidity has a positive effect on expected stock return both cross sectionally and over time. It can be interpreted as the daily price response associated with one dollar of trading volume, thus serving as a rough measure of price impact. Since this is an illiquidity measure, higher value means higher ex-ante expected rate of return, which consequently results in lower stock prices. AM values for MSE, given in Figure 5, are almost equal and even lower than the ones of Amman Stock Exchange documented by Alrabadi (2012).

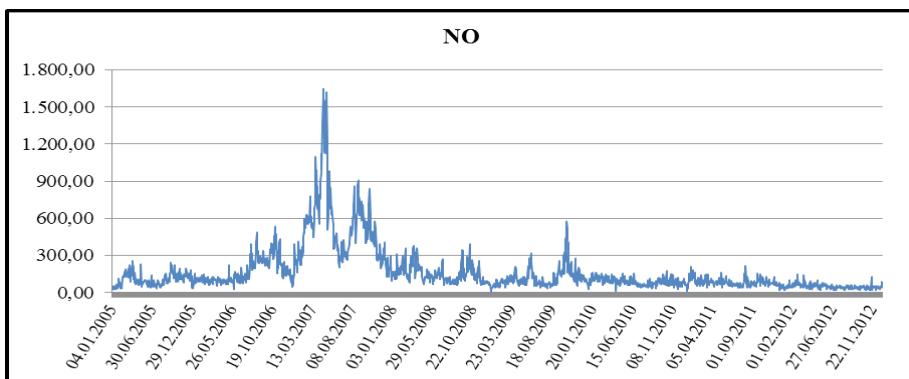
Figure 5: MSE Amihud's (2002) Illiquidity Ratio 2005-2012



Source: Authors own creation

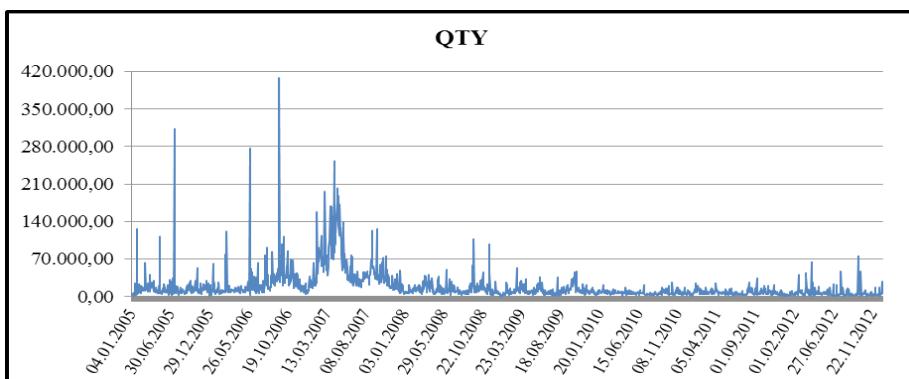
QTY, VOL and NO variables are related to the trading activity aspect of liquidity. Figure 6, 7 and 8, plots these variable values for the MSE. The higher the value of these variables indicates higher liquidity. From the results in all three figures, we can conclude that only 2007 MSE has dissent levels of concluded transactions, quantity trading volume and MKD trading volume. Their Means: 162 number of trades, 17,687 traded shares, and 26.7 million MKD (approximately 435 thousands €) confirm our statement. It means, with less than a half million euro, you can move the MSE. If we exempt 2007, this amount would be much lower.

Figure 6: MSE Number of Trades 2005-2012



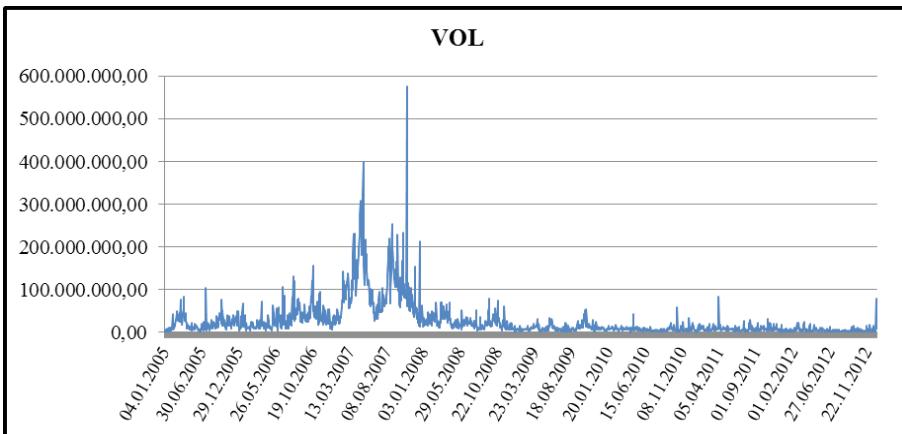
Source: Authors own creation

Figure 7: MSE Quantity Trading Volume 2005-2012



Source: Authors own creation

Figure 8: MSE Denar Trading Volume 2005-2012



Source: Authors' own calculations

Overall, aggregate market liquidity has improved through 2005-2007 because of the technical and legal developments of the MSE, and the entrance of foreign institutional investors, mostly from the Balkan Countries. However, a significant brake happened in 2008. Liquidity dried up swiftly through 2009-2012. Foreign institutional investors in order to cover their liquidity needs, raised from investor's requests for stepping out of their investment funds, sold their stock positions especially those in Macedonia where they made the highest returns (Lazarevski, 2011).

## 5. Conclusions of the Main Findings

In order to measure the level of stock market development in the seven selected SEE Stock Exchanges, we used three market indicators and the required rate of return. Based on results from the comparative analysis we can conclude that the values are below the acceptable levels in the developed and well-established market economies. In the case of Croatia, Slovenia and Serbia the higher market capitalization over GDP is achieved with very low trading volume and overvalued stock prices. Only the Hungarian and the Slovenian stock exchange show a significant level of liquidity and the required rate of return, which is not the case with the other five countries. These results confirm our hypothesis that the

merged stock exchanges (such as those of Hungary and Slovenia have higher/increased stock exchange liquidity, while, on the other hand, the profitability of the other SEE stock exchanges that did not go through the merging process has been driven to the brink of extinction.

Descriptive statistics of the Macedonian Stock Exchanges (MSE) deliver the following conclusions: the breadth variables SPR and PSPR, and the depth variables DEP and DDEP show moderate volatility, whilst the illiquidity and trading variables AM, NO, QTY, and VOL show very high volatility indicated by the high values of the coefficient of variation. Furthermore, the PSPR variable value of 8.25% indicates an extremely low stock exchange breadth and high transaction costs. Those low levels of quantity variables explain the low depth of stock exchanges, their MSE illiquidity and the stagnant levels of the MBI 10 index. Amihud's (2002) illiquidity ratio values are relatively high for the whole of the period under study. QTY, VOL and NO variables that relate to the trading activity aspect of liquidity, present in 2007 alone a relatively standard number of transactions, quantity trading volume and trading volume. Aggregate market liquidity has improved through 2005-2007 as a consequence of international stock market booms. However, a significant brake happened affected by heightened risk aversion on the part of international investors after September 2008 and liquidity was drying up all through 2012.

Based on the results of the analyses, we strongly believe that if they want to alleviate their future operation and existence, the SEE stock exchanges have to decide for one of the following options: (a) a "stand-alone" development of each SEE market, in parallel with aggressive policy measures in order to develop the internal financial market; (b) a bilateral connection of individual SEE exchanges with a developed market for establishing virtual trading venues sharing advanced platforms and visibility; (c) merging with some SEE exchanges, by harmonizing and negotiating the rules and regulation within the group. The first option is the one with less prosperity considering the constant pressure from the competition of the European stock exchanges, and in the interest of staying economically viable in such a competitive environment, the SEE stock exchanges will be forced to cut costs. It may be possible for the relatively small markets to link or merge their trading systems with some of the global markets. However, having in mind the insignificant

size and its preferences, it is less likely that this will be the option for the Macedonian Stock Exchange. Also, even though it is understood that the regional exchanges have the utmost chance for being viable in the long run, at the same time they are also extremely difficult for negotiating because of the usual political obstacles.

Regardless of the option they will choose, it is unavoidable that major changes have to be implemented on the financial markets, which will reinforce the listing standards, improve the trading systems and enhance the corporate governance rules. These changes are necessary to create a liquid and dynamic stock exchange that will be open to meet the needs of companies and investors.

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Figure 1: MSE Absolute Quoted Bid-Ask Spread 2005-2012

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Figure 3: MSE Quoted Depth 2005-2012

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Figure 5: MSE Amihud's (2002) Illiquidity Ratio 2005-2012

Figure 6: MSE Number of Trades 2005-2012

Figure 7: MSE Quantity Trading Volume 2005-2012

Figure 8: MSE Denar Trading Volume 2005-2012

## **The New Economics: the Need for Real Enforcement**

*Jeremy Cripps, Kalin Sergeev, Boris Minchev*

### **Abstract**

*This paper examines the bureaucratic constraints on growth in Bulgaria a member of the European Union. The aim of the paper is first to document these constraints with examples from small and medium size business enterprises. A second aim is to demonstrate how bureaucratic constraints, particularly the existing distribution network, contribute to the necessity of small and medium size business smuggling to remain competitive. The third aim is to put the situation in Bulgaria into the European context following the arguments of Prime Minister Cameron who has proposed “a leaner and less bureaucratic European Union.” The paper offers a solution to bureaucratic constraints; the introduction of a Uniform Commercial Code for the European Union, following the example of the Uniform Commercial Code adopted in the United States. The Uniform Commercial Code “a comprehensive code addressing most aspects of commercial law, is generally viewed as one of the most important developments in American law. Bulgaria’s Economy Minister has recognized the anti-competitive nature of business in the European Union noting that only smuggling generates any growth. He noted that “if we have to choose between [a] gray economy and no economy, Bulgaria is definitely better off having [a] gray economy.” Specific examples of the causes of the need for small and medium size business to adopt the methods of the gray economy will be documented. Specific examples of external anti-growth business competition from non-Bulgarian companies financed by European funding institutions will also be documented. The need to bypass existing legal distribution networks will also be documented. The*

*paper will then identify the benefits of a Uniform Commercial Code for the European Union based on the experience of the Uniform Commercial Code in the United States. Such a code will provide a means of replacing existing bureaucratic constraints on business in the European Union. A Uniform Commercial Code will also provide new economics for distribution in the European Union and in this way contribute to a leaner and less bureaucratic European Union.*

**KeyWords:** European Union, corporate governance, law enforcement, small and medium size business, Uniform Commercial Code

*“We now see that we are still a long way from being a Union in which the same rules apply”*  
(Higgins, 2013)

Enforcement of European Union law “is the prerogative of the European Commission” (Eurofound, 2013). The “failure to develop a uniform system of enforcement” of EU law (Eurofound, 2010) means that administrative enforcement is “achieved through national administrative mechanisms.” “The effectiveness of national enforcement mechanisms is “under review.” The effectiveness of national enforcement mechanisms follows one of at least two tracks. The first track, chosen by the United States in, for example, the Sarbanes Oxley Act (SOX) is known as ‘comply or else.’ In other words failure to comply leads to legal sanctions. The second track adopted by the 27 states in the EU is known as ‘comply or explain.’ A weaker version of ‘comply or explain’ known as ‘apply or explain’ may be seen “more appropriately” (The Netherlands Code, 2004) to convey the intent to enforce eventual compliance. According to the Center for European Policy Studies, employment of different versions of the law has led to “weak enforcement and compliance” and these undermine EU law and “are the biggest obstacles to reaping its full benefits” (Pelkmans & De Brito, 2012).

In the context of the Pelkmans and De Brito study, this paper investigates the apparent ‘apply or explain’ approach seen in Bulgaria,

with the intention of confirming their expressed need for enhanced enforcement in the EU single market. As they note (2012) “despite the recent more effective enforcement in the single market, it would be a mistake to hold that the enforcement issue is ‘solved’, far from it.” Nine cases are investigated employing forensic audit techniques to consider whether the purposes of the European Commission funds have been fulfilled.

As in Germany, so in Bulgaria, “per capita economic growth has been positive” and Chancellor Merkel has praised Bulgaria “as a model for other European economies to follow” (Krastev & Ganev, 2013). Yet “Bulgaria has no long-term vision” (Passy, 2012) and “rather than look for ways to improve state enterprise efficiency by improving governance structures,” many government departments, especially Education, Transport, and Finance, have failed to implement necessary reforms and “managerial positions have continued to be part of the political spoils system” (Jones & Miler, 1997). Public benefits, widely available before the 1989 transition, keep in place a culture of “firm performance” rather than individual initiative and enterprise (Klinedinst & Rock, 1997). The “lack of qualified staff” and “lack of implementation of laws” was seen in 2007 to be the biggest problems by the Bulgarian Industrial Association (Beekman, 2007). In spite of German financial policies, the situation has yet to change (Novinite, 2012). This provides a context for forensic research into corporate governance: the identification of perceived weaknesses and the provision of evidence on the control and care applied by the European Commission over EU funds in Bulgaria.

## Method

Forensic accounting “is the application of investigative and analytical skills for the purpose of resolving financial issues” (Hopwood et al., 2008) to provide evidence for legal or appropriate administrative action. EU Commission investments of European taxpayer funds are designed to “create smart, sustainable growth and get Europe out of the current economic crisis” (CORDIS, 2010). Thus investment policy focuses on competition and productivity (EBRD, 2011), fosters job creation (CPESS, 2007), and seeks to support capital formation (Krkoska, 2001). The risk of poor policy is inherent. For audit purposes this risk can be

checked by monitoring internal control and testing, at the micro level, the controls put in place (Whittington & Pany, 2010). This monitoring process includes detection of actual practice compared with the strength or weakness of the control mechanism and whether appropriate control policies have been implemented effectively. Unfortunately an effective audit process is not formally in place. Indeed, for some time there has been recognition that decentralization of the administration of European Funds requires appropriate levels of independent audit “because what happens with the centralization of power is you get corruption and stagnation” (Brewster, 2003). The cases investigated in this paper research the problem. We note that the then Chief Accountant of the European Commission stated that the system was “open till waiting to be robbed” (Evan-Pritchard, 2005) and that the quality of accounting and auditing continues to be “chronically sordid.”

To document the risk of failure to meet European Commission investment design this chapter documents nine separate cases covering areas where the European Union, through Commissions and the European Bank for Reconstruction and Development, and EU absorption funds have managed to:

- Focus on competition and productivity
- Create smart sustainable growth
- Foster job creation
- Support capital formation.

## Results

We provide, in summary, our audit of nine micro-level examples of the employment of European funds to promote these four conditions. The nine cases are as follows:

- 1) Improving the conduct of business in Sofia
- 2) A note on the Grey (shadow) economy
- 3) A restaurant opening in Bulgaria
- 4) The need to smuggle
- 5) CAP Agriculture
- 6) Freedom Square, Ruse
- 7) Tourist hotel, Simeonovo
- 8) The Strand mall Bourgas
- 9) The investment in Chalga

In this paper we then provide in well-supported detail our discovery of the facts and features of these micro-level examples of the current employment of European funds. We believe that other researchers may wish to take the opportunity to replicate our analysis and to come to similar conclusions.

## Audit Results

### 1. Improving the Conduct of Business in Sofia:

Ten years after Perestroika regulations for setting up business in Sofia required the acquisition of some 20 documents set out in Exhibit 1 before a business could open.



Район "Средец"  
София, ул. "Леве" 6, тел. 987 78 11

На основание Наредбата за провеждане на търговска дейност на територията на СО от 1993 г., при регистриране на дейността си, което трябва да стане в 14 дневен срок в служба "Контрол на търговската дейност" при Район "Средец" - ул. "Леве" 6, ет. 5, стая 505

ЗАДЪЛЖИТЕЛНО се представят следните документи:

1. Заявление за регистрация на търговски обект с приложение за работното време.
2. Съдебна регистрация на фирмата.
3. Документ за дължностна регистрация /съответната дължностна служба/
4. БУЛСТАТ.
5. Осигурилени номер на фирмата в Столично управление "Социално осигуряване" /бул. "Стамболовска" - пл. "Възраждане"/.
6. Акт за държавна/общинска собственост.
7. Нотариален акт /заповед за дактилизация/.
8. Удостоверение за наследници.
9. Договор за наем.
10. Разрешение от отряда "Архитектура".
11. Разрешение от противпожарна охрана /пожарната, стадион "Терено", тел. 45-22-23/.
12. Разрешение от Електроснабдяване Лул "Цар Симеон" 331/.
13. Договор за водоснабдяване и канализация /Зона Б5, тел. 22-18-53/.
14. Договор с Телекомюните.
15. Разрешение от СКЕИ - за магазини за хранителни стоки и заведения Лул "Вране" 20/.
16. Разрешение от ДВСК - за магазини за хранителни стоки и заведения, ако продават стоки от животински произход /Сточна гара, ул. "Димитър Николаев" 7, тел. 44-46-02/.
17. Такса смет в Данична служба "Средец" ул. "Турко" 12.
18. Съгласие на живущите.
19. Разрешение от Регионалната инспекция по опазване на околната среда - за производителя.
20. Разрешение от Министерството на здравеопазването за продажба на лекарствени средства.

ПРИЕМНО ВРЕМЕ: [REDACTED]  
Вторник 14 - 17 часа  
четвъртък 9 - 12 часа

Exhibit 1: Trade Regulations Sofia 1993 – Translation Appendix A

Remarkable Efforts to simplify since Bulgaria joined the European Union have led to a significant improvement toward company formation. As elsewhere in Europe, Bulgarian companies can now be formed via agents off-the-shelf (Zaraconsult, 2013) to take advantage of the lowest corporate tax in Europe at 10% (Deloitte, 2012)

Nevertheless in spite of the lowest taxes and the lowest average wages Bulgaria is ranked 66<sup>th</sup> in the world, and last in Europe, for overall doing business (World Bank, 2012). Detailed rankings are set out in Appendix B. and otherwise as set out in Exhibit 1 below in other categories.

One of the reasons contributing to the difficulty of doing business in Bulgaria may be seen to be the acceptance of Bulgarian as an official language of the European Union. Europe has too many official languages and will do well to follow South Africa's example when it comes to providing an English translation for legal and business activity. South Africa has eleven "official" languages but a Use of Official Languages Act which requires legal and business activity to be reported in English (SA Gazette, 2012). The European Union with twenty-three "official" languages and three "procedural languages (Europa, 2013) will attract more business when legal and business activity are always made available in English. The absence of the employment of a single operational official language, English creates two problems for doing business in Bulgaria. First many of the Bulgarian government documents and websites are not required to be set-up in any other language than Bulgarian, inhibiting direct foreign investment into Bulgaria and secondly Bulgaria is contributory to the massive bureaucracy required to meet this obfuscating reality. The World Bank Group rankings confirm the impact of bureaucracy on business in Bulgaria. A "massive downsizing" is seen to be "the best anticrisis measure for the Bulgarian government" (Novinite, 2010).

## 2. A Note on the Grey (Shadow) Economy

The Grey (shadow) economy in Bulgaria is variously thought to have been on the wane since 2007, the year of Bulgaria's accession to the European Union (Novinite, 2013. Nevertheless the size of the grey economy in Bulgaria was then estimated to be between 25 to 35 per cent of the country's gross domestic product (Sophia Echo, 2013). The

wane since 2007 however is in doubt. Expert analysis as recently as 2012 considered the grey economy in Bulgaria exceeds 30% (Novinite, 2012).

Whatever the level of the shadow economy, the facts are simply that the Bulgarian authorities are not yet prepared to take on the role of watchdog, ensuring for its citizens the rule of law in preference to permitting a wide range of illicit dealings. The grey economy is seen to be directly involved with government-funded construction projects, contracts for public procurement, and general under-reporting of company turnover, wages and salaries for tax evasion purposes. Recently the Center for the Study of Democracy hosted a public discussion at the press center of the Bulgarian Telegraph Agency on the subject of the continuing grey economy (CSD, 2013). The then Minister of Finance, Traicho Traikov, stated publicly that “a grey economy was better than no economy” (Novinite, 2011). Our audit examination of the grey economy begins then in the context of broad social acceptance of Bulgaria’s grey economy and in the absence of any apparent sincere determination to reduce or eliminate its presence.

### 3. Starting up a Restaurant

How hard is it to set up a small restaurant in Bulgaria? One might expect that opening a small restaurant is not a very “complex and costly process.” To the contrary in Bulgaria, the process is hindered from the outset by “regulations and administrative requirements” usually requiring the cost of “expert advice” (eObshtestvo, 2013). Indeed such is the complexity that expert facilitation is needed to complete the process in return of course for a modest cash fee.

The first barrier to doing business is bureaucracy. The process is thoroughly described in a website called eSociety (2013). A lawyer is required (minimum BGN 500) for the business incorporation documentation. The minimum time to open is 18 days which compares with a single day elsewhere in the world (World Bank, 2012). In practice 18 days in the case of a restaurant is optimistic, perhaps if the appropriate attorney is available and in a good mood. After creating your own company you need to hire an accountant. Fees become a significant expense especially if revenue generated exceeds BGN 50,000 when you must also register for VAT (NRV, 2013).

Unusually for the western world all these processes have to be completed in person by you or your sworn representative – the process may not be completed over the Internet in the country with Europe's third fastest Internet (Catone, 2011). Once the restaurant location is established a busy period of compliance ensues, obtaining approvals from the Fire Department, Local and Regional Inspectorates for Protection and Control of Public Health, utility suppliers and others. These processes can be expedited with unofficial “facilities” payments. Appropriate documentation is now in place for precise scales (these must also be certified by the national agency), permits from the water and electricity companies, a document confirming opening the electrometer and water meter readings (certificates from appropriate national agencies), and depending on the region many, many other documents which take days and days to be issued (Zavedenia, 2013).

Further delaying and complicating the opening is the fact that a full set of information is not available in any language other than Bulgarian. Even to a Bulgarian the process is seen to be a “secret” ensuring that more than a single company is needed and the process of small facilities payments keeps needless regulation on special rooms for eggs and extra freezers for meat and fish, at bay. Thus the process relies on an inefficient group of bureaucrats to liaise with professional facilitators providing a filtering system which denies initiative, innovation, and job creation. Like a chef's cleaver, the process is at the cutting edge of economic growth denial.

#### 4. The Need to Smuggle

Small retail businesses are at the core of Bulgaria's economy. On condition of anonymity our sources identify the business model which is fundamental to sustaining a manageably profitable small retail business away from the capital Sofia in Bulgaria.

Several critical barriers to the normal retail business mode exist. To get round the barriers retail business owners resort to “unorthodox” ways of doing business variously described by observers as bribery, creative accounting, and tax evasion (Novinite, 2011). According to our sources doing business without “unorthodox” activity is not a matter of choice but an essential feature of retail business in Bulgaria if you wish to stay in business (BBC News, 2013).

The principal source of consumer goods for resale in Bulgaria is Turkey (Bridgat, 2008). Turkey is a preferred supplier for a good reason. Relatively close proximity to Bulgarian retail outlets means low transport costs. The quality of Turkish imports in the case of the retail fashion industry compares favorably with European source brands such as Dolce and Gabana and Gucci from Milan. In addition production facilities in Istanbul indicate that Istanbul may be the world's new fashion capital (Skylife, 2009). Significant manufacturing and production facilities also exist, not just for clothes but for car parts, cosmetics, and consumer products with a wide range of price and quality to satisfy world demand (Biztradeshows, 2013).

Constraints on the importation of official retail goods from Turkey are twofold. The distribution network into and within Bulgaria is slow and expensive. Cargo carriers are slow regularly exceeding two weeks for delivery from Istanbul to Sofia (at 567 kilometers, less than a 7 hour drive by car). Additional time may be needed for rural retail business. Then cargo fees are correspondingly excessive as these will also include substantial customs duties.

Fortunately, for small retail business customs officers in Bulgaria are widely accepted to be the most corrupt public officials (Dalley, 2012). Thus private transport and relatively small (and unrecorded) facility payments to the customs reduce the cost of imports by more than 15% and therefore become the required model for small retail businesses who wish to stay in operation. Given the poor transport and poorly managed customs, the business model described is mutually beneficial for both parties and despite efforts to fight it (Krasimirov, 2012) smuggling is still happening on a large scale.

Thus consumer goods worth BGN millions enter Bulgaria, thereby escaping any record at customs. From an accounting point of view, these goods are not officially in the market place. No official documentation accompanies them. However there is a cottage industry providing "proven" documentation (forged) should there be a need to prove that the inventory is not stolen. On the relatively rare occasion when inventory items are unaccompanied by "proven" documentation a small facility payment will take care of the oversight.

Then the threshold for registration for Value Added Tax (VAT) purposes in Bulgaria is BGN 50,000. Many small retail businesses will

evade meeting this threshold and thus avoid the 20% VAT. Should a small retail business meet the VAT threshold it would be necessary to provide proof of source and this is contributing to Bulgaria, like Greece, becoming a nation of small shopkeepers and adopting tax evasion as a “national pastime” (Surowiecki, 2011). Clearly rising to the BGN 50,000 threshold is a matter to be avoided. No surprise then that almost all small retail businesses in Bulgaria are forced “to cook their books and avoid taxation” (Standart News, 2012).

Small business owners do not like committing fraud or bribery. “If there was a fast cargo service at normal prices I would never try to smuggle anything. For me it is better to have the invoices as it is sometimes very hard to find a forged invoice, and these do not come cheap as you can imagine” (Small retailer, Blagoevgrad, 2013). Currently, there is no viable alternative to trade with Turkey. European imports simply cannot compete with imports smuggled in from Turkey.

### 5. CAP Agriculture

Prior to World War II, agriculture “contributed 65 percent of NMP (Mongabay 1990) and four out of every five workers were employed in agriculture. The World Bank Report in 2012 indicated that the agricultural component of Bulgarian GDP was no more than 7.2% (Trading Economics, 2012). Bulgaria was “the leading food exporter in Eastern Europe” in the 1980s. Setbacks caused “by the economic difficulties” in the decade after the fall of communism in 1990 had a meaningful and significant impact on productivity (Globserver, 2012). Agricultural support from the SAPARD (Special Access Program for Agriculture and Rural Improvement), and the Cap (Common Agricultural Policy) have started to make some impression. The President of the Bulgarian Slow Food Foundation for Biodiversity, Dessislava Dimitrova has noted that “small farms can grow” and recent reforms can be “a good stimulus for farm development.” Even with food prices low there is clearly an opportunity for growth in high-price specialist Bulgarian foods, such as Bulgarian green cheese from Chrni Vit (Balkan Travelers, 2011) and a return to significant exports (Slow Foods, 2012)

Our investigation of this promising and as yet untapped national resource noted that there were indeed payments for agricultural activity getting to small farmers, albeit after not insignificant Ministerial

administrative costs at the national, regional and local level. Interviews confirmed that payments were based on “tilling the land.” Small farmers who were already tilling the land and those with land which they decided to till would benefit from these EU payments. Our contact with the Blagoevgrad area regional and local personnel in charge of the administration of these funds confirmed that funds were paid upon satisfactory evidence of tilling. There were no performance measures related to productivity or acreage at this stage. Thus, in general, these CAP handouts to small farmers are not being invested in agricultural product growth. To the contrary they are said to explain the increase in the acquisition of automobiles and consumer products.

## 6. Freedom Square Ruse

Ruse is the fifth biggest town in Bulgaria. Famous for its 19<sup>th</sup> and 20<sup>th</sup> century Neo-Baroque architecture, known as “Little Vienna under the Bridge,” the Giurgiu Bridge across the Danube, Ruse welcomes visitors from Romania. (Ruse, 2013) To restore the historic landmark Freedom Square, (Trip Advisor, 2013),” the city applied to the European Commission (ERDF, 2013). Funding was granted in July 2009 (Ruse Municipality, 2009). “Reconstruction and modernization of the city area for relaxation – central town garden” is a Euro 5 million project requiring matching funds from the City’s budget of Euro 450,000 (Investor BG, 2009).

The project was inevitably the subject of political debate with allegations of corruption supported with any number of rumors and stories locally and during the course of the program. Significantly the project was not audited. As early as July 2007 when the project was first initiated “Rusenski Stroitel, a construction company (“Ruse Constructor – 96”) filed a complaint, against a mayoral decision on eligible companies with the Bulgarian Commission for Protection of Competition. According to the complaint procedural errors were made including changing the deadline for receiving offers from March to April and then the deadline for filing documentation was back dated from June to May with inappropriate notice as reported in *Dyrjaven Vestnik* (2013) and recorded on the register of the Bulgarian Public Procurement Agency (*State Gazette* this is where all new laws, are published after they have been voted on).

There was subsequent confusion as companies that wanted to apply were excluded. Recognizing these procedural errors the municipality nevertheless responded that the claims, albeit true, were not sufficient to stop the project. There was also a jurisdictional question since the “mistakes” were not considered to be within the jurisdiction of the Commission for Protection of Competition. Therefore the Commission for Protection of Competition determined to take no action (RuseInfo, 2010).

Construction started in November 2010 by a consortium of three firms. Departures from documentation continued. The old marble pavement was replaced with imported cheap Chinese rhyolite regardless of European Union rules on EU quality certification. Similar disregard for proper documentation and quality certification continued in the newspapers and by word of mouth. Individuals working on the project confirmed privately how many opportunities were taken to re-document materials, adjust charges, and muddle quality certification all the way to the ribbon cutting ceremony held by then Bulgarian Prime Minister Boiko Borisov.

The Ruse project peculiarities followed on a long list of “weaknesses and irregularities in the management” of EU funds identified in 2009 (Europa). These and other irregularities were proved not uncommon when “a group of Sliven municipal councilors” identified similar corruption in a documentary uploaded on the internet, with English subtitles, entitled “The New Mafia” (SETimes, 2011). This then led to the unprecedented freezing of EU Funds by then Prime Minister Boiko Borisov (Eubusiness, 2011).

## 7. Tourist Hotel, Simeonovo

The European Agricultural Fund for Rural Development (EAFRD) has the following goals, contributions to improving:

- the competitiveness of agriculture and forestry;
- the environment and the countryside;
- the quality of life and the management of economic activity in rural areas

(Europa 2013)

One interesting and not untypical EAFRD project, nearing final completion this April 2013, may be found in the Bulgarian village of Simeonovo. The total value of this medium size project is set at Euros BGN 500,000 (Euros 250,000). The project is to foster tourism and improve the quality of life in this south-eastern area of Bulgaria where the average monthly salary is well below the Bulgarian average of Euro 393, the lowest in Europe

The building, a two star hotel with capacity between 20 and 30 people has been approved and will be fully subsidized by the EAFRD. To be accepted for such an EAFRD grant the applicant must provide evidence of up-front finance for construction of the project through to completion. Upon completion, within a specified time limit, and after appropriate inspection, the EAFRD reimburses the grantee upon appropriate documentation for the outlay of all related project costs.

In this way the European Commission fund expects to meet the EAFRD goals. Absent access to capital, likely in this impoverished area, and projects are not eligible for funding. This certainly limits funding to those with access to capital. This may not be seen to foster fair competition, except for the wealthy.

Fortunately, in this case, the grantee had access to the funds necessary to achieve completion. This introduces consideration of performance measures for the hotel. There is no profitability requirement, not even targets for return on investment or other measures of meeting EAFRD goals. The only requirement in this case is that the building meets the specifications agreed in the grant documentation including a requirement to be operational (but not necessarily at break-even) for five years.

The location of this hotel is far from any tourist or commercial area. Evidence of some level of paid occupation by unrelated parties of the hotel over the initial five years of operation is not required. Since the hotel guests need not be listed (or otherwise documented) the accounting records need not even be audited. Revenue and expenses may be adjusted to minimize taxation (perhaps keeping below the BGN 50,000 VAT threshold).



Exhibit 2: The two Star Tourist Hotel – Simeonovo

As noted the hotel is located in the small rural village of Simeonovo. With no paved road access, the building presently lies in the middle of a field (see Exhibit 2). The village has a population of 311 (GRAO) predominantly elderly people and pensioners. Physical verification, on foot, on several occasions confirms the area is almost deserted. The surrounding area boasts several abandoned houses and the former local school was bought by a British family for a private summer residence. During winter the village has no visitors. With just one bus stop and one small store, the village of Simeonovo boasts neither a historic monument nor any tourist attraction. Simeonovo is far from the nearest main road. Our author, who with his family has lived in Simeonovo for 20 years notes that there is no reasonable expectation of any of the EAFRD goals being achieved by this project.

The hotel, sited near to houses that have been abandoned and are beyond repair, may not have any EAFRD goal achievements; however the owner will acquire a modern house at a remarkably low price. A sound, yet subtle, logic justifies the project for the grantee, a wealthy and pleasant businessman from Yambol, who is the owner of the local cable TV channel and the main internet service provider in the region.

The local construction company has considerable experience on similar construction projects and, in the process, the EAFRD grant

application process. A representative of this company confirmed that to complete the application process, the estimated project costs are based on published current market prices. Such estimates usually exceed the actual prices to be paid in the grey economy by up to 20%. It is no surprise to find that the main business of this company has been the construction of similar EU funded projects. In this way a project to be granted Euro 500,000 may limit cash outflow to no more than Euro 400,000 including the cost of any necessary forged documentation. There is no need for Net Present Value calculations to evaluate such capital investment projects.

The funding of projects of this kind appears to be the rule rather than the exception in the case of EAFRD projects. There is no evidence in the Simeonovo case or from the experience of the contractor of growth or job creation, except in sustaining that particular construction company. We found it difficult to understand why the EAFRD does not require an independent audit of the costs of the construction. Indeed the hotel at Simeonovo confirms the need for serious reforms of the grant process which needs to be restructured so as not to encourage the continuation of unsatisfactory business practices.

### **8. Strand Company Bourgas**

The first outdoor lifestyle center opened in Bulgaria with a planned multiplex cinema and restaurant arcade (Strand, 2012). Bourgas, a regional economic hub, was seen to provide a growth opportunity by introducing a modern lifestyle design Mall into the Izgrev commercial zone near the main traffic hub of the city where Carrefour, Metro and Technomarket were newly established occupiers. Most important the Strand Company is a real-estate developer based in Bulgaria and provides the Bulgarian economy with a locally capitalized and funded company which needs to be sustained to generate Bulgarian management to achieve growth and exploit local employment with skilled jobs to strengthen the Bulgarian economy.

The focus of the lifestyle Mall was to be on regional industry and, by providing for inexpensive retail space for local industry, to promote growth in the region and to add jobs. The Strand Company raised Euro 25 million for the project and initiated the necessary applications and received approvals and began the project. Pioneering the development

of regional industry by providing a sales and marketing focus for regional products, they set about completing the product and achieving their aims.

After Strand began their project the European Bank for Reconstruction and Development (EBRD) announced that they were considering providing a Euro 45.6 million loan to Global Trade Center (GTC) one of the world's 250 largest multi-national Real Estate Companies headquartered in Poland (GTC, 2013). GTC has a history of EBRD funding for traditional (as opposed to lifestyle) Malls.

Traditional Malls have reached the end of their lifecycle. (Peterson, 2011) Worldwide Peterson noted traditional malls have become "an endangered species" only surviving while the Internet remains unaccompanied by modern distribution. Traditional malls typically lose money in the aftermath of the financial crisis and in countries such as Bulgaria, where per capita income is low. Empty space in the Sofia malls simply confirms this fact. (Sophia Echo, 2009) Meanwhile lifestyle malls, with significantly less capital investment, pay great attention to "going green," (Robaton, 2013) with no air-conditioned underground parking, windows that open, and self-sufficient power plants, which more than halve running costs.

EBRD's financing guidelines (Guide, 2011) set out criteria including:

- "Have strong commercial prospects"
- "Benefit the local community and help develop the private sector"

By no stretch of the imagination, could these criteria apply to the proposed GTC mall in Bourgas. Indeed a traditional GTC mall with a history of failing to break-even on operations will certainly not have any strong commercial prospects and the introduction of subsidized and artificial competition only serves to handicap the development of the Bulgarian private sector and the potential for retail growth and jobs in the Bourgas region. This we know from the Office of Fair Trading report that "interventions that assist some firms more than others, might be expected to affect competition." (OFT, 2004)

## 9. The Investment in Chalga

"Bulgaria's sex-soaked pop-folk music culture known as Chalga" (Sotirova, 2013) secured a Euro 1.5 million grant and brought

into question the ability of the Bulgarian authorities to understand the purpose of European Union funds made available for economic development. Whilst the most liberal leaning advocate of growth and jobs might hesitate to fund “performers resembling porn stars singing about gangsters and money” (Economist, 2013) the Bulgarian authorities were “quick to assure” that “from a formal point of view, everything is correct.”

Economist reported that the President of Payner Media, the grant beneficiary company, was a founding member of the then ruling GERB party, and the grant provided a “dubious moral message.” Payner’s owner then promised that “the funds would not be used ‘for silicone implants.’ He later decided to pull out of the Funding” (Sofia Globe, 2013).

## Summary of Results

In each of the nine cases we have considered how the project met each of the four criteria:

1. Focus on competition and productivity
2. Creating smart sustainable growth
3. Fostering job creation
4. Support capital formation.

*Focus on competition and productivity:* We considered whether the project was likely to spur other enterprise to enter the market and compete and whether this would lead to the employment of additional people after completion of the project itself. Could we find any evidence of potential for increased market activity other than the project initiatives undertaken?

*Creating smart sustainable growth:* The question here was whether the EU investment was likely to lead to the further attraction of foreign direct investment into Bulgaria as the EU investment identified sustainable opportunity in the marketplace.

*Fostering job creation:* EU investment intends to provide an initiative to attract investment in new jobs. Examples in Bulgaria include many Information Technology jobs located in Sofia and created by US

and other foreign investors such as the Balkan Accession Fund, Sitel, and 60K.

*Support capital formation:* Recognizing the limited sources of investment capital available in Bulgaria, EU investments are projected to encourage related investments sourced by inward foreign direct investment. We sought any evidence of similar projects which were attracting direct foreign investment. There is no room in this paper to provide the discussion on each of the projects and therefore the conclusive reasons why we came to our conclusions. For readers who doubt our conclusion we are happy to enter into correspondence and provide additional documentation and support. We do however believe that our conclusions are well-supported and that after reading our summary of the cases the conclusions we have arrived at are self-sustaining. We examined nine cases and came to the following conclusions related to the four stated purposes of European Commission funds. Our conclusions, based on the evidence from our nine cases are set out in Exhibit 3 below.

## Key

To provide our conclusions in tabular form, we adopted a simple key as follows:

S = Success

For a successful conclusion we would expect to find similar projects which met each of the four measurement criteria.

s = some success

Recognizing the probability of some market reaction to the EU projects we recognized project criteria where at least some headway was being made in achieving EU objectives.

F = Failure

When we could find no reason to see any improvement resulting from the EU initiative we identified this as a failure.

<b><i>Case base for Evidence</i></b>	<b><i>1</i></b>	<b><i>2</i></b>	<b><i>3</i></b>	<b><i>4</i></b>
1. Improving the conduct of Business in Sofia	s	s	s	s
2. A note on the Grey (shadow) economy	F	F	F	F
3. A restaurant opening in Bulgaria	F	F	s	F
4. The need to smuggle	s	s	s	F
5. CAP Agriculture	F	F	s	F
6. Freedom Square, Ruse	F	F	s	F
7. Tourist Hotel, Simeonovo	F	F	s	F
8. The Strand mall Bourgas	s	F	s	F
9. The investment in Chalga	F	F	F	F
Summary – Total number of EC goals achieved	s	s	s	s

### Exhibit 3: Summary of Results and Conclusions

Recognizing the minimalist response to their initiatives, the European Commission has nevertheless continued to provide funds for many projects in Bulgaria. We note that there has been very limited federal effort made to set-up or require the establishment of effective audit systems for European Commission projects. Some progress may be confirmed by the recent charges made against the former Minister of Agriculture for “failing to tackle chronic crime” (World Bulletin, 2013).

### Discussion

We have managed to obtain and analyze the facts for nine cases which we believe provide representative examples of the abuse of the funds of European taxpayers. We have no statistical basis on which to be sure that these nine cases are truly representative of the abuse of such funds. However on the basis of the failure of these cases to do more to meet European Commission fund goals we provide, our research provides a powerful argument for the need for wider audit of the employment of European Commission funds in Bulgaria and perhaps elsewhere in the European Union.

Our evidence must also be seen in the context of the widely accepted belief that the Bulgarian authorities are “endemically corrupt.” *The New York Times* reported that the European Commission was attributing “endemic corruption” to “systemic deficiencies that we inherited from the communist era and before” (Dempsey, 2012). The report also noted that abuses had been the subject of some inquiry” not only by Brussels but also by Europol, Europe’s law enforcement agency.” Yet the corruption remains endemic.

Our evidence confirms the Center for the Study of Democracy report which noted that “the European Commission bemoans the lack of progress made” and that after discovery of corruption “impunity ... is predominant in the country” (Vandystadt, 2012). The figures do not come from the Commission, but from the Center for the Study of Democracy (CSD), a think tank based in Sofia. CSD in their Policy Brief No. 35, June 2012 noted that “around 150,000 bribes are paid out a month” and that corruption is two to three times more prevalent in Bulgaria than the European average and is an “endemic problem.”

So our research has reproduced in detail similar findings and with regret we must report that our findings confirm that corruption is not only endemic at the center of Bulgarian political power but also abroad in the countryside and with little or no audit check.

Why has the situation been allowed to fester and continue like a cancer to grow with little or no mitigation?

The structural arrangement of the European Union is often improperly compared with the idea of the Federal government in the United States. The implementation of the Euro single currency is seen to be a significant marker *en route* to a Federal arrangement as may be found in the United States and in the United Kingdom and in Germany. In these three cases the Federal system began with a single language. This was expanded with a uniform set of commercial laws and then a single currency followed.

The post war idea of a United States of Europe (Churchill, 1946) saw the Federal system in the United States as an appropriate European model. The foundation of the Federal system in the United States has at its center the Federal Government in Washington with a strong US legal system which provides for a uniform code of laws and practices across the United States. The uniform code of laws is enforceable by the

Federal government and in the case of corruption the Federal Bureau of Investigation and the Internal Revenue Service Agency. Of particular interest in the case of corruption is the uniform commercial code, which has been adopted by the 50 States, and the right of the Federal government to take direct action when any commercial transaction takes place across state borders. Thus the abuse of Federal funds will be prosecuted by Department of Justice. A list of such actions may be found at the Department's website (DOJ, 2013).

A uniform commercial code and a strong single language Federal government enforcement agency in Europe would take charge of the European Commission funds and make sure that all projects where funds were committed were effectively audited. The structural inefficiency of the existing bureaucracy would be improved and this would have a significant impact on the economy when funds would be consistently monitored so that program goals are attained. This approach is needed to affect a leaner and less bureaucratic European Union.

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## Appendix "A"

### Translation of Exhibit 1: Trade Regulations Sofia 1993.

#### District "SREDEC" 6 Lege str. Sofia, phone: 987 78 11

On the basis of the regulation for trade activity on the territory of Sofia municipality from 1993, when registering the activity, which should be in 14 days term in "Control of the trade activity", district "Sredec"- 6 Lege str. V floor, room 505.

The following documents are OBLIGATORY:

1. Petition for registering, with applied work time.
2. Judicial registration of the firm.
3. Document for the tax registration /from the appropriate department/.
4. BULSTAT.
5. The insurance number of the firm from "Sofia social insurance department" /Stambolijski blvd.- Vuzrajdane square/
6. Certificate for state/municipality ownership.
7. A deed executed and authenticated by a notary.
8. A certificate for inheritors.
9. Rent contract.
10. Licence from "Architecture Department".
11. Licence from "Fire Department" / Gerena stadium, phone: 45 22 23/.
12. Licence from "Electric Supply" /331 Tzar Simeon str./.
13. Contract with "Water and Sewage Supply" /Zone B5, phone: 22 18 53/.
14. Contract with "Heat Supply company".
15. Licence from the Hygiene Epidemiological Institution –needed for food shops and places of public resort /20 Vranya str./.
16. Licence from the State Veterinarian Hygiene Commission –needed for food shops if the goods are animal derived /Stochna Gara, 7 Danail Nikolaev str. Phone: 44 46 02/.
17. Garbage tax /Tax Department "Sredec" 12 Gurko str./.
18. Assent of the neighbours.
19. Licence from the Regional Ecology Commission –for producers.
20. Licence from the Ministry of Health –for medicine sale.

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Working Hours:  
Tuesday 2-5pm  
Thursday 9-12am

## Appendix “B”

### Doing Business World Rankings - Out of 185 countries

#### Rank

Starting a business	66
Construction Permits	57
Getting electricity	123
Registering Property	128
Getting Credit	40
Protecting Investors	49
Cross-border trading	93
Paying Taxes	91
Enforcing contracts	86
Resolving insolvency	93



## **Factors Influencing the Salary Expectations among Macedonian Students: A Comparative Perspective with the EU Students**

*Marija Andonova, Nikica Mojsoska-Blazevska*

### **Abstract**

*The aim of this paper is to assess the salary expectations of Macedonian students, and the main factors that shape their expectations. Previous research elsewhere has shown that salary expectation is a major determinant that influences schooling decisions (Williams and Gordon, 1981; Betts, 1996; Wolter and Zbinden, 2001). Given that the main pathway to developing the human capital of an individual is schooling, learning about the factors that affect an individual's decision whether to acquire more education can contribute towards better educational policy in any given country. We employ a similar empirical approach as the one used by Brunello et al. (2001, 2004). We use all available information to regress: i) expected future earnings right after graduation from university and ii) expected future earnings 10 years after graduation from university, on a set of variables which include: the characteristics of the individual, their socio-economic background, the chosen field of study, the year of enrolment (junior or senior students), academic performance, sources of information for future earnings and the country of future employment, and the perceived employability and costs of studies. Our findings show that expected university earnings are significantly correlated with the father's education, year of study, sources of information on earnings in the labour market, gender, ethnicity, regular job during studies, perceived employability, the chosen field of study and the country of future employment. In other words, Macedonian students form their*

*salary expectations in a similar vein to those of their European counterparts. The major contribution of this study is to provide a pioneering study of salary expectations of Macedonian students, as well as providing a comparative analysis of the salary expectations of students in Macedonia and their peer colleagues from the EU Member States.*

*Keywords: Demand of schooling, salary expectations, higher education*

## **Introduction**

*“Education is development. It creates choices and opportunities for people, reduces the twin burdens of poverty and diseases, and gives a stronger voice in society. For nations it creates a dynamic workforce and well-informed citizens able to compete and cooperate globally – opening doors to economic and social prosperity”*

*(World Education Report, 2010, p. 9).*

After finishing upper secondary education, every individual is confronted with a major decision: whether to continue his/her education or to enter the labour market. The recent changes in educational policy in Macedonia have brought a large increase in the number of pupils that enroll into universities after graduating from secondary schools. The most important policy changes, as well as other factors leading to high university enrolments are the following:

- Starting from school year 2008/2009, upper secondary education became mandatory, with financial penalties for parents whose children are not enrolled or are not attending secondary schools regularly;

- There has been a great expansion of the capacity of the tertiary level education institutions, increased subsidies to tuition fees, as well as geographical expansion through dispersed studies across the country;

- High unemployment in the country, coupled with relatively high payoffs to higher education (i.e. unemployment rates decrease and wages/salaries increase with the level of education).

These factors have contributed to a large increase in university enrollments, from 64% of pupils in the respective age group in 2007 to 95% in 2011 (State Statistical Office, 2011). Students are expected to make rational choices by investing in their education, while expecting higher future incomes.

Benefits from getting a university degree in labor economics are measured through the returns to education: wage/salary returns, as well as the returns in terms of the probability of getting a job. According to Mojsoska-Blazevska (2011), in Macedonia, there are relatively high wage/salary returns to education: individuals who have completed four years at secondary school have, on average, 37% higher wages than those who only completed their primary education, while getting a university degree increases wages by 106% compared to those who have only completed their primary education. Similarly, the probability of employment increases exponentially with education, so that workers with completed tertiary education in 2011 had 2.5 times higher employment rates than individuals with completed primary education. Hence, there are large incentives for young individuals to demand more education. However, there is no study in Macedonia so far about the factors driving the wage expectations of students and hence their demand for education. This raises a number of questions. For instance, to what extent are students realistic about the market value of their labour after their graduation from university? Do they expect a gender wage gap in their earnings? Which characteristics of students and their social environment influence the expected earnings?

While the literature on returns to education is very broad, few studies have attempted to answer these questions. Most of the studies for wage and salary expectations are related to the US and European experience, with no similar studies either for the transition countries or the Western Balkan countries. In this respect, the aim of this paper is to provide a first insight into the salary expectations of Macedonian students after graduation from university and of filling in the gap in the empirical literature. This paper is organized as follows. In Section 2 a brief review of the relevant literature is presented, whereas Section 3 discusses data and methodology. Section 4 presents and discusses results and Section 5 concludes.

## Literature Review

Decisions on whether a person will choose to continue his/her education depend on perceived costs and benefits from it (Mazza and Hartog, 2011). However, there are only a few studies that try to explain how expectations are formed and what the major determinants are that affect expectations. Across the scarce studies in this area, the following factors are commonly found to affect students' expectations about future salaries: the socioeconomic background of the student, gender, field of study, academic performance, age of a student and sources of information (Wolter, 2000; Brunello et al., 2001; Wolter and Zbinden, 2001; Webbink and Hartog, 2004). We proceed by examining each of these factors separately.

### *Socioeconomic Background*

Most studies focus on the parents' education and income as the main socioeconomic factor that influences the wage expectations of students (Williams and Gordon, 1981; Webbink and Hartog, 2004; Delaney et al., 2011). Parental educational background is thought to influence a student's expectations on at least two levels: (i) information on salaries from educated parents are of better quality, (ii) students who have well educated parents can rely on their parents' personal networks for finding a job after graduation, and hence have higher salary (and job) expectations. Delaney et al. (2011) using data from seven Irish universities found out that parental education has a significant and positive effect on short- term and long term earnings expectations. This however is not in line with the results of the works of Betts (1996) and Androushchak and Natkhov (2008). In particular, Betts (1996) conducting a survey among 1,000 undergraduates from the University of California found that there is no strong effect between parental education and student's salary estimation. This is confirmed by Wolter (2000) and Wolter and Zbinden (2001). Wolter (2000) used a different approach; imagining different scenarios in which students were asked to predict their own future salaries, as well as the salaries of an average person with similar characteristics. In this study, as well as in the study of Wolter and Zbinden (2001) parental education as a variable proved to be insignificant. In contrast to all previous studies, Androushchak

and Natkhov (2008) found a negative effect of parental education on earnings expectations in Russia.

Different results appear when researchers examine separately the influence of the mother's and father's education on the student's salary expectations. Brunello et al (2001), in the study based on a survey conducted in 50 universities across 10 European countries found that having a mother with a university degree leads to a 3.3% increase in expected earnings right after graduation, and almost 4%, 10 years after entering labor market. In the same study it was found that the father's education is not statistically significant. This is confirmed by another study of Brunello et al. (2004).

The are consistent findings about the influence of parental income on students' salary expectations: salary expectations are higher when parental income is higher (Betts, 1996; Varga, 2001; Webbink and Hartog, 2004; Jerrim, 2008). Jerrim (2008) and Webbink and Hartog (2004) agree that students from high-income families expect higher salaries in order to maintain high living standards and their expectations are based on the income of the people around them. Webbink and Hartog (2004) state that this result may be a factor in explaining increased participation in extended education for students from wealthy backgrounds.

### *Gender*

Researchers in many academic disciplines recognize the existence of a wage gap between males and females (Blau and Ferber, 1990; Fillipin and Inchino, 2003; Chevalier 2004) which is thought to affect wage expectations for different genders: knowing the actual gender pay gap, students expect lower earnings for females. According to Chevalier (2004), women are still paid between 20% and 40% less than a man despite the introduction of equal opportunity legislation. He argues that part of the existence of a gender wage gap is explained by gender differences in educational and career choices, as well as the gender differences in expectations, but there is still a large part that is left unexplained. Blau and Ferber (1990) examining gender wage gaps found that women plan shorter terms of employment and because of that there are less capital returns.

According to several studies, women do expect to earn less than man (Caravajal et al., 2000; Wolter, 2000; Fillipin and Inchino, 2003; Botelho and Pinto, 2004; Webbink and Hartog, 2004; Jacopo and Hartog, 2011). Examining whether or not the earning expectations of students from Florida International University are realistic, Caravajal et al. (2000) found that female students expect and earn significantly less than male students. This is confirmed by Webbink and Hartog (2004) when using Dutch panel data. These authors examined the accuracy of students' predictions of their future salaries and found that female students expect to earn 5% less than males, which is very close to the reality in which they earn 6% less. Botelho and Pinto (2004) and Fillipin and Inchino (2003) agree that even though females expect lower earnings than males, they prove to be more realistic in their expectations.

### *Age*

Most of the reviewed studies have examined the influence of students' age over their salary expectations (Dominitz and Manski, 1994; Betts, 1996; Brunello et al 2001; Wolter and Zbinden, 2001; Brunello et al 2004; Botelho and Pinto, 2004). Dominitz and Manski (1994) found that earnings expectations are quite similar between junior and senior students. By contrast, several authors (Betts, 1996; Brunello et al, 2001; Wolter and Zbinden, 2001; Brunello et al, 2004; Botelho and Pinto, 2004; Borrego and Medina, 2010) agree that senior students expect lower wages than junior students. Brunello et al. (2004) provide three possible explanations for such a result: (i) formations of earnings expectations improve as students approach graduation and they become more realistic about future earnings, (ii) senior students take questionnaires more seriously and/or (iii) students are taking into consideration future positive inflation and productivity growth.

### *Field of Study*

Webbink and Hartog (2004) found that students in law, economics, health and technical studies expect to earn more than their colleagues in the social sciences, while students in languages expect the same wage as students in social studies. Androushchak and Natkhov (2008) found that law students expect to earn significantly more (20% more) than their colleagues from other fields of study. By contrast, Brunello

et al (2001) found that students in Science and Engineering have higher expectations than students in the Humanities, which is confirmed by the study of Borrego and Medina (2010). Jerrim (2008) examining the students' wage expectations using UK survey data explains that students in Science have unrealistic expectations because their chosen subject is traditionally challenging and therefore they expect to be rewarded.

### *Academic Performance*

The role of ability is in the center of discussion in the literature of schooling behaviour, but very few studies examined the relationship between ability and wage/salary expectations. Manski (1993) points out that young people use their ability to form their expectations, and school choice depends on it. Several authors (Carvajal et al, 2000; Wolter and Zbinden, 2001; Brunello et al, 2004; Jerrim, 2010) include academic performance variables in order to test if there exists a correlation between students' earnings expectations and their performance in college. Academic performance is measured through students' perception of their ability compared to the other students. The results are consistent: students who perceived themselves as high performers have higher expected university earnings.

### *Sources of Information*

The source of information about wages prevalent in the labour market can also affect earnings expectations. Adding this variable into regression, Brunello et al. (2001) and Wolter and Zbinden (2001) found opposite results. The former study found that when information is personal or collected from the daily and weekly press then this variable is significant and positively affects students' salary expectations. On the contrary, the latter study finds that students with no specific information about salaries have significantly higher expectations than the rest.

### *Other Findings*

Several authors examined other influences over students' earnings expectations. Anchor et al. (2011) comparing students' expectations in England and the Czech Republic found that students who have higher costs for their studies, in order to compensate those, tend to have higher salary expectations. McMahon (1981) and Jerrim (2008) examined the

influence of ethnicity over students wage expectations. Both authors agree that students from minority background expect higher starting salaries, and tend to be more optimistic about their future earning potential. Epple and Romano (2008) suggest that private schools attract students with higher quality and therefore these students expect higher salaries than their colleagues.

To sum up, when deciding on the amount of education to "consume" individuals compare different options and chose the one with the highest return. Therefore, expectations for the future earnings are a major determinant that has an influence on schooling decision. The review of the relevant literature revealed the complexity of the formation of expectations and that expectations are mostly influenced by the students' personal characteristics (age, gender), their socioeconomic background (education and income of their parents), field of study, and academic performance, sources of information on wages.

## **Methodology and Data**

Several authors using different approaches have tried to examine which determinants have influence on forming students' salary expectations (Wolter and Zbiden, 2001; Brunello et al, 2001, 2004; Webink and Hartog, 2004; Anchor et al, 2011). Our study is based on the methodology used in the work of Brunello et al. (2001), which originally is based on methods for estimation of private return on education known as Mincer's method. Mincer (1974) was one of the first authors who applied the concept of human capital for an empirical estimation of the returns on education. In the Mincerian equation, dependent variables are the earnings of an individual, which are presented in logarithmic form. Brunello et al. (2001) estimated linear regression in which the dependent variable is a logarithm of students' expected earnings which is regressed on a set of independent variables.

This data used in our study on the salary expectations of Macedonian students were collected through a survey that was conducted in 11 university faculties belonging to 3 (1 state and 2 private) universities in Macedonia. The share of these three universities in the

total enrollments in the universities across Macedonia is 80%. Appendix A presents details about the universities used in the study.

The questionnaire used in the work of Brunello et al. (2001, 2004) was adapted for the purpose of our study, taking into consideration the specific country context and our research questions. We asked students of their wage expectations under two different scenarios: i) expected monthly net earnings right after university graduation, and ii) expected monthly net earnings 10 years after graduation. The exact formulation of the questions asked is presented in Appendix B (in the Macedonian language).

In order to collect relevant answers about expected earnings after graduation, students were choosing from several intervals in which they thought that their future monthly net earnings belong. We used interval amounts that are commonly used by the State Statistical Office. The ordered variable was then transformed into a continuous variable by calculating the mean from each interval. We then apply linear regression, which is defined as:

$$\ln W_i = a + b_i X_i + e_i \quad (1)$$

where:

$a$  =constant;

$W_{i,c}$  =expected net wage of individual  $i$ ;

$b_i$  =vector of parameters to be estimated;

$X_i$  =vector of parameters, assumed that have influence on wage expectations and

$e_i$  =error, assumed to be well-behaved.

Table 1 examines variables used in our study,  $X_i$ .

Table 1: Description of variables

	Wage expectation with university degree	Continuous variable
	Wage expectation with university degree 10 years after graduation	Continuous variable
	Year of study	Dummy 1=juniors; 0=seniors
	Type of school	Dummy 1=private; 0=state
Field of study	Business and Economy	Dummy 1=yes; 0=otherwise
	Engineering	Dummy 1=yes; 0=otherwise
	Mathematics	Dummy 1=yes; 0=otherwise
	Medicine	Dummy 1=yes; 0=otherwise
	Father holding University degree or Master/PhD	Dummy 1=yes; 0=otherwise
	Mother holding University degree or Master/PhD	Dummy 1=yes; 0=otherwise
	Same field as father	Dummy 1=yes; 0=no
	Same field as mother	Dummy 1=yes; 0=no
	Repeaters	Dummy 1=yes; 0=no
	Academic performance	Ordered variable on a scale 1 to 5 1=very good 2=good 3=average 4=poor 5=very poor
	Employment in family business	Dummy 1=yes; 0=no/my family doesn't have household business
	Employability	Ordered variable on a scale 1 to 5 1=very good 2=good 3=average 4=poor 5=very poor

	Expected country of employment	Dummy country	1=Macedonia; 0=other
	Regular job during studies	Dummy	1=yes; 0=no
Information's about wages	W1	Dummy 0=otherwise	1=career center; 0=otherwise
	W2	Dummy 0=otherwise	1=daily/weekly press 0=otherwise
	W3	Dummy 0=otherwise	1=personal communications 0=otherwise
	W4	Dummy	1=never; 0=otherwise
	Costs	Continuous variable	
	Gender	Dummy	1=females; 0=males
	Ethnicity	Dummy	1=Macedonian; 0=other

The questionnaire (in the Macedonian language) was distributed among Macedonian undergraduates in the spring semester of the academic year 2012/2013. Different fields of study were selected randomly and students were asked to fill in the questionnaire during the first minutes of a lecture. This method delivered a 100% response rate and 496 questionnaires were returned.

Tables C1 and C2 in Appendix C present in detail descriptive statistics for the sample. Here we present some of those statistics. The average age of the students in the sample is around 21 years. At the time of the survey, 59% of the students were in their first year of study, while others in their last year of study. Students in Macedonia expect their average starting wage after graduation to be 24,085 denars, and 10 years after graduation 36,150 denars. A slightly higher share of the respondents are females: 56% compared to 44 % males. The majority of the student (85%) respondents reported Macedonian ethnicity. Males after graduation from university on average expect to earn 15% higher wages than females and 17% more after 10 years in labour market. Less than half (43%) of the students are studying in private universities. About 43% of respondents belong to households where fathers have a university degree or masters/PhD, and 44% of respondents belong to households where mothers have a university degree or masters/PhD.

A small proportion of students is enrolled in the same field of study as their parents, 19 % are in the same field of study as their fathers, while 13 % are in the same field of study as their mothers. Almost 1/3 of respondents need additional years of study to complete their university education.

## Results

The results from the estimated equation (1) are presented in Appendix D. Data are presented for the dependent variable: i) the salary expectations after graduation from university (column 1) and ii) wage expectations 10 years after graduation (column 2). We proceed by examining factors that significantly influence the salary expectations of Macedonian pupils.

The coefficient of determination for the first equation is about 22%, meaning that 22% of the variability in the salary expectations of pupils after graduation is explained by the independent variables/regressors. The coefficient of determination for the second equation is about 26%, meaning that 26% of the variability in the wage expectations of pupils 10 years after graduation is explained by the independent variables/regressors. Coefficients are jointly significant and coefficients have the expected signs. As Table D1 (Appendix D) shows, the following variables are found to have a significant influence on the wage expectations of pupils: year of study (juniors vs. seniors), field of study, father's education, sources of information, country of employment, perceived employability, holding a regular job during studies, gender and ethnicity.

In Macedonia, students who belong to households where the father has University degree, or Masters/PhD, expect to earn 10% more than their peers on entry into the labor market and 15.6% more after 10 years. In the EU countries having a father with University degree is not statistically significant (for instance, see Brunello et al., 2001). Our study shows that in Macedonia there is no effect of the mother's education on the salary expectation of students. Furthermore, in Macedonia as in the EU, there is no statistically significant correlation between expected earnings and the same field studied as parents.

We find that female students in Macedonia, as in most European countries, expect to earn less than their male colleagues, 10% less if they hold a university degree. This gap increases to 20% after 10 years on the job with a university degree.

Similar to the findings of several authors from Europe (Brunello et al 2001; Wolter and Zbinden, 2001; Borrego and Medina, 2010), junior students expect to earn more than senior students. In Macedonia juniors expect to earn 14% more than senior students at the labour market entry, and 9.5 % more after 10 years. Section 3 provided several possible explanations for the greater optimism of the junior students.

When examining the relationship between students' salary expectations and the chosen field of study, we found that students from Medicine on entry into the labour market expect to earn 25% less than Engineering students. After 10 years in the job, this percentage slightly decreases to 24%. The coefficients for the other fields of study are insignificant. This result is in line with the work of Brunello et al (2001).

Depending on how students are informed about salaries in their field of study, their earnings expectations might vary. In Macedonia, students who have gathered information about future earnings in the University career centres expect to earn 25% more at the beginning of their careers than students who don't have any information about future salaries. Students who informed themselves from the daily or weekly press expect to earn 15% more than students who don't have any information about future wages. These results are the opposite of the results from the study of Wolter and Zbinden (2001).

Students of Macedonian ethnicity expect to have 10% lower wages than their colleagues from other ethnicities at the entry of the labour market, which is in line with the work of Jerrim (2008). Lower expectations of ethnic Macedonians can be related to the policy of the equal representation of ethnic minorities (under the Ohrid Framework Agreement), as well as the relatively lower supply of workers from ethnic minorities who hold a university degree. Coefficients on ethnicity after 10 years in the job are not statistically significant. Although Epple and Romano (2008) suggest that students from private Universities expect more from their future earning, we have not found any correlation between type of school (private vs. state) and students' salary expectations.

Holding a regular job while studying can influence students' salary expectations in at least two ways: (i) students who work during their studies have insider information about wages and the labour market and (ii) they take into consideration their working experience and therefore expect higher wages. In Macedonia, students who hold a regular job during their studies expect to earn 13.7% more than students who don't work.

Because of the acknowledged brain drain in Macedonia, we asked students about the country of their expected employment. Students who expect to work in Macedonia, have 17% and 22% lower wage expectations than students who expect to work abroad at the entry of labour market and 10 years after graduation, respectively.

Contrary to the results from the work of Anchor et al (2011) we have not found correlations between the costs of studies and students' salary expectations.

## Conclusion

The aim of this paper was to fill in the gap in the empirical literature on the factors influencing the salary expectations of Macedonian students. In addition, we put the results into comparative perspectives with those of EU students. Our key finding is that expected university wages are significantly correlated with the father's education, year of study, sources of information on wages in the labour market, gender, ethnicity, regular job during studies, perceived employability, field of study and country of future employment. In other words, Macedonian students form their salary expectations in a similar manner to their European counterparts. However we need to be cautious when we apply these results to the entire student population as we are confronted with a non-balanced sample of Universities. The next logical step would be to extend this research by working with a more representative sample of Macedonian students.

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## Appendix A

University	Type of institution	Faculty
American College Skopje	Private	1. School of Business Economics and Management
		2. School of Computer Science and Information Technology
		3. School of Architecture and Design
St. Cyril and Methodius Skopje	State	4. Faculty of Economics
		5. Faculty of Civil Engineering
		6. Faculty of Agriculture and food
		7. Faculty of Natural sciences and Mathematics
		8. Faculty of Architecture
		9. Faculty of Electrical engineering
		10. Faculty of Medicine
European University Skopje	Private	11. Faculty of Economics

## Appendix B

*Почитувани стапени, Ве молиме да одговорите на следниот прашалник кој се однесува на перспективата на стапениште во Македонија во врска со приходите односно платата. Прашалникот е дел од магистереска теза и податоците ќе се искористат исклучиво за ова истражување. Оваа анкета ќе ви одземе најмногу 10 минути. На прашањата со ионудени одговори одговорете со заокружување. Ви благодариме за соработката.*

### 1. Од која **област** се Вашите студии?

(1) Бизнис	(4) Право, Политички науки
(2) Економија	(5) Медицина
(3) Природни науки, Инженерство	(6) Друго_____

### 2. Образование на Вашите родители (последна стекната диплома)?

#### Татко

- (1) нема формална диплома
- (2) занает
- (3) основно образование
- (4) средно образование
- (5) виша школа
- (6) високо образование (додипломски студии)
- (7) магистер/доктор на науки
- (8) не знам

#### Мајка

- (1) нема формална диплома
- (2) занает
- (3) основно образование
- (4) средно образование
- (5) виша школа
- (6) високо образование (додипломски студии)
- (7) магистер/доктор на науки
- (8) не знам

**3. Ако** Вашиот татко студирал, дали Вашите студии се од истото поле? (1) да (2) не

**4. Ако** Вашата мајка студирала, дали Вашите студии се од истото поле? (1) да (2) не

**5. Кога** ги започнавте студиите? Во 20\_\_\_\_.

**6. Колку** години се официјално потребни за дипломирање на вашиот факултет? \_\_\_\_\_ години.

**7. Кога** очекувате да дипломирате?

(1) 2013 (2) 2014 (3) 2015 (4) 2016 (5) 2017 (6) подоцна (\_\_\_\_\_)

**8. Означете го** Вашиот личен академски успех (**споредено со Вашите колеги**) на следнава скала.



**9. Дали** некогаш сте прочитале или слушнале изјави во врска со идните заработка на дипломираните студенти и каде? (можни се повеќе одговори)

- (1) во универзитетски центар за кариера
- (2) во дневниот/неделниот печат
- (3) лична комуникација (со родител, пријатели и слично)
- (4) никогаш

**10. Колку** очекувате да изнесува вашата месечна плата веднаш **по дипломирањето (на вашето прво работно место)**?

(1) Помалку од 5000 денари	(6) Помеѓу 5001 и 8000
(2) Помеѓу 8001 и 10000	(7) Помеѓу 10001 и 12000
(3) Помеѓу 12001 и 16000	(8) Помеѓу 16001 и 20000
(4) Помеѓу 20001 и 25000	(9) Помеѓу 25001 и 30000
(5) Помеѓу 30001 и 40000	(10) Над 40001

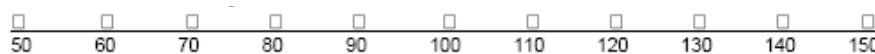
**11. Колку** ќе заработкаате да започнавте со работа **веднаш по завршувањето на средно училиште**? (наведете ја приближната месечна нето сума) \_\_\_\_\_.

**12.** Наведете ги **Вашите очекувања** во врска со зголемувањето на платата:

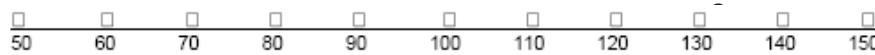
(1) Со **диплома**, по **десет години** на работното место, ќе заработкаам \_\_\_\_\_ % повеќе од првата година.

(2) Без диплома (со вработување веднаш **по завршување на средно училиште**), по **десет години** на работното место, ќе заработкаам \_\_\_\_\_ % повеќе од првата година.

**13.** Ако Вашата плата ја поставиме на 100, колку очекувате да заработка студент со слични карактеристики на Вашите, но од



**14.** Ако Вашата плата ја поставиме на 100, колку очекувате да заработка студент со слични карактеристики на Вашите, но од



**15.** Доколку Вашиот одговор во **13 и/или 14-тото** прашање е различен од 100 која е причината? (можни се повеќе одговори)

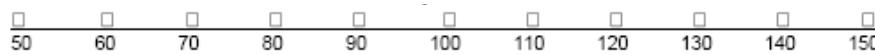
(1) Постојат разлики во карактеристиките и ставовите помеѓу мажите и жените

(2) Различна распределба на домашните задолженија

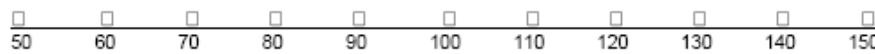
(3) Работодавачите очекуваат различни карактеристики помеѓу мажите и жените.

(4) Работодавачите имаат различни ставови во врска со еднаквите карактеристики и домашните обврски.

**16.** Ако Вашата плата ја поставиме на 100, колку очекувате да заработка студент со слични карактеристики на Вашите, но од



**17.** Ако Вашата плата ја поставиме на 100, колку очекувате да заработка студент со слични карактеристики на Вашите, но од



**18.** По дипломирањето, дали очекувате да работите во **семејниот бизнис** доколку вашето семејство има таков бизнис?

(1) Да      (2) Не      (3) моето семејство нема таков бизнис

**19. Каде** очекувате да најдете работа по дипломирањето?

(1) Странство (наведете држава) \_\_\_\_\_

**20.** Што мислите, какви Ви се шансите за наоѓање на соодветна работа **по дипломирањето**?

(1) многу слаби (2) слаби (3) просечни (4) добри (5) многу добри

**21.** Дали тие шанси се подобри или полоши во споредба со поседување само на **средношколско образование**? Изгледите по дипломирањето се:

(1) многу полоши (2) полоши (3) исти (4) подобри (5) многу подобри

**22.** Дали сте редовно вработени за време на студирањето?

(1) да, \_\_\_\_\_ часа неделно (2) не

**23.** Колкави се вашите годишни давачки поврзани со студиите (партиципација, книги...)? \_\_\_\_\_

**24.** Кои беа решавачки фактори за вашиот избор на студии?

Подредете ги следниве точки од

1 (најважно) до 5 (најмалку важно).

- Близината до моето родно место
- Академска репутација
- Трошоци (живеење, партиципација...)
- Можностите во врска со вработување и приходи
- Интерес за конкретното поле

**25.** Која година сте родени? \_\_\_\_\_

**26.** Пол. (1) машки (2) женски

**27.** Која е вашата етничка припадност? \_\_\_\_\_

**28.** Место на раѓање (град, држава). \_\_\_\_\_

## Appendix C

Table C1: Descriptive statistics

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
<b>year of study</b>	496	0	1	0.59	0.492
<b>type of school</b>	496	0	1	0.43	0.495
<b>Field of study</b>					
Business	496	0	1	0.20	0.399
Economy	496	0	1	0.09	0.285
Computer Science and Information technology	496	0	1	0.05	0.210
Mathematics	496	0	1	0.07	0.249
Civil Engineering	496	0	1	0.16	0.364
Architecture and Design	496	0	1	0.19	0.389
Medicine	496	0	1	0.07	0.253
Electrical Engineering	496	0	1	0.02	0.147
Agriculture and food	496	0	1	0.17	0.374
<b>Father's education</b>	496	0	7	5.02	1.236
no formal degree	496	0	1	0.00	0.045
apprenticeship traininig	496	0	1	0.01	0.090
primary education	496	0	1	0.02	0.126
secondary education	496	0	1	0.36	0.482
higher education	496	0	1	0.17	0.375
university degree	496	0	1	0.34	0.474
Master/PhD	496	0	1	0.09	0.282
Don't know	496	0	1	0.01	0.109
<b>Father holding University degree or Master/PhD</b>	496	0	1	0.43	0.495
<b>Mother's education</b>	496	0	7	4.96	1.306
no formal degree	496	0	1	0.01	0.078
apprenticeship traininig	496	0	1	0.00	0.063
primary education	496	0	1	0.03	0.182
secondary education	496	0	1	0.35	0.477
higher education	496	0	1	0.15	0.359
university degree	496	0	1	0.37	0.484
Master/PhD	496	0	1	0.06	0.246
Don't know	496	0	1	0.02	0.134

<b>Mother holding University degree or Master/PhD</b>	496	0	1	0.44	0.497
<b>same field as father</b>	496	0	1	0.19	0.394
<b>same field mother</b>	496	0	1	0.13	0.338
<b>repeaters</b>	496	0	1	0.33	0.471
<b>Academic performance</b>	493	1	5	2.41	1.102
<b>Wages information</b>					
WI1	491	0	1	0.07	0.258
WI2	491	0	1	0.12	0.328
WI3	491	0	1	0.67	0.471
WI4	491	0	1	0.14	0.344
<b>University monthly net wage</b>	496	5000	45,000	24,085.69	10,865.673
<b>high school monthly net wage</b>	489	0	60,000	11,818.00	6697,477
<b>Graduation wage after 10 years%</b>	491	0	400	49.35	43.556
<b>high school wage after 10 y%</b>	490	0	322	19.76	28.263
<b>opposite gender</b>	491	5	160	100.10	17.794
<b>opposite gender 10</b>	491	50	150	112.51	22.334
<b>other ethnicity</b>	491	50	150	101.96	15.234
<b>other ethnicity 10</b>	491	10	150	108.53	21.307
<b>family business</b>	490	0	1	0.31	0.462
<b>where</b>	488	0	1	0.66	0.476
<b>employability</b>	491	1	5	3.55	0.992
<b>regular job</b>	491	0	1	0.09	0.292
<b>Working hours</b>	34	4	50	19.82	14.147
<b>costs</b>	488	6500	360,000	92,133.48	64,860.180
<b>year of birth</b>	491	1968	1995	1991.73	2.285
<b>gender</b>	490	0	1	0.56	0.497
<b>ethnicity</b>	484	0	1	0.85	0.360

Table C2: Descriptive statistics by gender

Variable	%		%
	male		female
<b>Field of study</b>			
Business	8.6		11.2
Economy	1.8		6.9
IT	4.1		0.6
Mathematics	1.6		5.1
Civil engineering	9.0		6.9
Architecture	7.8		10.2
Medicine	1.8		5.1
Electrical engineering	1.4		0.8
Agriculture and food	8.2		8.8
<b>Parent's education</b>			
<b>Father</b>			
don't know	0.4		0.8
no formal degree	0.2		0.0
apprenticeship traininig	0.8		0.0
primary education	0.4		1.2
secondary education	15.5		21
higher education	8.0		9.2
university degree	13.3		20.4
Master/PhD	5.7		3.1
<b>Mother</b>			
don't know	0.8		1.0
no formal degree	0.2		0.4
apprenticeship traininig	0.2		0.2
primary education	1.6		1.8
secondary education	14.7		20.2
higher education	8.0		7.1

university degree	16.3		20.8
Master/PhD	2.4		4.1
<b>Same education as parent</b>			
same field as father	9.6		9.8
same field as mother	3.9		9.4
<b>Year of study</b>			
junior	27.1		31.8
senior	17.1		23.9
<b>Relative Academic performance</b>			
very poor	9.7		16.8
poor	10.5		14.2
average	15.7		16.4
good	6.8		7.2
very good	1.2		1.4
<b>repeaters</b>	16.3		16.7
<b>regular job during studies</b>	31		15
<b>Perceived Employability</b>			
very poor	1.8		1.6
poor	5.7		3.9
average	11.8		19.6
good	16.3		23.1
very good	8.6		7.6
<b>Country of employment</b>			
Macedonia	23.8		37.2
family business	16		14
Other country	16		18.5
<b>Ethnicity</b>			
Macedonian	34.9		49.8
other	9.1		6.2
Observations	44.3 %		55.7 %

## Appendix D

Table D1: Expected graduation and high school wage and expected wage gain 10 years after labour market entry

	University wage	University wage 10 years after graduation
	$\beta$	$\beta$
<b>Year of study (juniors=1)</b>	0.149***	0.095**
<b>Type of school (private =1)</b>	0.014	-0.004
<b>Field of study: reference category: Engineering</b>		
<b>MATH</b>	0.013	-0.117
<b>Medicine</b>	-0.247***	-0.239***
<b>Business and economy</b>	-0.005	0.020
<b>Father holding University degree or Master/PhD</b>	0.102**	0.156***
<b>Mother holding University degree or Master/PhD</b>	0.047	0.026
<b>Same field as father</b>	-0.043	-0.044
<b>Same field mother</b>	0.060	0.008
<b>Repeating</b>	0.014	0.005
<b>Academic performance</b>	-0.003	-0.007
<b>Wages information (reference category=never)</b>		
<b>WI1 (career center=1)</b>	0.251***	0.312***
<b>WI2 (daily/weekly press=1)</b>	0.151**	0.223***
<b>WI3 (personal communication=1)</b>	0.011	0.057
<b>Family business</b>	-0.008	-0.010
<b>Country of employment</b>	-0.170***	-0.219***
<b>Employability</b>	0.082***	0.131***
<b>Regular job</b>	0.137*	0.127**
<b>Costs</b>	0.000	0.000
<b>Gender (female=1)</b>	-0.103***	-0.201***
<b>Ethnicity (Macedonian=1)</b>	-0.106**	-0.052

\*, \*\* and \*\*\* indicate significance at the 10, 5 and 1% level, respectively



## **Creating a Market Oriented Organizational Structure as a Key to Overcoming the Financial Crisis – A Comparative Study**

*Ema Kastratovic, Marjan Bojadziev, Venera Krliu-Handjiski*

### **Abstract**

*The interconnectedness and the ever-growing interdependency of the European countries had set in motion a vast number of processes that ultimately led to the infamous financial crisis. Now, as we are taking the first steps out of this tight spot, it is of significant importance to look back and examine some of the factors that have aided certain companies to prevail during the crisis. Therefore, the purpose of this paper is to provide a theoretically based review and analysis of the organizational effectiveness of a selected number of medium sized banks in South East Europe (SEE), with particular emphasis on the role of organizational structure during and after the financial crisis period. The main result of this comparative study is to substantiate the underlying hypothesis of the research, which is to examine the positive link between the market driven organizational structure and organizational effectiveness.*

*Keywords: Organizational structure, organizational effectiveness, banking*

## 1. Introduction

The events that occurred in the midst of the economic crisis and stirred quite a heated debate over cause and effect, are failing to give way to forward thinking and solutions for economic recovery. However, the path to growth, even some years down the line, is still slow and fragile. This is due, in part, to the increased interconnectivity of the countries in the era of globalization. Such a condition has attracted considerable attention from researchers and policy makers. Yet, although they have made significant advances in examining the devastating effects of the financial crisis and its aftermath, most of these studies have concentrated on examining the macroeconomic perspective of the crisis. We believe that there is a need to take a look at the more practical aspects at an organizational level, such as the different types of organizational structure aimed at improving financial performance.

This study is focused on a comparative analysis of the more intricate factors within banking operations, from an organizational and managerial aspect. It is based on evaluating financial performance using a sample of comparable banks with operations in South Eastern Europe. The countries included in this research are at different stages of European Union (EU) accession, in order to reflect the lower impact of the crisis in the countries that are EU member countries (Romania and Bulgaria) compared to the candidate countries (Macedonia and Serbia). However, this is not the primary target for differentiation in this research, as these countries have similar gross domestic product (GDP) per capita levels. This aspect is used only to the extent of assessing whether the organizational structure of the banks helps in achieving stable or better effectiveness during a period of turmoil.

For this purpose, organizational effectiveness is measured through performance indicators such as profitability, return on equity (ROE) and return on assets (ROA). Therefore, this comparative study focuses on the following research questions:

A: Is there any impact of the type of organizational structure on organizational effectiveness?

B: Does organizational structure aid banks to sustain organizational effectiveness in periods of turmoil?

## **2. Brief Literature Review: the Banking Sector in Transition Economies**

In the general sense, most of the research on the impact of the financial crisis on the banking sector has been focused more broadly on the European Union or the USA. It is only more recently that studies such as those of Gardo and Martin (2010) and Gallego, Gardó, Martin, Molina, and Serena (2010) have come to light.

Gardo and Martin (2010) are among the first who base their research on countries from South-Eastern, Eastern and Central Europe, by assessing the state of the banking sector in the period from before the crisis until its occurrence. They concluded that although the crisis was manifested more severely in other regions, the Central European and South East European (CESEE) countries have shown rather heterogeneous developments, those with highest economic imbalance were most affected. A similar perspective on this issue was given by Gallego et al. (2010) by conducting a comparative study of the impact of the crisis of countries in Latin America and those of the CESEE. The research showed that countries showed resistance in succumbing to the devastating effects, only to be followed by a sharp downturn in early 2009. During that period, the region was still undergoing some of the transitional changes that started taking place by the end of the 1990s. The most dramatic changes took place in the past decade, with many structural and democratic reforms, economic integration and regional cooperation, and even though the expected outcomes of the crisis were not felt so severely, the region was yet lagging in the recovery rate of other more developed regions.

### **2.1. Changes in Ownership Structure**

When referring to the SEE countries, one of the most important elements of the transformation from the state owned banking system into a new organizational form was the introduction of the privatization process and the entrance of foreign investors. Foreign banks as owners, introduced new standards and practices, tighter supervision, new banking products and consequently, stronger competition. Policy makers

stimulated this process since it was presumed to have a positive impact on both stability and efficiency of the local banking system.

The research by Fries and Taci (2005) in the post-communist countries showed evidence that the foreign banks transferred their know-how, stimulated competition, and proved to be reliable credit sources. Other studies also examined the performance of foreign banks in transition economies, by analysing data on efficiency and profitability, and comparing it to that of domestic banks (Bonin, Hasan & Wachtel, 2005; Havrylchyk & Jurzyk, 2006). The authors' research on banks in Central and South - East Europe concluded that the foreign-owned banks were not only more cost-efficient, but also provided better service.

However, the global crisis, did in fact pose a challenge to the sustainability of the banks present within the region. Why? Because of their problems "back home". Therefore, the deleveraging of their home markets and the worsened financial situation pulled down the stability of the SEE region. It created greater uncertainty, as studies by De Haas and Van Lelyveld 2010), and Popov and Udell (2010) have shown. They state that the lending to the foreign banks' subsidiaries depended largely on the financial strength of their parent banks. Until now, the majority of the banks within the SEE region are foreign owned, and have endured the prolonged effects of the financial crisis.

## **2.2. Some Approaches to Determining the Organizational Effectiveness of Banks**

In order to proceed with the methodology of the paper, we shall look into some aspects of determining organizational effectiveness. This has proven a struggle for many researchers in suggesting a commonly acceptable and unified approach. Some of the proposed models by various scholars classify four general categories for determining organizational effectiveness, namely: 1) multiple constituency 2) internal process 3) a systems approach and 4) a goal approach. Regarding this specific paper and in evaluating bank organizational effectiveness in general comparative studies, the most common approach is the goal-based approach, suggested by David and Stanley (1999). It comprises of measuring organizational effectiveness in terms of the accomplishment

of business goals and objectives. Similar to the use of financial data when measuring a bank's performance.

However, we do emphasize the importance of internal variables such as leadership, communication and structure, as suggested by Cameron (1983) in describing the internal process model. This is in partly supported by the opinion of Likert (1967) that there are intervening (objective, motivation, morale, etc.), causal (strategies, skills, management decisions, etc.) and the end result (achievement, profit, etc.) variables. Also, there are other models that consider leadership elements being a soft part of the organization, while the "organizational structure: is a hard or formal part of the organization" (Bojadziev, Tomovska, Stefanovska, & Nikolovska, 2011, p. 7). Apart from such distinctions between models and variables in measuring effectiveness, we shall mainly focus on the organizational structure as an important factor.

### **2.3. Organizational Structure and Its Impact on Organizational Effectiveness**

Though many definitions can be found for organizational structure, one can emphasize the following aspects: task allocation, supervision and coordination directed at achieving organizational goals (Pugh, 1990). More broadly, organizational structure is the means to pass down mission as an organization's basic purpose and scope of operations (Bateman & Snell, 1999). Even so simply put, choosing the optimal organizational structure within a company is not as simple, since there is a need for a multi-criteria selection approach, as Biggiero and Laise (2003) argue in their research. They point out that albeit different organizational theories propose different selection criteria; they are in fact compatible (non-mutually contradicting).

Unfortunately, there has been limited research in providing a conclusion as to which organizational structure is best suited for achieving better performance results. Furthermore, the relationship between organizational structure and effectiveness, even though with a long history and viewed from different aspects, has been brought up more recently in the context of organizational design. This is a field specifically devoted to studying the links between environment,

organizational structure, and organizational outcomes, which is in many respects an emerging field (Csaszar, 2012).

Despite this, a fairly recent paper by Csaszar (2012) shows some evidence that organizational structure does in fact influence organizational effectiveness. In his study he examines mutual funds, and has taken omission and commission errors as performance results. The author analysed the impact of a centralized and decentralized organizational structure on those performance indicators, to come to the conclusion that “decentralized structures accept more projects, make fewer omission errors, and make more commission errors than centralized structures” (Csaszar 2012, p. 30). In this regard, a relationship between the impacts of different types of structures and effectiveness is reflected.

### **3. Methodology and Analysis**

In order to assess the influence of the organizational structure on the performance of specific banks, this research was conducted by using primary data from three banks: ProCredit, SocieteGenerale, and Sparkasse. They all are part of a holding group, thus falling under the foreign-owned bank ownership structure. We have considered them from a regional aspect (SEE), with operations in four specific countries: Macedonia, Serbia, Romania and Bulgaria. The countries used in this research were chosen based on their region and their status in terms of EU accession: Romania and Bulgaria are members of the European Union, whereas Serbia and Macedonia are in the pre-accession process.

The study encompasses annual financial data ranging from 2007 to 2011, for a total of 12 subsidiaries, presented as consolidated annual results per bank group, or as an average performance result per bank group. For the purpose of this study, indicators such as profitability, ROE and ROA have been used as measures of organizational effectiveness.

Based on the analysed data, the study is comprised of three parts. In the first part, we analysed the banking sector performance in the selected countries in order to gain a perspective of the regional environment of the banks operations. In the second part, we analysed the organizational structure of the banks based on the publicly provided

information made available by the chosen banks within each country, in order to assess whether there are different types of organizational structures among the bank groups. In the third part, we assessed the financial data selected as a performance indicator for the purpose of this study.

### **3.1. Cross Country Situational Analysis**

After the financial crisis and according to the most recent data from the World Bank, there has been an annual growth in GDP of merely 2 % in both 2010 and 2011 in the SEE countries. In 2012, the SEE countries showed signs of a double –dip recession, with almost no GDP growth, with Serbia being the most affected with a GDP almost half of that of the other countries summarized GDP (South East Europe Regular Economic Report No.3, Wold Bank, 2012, pg. 4)

We have selected the data relevant to the countries included in this research for the past two years and the prospects for 2013 (See Table 1). Individual economic growth in the years after the crisis varies among the SEE countries, with the largest contractions depicted in Macedonia and Serbia by about 1.1% and 1.6 % respectively.

Also afflicted with high unemployment levels (highest among EU countries), and stagnation in consumption, tough recovery is expected for the whole region. Even with the signs of the gradual increase of economic growth in the SEE as a group, these countries will remain in recession for the year as a whole.

**Table 1.** Economic growth rates

	2011	2012	2013
Macedonia	2.8	0.0	1.0
Bulgaria	1.7	0.8	1.8
Serbia	1.6	-2.0	2.0
Romania	2.5	0.6	1.6
SEE6	2.2	-0.6	1.6
EU11	1.5	-0.4	-0.1

Source: South East Europe Regular Economic Report, No.3, 2012 p. 4.

Modest growth has been shown in eleven EU countries as well, which have expanded by about 1.6% in 2011, with Romania leading with 2.5 %, followed by Bulgaria with 1.7%.

In this volatile external environment, all the above mentioned countries are expected to have a very modest increase in 2013 of about 1,2%, however, there is a situation of heightened uncertainty since the labour market outlook seems still unfavourable according to the World Bank statistical data. Also, the aforementioned signals potential turbulences in the financial sector.

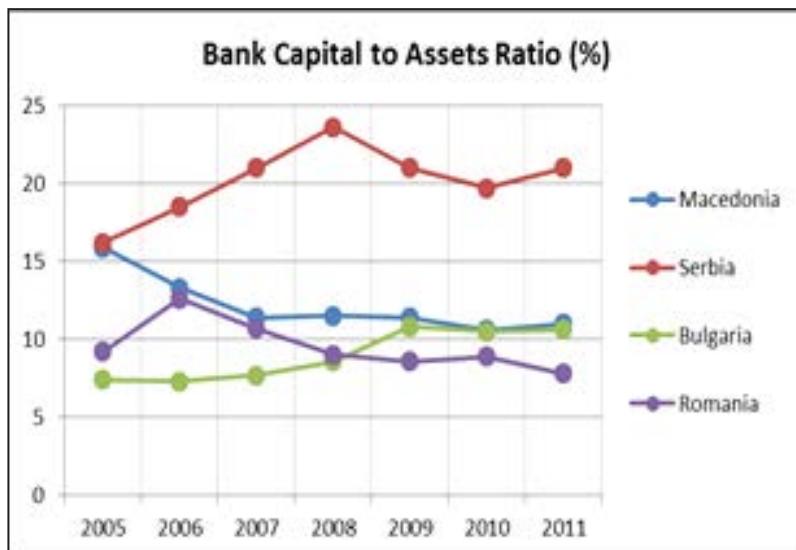
### **3.1.1. The Banking Sector in Selected Countries**

The countries in the region are highly integrated within Western Europe through trade, labour, and finance, the latter being the fastest transmitter of the Eurozone troubles. Some of the selected countries have adopted the Euro, whilst others peg to it. The data shown below are likely to portray the most immediate effects of the crisis (see Graph 1 and Graph 2). In 2008, the rapid credit growth came to a halt when the crisis began; and the banks within the region saw foreign funding dry up with some runs on deposits.

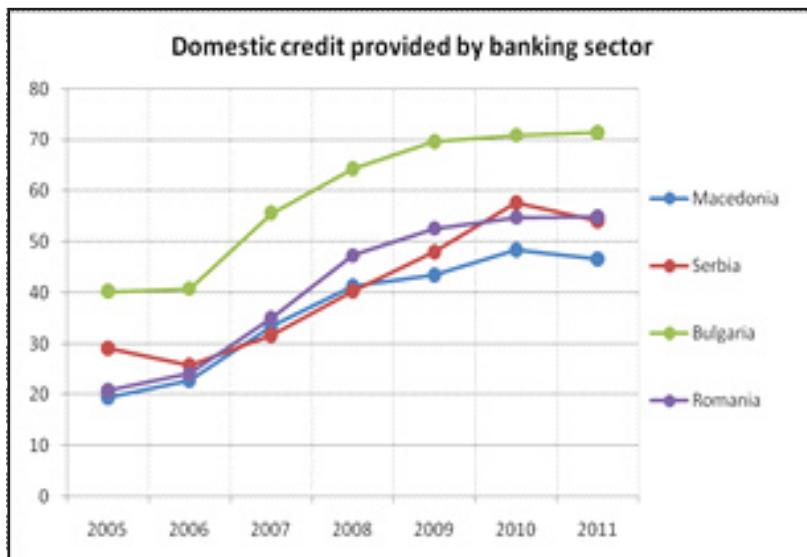
However, annual domestic credit growth averaged 25 % between 2006 and 2008, fuelled by foreign capital flows into the financial sector. After 2008 when the crisis hit home, the credit provided by the banking sector still showed progression, although with a lower growth. The banks within the countries had to adjust to the credit crunch that reflected lower demand as well as problems of asset quality due to parent bank deleveraging. Macedonia showed the slowest growth in the following years of around 9%, lagging behind the other countries in the region. The highest credit offering growth was measured in Bulgaria amounting to 71.6%, followed by Romania, leaving Macedonia and Serbia somewhere in the middle with an average of about 50 %.

This was motivated partly by plentiful global liquidity, partly by the region's economic prospects and political stability, and largely by prospects of eventual EU membership for Western Balkan countries. However, as mentioned previously, despite the slow but certain growth of credit provided by the banking sector, there was still an issue of the asset quality.

Graph 1: Bank Capital to Assets Ratio



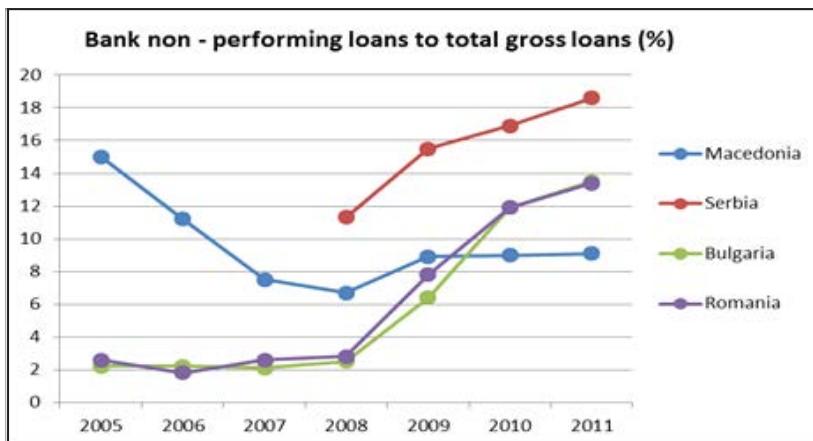
Graph 2: Domestic credit provided by banking sector



Source: World Bank, stylized data from database

Although the Eurozone crisis has been contained to date, the SEE banking systems are still battling the existence of high nonperforming loans, low credit growth, eroding capital, and minimal profitability. High levels of nonperforming loans (NPLs) show that the loan quality has deteriorated, and banks have chronic difficulties in writing off NPLs because ineffective insolvency regimes generally preclude a rapid resolution of problem loans. This is one of the main reasons that the banks' ability to resume lending has deteriorated and shown slower growth. The most affected by such banking decisions were the small and medium enterprises (SME) (which comprise the majority of companies within the region). Larger banks seem reluctant to give credit to such enterprises, whereas medium sized banks found a niche market in this aspect, however with more stringent processing. As shown in Graph 3 below, the amount of non-performing loans within the region has soared, in some countries to a staggeringly steep progression. Since 2008, the average percentage of non-performing loans in the countries was around 6%, while in 2011, it showed an increase of yet another 6%. In 2011, the highest increase was noted in Albania, Serbia and Bulgaria, and Romania with 14.4%, 18.6%, and 13.5% respectively. On the other hand, Macedonia has shown the least increase in non-performing loans, ensuring higher stability in this aspect.

Graph 3: Bank non-performing loans to total gross loans (%)



Source: World Bank, stylized data from database

### **3.2. Organizational Structure of the Bank Groups**

As mentioned previously, the three analysed banks are each a part of a specific bank holding group. As such, it is safe to state that the parent bank's structure is primarily regional (geographical). This is primarily attuned with the bank's overall strategy and mission, and aimed at the diversification of the asset portfolio, increasing market share and achieving better performance results. However, taking into consideration organizational structures of the bank subsidiaries at country level, the organizational structure is formal and functional. From the assessment of the organizational structures of ProCredit, Sparkasse and SocieteGenerale, it is clear that they are divided into divisions and departments that reflect to some extent a market driven organizational structure. This implication arises from the fact that SocieteGenerale has two separate divisions for different client types (retail and corporate), but with no further departmentalization. In Sparkasse, on the other hand they fall under a joint division (legal entities division) with then a further departmentalization according to legal entity size.

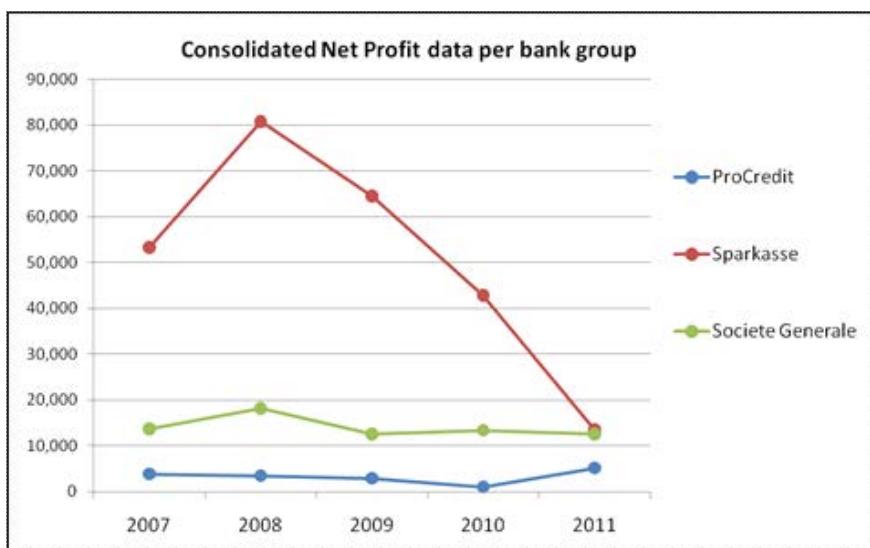
An interesting finding is that ProCredit on the other hand, puts the different sized entities' departments under the operations division. The absence of a corporate and retail division or the lack of a large corporate client division (as the case in SocieteGenerale) in term reflects the mission and strategy of ProCredit, which is to its entirety niche market oriented (servicing the SME's market). As set forth in the organizational chart, this implies that ProCredit is leaning towards a team based organizational structure, but in the aspect of market driven organizational structure, it is the most prominent among the three banks. The organizational charts of the banks can be found in the appendix to this paper.

### **3.3. Bank Performance Analysis**

After the analysis of the financial statements of the selected banks and consolidating the aforementioned performance results (net profit, ROE and ROA), we were better able to form a opinion on the banks' effectiveness.

Graph 4. bellow depicts the consolidated net profit data for the three bank groups. It clearly shows that although the net profit level is highest at Sparkasse, it shows a steep slump in the post crisis period. Societe General, although at a lower level, has a stable net profit line after the financial crisis, with relatively small downward fluctuations. ProCredit has the lowest net profit level, however it is the only bank group that shows only a very small fluctuation in net profit levels, and an upward trend in the financial crisis recovery period. The peaks and troughs of the net profit line also reflect the impact of the financial crisis in the SEE region, which as stated previously in our study, mostly affected these economies during late 2009.

Graph 4: Consolidated net profit data per bank group

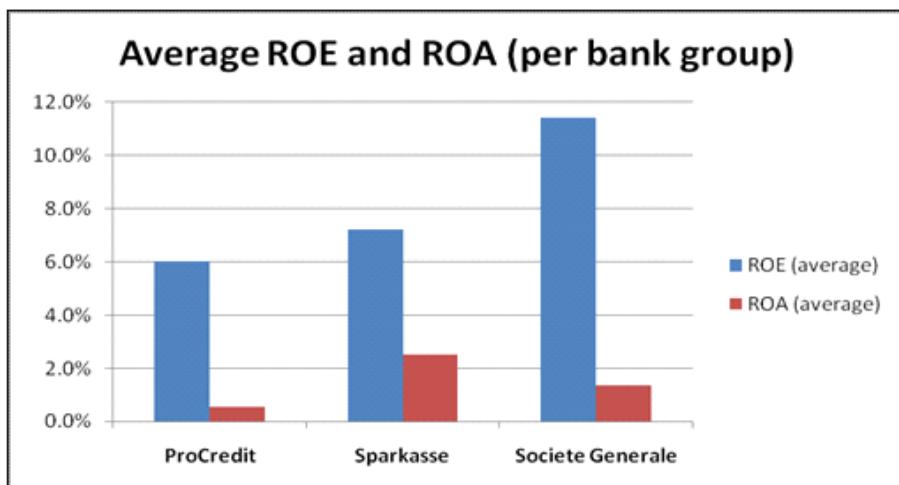


Source: Bank financial statement data from selected countries on an annual basis

We cannot draw conclusions solely based on the net profit level. A fuller extent of the performance of banks is done through ratio analysis. The two fundamental, and essential ratios, show a very clear picture of the banks' overall corporate health. Therefore, in the following two graphs, there is a representation of the ROE and ROA of

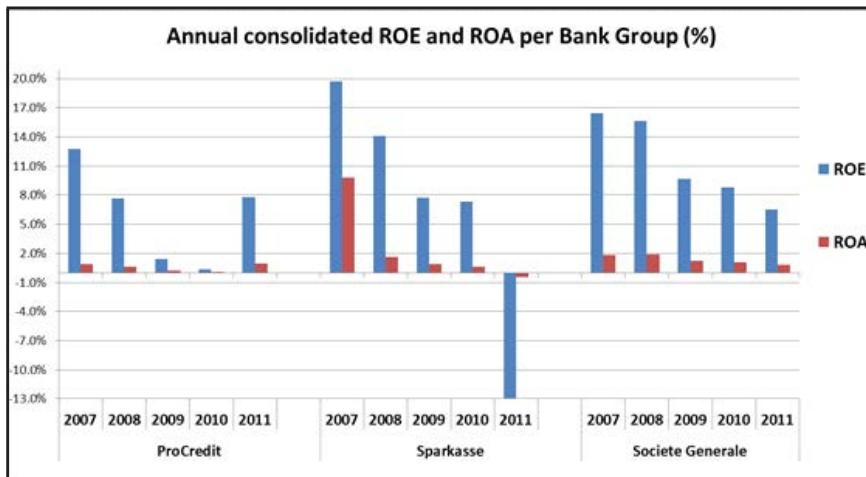
the bank groups. These ratios allow for flexibility when comparing banks since the ROE does not account for asset size. If we take the average ROE and ROA of the 5 year data, it is evident that Societe Generale is the most efficient, however it might be misleading as when the ROE and ROA levels are compared, it might imply that the banks is overburdened with debt (Graph 5). However, if we break down the ROA and ROE data on an annual basis (Graph 6) it clearly indicates that despite the higher ratio levels, ProCredit is the only bank that shows an upward trend in financial recovery from the crisis.

Graph 5: Average ROE and ROA per bank group



Source: Bank financial statement data from selected countries on an annual basis

Graph 6: Annual consolidated ROE and ROA per Bank Group (%)



Source: Bank financial statement data from selected countries on an annual basis

#### 4. Conclusions and Limitations to the Study

The comparative analysis of the banks' organizational structures depicts different types of structure within each bank group, although all of them show some elements of market driven orientation. This is reflected through the divisional allocation of the customer markets (retail and corporate).

However, ProCredit is the only bank with a clear market oriented organizational structure, which is shown through the distinction of the specific customer segments within their customer market (very small, small, and medium enterprises) under the operations division. Also, only in the case of ProCredit is there any evidence of migration from functional towards team structure. This in turn, implies that these departments have higher authority, delegated responsibility and decision making power, thus making them more efficient. As previous similar positions expressed in the literature have shown, such decentralization allows for the acceptance of more projects (Csaszar, 2011) and the use of more soft information (Stein, 2002). Therefore, when we are looking at

organizational efficiency, the rationale behind the reason for ProCredit's lower level of efficiency is that banks with such a specific market (SMEs) are more prone to accept smaller and riskier clients, therefore exposing themselves to a higher level of non-performing loans, as well as higher operational costs.

This indicates that the answer to our first question "*A: Is there any impact of the type of organizational structure on organizational effectiveness?*" is that there is some signal of a positive relationship existing between organizational structure and effectiveness. However, other underlying factors might play a greater role and should be taken into a consideration, which poses a limitation to this study. We consider this as an advance in furthering the research, by taking into consideration the organizational context as well as the mission and strategy of the company for their influence on strategy, and in turn, their effectiveness.

In order to answer our second question "*B: Does organizational structure aid banks to sustain organizational effectiveness in periods of turmoil?*", we again look at the effectiveness level of the banks. The study does not come to a conclusive result in regard to whether a specific type of organizational structure provides for the highest performance results. This is reflected through the fact that the efficiency of Societe Generale is the highest, despite them having a more subtle form of market orientation as opposed to ProCredit.

It is however worthwhile pointing out, that only ProCredit shows the fastest recovery after the financial crisis and the only upward trend when it comes to performance results. So it is possible to imply that their structure provided for more sustainable results during and after the period of financial turmoil, however for the purpose of furthering this study, we would take into consideration the specific market sector and its vitality during the crisis.

All things considered, this study, like other papers in the emerging field of analysing organizational aspects, broadens the pool of information available and gives insight into considerations for future research in order to gain more specific and conclusive results.

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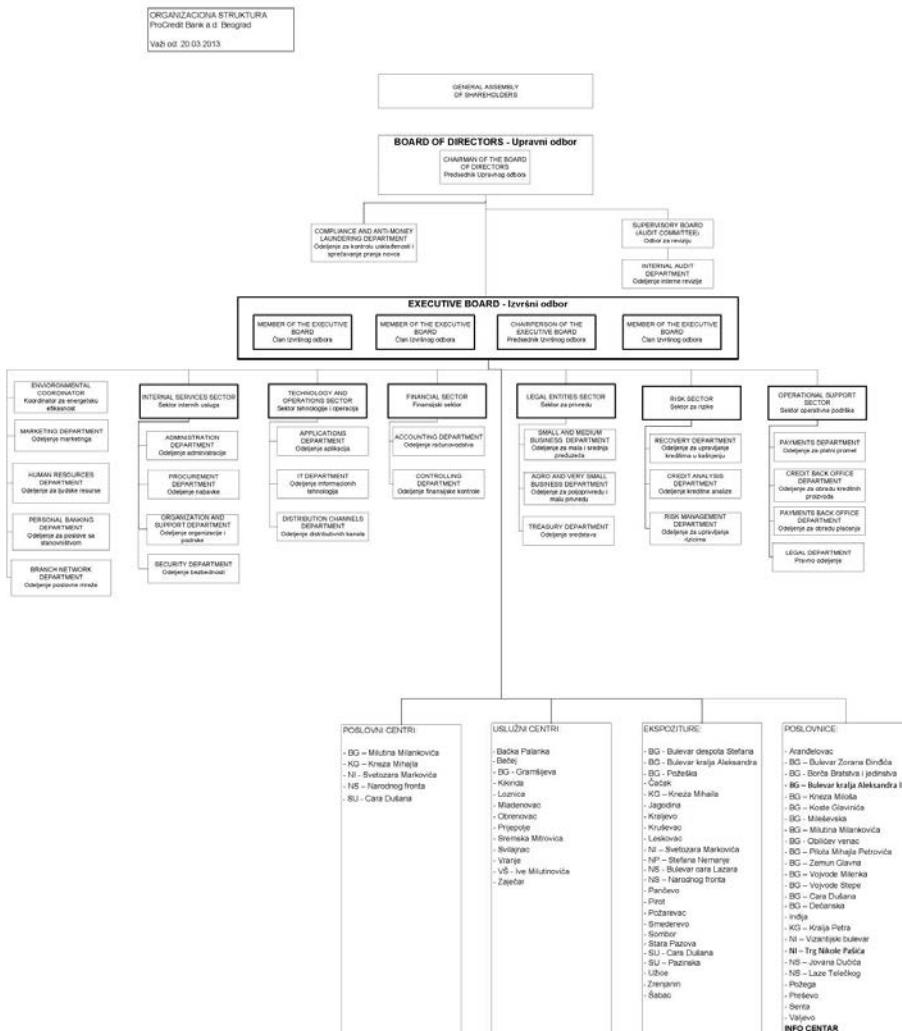
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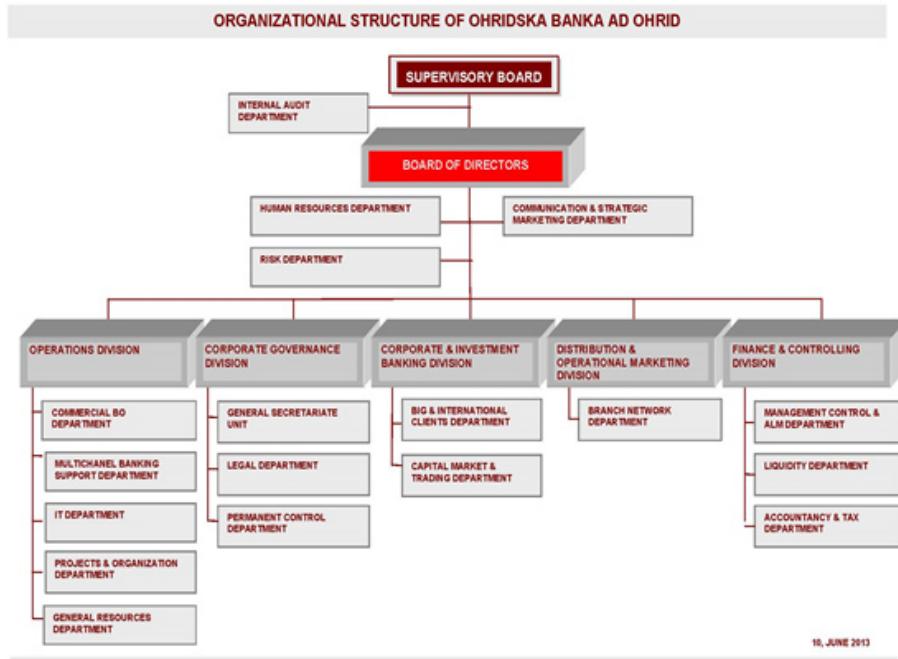
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## **Appendix 1: Organizational Chart of ProCredit Bank**



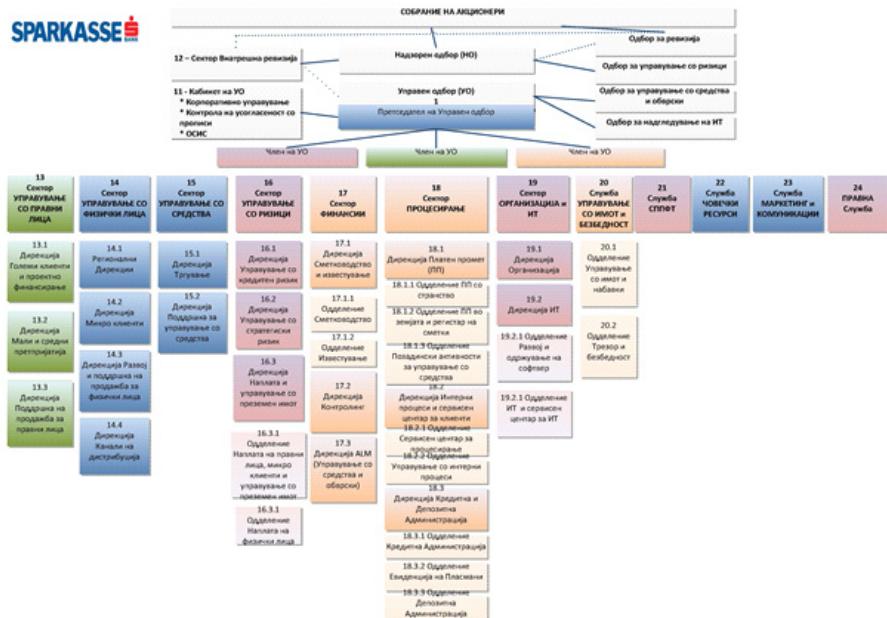
## Appendix 2: Organizational Chart of Societe Geenrale

(Source: [www.ohridskabanka.mk](http://www.ohridskabanka.mk))



### Appendix 3: Organizational Chart of Sparkasse

(Source: [www.sparkasse.mk](http://www.sparkasse.mk))



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## About the Authors

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**The late Gáspár Bíró** was professor of International Relations at the Institute of Political Sciences of the Faculty of Law, Eötvös Loránd University Budapest. He was former Rector of University American College Skopje. In 1989, Gáspár Bíró served as Chief Counselor in the Secretariat for National and Ethnic Minorities at the Council of Ministers of the Republic of Hungary, and in the following year he took the post of

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**Marjan Bojadziev** is Rector, CEO, and full time professor at the University American College Skopje. His main areas of interest include finances, entrepreneurship, organizational behavior, and strategic planning. He used to hold top management positions at the Macedonian Bank and the Inter Falco Holding Company. He is a Harvard School of Business Trainee and EFER Alumni.

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