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***PUBLIC ADMINISTRATION***



## SCORING THE DEFAULT RISK OF LOCAL AUTHORITY

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**Abstract:** *In the Nineties, almost all public administrations were affected by a change that made municipalities more responsible in using public resources. More recently, the global crisis and the gradual cuts in funding from the State led to significant repercussions on the budgets of local authorities with an increasing number of defaults. The Italian government introduced the procedure of "financial default" to rescue local authorities in financial difficulties from 1989. However, to date, a methodology to constantly monitor the local authorities' "health" and to prevent financial defaults has not yet been formalized. As previous studies highlighted a close link between financial condition and service delivered to citizens, the study aims to construct a set of specific indicators to judge the default risk of Italian LAs in order to prevent defaults. In this research we use a deductive method. The research was carried out in eight different steps according to a logical process of identifying the risk indicators and the consequent risk ranges. The results are significant as they clarify the situation leading potentially to default and they propose a set of specific risk indicators to evaluate and to prevent the risk of default. This logical process could easily be adopted at an international level, with the necessary modifications for specific accounting regimes.*

**Keywords:** *local authorities' defaults, default risk ranges, default prevention, default indicators.*

### 1. INTRODUCTION

In the Nineties, almost all public administrations were affected by changes making local authorities (LAs) more responsible in the use of public resources and in meeting the Maastricht Treaty's objectives (Council of Europe, 2007). These reforms were inspired by the New Public Management theory (Pollitt & Bouchkaert, 2011).

Financial health is a necessary condition under which governments must operate as there is a close link between financial condition and service delivered (Jones & Walker, 2007). At international level, literature concerning financial health in LAs is quite limited in number and, with few exceptions, is restricted to the Australian, Canadian and U.S. context (Holian & Joffe, 2013). Moreover, local governments are not self-contained entities existing by themselves; consequently, each governmental level affects the others (Coe, 2007: 68). Timely identification of early symptoms of difficulty is an extremely complex issue - and a very pertinent one nowadays.

This exploratory study aims to make a contribution to two different audiences - the scientific community and the institutions. It is our intention to pursue the debate within the scientific community by using a means of analysis derived from the literature, integrated with solutions made necessary by specific problems of the sector. From an institutional point-of-view, our system of indicators allows an institution to easily "take the pulse" of Italian LAs by classifying them within a risk default range (no risk, low risk, high risk) and using data that can be extracted from the Ministry of the Interior database. This information has the advantage of being certified and comes from a reliable source. LAs can be compared by the scientific community and by external institutions and more detailed enquiries instituted, should results suggest early signs of financial difficulties. Regular analysis can highlight potential financial problems and provide information necessary for timely corrective action, in order to guarantee public services to citizens.

Our aim is to construct a system of specific indicators with which to judge the default risk of Italian LAs. Timely identification of early signs of problems in local authorities would meet requirements both of higher government levels and of the scientific community. In other words, we propose a proactive approach in order to predict future defaults and, consequently, to prevent them (Cahill & James, 1992). To achieve this aim, in this article we shall:

- examine the trends for Italian LAs declared to have defaulted;
- formulate, based on the theoretical framework, on Italian practices and the course of these difficulties, a system of specific indicators that identify early symptoms of instability;
- describe the results of empiric research into Italian LAs that defaulted, aimed at testing the system of indicators;
- determine the risk range according to the results of empiric research;
- highlight both the limits and possible future developments of the research in some concluding observations.

## **2. THE LITERATURE REVIEW**

Scholars in Italy and abroad have written a great deal about businesses in crisis, but studies on LAs in crisis are relatively rare and frequently address the issue from a political economy viewpoint (Kloha *et al.*, 2005). The first problem to solve is the definition of financial health or what is sometimes called, highlighting its negative side, fiscal stress, default conditions. Unfortunately, this definition is not unique (Levine *et al.*, 2013). This variety of definitions inevitably leads to a diversity of operational measures adopted when attempting to measure or predict LAs financial distress (Downing, 1991). However, the main challenge is to determine how to measure financial health, or from the opposite viewpoint, how to measure the default risk. Within the literature there are four generally agreed upon measures: cash solvency, budget solvency, long run solvency and service solvency (ICMA, 2003). Cash solvency measures a local authority's liquidity and effective cash management, and its ability to pay current liabilities. Budgetary solvency refers to the ability of the LA to generate sufficient revenues to find its current or desired



service levels. Long run solvency refers to the impact of existing long term obligations on future resources. Service level solvency refers to the ability of the government to provide and sustain a service level that citizens require and desire.

In general, the measures range from basic approaches, such as accounting information and financial reporting analysis (Kleine *et al.*, 2003) to more sophisticated statistical modelling approaches (Murray & Dollery, 2005). An important aspect of the default risk is the proxy used in order to discriminate financially unhealthy local governments from the healthy ones. Several variables have been proposed such as ratio indicators (ICMA, 2003) or the quantity, quality and cost of service delivery (Zafra-Gomez *et al.*, 2009).

Given the negative impact produced by the financial crisis of a single LA within the nation, some countries have introduced specific procedures to rescue public bodies in financial difficulties (Högye, 2002: 593-616). The Italian government introduced a procedure of “financial default” for LAs in serious financial difficulties (Decree Law 66/1989).

Obviously a system of indicators is needed, able to identify the causes of the financial difficulties and, consequently, to understand whether the state of crisis derives from improper conduct by the LA or not. At the same time, such a system would enable prompt intervention before the financial difficulties are transformed into an irreversible crisis. A common element, however, in the literature examined and, above all, in practice developed in European countries is that there is no such shared system of indicators or tracking that can be used as a "warning signal" for potentially endangered authorities (Council of Europe, 2002: 36-37).

Numerous instruments have been put forward for timely identification of crisis. These fall into three groups - intuition-based, founded on analysis of indices or on models.

The first signs of decline are manifested in objective elements of imbalance that may be found in the static or dynamic indices commonly used in financial analysis (Tektaş *et al.*, 2005). Hence the usefulness of setting up an executive dashboard of indicators aimed at picking up even minimal signs to enable timely intervention in corporate crises (Altman, 1968; Beaver, 1966). Other studies chose to concentrate on the predictive capacity of financial statement analysis in identifying potential corporate instability (Beaver *et al.*, 1968; Wilcox, 1971). These methods can also be used to investigate the state of health of LAs. Previous research highlighted the possibility of measuring the fiscal health of local governments by analysing their balance sheets together with other variables (Hendrick, 2004), as LAs have the same issues connected with finding and managing balance as have private bodies. Some studies focussed on quantitative variables able to monitor – and so to evaluate – the trend of per capita revenue, with specific attention to own source revenues, to the ratio between debt and amount of revenue (debt limit), to temporal and quantitative differences between ability to collect revenues and to realize expenses, to an operating deficit and to the ability to generate liquidity (Maher & Deller, 2013).

The review of the literature has shown that there is a need to prevent financial default of LAs. It has also been shown that the state of health of a local authority can be judged, based on its balance sheet.

Given all this, we believe it possible to build a dashboard of indicators capable of identifying authorities in financial difficulty and determining the risk default ranges. Yet from a practical point-of-view, there are many issues to be resolved in identifying a suitable system of indicators. Once it has been built, the system must then be tested for effectiveness in timely signalling of critical financial situations in LAs.

### **3. IDENTIFYING SYMPTOMS OF DEFAULT IN ITALY**

From the point-of-view of territorial organisation and workings, in Italy there are 4 levels of government. The base or primary level of Italian public administration is made up of 8,093 municipalities. 70.3% of municipalities have a population of less than 5,000 inhabitants. On the second level, Italy has provinces (110) whose function it is to coordinate and mediate within local administrations (municipalities). On the third level, there are 20 regions, through which central political and administrative power is channelled. Finally, there is central government.

Each municipality has a mayor, a municipal executive board, a city council and a professional bureaucracy. The executive structure of Italian local government is similar to the U.S.A. model of mayor-council government in that the mayor and city council are separate offices.

Municipalities are allowed to raise local taxes and charge fees for the services that they provide, but a significant percentage of their revenues is still accounted for by transfers from higher levels of government, especially in low-income areas of the country.

From an accounting viewpoint, municipalities still rely predominantly on cash and commitment-based budgetary accounting, although they are technically expected to also publish an accrual-based financial statement (Anessi-Pessina & Steccolini, 2007). The budget, which is commitment-based, must be approved by the council and is required to balance. Budgeted revenues can include borrowing, which, however, can only be used to cover capital spending. Past-year surplus may be added to budgeted revenues, while past-year deficits must be covered by adding them to budgeted expenditures. The fiscal year coincides with the calendar year. Revenues are classified by kind, into several large groups (“titoli”). Expenditures are classified by kind and purpose, once again into several large groups (“titoli”).

The Italian government introduced a procedure of “financial default” for LAs in financial difficulties under Decree Law 66 of 1989. In Italy, the recognition of instability is therefore relatively recent and now permits municipalities and provinces to instigate a recovery process if their financial conditions are preventing them from discharging primary functions and services.

The default procedure aims to balance the budget. It permits Italian local authorities whose financial conditions do not allow them to guarantee primary functions and services, or who are in conditions of insolvency, to start a recovery process.

Once the local authority has declared financial default and approved the ruling, a clear division is made between the previous administration and ordinary activities. The Ministry of the Interior appoints an OSL (Extraordinary Liquidation Body) that draws up a recovery plan, then arranges payment of previously incurred debts and balances the situation. The council that declared default remains in office, but only to carry out ordinary activities.

Since the law was introduced in 1989 up to our data extraction on December 31st 2011, 459 authorities had declared financial instability, of which just one province, that of Naples, in 1993. All things considered, the phenomenon is not very widespread, considering that it involves 5.51% of the 8,093 Italian municipalities and only a minimal percentage of the country's 56 million inhabitants. It has been noted, however, that this number is probably not representative of the total number of local bodies actually in financial difficulties.

The early years of introduction of the procedure were characterized by a high number of defaults but later on this phenomenon diminished, probably as a result of the changes in recovery procedure, which, since Constitutional Law 3/2001 came into force, decreed that the state could no longer give financial aid.

This resulted in a fresh increase in the number of financial defaults (Ifel, 2011a: 58-61), which then focussed the attention of media and scholars on LA financial crises (Mazzara & Nigro, 2009: 7).

The question of LA default has produced a new accounting practice that attempts to fill the void created by the lack of legal instruments available for identifying LA crisis in its early stages. This lack has frequently been underlined by the Ministry of Economy and Finance (2008: 52; 2009a: 63 and 70-71; 2009b: 36) and by the Italian Court of Auditors (2011).

Yet despite interest shown by the institutions (Ministry of the Interior and Italian Court of Auditors), to date, a methodology for constantly monitoring LA "health" and preventing defaults has not yet been formalised.

#### **4. RESEARCH METHOD**

The deductive method was used in this explorative research, as being the only one possible, considering the special characteristics of bodies examined and of their balance sheets.

Firstly, we identified the LAs - municipalities and provinces - declared to have defaulted since the law was introduced in 1989 up to our data extraction on December 31st 2011. It should be noted that this information is the exclusive property of the Ministry of the Interior and that, at time of writing, it is unavailable through any database either to institutions or to the public.

Next, given its complexity, the research was broken down into the following steps:

1. for those LAs that had defaulted, we collected data available in their final accounts from the Ministry of the Interior website for the year of default and the two previous years;

2. taking into account both the literature and accounting practice acquired in dealing with their balance sheets, we built a dashboard of indicators for use in preventing LA crisis;
3. we ran the calculation using indicators for the LAs chosen;
4. we constructed a sample of the same number of healthy LAs, with similar geographic location and demographic dimensions as those declared to have defaulted;
5. we gathered data and ran the calculation using indicators for the above mentioned healthy LAs;
6. we verified the effectiveness of indicators for both distressed and healthy LAs, in the year when default was officially registered and the two previous years;
7. we gathered data and ran the calculation using indicators for Italian local authorities belonging to each demographic category;
8. according to the results of the previous step, we determined the risk ranges.

Before beginning to collect data, it was necessary to choose which defaulting authorities should be examined.

Although there were many more cases of financial distress in the period 1989-1996, we only calculated indicators for authorities in financial distress after 8th November 2001 – for two kinds of reason. First, the recovery process brought into being by the constitutional reform of 8th November 2001 was quite different from the previous one and laid down that recovery costs should be borne by the local community and not by the State. Then, the managerial and accounting systems of local authorities underwent profound reform in compliance with Legislative Decree 267/2000 (still in force), so comparison with results from preceding years is in effect impossible (Italian Court of Auditors, 2011: 412).

Next, we gathered the main accounting data contained in the final accounts. This information, readily available on the Ministry of the Interior website, is both official, inasmuch as authenticated by the Head of Financial Affairs and the Secretary, and standardised, since all LAs must compile and submit their final accounts to the Ministry.

The subsequent phase was to build a system of risk indicators, made up of quantitative and qualitative indices and able to predict early warning symptoms of financial distress in order to identify them before more serious problems occur (Kloha *et al.*, 2005). A "system" is needed, because the indices, if used separately, would give only an incomplete picture of the phenomenon being studied and would not capture the connections between the numerous aspects analysed (Puntillo, 2007: 50).

## **5. THE PROPOSED INDICATORS**

For our purposes, the choice of indicators was based on knowledge from academic sources, obtained through analysis of Italian and international literature, as well as from the field, thanks to the publication of manuals and reports by institutions. We decided not to consider the indicators used by credit rating agencies as in Italy the rating is not mandatory and it mainly concerns the large municipalities (Manes Rossi, 2009). Also, given the aim of our analysis, we should remember not only that about 93% of Italian municipalities have less than 20,000 inhabitants, but also that 93.46% of local

authorities in financial distress had a population under that level. Moreover, previous studies agreed that model ratings cannot be considered as proxy default probability (Holian & Joffe, 2013).

Our investigation was naturally an analysis conducted from the outside. We therefore used an historical perspective, using historical ratios, and a spatial one, comparing results from authorities with similar territories. This enabled us to evaluate trends in phenomena.

Previous research highlighted the presence of many proposals for capturing early warning signs of local financial emergencies; however the problem is that these methods are mainly focused on a short time period, are not systematic and are very different (Weikart, 2013). Moreover, other authors underline that indicators for providing information on local situations are not always useful, as there are too many variables to monitor without any clear indication of which ones are the most important; they do not consider the specific economic and social characteristics of the locality; the use of averages can be misleading and data are frequently unavailable (Kloha *et al.*, 2005; Sohl *et al.*, 2009).

In general previous research pointed out that there is no single measure that fully captures the financial condition of a local authority. Financial condition is affected by a combination of environmental, fiscal and organizational factors, including decisions and actions of the governing board (Wang *et al.*, 2007). In particular, Zafra-Gomez *et al.* (2009), hold that financial condition can be measured by means of a series of indicators related to solvency, sustainability, flexibility and vulnerability. According to the previous proposition and as mentioned in our literature review, the International City/County Management Association (ICMA, 2003) identifies three dimensions of local authority solvency: cash solvency, budgetary solvency and service level solvency.

In order to determine indicators for preventing default, we decided not to consider the risk indicators of LAs with more than 20,000 inhabitants, as their meagre number did not allow us the statistical generalisation of results. Within the range from 0 to 20,000 inhabitants we divided them into two groups: one with less than 5,000 inhabitants and the other over 5,000 up to 20,000, as 5,000 is the threshold for identifying a small LA (Ifel, 2011b). In this regard, the Italian Court of Auditors (2013) identifies an association between population size and the performance they use to analyse their balances.

Although external forces, mostly socioeconomic, could heavily affect LA default, we consider as healthy those LAs that are able to meet their payroll, pay their current liabilities, meet their debts service and undertake service obligations (Downing, 1991). In particular, we focused on financial conditions by evaluating revenues, expenditures, operating results, debt limit and Off Balance Sheet (OBS) debts (Zafra-Goméz *et al.*, 2009).

We believe that the creation of a system of indicators for monitoring the health of LAs cannot ignore indications from the institutions. The Italian Court of Auditors (2006; 2008; 2009; 2010; 2011) identified, on several publications, the causes of default.

Previous studies (Gori & Fissi, 2012) highlighted that the default does not depend on a single cause but it is the result of mix of factors. However, some causes are more common and have a higher importance for the risk level. In this sense, Hou (2006)

identifies three kinds of budget deficit: structural, cyclical, and managerial. A structural deficit reflects a long-term shortfall between recurring revenues and recurring expenditure. Moreover, a cash flow deficit can become a structural deficit if the recurring revenue becomes inadequate to maintain recurring expenditure over the cycle (cyclical deficit). Lastly, managerial deficits result from poor financial management or deliberate spending in excess of revenue. So, while cyclical and managerial deficit can be easily remedied by using stabilisation funds or a policy of reducing expenditure respectively (Grizzle, 2010), a structural deficit is decidedly worse. Consequently, we decided not to weight the indicators, but to divide them into three types, according to how much the information was able to highlight the first symptom of financial distress. Moreover, we decided to run indicators for the year of default and for the two previous years (Figure 1). The first group contains key indicators for analysis of financial condition that, in the case of a positive result (low or high risk), highlight the presence of a default probability (Indicators 1, 2 and 3). These indicators check the short-run solvency and service level solvency. If one of these parameters is positive it is necessary to closely monitor the municipality. The first indicator measures the difference between the speed of revenue collection (tax and non-tax) and that of payment of current expenses. This indicator measures the structural surplus or deficit, expressed in terms of cash-flow, due to management.

**Figure 1. The form used to calculate risk indicators for each defaulted LAs.**

Municipality _____	Default year "n"
Demographic class	$\leq 5,000$ $5,001 \leq x \leq 20,000$ <input type="checkbox"/> <input type="checkbox"/>
	Year n      Year n-1      Year n-2
<b>Group 1</b>	
1. Difference between speed of collection of own revenue and speed of collection of current expenditure (%)	
2. Ratio between cash advances not refunded and current revenue (%)	
3. Ratio between current positive residuals and current revenues (%)	
<b>Group 2</b>	
4. Quality of management result	
5. Per capita operating result	
6. Debt limit	
7. Ratio between current negative residuals and current expenditures (%)	
<b>Risk multiplier</b>	
8. Ratio between OBS debts and current revenues (%)	

The second indicator in the first group monitors the risk associated with cash advances by measuring the ratio between un-recouped cash advances (bank overdrafts that are not reimbursed) at year-end and total current revenues. Compared with the previous indicator, this one represents a step up the risk ladder and the higher the ratio, the more serious the risk.

Lastly, the third indicator in the first group measures the ratio between the amount of receivables on own-source revenue and total own-source revenue, thereby highlighting their ability to collect.

Indicators 4, 5, 6 and 7 are in the second group and they track flexibility, local authority independence and long run sustainability. These indicators are less important and reveal a default risk only if two of them are positive. The fourth indicator measures the part of the administration's results made up of receivables from own-source revenues (active residuals). In other words, the management of residuals affects the quality of administration results. And the more the budget surplus depended on active residuals, the more uncertain are the effective results and the worse its quality, since we do not know when and how much will be collected.

The fifth indicator measures the financial results per capita (or the result minus effects of active residuals). The sixth indicator measures the debt limit, given by the ratio between passive interest and current revenues. It shows the part of current revenue destined to cover the authority's costs for payment of passive interest. The seventh indicator of the second group measures the ratio between residuals and current expenses and shows the incidence of debt from previous years on expenses for the current year.

Finally, indicator eight must be considered a risk multiplier as this cause of default is common to all the authorities in default. This indicator often shows positive because of OBS debts deriving from bad results of municipal-owned corporations (Italian Court of Auditors, 2013). OBS debts should represent an exceptional event for a LA. If positive, this indicator, regardless of value, has a multiplier effect on the risk of default. The eighth indicator, the risk multiplier, shows "exceptional" debt situations – for example, the need to cover the deficit of subsidiaries or the existence of rulings condemning the municipality to pay damages – and their "weight" with respect to the ordinary activity of the authority (current revenues)

The aim of the selected indicators is to monitor authorities' default risk, comparing them with the performance of similar geographic locations and of similar demographic groups. This enables us to identify any discrepancies - positive or negative - between the performance of the authority under examination and that of entities with similar dimensions and geographical locations.

From an operational point-of-view, the risk indicators described were calculated for the year when default was filed and the preceding two years, using for each authority the form shown in Figure 1.

The indicators selected for defaulted authorities are then calculated for the same number of "healthy" authorities.

## **6. TESTING THE INDICATORS**

The system of indicators created was then tested for effectiveness. For this, we used the “logical process” employed by Altman (1968) for testing his Z-Score.

In our research, the test was carried out on accounting data from final accounts of LAs in default over the period 8th November 2001-31st December 2011, and of the same number of financially "healthy" municipalities. Here, there were two problems to be solved:

1. deciding when a LA may be defined as "healthy";
2. defining the method for building the sample of healthy authorities.

A concise way of defining an authority as healthy had to be found. We therefore turned our attention to the final accounts.

According to Italian Court of Auditors reports (2009, 2010a and 2011: XV) healthy authorities are those with a positive operating result, as this result is not affected by the influence of residuals that are the most manipulative elements of financial statements.

The second issue was how to build a sample of healthy authorities for testing the indicators. This was important both from a statistical point-of-view and from an organisational-economic one. In doing this, we adopted a statistical sample with a previous theoretical sampling that minimises differences between the elements (Patton, 2003). We identified the healthy authorities among neighbouring municipalities in the same demographic class, thereby taking into account fundamental aspects of comparison. Firstly, “nearby” local authorities share similar socio-economic characteristics (Hammer & Green, 1996). Choosing a statistical sample, rather than a theoretical one, would have seriously affected the level of comparability between local authorities. Indeed, earlier studies (Wang *et al.*, 2007) have shown the importance of considering socio-economic conditions of the geographical area, when analysing the financial state of a local authority.

The choice of neighbouring municipalities did not undermine results. Unlike in the USA, in Italy the demand for local public services does not concern neighbouring municipalities as citizens can only use services where they are resident. In other words, horizontal intergovernmental relationships have scarce consequences for the fiscal health, condition, and wellbeing of local governments (Honadle, 2003). Having identified the “healthy” authorities, we collected the data submitted in their final accounts and built a system of indicators taking into account information from the year the authority in difficulty filed for default, plus two preceding years (Winn, 1993), using the same form (Figure 1) as for defaulting municipalities. The same form was used to determine average national indicators.

## **7. THE RESULTS OF RISK INDICATORS**

The phenomenon of default in LAs is not widespread in Italy. Data from the Ministry of the Interior shows only 459 authorities declaring default from 1989 to 31st December 2011.



Before calculating the indicators, we identified authorities in default in the period between 8th November 2001 (when Constitutional Law 3/2001 came into force) and 31st December 2011. There were a total of 45 municipalities, however, at present final accounts are available for only 39 of these. Next, for each municipality, a corresponding healthy authority, with similar dimensions and location, was identified. Table 1 shows the authorities in default and their corresponding healthy authority.

Next, for both types of authority and for each of the three years analysed, we identified risk indicators for the bankrupt authority and the corresponding average levels in their area, then we calculated the indicators.

The analysis of risk indicators shows that authorities in default generally produce worse-than-average results. Often, however, healthy authorities, despite performing better, achieve results below the average registered in their geographical area. This probably depends on two kinds of factors. On the one hand, the local socio-economic situation affects all municipalities in the area and, on the other hand, the demographic group of the authorities examined tends to level out some of the results produced in the territory. Of the municipalities in default, 70% were small, with a population of less than 5,000 inhabitants, and presumably suffer more than larger authorities from the reduction in available resources (Ifel, 2011b: 105-108)

**Table 1. The 39 defaulted municipalities and the corresponding healthy authorities.**

No.	Defaulted Municipality	Province	Inhabitants	Healthy municipality	Province	Inhabitants
1	Borgorose	RI	4,785	Contigliano	RI	4,428
2	Umbriatico	KR	1,114	Laino Castello	CS	970
3	Pontelandolfo	BN	3,028	San Lorenzello	BN	2,314
4	Maltignano	AP	2,392	Venarotta	AP	2,279
5	Gallodoro	ME	406	Savoca	ME	1,668
6	Ramacca	CT	10,568	Motta Sant'Anastasia	CT	10,705
7	Enna	EN	28,476	Giarre	CT	26,827
8	Moschiano	AV	1,711	Taurano	AV	3,570
9	Paternopoli	AV	2,645	Pietradefusi	AV	2,491
10	Pignataro Interamna	FR	2,521	San Vittore del Lazio	FR	2,707
11	Arpaia	BN	1,943	Bonea	BN	1,536
12	Lungro	CS	2,950	Sant'Agata di Esaro	CS	2,061
13	Mentana	RM	19,245	Bracciano	RM	27,772
14	San Procopio	RC	582	Terranova Sappo Minulio	RC	547
15	Soriano Calabro	VV	2,886	Acquaro	VV	2,664
16	Capistrello	AQ	5,397	Luco dei Marsi	AQ	5,879
17	Rocca Priora	RM	11,490	Lanuvio	RM	12,894
18	Apice	BN	5,808	Guardia Sanframondi	BN	5,367
19	Camini	RC	743	Pazzano	RC	686
20	Casabona	KR	2,904	Belvedere di Spinello	KR	2,351
21	Filignano	IS	729	Scapoli	IS	783
22	Lauro	AV	3,636	Sirignano	AV	2,982
23	Montecalvo Irpino	AV	4,013	Flumeri	AV	3,225
24	Rionero Sannitico	IS	1,177	Colli a Volturno	IS	1,387
25	Roccamandara	KR	3,616	Cropani	CZ	4,015

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26	San Giorgio a Liri	FR	3,170	Esperia	FR	4,012
27	Velletri	RM	52,647	Nettuno	RM	44,444
28	Baia e Latina	CE	2,349	Sant'Angelo d'Alife	CE	2,334
29	Barni	CO	628	Magreglio	CO	666
30	Briatico	VV	4,084	Cessanti	VV	3,483
31	Caserta	CE	79,231	Benevento	BN	62,035
32	Castel Volturno	CE	24,307	Mondragone	CE	27,619
33	Fuscaldo	CS	8,383	San Marco Argentano	CS	7,634
34	Roccamonfina	CE	3,688	Mignano Monte Lungo	CE	3,290
35	San Gregorio Matese	CE	991	Castello del Matese	CE	1,538
36	Volturnara Irpina	AV	4,103	Montefalcione	AV	3,461
37	Casal di Principe	CE	56,000	Trentola Ducenta	CE	17,673
38	Castiglion Fiorentino	AR	13,685	Foiano della Chiana	AR	9,622
39	Riomaggiore	SP	1,740	Calice al Cornoviglio	SP	1,177

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The analysis of trends in the speed of collection of current revenue and current expenditure is particularly interesting. There are significant differences between the two values for defaulting authorities, while the gap is less marked for the healthy municipalities. Both indicators are connected with the rate of acquiring residuals: the lower the ability to collect revenues, the higher the rate of formation of positive residuals. The same reasoning may be applied to current expenditure and formation of negative residuals. These indicators give information about the cash flow and the ability of LA to face its debts.

In the year when default is filed, the gap between ability to collect revenue and that of expenditure is reduced, reaching levels close both to the general average and to the performance of healthy authorities, which we might consequently describe as "normal". The analysis of indicators highlights that, under "Quality of management results"(ratio between own current positive residuals and management result), an authority in difficulty usually has a lower indicator than a healthy one, that is to say, has a better result. When default is imminent, in fact, the authority's residuals - particularly the positive residuals - are revised and frequently reduced. The same logic may be applied to the "Ratio between current positive residuals and current revenues". Receivables that have become irrecoverable are likewise usually written off.

As far as "Operating results" are concerned, we have already mentioned the extreme difficulty of identifying healthy LAs, similar in dimensions and location to those in difficulty, that register positive results over the three years examined. Although their indicators are better than those of defaulting municipalities, they still register worse-than-average performance for their geographical zone.

The "debt limit" is similar for healthy authorities and those in default and values registered are generally quite low. Control of this aspect is facilitated by the requirement to draw up a multi-annual budget which of necessity means projecting debt exposure both for capital share and for passive interest over the next three years.

According to opinions in periodical reports from the Italian Court of Auditors and the Ministry of Economy and Finance, cash advances and OBS debts are frequent. The

use of off-balance-sheet debt and cash advances is more frequent in defaulted authorities than in healthy ones. If we consider that the defaulted municipalities on average have low performance indices, the risks associated with cash advances become even clearer. Their maximum amount is tied to the total of determined revenues, but if we consider that generally the speed of revenue collection slows as the year of default approaches, the amount that can be advanced presumably decreases over time. This mechanism may then provoke a dangerous spiral that, by reducing liquidity, makes the authority incapable of paying expenditure deriving from basic functions and consequently leads it to default.

## 8. THE RISK RANGES

Application of the indicators has shown differences between groups (authorities in difficulty, healthy authorities and national average), but also similar performance within groups. We believe a link may be found between the trend of the system of indicators and the authority's financial condition. In particular, we determined the default risk ranges by comparing the average performance indicators of the defaulted LAs and of the healthy ones together with the national average results of risk indicators of the LAs of the same demographic group (Table 2 and 3). The three levels of risk correspond to three separate general financial conditions of the local authority. Hou (2006) observes that there are three different types of balance deficit that can be at three different levels of risk, because of the seriousness of the financial situation.

**Table 2. The average indicators for LAs up to 5,000 inhabitants (Demographic group 1).**

Indicators	Average of defaulted authorities	Average of healthy authorities	National average
<b>Group 1</b>			
Difference between speed of collection of own revenue and speed of collection of current expenditure (%)	-30,50	-31,04	-13,16
Ratio between cash advances not refunded and current revenue (%)	4,34	1,96	1,17
Ratio between current positive residuals and current revenues (%)	57,60	46,21	17,50
<b>Group 2</b>			
Quality of management result	141,21	59,80	1,00
Per capita operating result	-640,61	1.322,17	-21,77
Debt limit	0,07	0,05	0,05
Ratio between current negative residuals and current expenditures (%)	35,58	33,66	14,04
<b>Risk multiplier</b>			
Ratio between OBS debts and current revenues (%)	1,54	0,21	0,48

**Table 3. The average indicators for LAs from 5,000 to 20,000 inhabitants (Demographic group 2).**

Indicators	Average of defaulted	Average of healthy	National average
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	authorities	authorities	
<b>Group 1</b>			
Difference between speed of collection of own revenue and speed of collection of current expenditure (%)	-18,25	-14,05	-7,87
Ratio between cash advances not refunded and current revenue (%)	6,05	6,23	1,25
Ratio between current positive residuals and current revenues (%)	48,13	29,28	20,88
<b>Group 2</b>			
Quality of management result	78,74	12,73	1,61
Per capita operating result	33,36	-6,99	-11,27
Debt limit	0,0614	0,0576	0,0477
Ratio between current negative residuals and current expenditures (%)	25,16	17,08	14,61
<b>Risk multiplier</b>			
Ratio between OBS debts and current revenues (%)	0,17	0,42	0,96

To run the average risk range, we considered only the second year before the default in order to identify the early symptoms of financial difficulty. We identified, for each indicator and for both demographics groups, three different risk levels of defaulting: no risk, low risk and high risk. In particular, we considered that the average national result and the average of defaulted authorities have to be placed, respectively, in the no risk area and in the high risk one, since the majority of Italian authorities is not in default and must be considered healthy, therefore in the “no risk area”, while the defaulting administrations must be placed in the “high risk area” – also for the years before default. Including authorities that later defaulted and the low risk group within the national average did not significantly skew results, as the percentage of defaulted and healthy authorities is statistically insignificant (Levine *et al.*, 2002). As far as the “healthy” local authorities are concerned, previous studies (Gori & Fissi, 2012: 105-115) have shown their performance to be regularly below national average, since they are affected by the socio-economic conditions of their territory. So on an ideal scale, they can be considered more at risk and, therefore, placed in the low risk range.

For each indicator the difference between the average national result and the average of defaulting authorities represents the distance between two extreme positions used to calculate the proportion between the three risk areas. The average result of healthy authorities is used to calculate the threshold for low risk because previous studies have shown that these entities, despite having features that allow one to call them "healthy", have performance on average higher than those in financial difficulty but below the national average (Gori & Fissi, 2012). Table 4 and 5 show the risk range for each indicator and for both demographic groups.

**Table 4. The risk range for LAs up to 5,000 inhabitants (Demographic group 1).**

Indicators	Risk range		
	No risk	Low risk	High risk
<b>Group 1</b>			

Difference between speed of collection of own revenue and speed of collection of current expenditure (%)	-13,16; -19,48; -25,26; -∞	19,47	25,25
Ratio between cash advances not refunded and current revenue (%)	1,17;1,75	1,76; 2,15	2,16; ∞
Ratio between current positive residuals and current revenues (%)	17,50; 25,64	25,65; 54,35	54,36; ∞
<b>Group 2</b>			
Quality of management result	0,00; 35,13	35,14; 84,46	84,46; 141,21
		-0,01; -35,13	-35,14; -∞
Per capita operating result	1.322,17; -43,53	-43,54; -249,81	-249,82; ∞
Debt limit	0,0478; 0,0520	0,0521; 0,0544	0,0545; ∞
Ratio between current negative residuals and current expenditures (%)	14,04; 16,02	16,03; 35,64	35,65; ∞
<b>Risk multiplier</b>			
Ratio between OBS debts and current revenues (%)	0,00; 0,95	0,96; 1,30	1,31; ∞

**Table 5. The risk range for LAs from 5,000 to 20,000 inhabitants (Demographic group 2).**

Indicators	Risk range		
	No risk	Low risk	High risk
<b>Group 1</b>			
Difference between speed of collection of own revenue and speed of collection of current expenditure (%)	-7,87; 10,36	-10,37; 17,72	-17,73; -∞
Ratio between cash advances not refunded and current revenue (%)	1,25; 3,02	3,03; 4,62	4,63; ∞
Ratio between current positive residuals and current revenues (%)	20,88; 26,68	26,69; 31,86	31,87; ∞
<b>Group 2</b>			
Quality of management result	0,00; 11,12	11,13; 14,32	14,33; ∞
		-0,01; -11,12	-11,13; -∞
Per capita operating result	n.d.	n.d.	n.d.
Debt limit	0,0477; 0,0503	0,0504; 0,0602	0,0603; ∞
Ratio between current negative residuals and current expenditures (%)	14,61;16,49	16,50;17,65	17,66; ∞
<b>Risk multiplier</b>			
Ratio between OBS debts and current revenues (%)	n.d.	n.d.	n.d.

## 9. CONCLUSIONS

When constitutional reform in 2001 required defaulting bodies to organise their own recovery without government aid, a downward turn in defaults occurred. This change in legislation led many local administrations, which were in serious debt, not to declare default (Italian Court of Auditors, 2013). It is therefore important that the

organism in charge of public finance monitor the state of health of LAs, intervening promptly in critical situations that might lead, if unchecked, to default.

Routine analysis is fundamental to better management of public resources: regular check-ups and early detection and treatment are key components of good financial health. The first hypothesis was confirmed: the system of indicators can be considered as an “early warning system” in order to recognize symptoms of financial distress before they become a real emergency (Kloha *et al.*, 2005). The results of our exploratory investigation are significant in that they have clarified the causes, or rather, situations leading potentially to default.

Application of the indicators to authorities in different financial conditions (authorities in difficulty, healthy authorities and national average) has shown similar performances within groups, enabling us to determine a range of risk.

Our set of specific risk indicators, while not overcoming every obstacle in assessing LA accounts, allows us to express a judgement, albeit not definitive, about the risk of default of a LA in Italy. Although state-local relationships differ across the countries, this logical process could easily be adopted at an international level, with the necessary modifications for specific accounting regimes.

Our research is an external analysis and the quality of results would improve notably for research carried out internally, with access to information unavailable to those without direct contact with the LA. However it allows us to evaluate the default risk by using official data available on the website of the Ministry of Interior. This ranking system should help external bodies such as the Italian Court of Auditors and Ministry of the Interior in controlling LAs in order to prevent defaults and to highlight bad practices in managing public resources. The indicators calculated could be a significant initial report for a database, allowing fact-based judgement of potentially dangerous financial situations and this may offer valid input in activating controls by the Court of Auditors. Moreover, the non-systemic calculation of indicators currently used by the Ministry of the Interior and the Italian Court of Auditors to identify potentially critical situations is limited. Compared with this, our proposal can place authorities in specific risk categories where, depending on the seriousness of the situation, appropriate instruments of control and monitoring may be used, before an irreversible default occurs.

Finally, the methodology proposed uncovers all those situations of financial difficulty that, for mostly political reasons, are not openly declared but actually procrastinated by local authorities.

Seen from the perspective of scientific enquiry, by calculation of specific risk indicators, we see that the causes frequently indicated by the institutions (Italian Court of Auditors and Ministry of the Interior) and technical experts (Ifel) give fundamental information to control and prevent defaults. The results from the scientific viewpoint could potentially interest and enrich the institutional outlook. The analysis demonstrates that it is possible to individuate the early symptom of default and that the main problem to be tackled, certainly from a legislative point-of-view, is the management of residuals, particularly positive residuals. The data shows an anomalous trend in residuals in the period immediately preceding default and in the year of default. As declaration of default

approaches, in fact, the quantity of positive and negative residuals dwindles, clearly showing how both categories had been artificially "inflated" previously.

Moreover, alteration of positive residuals affects the cash situation and, vice versa, chronic recourse to cash advances may derive from lack of positive residuals. The latter, in fact, go to form the management surplus and, when this is spent, determine a cash flow that cannot be "reconstructed" by collecting positive residuals.

Further developments would be needed at least in two directions. First, we may hypothesise testing the proposed indicators and the risk threshold by applying the risk ranges to a sample of local authorities. Second, additional analysis is needed in order to develop a set of specific tools to control entities that are in a state of low or high default risk.

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**NOTE:** Although this work represents a joint study by the authors, sections "Introduction", "The literature review", "Identifying symptoms of default in Italy", "Research Method", and "The proposed indicators" can be attributed to Silvia Fissi; "Testing the indicators", "The results of risk indicators", "The risk range", and "Conclusions" to Elena Gori.

## THE INEFFICIENCY REDUCTION IN SCHEDULING THE PUBLIC POLICY AGENDA

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**Abstract** *In this paper, I have tried to demonstrate that a major problem related to the reduction of the inefficiency of the public policy agenda is that of representation. In other words, to demonstrate how many or how few of the public opinion priorities are translated into public policies, especially through suffrage mechanisms or other connection types developed between the elected officials and citizens. On one hand, representation is the key to the proper functioning of any democracy and an important value itself. On the other hand, a good functioning of the democracy must take into account as a primary value not only representation, but also the means of solving the problems. This involves information processing, communication, and the way through which the public's preferences are created and influenced by the governmental strategies and through collective dynamics along with establishing the public agenda. The main conclusions one may draw from this presentation are the following: reducing the inefficiency of the public policy agenda implies the congruence between the parliamentary and public agendas; bringing forward the concept of policy congruence is possible only if there is an obvious congruence between citizens' priorities and governmental activity; placing citizens' priorities on different levels in the governmental and parliamentary agendas (although priorities of the Government may be similar with those raised by the Parliament) may suggest multiple possibilities for influencing the two agendas by forces other than the public opinion.*

**Keywords** *public policy, democracy*

### 1. THE PUBLIC POLICY PROBLEMS AND THE PUBLIC AGENDA

For our purpose, a public policy problem can be defined as *a condition or situation that generates needs or dissatisfactions, and in order for them to be corrected, a governmental action is required*. For example, conditions like polluted air, altered food, over populated prisons and cities produce situations that might create potential problems for citizens, taking into consideration that their dissatisfaction and discomfort are rising.

The degree of dissatisfaction or discomfort (that also involves governmental intervention) is measured by citizens through *a standard* or *a criterion*; if these two rate a situation as being normal, inevitable, or one for which they are directly responsible for, no governmental action will be taken, because that situation does not represent a citizen's will, so it does not find itself on the public agenda.

And so, the public agenda represents a set of problems to which the public participates (Jones, B.,D., and Baumgartner, F.R., 2005, p. 206). Because the public opinion has the tendency to become vague and confuse when it comes to technical

problems or complex solutions, we have to mention that the public agenda does not include the public policy solutions that are granted for either by the political elites or by certain public segments.

We also emphasize that situations do not become problems unless they are perceived as such, expressed and brought to the attention of the authorities; this kind of action is frequently used by officials, politicians that find themselves in search of problems.

More than that, a situation becomes a problem on the public agenda if it identifies itself with an area of state intervention, for which a governmental solution is possible. Regarding this, Aron Wildavsky said that authorities will rather ignore a problem if it is not multiplied by its solution. Hurricanes and earthquakes cannot be considered problems due to the fact they are unpredictable, but the damage that they cause does indeed represent a public policy problem and many programs that seek to reduce the damage effects of these natural phenomena have been created (Wildavsky, A., 1975, pp.134-140).

The cases in which solving the problematical situations is in the best interest of people different than the direct beneficiaries are quite frequent. For example, the Romanian administration has begun its „war against corruption” more as a reaction to media and international officials, rather than a consequence of the actions of those directly affected by corruption.

For Romania, the most important problems on the public agenda for 2009-2010 , are represented bellow, after a national survey performed by the Gallup-Romania organization.

So, the chart bellow contains the answers obtained for the following question: *What are, in your opinion, the most important three things that the present government should resolve by the legal end of its mandate in 2010?*

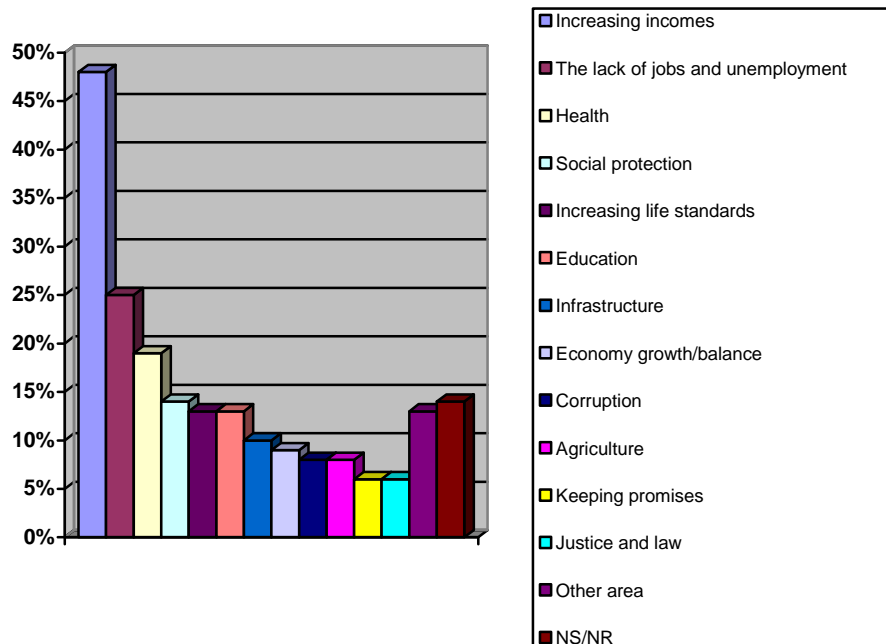
**Way of interviewing:** face to face interviews in the respondents house, and also telephone ones, by using the same questionnaire. The questions were the same, no matter the way to interviewing.

**Representative type:** probabilistic group, stratified, multi-staged one. Dual frame of representation: houses with telephones connected to the main market telephone operator (representative in 761 houses) and the adult population of Romania (400 representative houses selected through the random method. Both representations have been projected according to the territorial distribution of the adult population of Romania. The assignment of the representative sample was proportional to the group size.

**Stratification criteria:** 8 historical regions and the urbanism degree (8 different types of regions).

**Units of selection:** In the representative case of the face to face interviews, the primary units of selection were the regions. The selection of the houses in this case was made through the random method, and people were selected through the “last birthday” method. In the case of the representation sample for the telephone interview , the primary unit of selection was the house itself, and people were also selected through the “last birthday” method.

**Figure 1. Answers obtained for the following question: What are, in your opinion, the most important three things that the present government should resolve by the legal end of its mandate in 2010?**



Source: Gallup Romania, national survey- September 2009

**Moderation:** In order to fix the unequal selection probabilities and adjust the different types of non-answers, the final representative segment was moderated through the RAKING method and the moderation variables were: region, urbanism degree, sex, age, race, occupation, level of education and having a telephone subscription. The moderation algorithm used as references official statistic data especially from the last demographic survey.

**Representativeness:** the moderated final segment is representative for the adult population of Romania, with a  $\pm 2.9\%$  error percentage, with a 95% trust level. Besides segmentation errors, the way in which questions were asked and the practical difficulties when writing down data from the field or by telephone can also cause other errors that might alter the results of the survey.

**Date when the information was collected:** September 2009.

The answers that were collected emphasize the priorities of the Romanian public for 2009 and 2010 but it doesn't pay any attention to their preferences in terms of real solutions.

The ideal solution would be for us to consider the connection between the public agenda and the governmental one. But we must say that, if we use the results of the previous survey as a temporal method of the governmental agenda, the process of establishing a connection between the two types of agendas is altered by the existence of possible threats caused by the irregular types of questions, by the number of respondents etc. (Jones, B., D. and Baumgartner, F.R., 2005, p.226).

When analyzing the previous survey and also comparing it to similar surveys in past periods, we can notice a quite slow dynamics of the public agenda when it comes to Romania (there is a powerful domination of the problems that refer to the increase of incomes and jobs; on the other hand, the problems that were generated by the big global challenges- such as terrorism, pollution, energy crisis, organized crime- are almost completely left aside.)

And this happens in spite of the fact that also in the situation in which various problems continue to stay in the public's attention, the way in which they are defined changes along with the change of the values and conditions that generated them. More than that, when a way of thinking changes, as a result of the changes and transformations that took place at a societal level, situations that were considered to be normal at a given time, can turn into a problem. For example, domestic violence which has been considered throughout ages a personal problem is now treated as a felony.

## **2. THE GOVERNMENTAL AGENDA**

Shifting problems from the public agenda to the governmental one is the result of a political process that also determines the adequate solutions. Is the fact that people with disabilities should have the right to a proper means of transportation a transportation issue or an issue connected to human rights? Special means of transportation for the disabled ones is the solution to the transportation issue. The human rights perspective involves equal rights for the transportation of the disabled people and also the existence of proper devices that can allow these disabled people to equally use the public means of transportation (Popescu, L.G., 2006, p.298).

*Causality* is the second aspect of a public policy problem. A situation can turn into a problem but what are the causes that generated that situation? Many problems- delinquency, poverty, inflation and pollution – have multiple causes. Inflation is characterized by a generalized growth of prices, measured by the index of commodity prices and it represents a political public problem with multiple roots: under-production of goods and services, excessive demand of goods and services, too much money flowing, the result of a psychological inflation (people expect prices to rise) etc. In order to solve a problem, we should pay attention to the causes, not only to the manifestations (symptoms) but, in many situations, it's not easy to identify or detect the main causes. Identifying the roots of a problem and negotiating a compromise regarding them is not an easy task for the policy makers, because defining the problem turns into a problem itself.

The difficulty in creating a governmental agenda is also determined by the fact that the nature and purpose of many public political problems are hard to express because of their dispersed or "invisible" nature. And because determining the size of the problem is often inadequate, those who elaborate public politics don't correctly evaluate the given situation and it becomes impossible for them to offer adequate solutions or even to undertake governmental actions in order to solve the problem. Next to these inaccuracies we can also mention the inadequate understanding of the causes of the phenomena. Other problems that are difficult to quantify are: children abuse, illegal immigration, tax evasion etc.

Another aspect connected to the governmental agenda refers to its capacity of being easy to control/manipulate, as some of the problems involve a higher level of behavioural changes than others.

Controlling the problems is also conditioned by their tangible or intangible nature. Problems like lack of jobs or bad project management can be easily solved by increasing the resources and the incentives held by people or agencies.

The object of this paper is the public policy agenda. What are those characteristics that tell a public problem apart from a private one? Generally, the public problems are thought to be the ones that affect the lives of a substantially large number of people, while their consequences are also felt by people who aren't directly involved in that issue.

Let's say a citizen is dissatisfied by the value of the amounts that were taxed under a certain fiscal law. As long as that citizen acts in his own behalf, trying to find a derogation from the fiscal institutions, in his favor, then we are talking about a personal problem. But if that citizen, along with other people directly or indirectly affected by the same problem, try to modify the legislation, than the personal problem turns into a public matter.

The fact that a situation or a condition is perceived as a problem doesn't mean that it depends only on its objective dimension but also, to a great degree, on how people relate to that situation. If a person has a certain social standard, it's not a real problem for him to find a job, as he is not threatened by the increasing unemployment rate; he even considers this a necessary step in lowering inflation. But for a worker, unemployment is a threat and he will negatively react to this. A person's perception is influenced by its own experiences, values and situations that involve him/her. There isn't a single and valid way of defining the problem, even though many people have opinions and preferences when it comes to a certain situation.

There are frequent cases when various ways of describing a problem converge, to get the public's vote. We decide if a certain situation can or cannot be considered a public problem if we take a look at the terms that was used to define that problem and to accept the proposed definition. More than that, the terms that were used to define it and the causes that generated it determined the emergence of those solutions that were considered to be adequate.

The following survey illustrates the acceptability rate of the Romanian public when it comes to the public agenda. When asking the question: "*What are the areas in which the present government took the most measures, according to your own expectations?*", you can see the answers in the chart below.

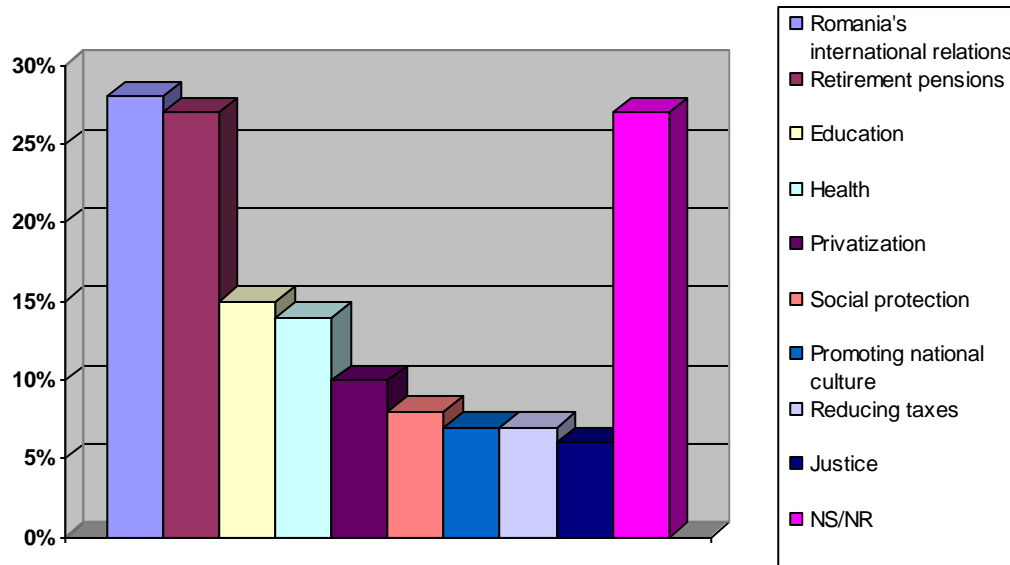
The methodology used for this survey is similar to the previous one.

This survey emphasizes a quite weak support of the governmental agenda. We also have to mention the rather high percentage of those who wish to answer (27%) *I don't know/I'd rather not answer*. These numbers prove the existence of a category of citizens still in *latent* condition, meaning that they are only preoccupied by personal problems and are thus not interested in what happens around them.

There are many explanations for this; starting with the fact that their only preoccupation is *fighting for what tomorrow brings* and ending with their lack of civic

responsibility. The same explanations can be used when talking about the lack of interest when mentioning the important global challenges (human rights, energy, terrorism, security, delinquency) among the priorities of the public or governmental agenda.

**Figure 2** Answers obtained for the following question: “ What are the areas in which the present government took the most measures, according to your own expectations?”



Source: Gallup Romania, national survey- September 2009

### 3. AGENDAS CONGRUITY

Limiting resources naturally determines a limitation in the space of the governmental agenda. Other forces than the public opinion try and fight to get a space on this agenda and this is also important. It's obvious that we will no longer have a representation if the policy makers and the ones that obey them prioritize problems differently. More than that, representation can lack even if such a correspondence does exist, due to the blocking of political public actions, either by the political system ( its level of complexity can generate various blockings) or by the leaders whose opinions are different from the public's.

### 4. THE PARLIAMENTARY AGENDA

The activity referring to the parliamentary debates is a first line component in the process of public politics. In other words, when a convergence between the parliamentary agenda and people's needs appears, the parliamentary debates can react more easily at the process of changing informational flows than the ulterior stages of the process of public politics. As a consequence, it is reasonable to expect a quick answer offered by the

parliament, an answer that has to comply with the priorities on the public agenda. We cannot talk about convergence when the parliamentary debates concerning a problem of great interest for the public have been led about a year after the problem was brought to the public eye (Jones, B.,D., and Baumgartner, F.R., 2005, p.245).

## **5. THE EFFECTS OF THE CITIZENS PARTICIPATION AND THE DECISIONAL TRANSPARENCY ON THE INEFFICIENCY REGARDING THE PUBLIC POLICY AGENDA**

The democratic context involves the citizens' participation in actions meant to influence the political decisions. If only a small category of citizens exert their right to vote than only their interests will be represented in the adopted public politics and the interests of other people will not be taken into account.

But if these categories of classic *non-voters* do come to vote, they will offer democratic support to those candidates that fight for their interests, by almost totally ignoring the projects of public policy that are included in the electoral offers. From this perspective, it is important for us to understand the causes for which certain groups of citizens do come to vote and why others don't. In the representative democracy, the vote is the most common form of participation. For most citizens, exerting their right to vote is seen as an act of civil responsibility.

There are also other forms of participation. Let's take the example of a citizen that is dissatisfied by the substantial growth in taxes year after year. What are his options at the following elections? He has four potential answers: *loyalty*, *voice*, *leaving* and *not going to vote*. According to this formulation, going to vote is a form of *loyalty*, a passive yet constructive answer offered for the governmental actions.

*The voice* is an active and constructive answer that manifests itself through forms of support for the officials/candidates that promise to lower taxes, even supporting/joining one of the groups whose main goals is lowering taxes.

The destructive answer is both active and passive. The citizens who think that they "cannot fight against City Hall" will definitely *not go to vote*. We can no longer talk about participation in their case. The active version of the destructive answer is leaving ("voting with your feet") (Lyons, W.E., and Lowery, D., 1997).

Citizens will shift their attention towards a community that is closer to their tax related preferences. Every citizen is put face to face with these options of participating. When talking about the health of a political system, it is desirable for most citizens to constructively participate and only for a small part of them to decide not to go voting.

"The citizens participation is the process through which the preoccupations, the needs and the citizens values are incorporated in the process of making public decisions".

Main values for practicing public participation:

- the public should have a saying when it comes to the decisions that affect their lives;
- public participation also includes the promise that it will influence decision making;



- the public participation process brings forward interests and seeks to solve everybody's needs;
- the public participation process requires and facilitates the involvement of those people potentially affected;
- the public participation process invites participants to define their personal degree of involvement;
- the public participation process shows participants the way in which their contribution affected the decisional process;

By assuming a number of extensive measures that are targeted to public scrutiny and stimulation of political inputs, citizens are offered the possibility to participate in the government act in a way that doesn't involve vote presence or joining a group of interests. In other words, the number of citizens that can govern is increasing.

Advantages of the citizens participation in administration:

- re-establishing and building trust between administration and citizens;
- supporting the administration in a faster identification of the community needs, with a greater degree of satisfaction for the citizens;
- free information about the decisions that must be made by the administration;
- leading the community towards peace and not conflicts;
- a more creative mutual approach (administration and citizens together) towards problems and opportunities;

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## EXPERT VERIFICATION OF THE RESEARCH RESULTS: PUBLIC ADMINISTRATION ASPECT

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**Abstract:** *Methodology of elaborated verification of new theoretical methodological workings on public administration innovative problems has been grounded. The methodology realizes consequent evaluation of quality of the new workings (from general to concrete) by means of applying the methods of focus-group expertise and competent expert. The elaboration of methodology at each of its steps is examined in detail.*

**Keywords:** *Methodological tools, verification research, competent expert, criteria verification.*

### 1. INTRODUCTION

One of the main priorities of modern public administration reforms in Ukraine directs to a large-scale innovation of the system of public administration (further on – SPA) according to the world tendencies, especially concerning introduction of the acknowledged innovations [Попов С., 2013 А] in raising efficiency and image of SPA in the society, providing its transparency, improvement of delivering public services, upgrading social trust to the authorities and their mutual interaction, etc. Complexity and scope of qualitative changes in SPA condition their longevity. Foreign experience proves that such changes in average last 10 years [Крылова Е., 2009]. Topicality of the public administration innovative problem raising attracts attention of many researchers and practical workers, especially concerning the questions of development of theoretical-methodological provision (further on – TMP). The latter, in its turn, demands verification of new workings out.

Rendering the main material. Traditionally, verification of the gained results is applied in natural sciences, and also as a method of quality evaluation of political and social forecasts. The verification principle is one of the fundamental ones in the scientific method of the branch of knowledge “public administration” [Ковбасюк Ю., 2011] which is, by the way, used in the dissertational researches by V.M. Bashkatov [Башкатов В., 2012] and S.P. Shubin [Шубін С., 2012]. The first researcher used the method of expert assessments for the practical verification of theoretical methodological results concerning the model of democratic changes in conditions of the transitive democracy, system

factors of the country's democratization. According to his own author's approach, S.P. Shubin confirmed the validity of new scientific data, positions, proposals and conclusions, which are described in his dissertation.

A Big Thesaurus of the modern Ukrainian language [Бусел В., 2007] defines the term "verification" as checking of the truth, determination of trustworthiness. Verification, according to the definition of Webster's Dictionary, is a creation or confirmation of the truth or precision of a fact, theory, etc. [Neufeldt V., 1991]. Peculiarities of the research subject condition differences of the verification conduction methodology. The author of the present article applied the method of focus-group expertise [Попов С., 2013В] for the verification of new workings out of TMP public administration innovative activity (further on – PAIA). Nevertheless, that method allowed evaluating their quality only in general due to the labor-consuming expertise, scatter of the knowledge depth and views of experts; though their scientific interests are close to the subject of the present research. That was the reason why there arose the necessity in improvement of the verification methodology by means of its widening with other methods, which make it possible to reveal the essence of new elaborations and assess their quality deeper. The aim of the present article is grounded improvement of the verification methodology of new elaborations in TMP PAIA, which will allow to deeper evaluate their quality.

## **2. THE METHODOLOGY OF VERIFICATION**

At present, there are known direct and indirect kinds of verification, among which the first ones are rather problematic as for their application in the field of knowledge of "public administration" because of their weakness in structuring (or absence of such an ability) objects of research, and also complexity of their construction and functioning, the necessity of elaboration of the specialized apparatus, great expenses, risks as to its consequences, etc. [Ковбасюк Ю., 2011].

In such a case, application of the direct kind of verification of new elaborations is additionally complicated with the fact that PAIA as the object of research sharpens the manifestation of the following phenomena:

- contradictions caused by the simultaneous activity of PAIA and traditional functioning of SPA, complexity of administration of wide-range innovations;
- a wide variety of non-defined features of the outer (conditioned by political, organizational legal and other factors, complexity of innovations, which are still more complicated with the acceptance of their conductors and adjustment to SPA, and also to the subject field of their application) and inner (conditioned by non-homogeneous innovative readiness of SPA subjects, their ability for adaptation to innovations) characters;
- a widened need in outer and inner resources of the necessary quality and volume, etc.

The above described limitations direct to the usage of an elaborated kind of verification, which do not exclude partial application of "direct" methods in case of necessity. It is proposed to conduct the methodology of carrying out the elaborated verification in two stages. At the first stage the quality of new workings in general should

be made using the method of focus-group expertise. At the second stage it is necessary to specify the gained assessments, and also to more concretize the quality indices of new workings using the method of component expert.

The general aim of verification is a complex quality assessment of the gained results on TMP PAIA due to a definite totality of characteristics. General criteria for conducting this research are the following:

- verification is an ordered process of using concrete criteria, indices, methods and tools (modes, means, actions, procedures, etc.), which provide attaining the corresponding assessments and grounded analysis of the new workings' quality;
- indices of new workings in TMP PAIA quality are their most important totality, which qualitatively and quantitatively characterize their actuality, righteousness, verity, importance, etc. for the development of the theory and practice, their usefulness for the educational training process;
- the verity of indices assessment of the new workings' quality, which should be verified, is provided by iterative means of their specification and an all-round analysis, complex and consequent usage of the corresponding methods, which decrease the impact of undefined phenomena on the final conclusions' formation;
- reliability of the indices assessment of the quality of new workings is provided with the formation of verification expert environment, the scientific and practical interests of which are most close to the subject of the present research.

The first stage of verification. The methodology of generalized assessment of new workings' quality in TMP PAIA includes the following stages: preparatory; getting and working out of expert assessments, working out of generalized conclusions (Table 1. Methodology of generalized assessment).

**Table 1. Methodology of generalized assessment**

№	Stages of Methodology	Stages Characteristics
1	Preparatory Stage	<ul style="list-style-type: none"> <li><input type="checkbox"/> formulation of the main aim and criteria of verification</li> <li><input type="checkbox"/> choice of verification conduction method</li> <li><input type="checkbox"/> grounding of tools for verification</li> <li><input type="checkbox"/> choice of verification assessment indices</li> <li><input type="checkbox"/> selection of verification environment subjects</li> </ul>
2	Gaining and working out	<ul style="list-style-type: none"> <li><input type="checkbox"/> gaining verification expert assessment of expert assessment</li> <li><input type="checkbox"/> according to the apparatus tools chosen</li> </ul>
3	Working out of generalized	<ul style="list-style-type: none"> <li><input type="checkbox"/> generalization of expert assessment conclusions</li> <li><input type="checkbox"/> working out of conclusions concerning verification of the result gained</li> </ul>

Preparatory stage. The main aim of the totalized verification is confirmation of the truthfulness (righteousness) of the new scientific results on TMP PAIA. The main criteria of this methodology elaboration (accounting for the general criteria) are the following:

- methods should be concrete and available for practical conduction of the indirect verification, and also acceptable for the provision of safety and trustworthiness of assessment;

- tool apparatus should be conductible from the point of view of labor-consuming and available in usage and, similarly, reflect both primary (basic) ideas, which were used in the research of TMP PAIA, and new principally important theoretical workings out without their over-detailing;
- indices should be both qualitative and quantitative, and also concrete and transparent for understanding, acceptable for measuring and provide reliable and trustworthy confirmation of the verity of new scientific claims;
- reliability of the quality assessment of new workings out is provided by bringing in experts to the verification, scientific and practical interests of whom are the closest to the subject of the present research. The results of generalized verification are to be used for discovering a competent expert.

As for the choice of methodology of verification conduction, methods of empirical research are widely used in public administration [Ковбасюк Ю., 2011]: methods of individual and group expert assessments. The latter methods (methods of scientific commission, “brain storm”, “Delphi”, others) are more complicated in application, resource-consuming, especially in time. Though, their advantage is considered as higher reliability of the group thought than an individual one.

The most widely used, accessible and acceptable for the verification conduction are the methods of individual expert assessments (methods of interview, expert questioning, focus-group, completing forms, testing, etc.) as those which provide [Ковбасюк Ю., 2011]: independence of formation of expert assessment of qualitative and quantitative character; lowering of impact on this assessment from the side of conformism and political situation; previous, simplified formalization of the verification procedure. The most widely used are the methods of completing forms, interview and analytical expertise, which, in the present case provide for the acquisition of the corresponding expert evaluations. Besides, the first method, on condition of the correct composition of the question list, will simplify the procedure of getting and working out of the verification assessments, elaboration of final conclusions due to the previous clear structuring of questions, which mostly bear a closed character.

The interview method provides a wider experts speculation expression and higher reliability of their assessments: during a conversation experts express their thoughts on the previously drawn circle of open, closed and half closed interviewer’s questions [Ковбасюк Ю., 2011]. This method, compared to the first one, is more complicated but available for realization. The deepest and most reliable verification assessments of an independent character can be acquired by means of the method of analytical expertise. Nevertheless, its disadvantage are much higher labor-consuming and volume of time-waste, because an expert needs: not only a deepened elaboration of the material, but also in modernizing his/her own knowledge on the innovative problem scope; in the working out of the final analytical memorandum which goes on together with the working-time spending, which makes application of this method additionally more complicated. Other difficulties may arise in connection with: multi-sense definition of the same notions by experts, their keeping to other views on giving them advantages to scientific works of other researchers; the necessity of an interviewer’s ability in skillful interview conduction and creation of preconditions for honest expression of his/her thoughts by an

expert, and also keeping to a certain logics in the formulation of questions and tasks to the experts and the order of their discussion, etc.

Being grounded on the previously said, the most adequate for the generalized verification on the subject of the present research, may be considered the methods of completing forms and interview, which are well-developed and tested, available, non-wasteful, and they also provide for the adequate reliability and trustworthiness of assessment.

As for the structuring of the verification tools (question lists and interview), taking into consideration the previously defined criteria and the subject of the present research, it is necessary:

- clearly, logically and generally structure the problematic aspects of PAIA, used primary ideas and new theoretical elaborations which are to be verified. Actual problems and primary ideas should be considered those which result from the analysis of the modern state of public administration innovations, namely: global and national innovative development tendencies, subject field and the mostly acknowledged kinds of modern innovations; problematic questions of PAIA and its TMP. The new research results are to be examined through the system-activities approach to PAIA, regularities and principles of large-scale introduction of innovations, and also peculiarities of their classification, innovative process, strategic management of large-scale innovations and systematization of the main factors of resistance to qualitative changes;
- to choose a non-labor demanding quality (up to 10-12) of closed and open questions, which could in a general way characterize primary ideas and principally important theoretical issues;
- the formulation of questions should be available and transparent for acceptance and their thoughtful working out by experts in a short period of time. To render a possibility of briefly express the experts' opinions in the open questions.

As for the verification indices, in the general case they should reflect qualitative characteristics concerning the following issues:

- actuality, theoretical importance and practical meaning of new TMP aspects, relevance of their application in educational process, professional training of public servants, training of post-graduates;
- confirmation of the righteousness, verity and innovation of new elaborations;
- success in introducing public-administrative innovations, development of PAIA, etc.

To assess indices to the corresponding questions there may be chosen: a five-point grade for the assessment of the importance rate of the results obtained; a four-point grade – for the assessment of the rate of actuality of SPA innovative modernization; a three-point grade – for the assessment of the rate of theoretical importance of the result obtained, its practical importance for the innovative SPA development, and also useful for the educational process. Moreover, to give an expert possibility to express his/her thought on the closed questions.

As for the formation of the verification environment, in the general case, experts may be experienced public servants, scientists, students and post-graduates of the National Academy of Public Administration, Office of the President of Ukraine, and its Regional Institutes, which are both theoretically prepared and practically experienced in

the aspects of SPA reformation. The guiding point for choosing experts-scientists may be their works (dissertations, monographs, articles), most closely related to PAIA by their problematic. Nowadays, the amount of such experts in the field of knowledge the “public administration” is enough for conducting verification on the subject of the present research.

As for the stage of obtaining and working out expert assessments, conducting of questioning and interviewing is possible both at direct questioning and communication, and by phone regime or with the help of applying modern information telecommunication technologies, namely: at the mode of forum, video conference, etc.

With the aim of working out question lists it is relevant to use the SPSS program product, which makes it possible to elaborate a great amount of information in totality of parameters. Taking into account the complexity of the material to be verified, it is desirable to previously acquaint experts with the contents of the interview, and conduct it at their readiness.

The results should be documented in electronic and paper carriers.

Concerning the final stage of this methodology, the verification results are formulated as generalized conclusions, where there are reflected:

- the rate of achieving the main verification aim as a diagnostic form (approval, confirmation) of the righteousness of new scientific issues on TMP PAIA;
- the rate of correspondence of the verification research to the previously defined criteria;
- summarized analysis of the most important expert assessments, in which there is given detailed argumentation as for the facts to what extent the obtained theoretical aspects were confirmed and with the help of which speculations, specifications and proofs by experts they were justified;
- theoretical and practical recommendations for the further application of conclusions.

An important summary of the first stage of verification research is finding out the most experienced experts, and among them – competent ones who could be called for further verification.

At another verification stage, there is used the methodology which is grounded on the method of competent expert with the corresponding confirmation logics (objection) of the verity of new TMP PAIA elaborations. The main aim of this methodology is in the more detailed (than at the first stage) iterative cooperation in the form of “competent expert – researcher” with the aim of clearing up the qualitative characteristics of new theoretical methodological elaborations. From the point of view of general criteria, structuring of this methodology is based on the following main criteria:

- verification of new elaborations should start with the understanding of the persons interested in the TPM PAIA working out, finding out the necessity and importance of its working out, being grounded on the problematic fields both as innovative activity and its theoretical methodological provision;
- expediency of the new researches chosen themes should be grounded on their demand, basing on the most important needs of TMP working out and PAIA development;

- the quality of new TMP workings out is, firstly, checked to the correspondence (deviation from) to the most important results of the previously determined main directions of its problematic field;
- verity of the new most important results is confirmed with clearing up the adequacy of the methodological apparatus used in the research; essences of the main approaches, models, claims, suppositions, etc., and also giving grounds to the ability of their application at new workings out elaboration.

The first stage of this methodology (Table 2) is focused at clearing up the TMP PAIA development needs. In this case, a competent expert-interviewer puts the following questions to the researcher-recipient:

- (1) what subjects are mostly interested in TMP PAIA working out?;
- (2) what is the necessity and importance of TMP PAIA lie in and on the basis of what documents?;
- (3) which research directions form the generalized problematic field of TMP PAIA?

**Table 2. Methodology “The Competent Expert”**

№	Stages	Characteristics of Stages
1	Conceptualization of the necessity,	<ul style="list-style-type: none"> <li><input type="checkbox"/> determination of TMP PAIA importance and essence of TMP PAIA interested subjects;</li> <li><input type="checkbox"/> working out grounding of the necessity and importance of TMP PAIA;</li> <li><input type="checkbox"/> finding out generalized problematic TMP PAIA field</li> </ul>
2	Grounding of the expediency of TMP	<ul style="list-style-type: none"> <li><input type="checkbox"/> grounding of the main TMP PAIA main directions research directions as for their adequacy for the most important PAIA needs</li> </ul>
3	Defining the correspondence of the results obtained to the main directions of the problematic field	<ul style="list-style-type: none"> <li><input type="checkbox"/> analysis of the TMP research results obtained according to three groups: “relevant and calculated” (most important); “relevant but uncalculated”; “irrelevant but calculated”</li> </ul>
4	Evaluation of the quality of the most important research results	<ul style="list-style-type: none"> <li><input type="checkbox"/> evaluation of the adequacy of the methodology apparatus used for gaining the most important TMP research results;</li> <li><input type="checkbox"/> finding out verity of the used in the research logics,</li> <li><input type="checkbox"/> rate of suppositions grounding and their correspondence to the previously formulated needs</li> </ul>

The second stage of the methodology concerns expediency of research of the main TMP PAIA directions. Due to this stage, a competent expert-interviewer proposes to the researcher-respondent to answer the following questions:

- what TMP research directions are the most important (key) from the point of view of their correspondence to the modern PAIA development needs?;
- what is the relevance of analyzing the most important directions from the point of view of their impact on the development of theory, practice and scientific methodological provision of the educational process?

The third stage deals with the definition of correspondence (deviation) of the factually gained results to the main directions of TMP PAIA research, which were determined due to the previous methodological stage (Table 2). In that case, a competent



expert-interviewer defines the correspondence (deviation) of the research results by means of their division into three groups: “relevant and calculated” (further on - RC); “relevant but uncalculated” (further – RUC); “irrelevant but calculated” (further – IRC). The “relevant and calculated” results are estimated as the most important among those obtained in one’s own research: they answer to the main TMP directions. With the aim of corresponding separation of results, a competent expert-interviewer marks one of the variants with the chosen criteria with the sign “v” in Table 3.

**Table 3. Separation of the results obtained according to their importance**

Research Obtained	Result	RC	RUC	IRC
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The fourth stage is directed to the assessment of the verity of the most important TMP PAIA research results on the following questions of a competent expert-interviewer to a researcher-recipient:

- which methodological tools are used when getting the most important TMP PAIA research results?;
- what main approaches, models, claims and suppositions, worked out by the predecessors, are used at working out of the new most important results?;
- what is the essence of grounding such approaches, models, claims and suppositions for their application at the elaboration of new workings out?;
- what is the essence of the new most important elaborations from the point of view of TMP PAIA development?

After ensuring in the full grounded answers to the above mentioned questions, a competent expert-interviewer formulates conclusions as to the verification of the new most important results on the following subject:

- correspondence of the main theoretical-methodological elaborations from the point of view of their necessity, importance and practical demand from SPA subjects;
- relevance (deviation) of the obtained new most important results to TMP PAIA development demands;
- argumentation of the truthfulness of the obtained new most important results by means of confirming: adequacy of the used methodological tools and applied main approaches, models, claims and suppositions, which were worked out by the predecessors, to the subject of the present research, and also grounding of ideas, laid in new elaborations.

### 3. CONCLUSIONS

Application of the direct kind for the verification of new theoretical-methodological result in the field of knowledge „the public administration” is, in general, problematic, and as for questions of public administrative innovative activities, is even more complicated. In that case, it is possible to use an indirect kind of verification as an ordered process of application of concrete criteria, indices, methods and tools (skills, modes, actions, procedures, etc.), which will enable to acquire the corresponding assessments of the quality of new theoretical results and their detailed analysis.

General methodology of verification may include two consequent stages. At its first stage, there should be used the method of focus-group expertise, and at the other – the method of competent expert. Such an approach will enable to primarily form generalized quality assessments of new theoretical results, and later on to specify them and in more detail concretize with the help of a competent expert, found out at the first stage.

The principal question at the elaboration of the general methodology is determination of a list of indices which could fully enough and transparently characterize the verification object and enable to formulate final conclusions in a grounded way. Generalized conclusions should describe: the rate of achievement of the main aim of verification research and its correspondence to the previously elaborated criteria; grounded argumentation as to adequacy of the applied theoretical elaborations of the predecessors and grounding of new workings out on the basis of logical speculations and experts' claims.

An important question is defining the expert staff, and among them – a competent expert. The main verification tool is proposed using an interview and answering question lists, which may be realized with the help of traditional and modern information-telecommunication means in the distance mode.

Further direction of research should be an experimental testing of the proposed methodology, which will enable to improve each of its stages.

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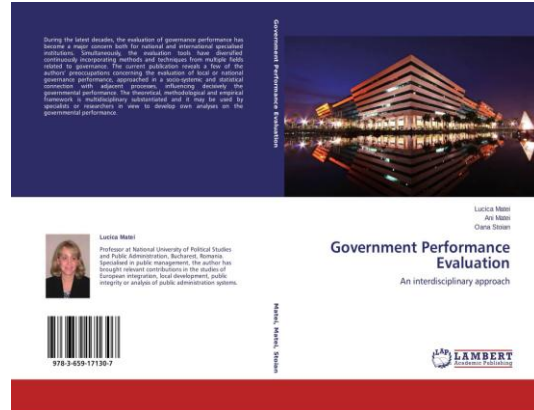
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**BOOK REVIEW**

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**Lucica Matei, Ani Matei, Oana Stoian. (2014). *Government Performance Evaluation: An interdisciplinary approach*, LAP LAMBERT Academic Publishing, 160 pages, ISBN-10: 3659171301, ISBN-13: 978-3659171307.**



The book “Government Performance Evaluation: An interdisciplinary approach”, written by professors, specialists in administrative sciences, is dedicated to students and practitioners in the public sector, as well as to readers interested by this topic, wishing to know and study the instruments and modalities for evaluating the public sector performance.

Lucica Matei (1956-2014) was Professor and Jean Monnet Chair Holder at the Faculty of Public Administration of the National University of Political Studies and Public Administration, prestigious professor researcher, appreciated in the national and international academia due to her outstanding outcomes. Her expertise was acknowledged in public management and public services, European administration, local development, public and nonprofit marketing. She published as author or editor over 30 books at Romanian or foreign publishing houses. “Government Performance Evaluation: An interdisciplinary approach” represents her last book. At the same time, she was author or co-author of over 100 articles focused on her areas of expertise. She was member of several editorial teams of prestigious foreign journals, as well as coordinator of thematic series: “Science of Administration and Public Management” (Economica Publishing House, Bucharest), “Jean Monnet Handbooks” (Economica Publishing House, Bucharest), “Administrative Studies and Public Management” (Shaker Verlag, Germany). Her outstanding career of professor and researcher represents an example for the young generation.

The book is focused on empirical research and it reviews a few modalities for government performance attempting to integrate finalities of daily socio-economic processes within a coherent ensemble, and to evaluate the possible impact on government performance.

After the introductory and explicative part, the structure of the book follows the process of performance evaluation in the public sector and it presents both a theoretical framework for performance in the public sector as well as original models for its evaluation. The authors refer to the models of reducing the administrative burden on administrative efficiency, such as using PFIC as European model for internal control, Europeanization instrument or instrument of New Public Management and using BARS (Behaviorally Anchored Rating Scale) in view to evaluate the performance of local government.

The methods are approached interdisciplinary and may be developed and applied by the public managers interested in general in performance of public sector and in particular in performance of public organizations.

The authors achieve an excellent connection concerning the evaluation of government performance in particular and evaluation of public sector performance in general.

The book is structured in five chapters, the first presenting the theoretical and conceptual framework of governance, government performance, public service performance, reducing the administrative expenditures and evaluation of public sector performance.

The second chapter analyses and describes the instruments for performance evaluation (Common Assessment Framework, Sustaining European governance - financial management instruments and Behaviorally Anchored Rating Scale) in the public sector.

The third chapter presents two empirical studies: 1. an empirical support in view to analyze government performance in the EU, a comparative study in the EU Member States and accession countries and 2. an empirical study focused on a sample of 11 states in South-Eastern Europe, situated on different integration levels into the EU, both studies concerning public integrity, economic freedom and government performance. The vision and approach are apparently restrictive, using GDP per capita as single indicator. The complexity of analysis overcomes this issue, elements of government performance being revealed by the concepts of public integrity or economic freedom.

The fourth chapter presents the methodological research framework, specific to behavioral sciences, adequate to the requirements of the current research (Behaviorally Anchored Rating Scale - BARS). The stages of research in BARS refer to triangulation method, grounded theory – the qualitative perspective and the quantitative approach.

The last chapter presents a case study in Romania, precisely in Cluj Napoca, based on *de facto* situation of the city, continuing with the description of empirical proofs and data analysis. This chapter highlights the role of administrative and political structure in the evaluation of local government performance. The authors have analyzed the situation on reporting performance to local councilors in Cluj-Napoca.

The book represents a relevant study for the evaluation of public sector performance in general and evaluation of local government performance in particular in Cluj-Napoca.

The book holds significant attributes of originality and it is useful as it reveals new models and it turns into account the theoretical framework for systemic substantiation.

The models presented are successful ones, especially within the context that there is no single model to comply with all real situations.

Beyond the pragmatically approach of performance evaluation in the public sector, the book has other strengths: broad bibliography based on studies and field literature, accuracy, several practical examples, a series of tables, figures and charts in view to emphasize the most important practical elements. The authors emphasize that the study of the current paper should be accompanied by profound studying and understanding fundamental publications, which have been each time highlighted in quotations or references.

Concluding, the book provides innovative, interdisciplinary ideas in light to understand the processes specific for performance evaluation in the public sector.



***FINANCE***





## **AN EXAMPLE-BASED, DIAGNOSTIC INVESTIGATION OF VALUE CREATION AND VALUE DESTRUCTION BY CORPORATE ACTIVISTS**

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**Abstract:** *This paper investigates, through an example-based scenario, the extent to which corporate activists create or destroy shareholder value; there are five high-profile campaigns analyzed related to four major players. The foundation of the analysis is a variant of DCF model which examines the cash flows to equity. In 4 out of 5 cases the financial metrics are computed in order to assess the performance of the subject company ex-ante and ex-post activists' involvement.*

**Keywords:** *Shareholder value, value creation/ destruction, buyback, merger proposal, spin off, activism.*

### **Acknowledgements**

First and foremost, I would like to thank Dr Eugene Nivorozhkin for his support and guidance during my final academic year at UCL; the material covered in the financial management courses was most helpful in writing this paper. I also wish to express my sincere gratitude to my parents, Violeta and Liviu, and friends for motivating and inspiring my work.

For better understanding this article, it is divided as follows:

- Notes
- Introduction
- Carl Icahn – Apple, Share buyback    Figure 1
- Bill Ackman – J.C. Penney, Replace CEO (Mike Ullman with Ron Johnson)
- Christopher Cooper-Hohn – EADS, Sell stake in Dassault Aviation
- Nelson Peltz – PepsiCo-Mondelez, Merger proposal        Figure 2
- Christopher Cooper-Hohn – Coal India, Price restriction removal and cost cutting
- Conclusion
- Exhibits: Exhibit 1.1; Exhibit 1.2; Exhibit 1.3; Exhibit 2.1; Exhibit 4.1; Exhibit 4.2; Exhibit 4.3; Exhibit 5.1; Appendix 1; Appendix 2
- References

## 1. Notes

The financial metrics were calculated by the author, unless referenced accordingly. The accounting information (income statement, statement of financial position, cash flows figures), used in the computation of the metrics, was taken from the Financial Times, Financials section, unless stated otherwise or referenced accordingly.

Additional high-profile examples of corporate activism are illustrated in Appendix 1. However, only three are briefly analysed in the appendix: TWA (Carl Icahn), Genzyme (Carl Icahn) and Xenoport (Greg Taxin).

Please refer to Appendix 2 for a better understanding of the framework used to explain how and what impacts upon shareholder value.

Acronyms:

APP = acquisition purchase premium (nominal figure)

APP% = acquisition purchase premium expressed in percentage terms in text but on a 0-1 scale in calculations

CAP = competitive advantage period

CAPM = capital asset pricing model

CF = cash-flow

COGS = costs of goods sold

DCF = discounted cash flow

ECF = equity cash flow

NPV = net present value

PV = present value

ROCE = return on capital employed

ROE = return on equity

VC = value creating/creative/creation

VD = value destroying/destructive/destruction

WACC = weighted average cost of capital

Corporate activism is building momentum and it is going global. This year, the number of activist campaigns exceeded 200 (13D Amendments) as compared to 27, 13 years ago. Activism has no boundaries; in addition to going global, it extends to a variety of firms, regardless of size and of the corporate governance quality: Apple, PepsiCo and India Coal are just a few examples (Lipton, 2013).

This paper will discuss high-profile examples of activists' value creation and value destruction proposals/actions based on a variant of DCF valuation methodology which is concerned with the cash flows to equity; the model is explained in Appendix 2. The conclusion will provide an answer to why the differences in value arise.

## 2. Carl Icahn – Apple, Share buyback

Supporting the intrinsic value school, Icahn believes that Apple's shares are undervalued and suggests a share buyback of \$150bn. In addition, this amount should be borrowed rather than expatriated to the U.S. (Bradshaw and Foley, 2013).

The buyback can impact upon value in two ways: signaling and leverage (Pettit, 2001).

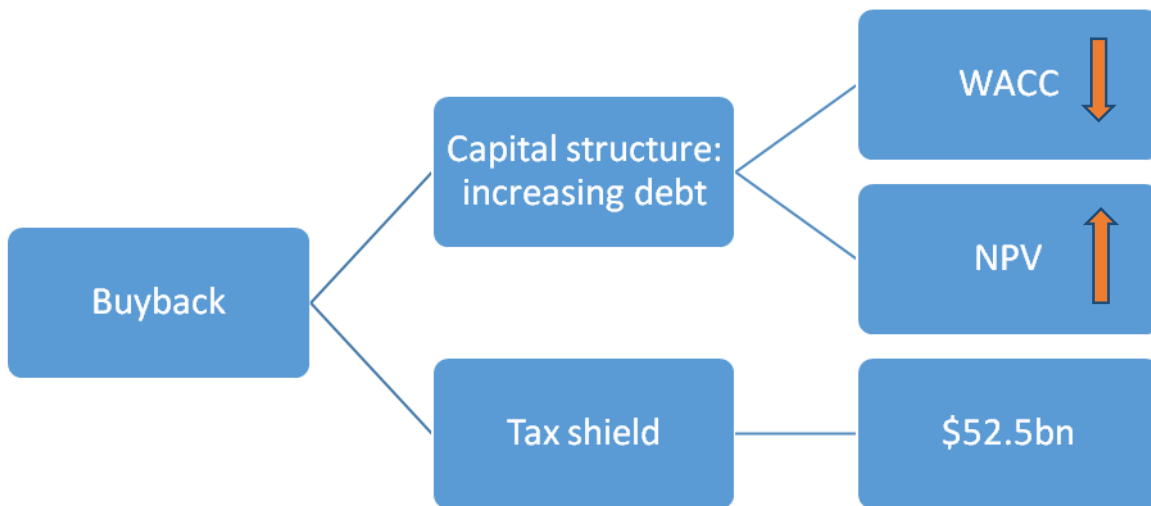
Signaling – Value destruction

Investors may believe Apple has no other alternative investments. Apple’s smartphone market decreased to approximately a third of Samsung’s and iPad is losing market share to competitors (Amazon, Microsoft, Google). Investors may see value creation if Apple invests in 3D imaging and motion control sensor in order to launch the revolutionary iTV (Botha and Gregorio, 2013), thus creating a new market; this will increase Apple’s advantage horizon (CAP) and cash flows which will result in value creation.

Leverage – Value creation

Using Mauboussin’s (Mauboussin, 2011) methodology, Apple’s rate of return for continuing shareholders equals 11.69% (Exhibit 1.1). This is higher than apple’s cost of equity, 5.74 % (Exhibit1.2), hence the buyback results in VC for continuing shareholders.

Figure 1 illustrates the two main financial effects associated with Icahn’s share buyback proposal.



Increasing the gearing ratio, will result in decreasing WACC because the cost of debt is generally 2 to 2.5 times cheaper than the cost of equity (Clark and Mills, 2013, p. 46). The direct implication is VC because the CFs will be discounted at a lower rate, yielding higher company valuation.

A lower WACC, implies more investment opportunities; there will be more potential investments with a positive NPV.

The tax shield (52.5bn, Exhibit1.3) results in VC: higher CFs increase company value.

Overall the \$150bn buyback results in VC in the short-run, but does not guarantee VC after Icahn cashes out. This is a high-growth, fast-developing industry and innovation

is the key. Reinvestment in innovation will create new markets for Apple and increase its CAP, which will create value in the long-run. Increasing the CAP is crucial for creating shareholder value because during CAP the company benefits from a higher growth rate within a two-stage DCF valuation model.

**3. Bill Ackman – J.C. Penney, replace CEO (Mike Ullman with Ron Johnson)**

Ron Johnson’s poor managerial decisions:

- Changed pricing strategy – replaced discounted prices with fair prices;
- Did not perform a trial on the new pricing strategy to test its successfulness by measuring, for example, sales per square foot ratio;
- Rebranded J.C. Penney by attracting boutique stores, changing the shopping experience that customers were loyal to;
- Eliminated signs and visual position leading to incorrect or unreadable prices (Bhasin, 2013);
- The acquisition of Martha Stewart resulted in a lawsuit and in a loss making deal (-\$12.54m) (Exhibit 2.1).

The poor management resulted in underperforming financial metrics as indicated below:

	2011	2012
ROE	7.12%	-3.79%
ROCE	7.98%	-0.02%
Change in cash flow	\$(389)m	\$(1,115)m

The net change in cash decreased, ROCE and ROE plummeted, resulting in enormous VD. Decreasing cash-flows negatively impact on shareholders’ value and so does the ROE metric as indicated in the DCF approach considered in this paper (Appendix1).

Mr. Johnson’s poor performance results from misunderstanding the behavioral economics behind J.C. Penney’s core customers, who are value orientated versus Apple’s customers who are innovation orientated. The incapability of making the transition/distinction from/between Apple to J.C. Penney resulted in a managerial catastrophe, alienated customers and consequently plummeted financial ratios. This led to significant VD.

**4. Christopher Cooper-Hohn – EADS, Sell stake in Dassault Aviation**

The following table displays the key metrics for Dassault Aviation, as a separate entity, and EADS (consolidated with Dassault).

	2011	2012
Dassault		
ROE	7.28%	10.58%
ROCE	8.00%	10.91%

WACC	8.00% (Dassault, 2011)	8.70% (Dassault, 2012)
EADS (consolidated)		
ROE	11.67%	11.80%
ROCE	3.94%	4.90%
WACC (EADS, 2012)	10.40%	10.20%

Mr. Hohn’s suggestion makes financial sense from a shareholder point of view, as he expects as high a ROE as possible from the approximately 1% stake held in EADS. On the other hand, Dassault is clearly more efficient at using its capital. Since ROCE is especially important in comparing capital intensive firms’ profitability, EADS could benefit from Dassault’s efficient use of capital. In addition, Dassault has a significantly lower WACC, which positively impacts upon EADS valuation, using a DCF approach. Should Dassault be sold, EADS’ WACC will consequently increase. This implies that cash-flows will be discounted at a higher rate, therefore, negatively impacting EADS valuation, using a DCF valuation method. This will directly result in VD.

Mr. Hohn should address instead, the issue of high WACC and low ROCE metrics, by undertaking more debt (change in capital structure) and reducing COGS or operating costs respectively.

**The VD argument is strengthened by comparing EADS, Boeing Co and Dassault, net income/sales% metric.**

	2011	2012
EADS(consolidated)	2.10%	2.17%
BoeingCo	4.77%	5.85%
Dassault	9.60%	12.74%

EADS and subsidiaries are doing poor compared to the main peer/competitor, Boeing Co, while Dassault alone is performing incredibly well, effectively managing operational costs. Dassault’s performance has a positive impact on EADS’ value and should not be sold unless the APP received creates enough financial gains to overcome the negative impact associated with the sale.

**5. Nelson Peltz – PepsiCo-Mondelez, Merger proposal**

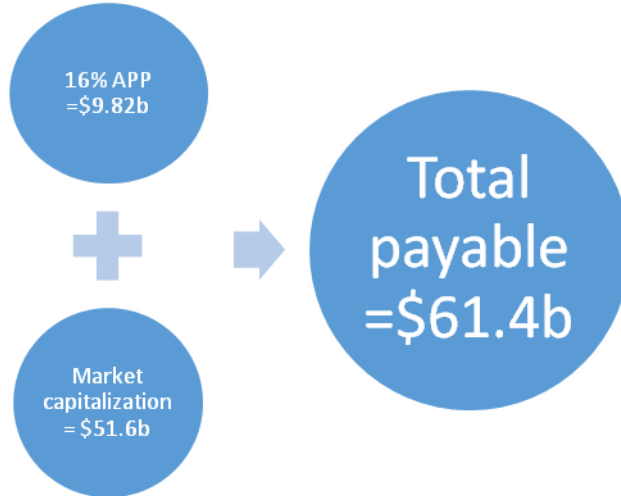
Triam Partners released a white paper (Triam Partners, 2013) suggesting:

- A. PepsiCo’s merger with Mondelez, an all-stock transaction, and
- B. PepsiCo’s separation of Snacks/Beverages into two separate entities. Only the merger proposal will be analyzed in this paper.

The main reasons for the proposal were the realizable synergies. The NPV and the value gap will, therefore, be calculated in order to assess whether the merger is VC or VD.

The APP% is 16% at an agreed stock price of \$35. The market price, APP and the total payable amount are illustrated below (Exhibit4.1).

Figure 2



The realizable synergies suggested in the white paper:

Expense-related \$3.4billion  
 Revenue-related \$3billion } It yields \$6.4 billion total realisable synergies

Managerial and financial synergies are only mentioned in proposal B, which will not be considered in this paper; the two proposals are described separately and their implementation is not restricted to simultaneity.

The merger’s NPV (Sirower, 1997, p.10) is negative, -\$3.42billion (figure 2). The NPV is a major investment appraisal technique and it is straight forward that a project with a negative figure results in VD because it does not add shareholder value. For the NPV figure to be fundamentally correct, the future cash flow stream has to be discounted to the PV. However, Sirower’s (1997) methodology for merger valuation replaces within the NPV calculation frame work the initial investment with the premium paid and the stream of cash flows with the implied synergies. Since no discount occurs in this calculation, it is assumed that the forecasted expense and revenue related synergies are given in PV terms. Discounting, however, does not change the fact that the merger should not be pursued, since the figure is negative; in other words, if discounting was omitted, applying it will only reduce the synergies figure, lowering the NPV of the merger.

On a second note, according to Clark and Mills (2013, p. 92), this transaction results in VD because the ‘APP exceeds the present value of net realizable synergies’ and because the value gap is positive. As defined by Clark and Mills (2013), the VG is the difference between the APP and net realizable synergies. These yields a VG of \$3.42 billion (Exhibit 3) and similarly to the NPV investment appraisal technique the merger proposal should not be pursued.

	ROE	ROCE
Mondelez		
2011	10.02%	4.64%
2012	9.40%	5.08%
PepsiCo		

2011	31.29%	17.60%
2012	27.71%	15.83%

The financial metrics calculated above show that PepsiCo is more efficient at deploying shareholder’s funds and at employing its capital, by a great margin. Should a merger take place, PepsiCo’s ROE metric will decrease, leading to value destruction as suggested by the DCF Equity Valuation Model in Appendix2.

Other considerations to take into account:

- Integration risks - Mondelez is already facing restructuring programs because it was the target of prior acquisitions. Trying to integrate Mondelez while facing its own strategic changes can pose high execution risk (Steib and Giraldo et al., 2013, p. 4).
- Restructuring costs - the merger can create additional corporate restructuring costs, reducing cash-flows and the ROE metric, leading to VD.

For the reasons outlined above, PepsiCo’s merger with Mondelez is not value creative and should not be pursued.

**6. Christopher Cooper-Hohn – Coal India, Price restriction removal and cost cutting**

Existing issues:

- Government did not raise prices for approximately 2 years;
- Operating costs% are surging (see table below);
- Inflation makes coal price fall in real terms;

According to Mr. Hohn, Coal India can increase its net profit by \$20b should it remove price restrictions.

	2011	2012
Operating costs%	29.88%	69.59%
COGS%	11.20%	10.35%
ROE	32.62%	36.56%
ROCE	27.81%	29.25%
Net income%	19.72%	21.14%

Mr. Hohn’s suggestions:

1. Remove price restrictions - current price \$25, market price \$70 (Hohn, 2013).
2. Reduce costs - while COGS% decrease by 0.85%, operating costs% more than double.

The elimination of price restrictions will directly result in surging cash-flows, instantly creating value, using a DCF valuation approach. Reducing costs will result in higher ROE and ROCE metrics, which will also increase value as explained in Appendix1.

Mr. Hohn’s \$20bn net profit increase suggestion, should the price restrictions be lifted, yields a net profit increase of 717.3%. The result of successfully implementing Hohn’s proposals will result in a VC boom for shareholders.

Activism will inevitably lead to three outcomes: VD, VC or both, depending on the time scale one looks at (Apple's buyback results in VC in the short-run but may lead to VD in the long-run if research and development is not pursued, thus reducing the advantage horizon). The certain aspect is that activists will inevitably be interested in maximizing personal value because ultimately this is the motivation behind becoming an investor; to cash out high returns. Whether, their financial motivation will positively impact upon shareholders' value in general, depends on several considerations. Firstly, timing plays an important role. This refers to whether the activist takes a long or short-term approach to investment. The keener one is in quickly cashing out abnormal profits, the greater the chance for strategic decisions that maximize short-term earnings at the expense of longer-term value to occur.

Secondly, comes the understanding of the overall business. Activists often engage in proxy battles. When those are won, they have the opportunity to take control of managerial decisions. Not understanding the business may result in alienated customers and consequently VD through decreasing cash-flows and profitability metrics, as in the case of J.C. Penney.

Exhibit 1.1

$$\text{Expected return from a buyback} = \frac{\text{Cost of Equity}}{(\text{Current stock price})/(\text{Intrinsic value})} * 100$$

$$\text{Expected return from a buyback} = \frac{8.79}{(\$525)/(\$698.25)} = 11.69\%$$

Where the current stock price is the buyback price suggested by Icahn and the intrinsic value is the price of Apple's shares ex-post buyback, as suggested by Icahn (33% increase) (Marcial, 2013).

Exhibit 1.2- Apple's cost of equity as of 03.12.2013

The cost of equity or the required return to equity, using CAPM, is given by:

$$R_e = R_f + \beta * (R_m - R_f)$$

Where:

$R_e$  = Apple's required return on equity

$R_f$  = risk free rate: U.S. 10 year government bond (Bloomberg, 2013)

$\beta$  = Apple's beta (Reuters.com, 2013)

$R_m$  = annualized real returns on equities from 1900 – 2012 (Credit Suisse Global Investment Returns Yearbook, 2013)

Apple's cost of equity equals:

$$2.83 + 0.84 * (6.3 - 2.83) = 5.74\%$$

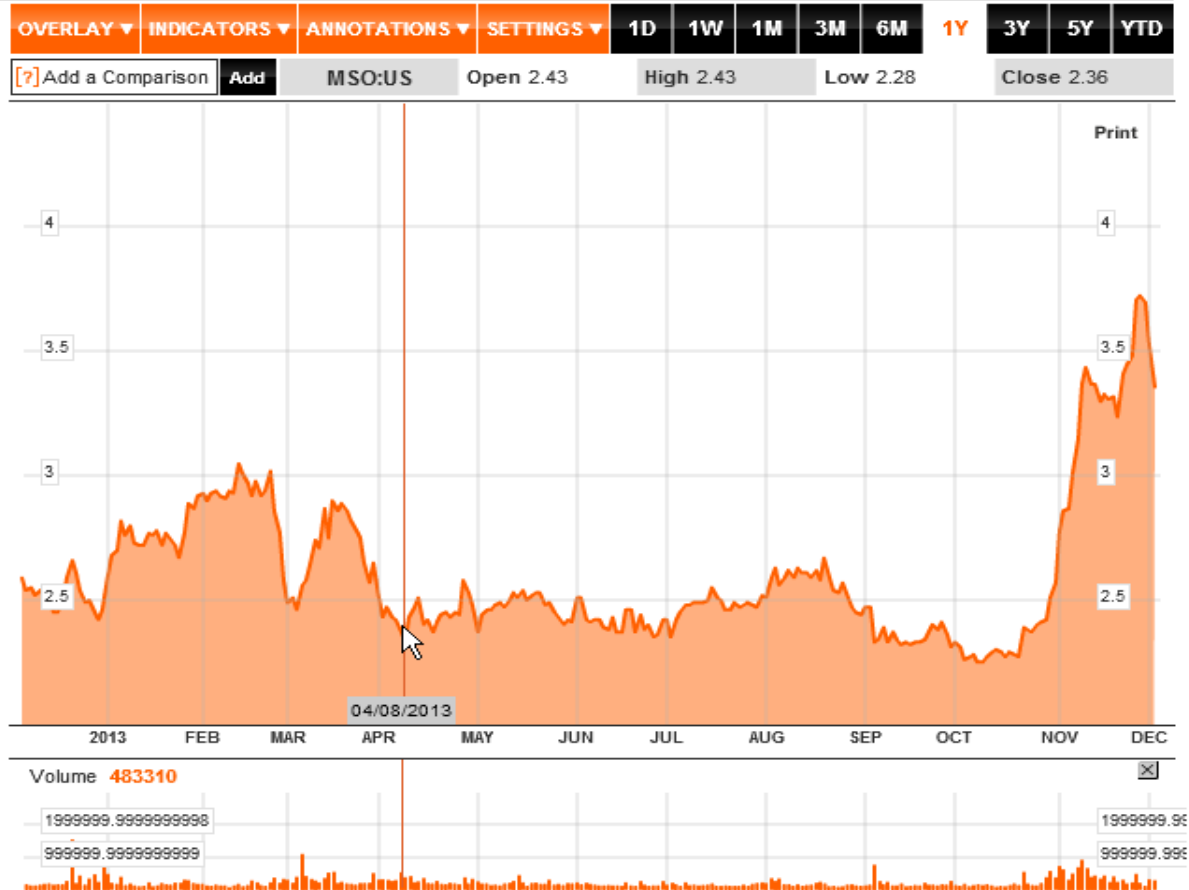
Exhibit 1.3



Considering a 35% corporate tax, an estimate of the tax shield is  $(\$150bn * 0.35) = \$52.5bn$

Exhibit2.1

Interactive Stock Chart for Martha Stewart Living Omnimedia Inc (MSO)



(Bloomberg, 2013)

The calculation is computed by finding the market capitalization of Martha Stewart when the acquisition took place and deducting the market capitalization when Mr Johnson left J.C. Penny.

$$(11\text{million shares} * \$3.5) - (11\text{million shares} * \$2.36) = \$12.54 \text{ million}$$

Exhibit4.1

The agreed price = \$35/share; Outstanding shares = 1,753,790,000; APP% = 16%.

$$APP = \text{outstanding shares} * \text{agreed price} * APP\%$$

$$APP = 1,753,790,000 * \$35 * 0.16 = \$9,821,224,000$$

*Market capitalization = outstanding shares \* agreed price \* (1 - APP%)*

*Market capitalization = 1,753,790,000 \* \$35 \* 0.84 = \$51,561,426,000*

Exhibit4.2

*NPV = net realisable synergies – premium paid = \$6.40bn – \$9.82bn = –\$3.42bn*

Exhibit4.3

*Value Gap = APP – net realisable synergies = \$9.82bn – \$6.40bn = \$3.42bn*

Exhibit 5.1

Net income 2013 = \$2.8bn

Potential Net income, should price restrictions be removed = \$2.8bn + \$20bn = \$22.8bn.

Appendix 1

Activists/Action	Buyback/ Increase dividend	Fire CEO	Disposal of assets, Change in capital allocation	Spin off	Acquisitions/Mergers
Carl Icahn	Apple, Time Warner	Genzyme	TWA, Texaco, Transocean	US Steel, CVR	Sanofi-Aventis - Genzyme
Daniel S. Loeb		Sotheby, Yahoo!		Sony, Penn Virginia	
Bill Ackman		JC Penney			
Nelson Peltz				PepsiCo, Cadbury, Ingersoll- Rand	PepsiCo-Mondelez
Greg Taxin	NutriSystem, Value Vision	NutriSystem, XenoPort	XenoPort		
Chris Hohn	Coal India, EADS	Deutsche Borse	Coal India, EADS		

Greg Taxin’s (Clinton Group) propositions to Xenoport were to switch capital allocation from Horizant to the multiple sclerosis and psoriasis compound (XP23829). The compound has better side effects than Biogen’s equivalent (Tecfidera) and could become a blockbuster, increasing Xenoport’s cash-flows, hence, resulting in VC.

Carl Icahn’s suggestion to Genzyme to focus on the development of therapies such as Cerezyme to treat Gaucher’s disease can result in great VC by substantially increasing cash-flows. Cerezyme costs \$3,000 to produce and sells for \$300,000. Given the fact that all type patients (non-neuropathic, acute infantile neuropathic and chronic neuropathic form) need to consume it in order to survive, Cerezyme has the potential to become a blockbuster drug (>\$1 billion revenue/annum). Genzyme’s monopoly on this niche market would guarantee a surge in cash flows and enormous VC (Bertoni, 2011).

Carl Icahn has caused great VD in the past in Trans World Airlines (TWA), but not to himself. After TWA filed for bankruptcy (1995) he signed a contract with the airline, according to which he would be entitled to purchase discounted tickets (up to 45% under published fares) in return for a loan made to the firm. This resulted in enormous VD, as cash-flows were significantly reduced (Grover, 2013).

Appendix 2

The following, is a simplified version of the Equity Valuation model as found in Esty's paper *Note on Value Drivers* (1997). It is used to relate ROE performance to equity value.

The model is explained below by assuming constant cash flows to equity:

$$E_{MV} = \frac{ECF_1}{1 + K_e} + \frac{ECF_1}{(1 + K_e)^2} + \dots$$

Where:

$E_{MV}$  = market value of equity;  $ECF_1$  = cash flows to equity;  $K_e$  = cost of equity.

Solving the perpetuity yields:

$$E_{MV} = \frac{ECF_1}{1 + K_e}$$

Assuming that ROE times the book value of equity equals to the equity cash-flows, the perpetuity can be written as:

$$E_{MV} = \frac{ROE * E_{BV}}{K_e}$$

Since  $ROE = \frac{Net\ income}{E_{BV}}$ , dividing both sides by  $E_{BV}$ , yields:

$$\frac{Market\ value}{Book\ value} = \frac{ROE}{K_e} \rightarrow Market\ value = \frac{ROE * Book\ value}{K_e}$$

Where:  $E_{BV}$  = book value of equity.

The main advantage of the equity valuation model is that it allows for the linkage between the ROE metric and the market value of the firm; it facilitates the understanding of the connection between improved profitability ratios and their impact upon shareholder value.

In addition to the equity valuation model, a simplistic DCF valuation model will help one understand how changes in capital structures and WACC can create shareholder value, assuming the first CF grows at a constant rate:

$$DCF = \frac{CF_1}{1 + WACC} + \frac{CF_1 * (1 + g)}{(1 + WACC)^2} + \frac{CF_1 * (1 + g)^2}{(1 + WACC)^3} \dots$$

Solving for the perpetuity yields:

$$DCF = \frac{CF_1}{WACC - g}$$

Where  $g = \text{constant growth}$ .

The simplistic DCF model illustrated above provides two useful facts:

- Increasing CFs and  $g$ , increases DCF;
- Reducing WACC increases DCF.

The main body often refers to how improving cash flow creates shareholder value or how WACC impacts upon the valuation of the firm.

With regards to the firms' growth, this is higher during the CAP. Expanding CAP, therefore, implies higher growth for a longer time span, creating value for shareholders within a two-stage DCF framework.

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## RELATIONSHIP BETWEEN STOCK MARKET VOLATILITY AND EXCHANGE RATE: A STUDY OF KSE

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**Abstract:** This paper guides us about the impact of Exchange rate Pakistan rupee in terms of US Dollar and KSE 100 index. We take the data of period comprises from January 01, 2006 to December 31, 2012 excluding year 2013 due to general elections of Pakistan, which held in May 2013 after which stock market took a boom. We applied different statistical tools to analyze the obtained data. We also analyze the causal relationship between both the time series. First of all we carry out normality test and found that both PKR-USD exchange rate and KSE 100 index are non-normally distributed. We conclude through unit root test that both series are stationary at the level form. Furthermore we found negative correlation in between KSE100 indices and USD-PKR exchange rate though very weak relationship exists. Furthermore we check for causal relationship between two time series through Granger Causal Test and found that bidirectional relationship exists between KSE 100 indices and Exchange Rate.

**Keywords:** KSE 100 (Karachi Stock Market Index 100), Exchange Rate, Normality Test, Unit Root Test, Correlation, Granger Causality Test.

### 1. INTRODUCTION

The Karachi Stock Exchange or KSE is located in Karachi. KSE 100 index was introduced on November 01, 1991 and it represent the whole economy of Pakistan because it is comprises of 86% of market capitalization. Whenever we want to measure Pakistani economy we generally accept KSE 100 index as an indicator.

We can explain currency exchange rate as if we take currencies of two different countries and compare one of them in terms of other country currency. Like in this paper we took USD of US against PKR of Pakistan, talking about PKR in terms of USD we need around PKR100/- to get USD 1/-. This ratio of one currency in terms of other currency is known as exchange rate. Talking about stock market fluctuations, exchange rate also fluctuates over a period of time.

Factors like exchange rate, interest rate, GDP of a country, employment rate, and companies business listed on stock market, state bank policies and other information can influence stock market, or causes stock market to fluctuate (Kurjhara, 2006). And Index is comprises of those stock prices. In general if we talk about the effect of exchange rate on economy of a country (KSE index) or their relationship, by increase in exchange rate importers will get positive impact and a negative effect on exporters. As exporter are

unable to compete or we can say meet international trade standard and importers get benefit because they can compete better in local or domestic market as compared to others which results in increase of their profitability (Yau and Nieh,2006).The stock market and exchange rate relationship and individually both variable get importance because they directly affect economy of any country. Economist and investors utilize both variable to predict future prices and etc (Kim, 2003). International competitiveness of firms directly get influenced by change in exchange rate on either way if they import inputs or exports output (Joseph, 2002).

After the formation of new government in May 2013 and as now they unleashed their economic policies of which a major part is multinational organization investing in country. Multinational companies always take care of exchange rate as it directly affects their profitability. Recently Finance Minister Mr. Ishaq Dar emphasizes on controlling devaluing currency of Pakistan in order to get economy back on track. The exchange rate relationship with economy (KSE) is very important but in current scenario of country it becomes more concern for economist. In this paper we try to analyze the impact of exchange rate on economy and its magnitude and direction. We didn't include year 2013 because due to formation of new government and huge expectations of nation stock market record a boom period.

## **2. LITERATURE REVIEW**

Some studies show significant positive relationship between the two markets (Cheung and Westermann, 2000). According to (Solnik, 2000) he analyzed stock market (KSE100) and home currency and found correlation between, significant negative correlations. There are studies which have found weak or no relationship between the two markets (Bodart&Reding, 1999).

When we studied Agarwal G., Kumar S., &Sirivastava A. 2005, they examined Nifty returns with Indian rupees-US Dollar exchange rate. They went for causal relationship between Nifty returns and Indian-USD exchange rate. Daily closing prices of stock and daily exchange rate have been taken by them. Then they converted them into natural logarithm. They found data non normal, furthermore they tested for stationarity of data and found the two time series stationary at level. After confirming for stationary they examined correlation and found weak negative correlation between two variables. To check the causal relationship authors used Granger Causality Test. They come up with result that there is cause and effect relationship between Nifty returns and exchange rate which is running for former to later (Agarwal G., Kumar S., & Sirivastava A. 2005).

Whenever exchange rate of any currency increases it have negative impact on local/domestic markets because it reduces the advantage of export for that particular country (Yucel and Kurt, 2003). Vice versa if a country is dominated by its imports and exchange rate of that country increases then it may have positive impact on country economy, stock market (Adjasi et.al; 2008).

Different researchers used multiple aspects to figure out if there is any relationship exists between stock market return and exchange rate. Booth (1997) and Chan (2003) highlighted few significant factors of economy which can impact stock

market. According to them exchange rate, money supply, currency control by state bank, foreign exchange reserves and interest rate. Brown (1990) and Mukherjee in (1995) used different factors i.e. inflation, money supply, government bonds and call money rates to figure out the if there is any bond exists between stock market and macroeconomic variables.

According to Maysamhi-Koh (2000), after studying three variables exchange rate, interest rate and stock market he discovered bond between them. According to them both interest rate and exchange rate effect stock market returns. In 1992 Oskoe and Sorabian concluded that there is bidirectional relationship exists between two variables by using cointegration test for the first time. But there was no long term relationship found by researchers. Abdallah and Murinde (1997) plotted their research for Pakistan, India, Korea and Philippines and concluded that except Philippine other countries Exchange rate granger causes stock market while Philippines stock market granger causes exchange rate.

Nieh and Lie (2001) studied G7 countries for relationship between stock market and exchange rate. According to their results by using data from 1993 to 1999 there is no long run chemistry or relationship exists between two variables. Though short run significant relationship exists between few G7 countries with USA having no relationship in between their stock market and exchange rate. In year 2006 Vygodina and Ozair carried out same research by taking USA data. Ozair (2006) found no co integration and no causal relationship between two under studied variables.

To draw a verdict for relationship between stock market and exchange rate from existing literature is not possible. There was every possible outcome from empirical studies of different researchers. Some showed relationship and some does not, according to few there is causal relationship and for some there were nothing, few concluded that unidirectional relationship exists and few went for bidirectional. So this study tries to examine the stock market of Pakistan (KSE) and exchange rate and we will try to conclude if there is any causal relationship exists between two variables or not.

### **3. DATA AND METHODOLOGY**

In this article we tried to study different dynamics and bonds between stock market returns and exchange rate. And for this purpose we study KSE 100 index and US Dollar and Pakistan Rupee exchange rate. We kept frequency of data at daily level because daily returns are more accurate and can capture better results between KSE 100 index and USD-PKR exchange rate. The time span of current study is from January 01, 2006 to December 31, 2012. And data consists of two variables, 05 days in a week closing prices of KSE100 index and 05 days in a week ratio of USD-PKR. Data has been taken from Oanda, the currency site and Yahoo Finance, to get stock market return. Natural logarithm of both the time series taken before testing several statistical tests and tools. And natural logarithm has been taken as:

Return =  $\ln CP(t) / CP(t-1) \dots$  whereas cp (t) is the closing price of t<sup>th</sup> day.



Exchange =  $\ln ER(t) / ER(t-1) \dots$  whereas ER (t) is the exchange rate of  $t^{\text{th}}$  day

After reviewing the existing literature and to get the objective of current study following hypothesis have been formulated:

**Hypothesis 1:** KSE100 index and Exchange Rate (USD-PKR) are not normally distributed.

**Hypothesis 2:** KSE100 index and Exchange Rate (USD-PKR) both series are non-stationary (unit root exists).

**Hypothesis 3:** There is Correlation in between KSE 100 index and Exchange Rate (USD-PKR).

**Hypothesis 4:** There is no cause and effect relationship or bond exists between two studied variables.

To check the above mentioned hypothesis we run different statistical tools and tests on software like SPSS version 16 for windows and EViews version 7. To analyze the relationship between KSE100 index and exchange rate we took following tests:

**a. Normality Test:**

Following (Gujarati, 2003) we used the Jarque-Bera (JB) test to check the normality of data. We compute descriptive statistics of individual variables to check normality. We take values of skewness and kurtosis from descriptive statistics. The scale of normally distributed data is that its skewness must be equal to 0 and kurtosis equals to 3. So we assume our null hypothesis that our variable have  $S=0$  and  $K=3$ , and in case of rejection of null hypothesis we derive that variables are not normally distributed.

$$JB = n [S^2 / 6 + (K-3)^2 / 24]$$

Here  $n$  denotes no. of observations,  $s$  is skewness and  $k$  is kurtosis.

**b. Unit Root Test:**

To check whether a time series is stationary or non-stationary we used unit root test. Any data series is said to be stationary if its mean and variance remain constant over a period of time. After undertaking unit root we further confirm stationary of KSE 100 index and Exchange rate by carrying out ADF Test.

**c. Augmented Dickey-Fuller (ADF) Test:**

Augmented Dickey-Fuller test is a modified version of Dickey Fuller Test. In order to statistically check whether our time series variables are stationary or not we used Augmented Dickey Fuller test. In this test we compare the T-Stat with critical value of studied variable to determine stationary in its time series.

**a. Correlation Test:**

Then we carried out correlation test through Eviews version 7 in order to check whether there is any correlation, positive or negative, weaker or stronger exists between KSE100 index and Exchange Rate or not.

**b. Granger Causality Test:**

After presence of correlation we wanted to check whether any causal relationship exists between KSE100 index and Exchange Rate or not. To check the causal relationship we carried out Granger Causality Test by using EViews. According to the concept of Granger's causality test (1969, 1988), a time series  $x$  is said to be causing  $y$  when past values of  $x$  can predict future values of  $y$ . In this case we can say that  $x$  granger causing  $y$ . What we used to say generally about cause and effect relationship is known as Granger Cause Relationship in statistics.

As we know that our time series of KSE100 index and exchange rates are stationary so we can carry out Granger Cause Test.

**4. EMPIRICAL ANALYSIS**

As we discussed five steps in Methodology, the empirical analysis of carried out tests are follows:

First of all we checked our variables for normality test. This test was conducted with the help of JarqueBera concept. We individually compute descriptive statistics of both variables by using Eviews version 7. From there we can easily check for normality test by taking kurtosis and skewness values. Any variable to have normally distributed must have skewness value equals to 0 and kurtosis equals to 3. In our case skewness values of KSE100 index and exchange rate are -1.104176 and 0.271766 respectively whereas kurtosis values of tested variables are 13.35747 and 13.727 respectively. Descriptive statistics of both the variables are given below under Table 1.1. Hence we can conclude that our variables, KSE100 index and exchange rate are non-normally distributed.

After affirming the non normal distribution of our variables, we wanted to know if our both time series are stationary or not. There are two ways by which we checked stationarity of time series. The first and simplest method to check stationarity of any time series is to draw conclusion from its graph. In this case we plotted normal log values of KSE100 index and Exchange rate on line plot graph by using Eviews. By visual conclusion we can say that our time series are stationary, because we observe same trend in mean and variance of variables. The graphs for both the variables are shown in Fig 1.1 and Fig 1.2. As we can see there is not much fluctuations shown in graphs so we can say that both the series are stationary at level.

After confirming through simple graph method we also checked stationarity of our time series data i.e. KSE100 index and Exchange rate through Augmented Dickey-Fuller Test. We individually run Augmented Dickey Fuller test for KSE 100 index and

Exchange rate by using E-views software. The results of ADF test are shown under against Table 1.2.1 for KSE100 and 1.2.2 for Exchange rate. Our null hypothesis for this test is that unit root exists in KSE100 series and exchange rate series but if we compare results of test our T Stats for KSE100 and exchange rates are -40.37542 and -21.39268 which are considerably less than critical value of -3.433335 at significant level 1%. So we can reject our null hypothesis and conclude that our time series are stationary at level.

Now it comes the step of Correlation between KSE index and Exchange Rate. Correlation result is given under Table 1.3 which shows negative correlation between two variables having value -.017. This is obviously very weak relationship between KSE 100 index and Exchange rate. Now it comes the question of casual relationship between two time series. To check the direction of this relationship we carried out Granger Causal Test. Granger Causality Test was conducted. The output of granger causality test is given under against table 1.4. We can easily reject our both hypothesis because according to the obtained values of F Stats 0.63367 and 0.61595 respectively for KSE100 index and Exchange rate both are well above the critical value. We can conclude that there is a two way cause and effect relationship between KSE100 index and exchange rate. So the causality is bidirectional.

## **5. CONCLUSION**

We empirically examine the dynamics between exchange rate and KSE index in terms of their relationship and causality between them. First of all we converted the closing values into natural logarithm to get the log values. After getting two natural logarithm, time series we checked for normality of data by using Jarque-Bera test. After confirming the non normal distribution of data we went for stationary or non stationary time series. For checking and confirming stationarity we used two methods; first we used simple graph method and then Augmented Dicket-Fuller Test. Both test showed stationarity of time series data at level. The results of coefficient of correlations tells us that there is negative relationship exists between KSE100 index and PKR-USD exchange rate. After affirming correlation we tested for cause and effect relationship by implementing Granger Causality Test which proved bidirectional causal relationship between KSE index and exchange rate.

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**Appendix**

**Table 1.1 Descriptive Statistics**

	KSE	EXCHANGE
Mean	0.000271	0.000228
Median	0.000280	0.000000
Maximum	0.082547	0.058747
Minimum	-0.164302	-0.044875
Std. Dev.	0.014436	0.005674
Skewness	-1.104176	0.271766
Kurtosis	13.35747	13.72317
Jarque-Bera	9631.232	9899.833
Probability	0.000000	0.000000
Sum	0.558345	0.470004
Sum Sq. Dev.	0.429271	0.066319
Observations	2061	2061

**Tale 1.2.1 ADF Test KSE**

Null Hypothesis: KSE has a unit root  
 Exogenous: Constant  
 Lag Length: 0 (Automatic - based on SIC, maxlag=25)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-40.37542	0.0000
Test critical values:		
1% level	-3.433326	
5% level	-2.862741	
10% level	-2.567455	

\*MacKinnon (1996) one-sided p-values.  
 Augmented Dickey-Fuller Test Equation  
 Dependent Variable: D(KSE)

Method: Least Squares  
 Date: 02/10/14 Time: 00:02  
 Sample (adjusted): 2 2061  
 Included observations: 2060 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
KSE(-1)	-0.883897	0.021892	-40.37542	0.0000
C	0.000235	0.000316	0.743035	0.4575
R-squared	0.442000	Mean dependent var		-4.72E-06
Adjusted R-squared	0.441729	S.D. dependent var		0.019197
S.E. of regression	0.014343	Akaike info criterion		-5.650092
Sum squared resid	0.423395	Schwarz criterion		-5.644625
Log likelihood	5821.594	Hannan-Quinn criter.		-5.648087
F-statistic	1630.174	Durbin-Watson stat		2.006878
Prob(F-statistic)	0.000000			

**Table 1.2.2 ADF Test Exchange Rate:**

Null Hypothesis: EXCHANGE has a unit root  
 Exogenous: Constant  
 Lag Length: 6 (Automatic - based on SIC, maxlag=25)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-21.39268	0.0000
Test critical values:		
1% level	-3.433335	
5% level	-2.862745	
10% level	-2.567458	

\*MacKinnon (1996) one-sided p-values.

Augmented Dickey-Fuller Test Equation  
 Dependent Variable: D(EXCHANGE)  
 Method: Least Squares  
 Date: 02/10/14 Time: 00:05  
 Sample (adjusted): 8 2061  
 Included observations: 2054 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXCHANGE(-1)	-1.997136	0.093356	-21.39268	0.0000
D(EXCHANGE(-1))	0.680064	0.084157	8.080880	0.0000
D(EXCHANGE(-2))	0.475891	0.073255	6.496325	0.0000
D(EXCHANGE(-3))	0.302228	0.061728	4.896132	0.0000
D(EXCHANGE(-4))	0.151142	0.049510	3.052792	0.0023
D(EXCHANGE(-5))	0.003708	0.036504	0.101581	0.9191
D(EXCHANGE(-6))	-0.085450	0.022043	-3.876554	0.0001
C	0.000458	0.000119	3.846346	0.0001

R-squared	0.649013	Mean dependent var	3.99E-06
Adjusted R-squared	0.647812	S.D. dependent var	0.008940
S.E. of regression	0.005306	Akaike info criterion	-7.636199
Sum squared resid	0.057595	Schwarz criterion	-7.614281
Log likelihood	7850.376	Hannan-Quinn criter.	-7.628162
F-statistic	540.4670	Durbin-Watson stat	1.999088
Prob(F-statistic)	0.000000		

**Table 1.3.**

**Correlations**

		EXCHANGE	KSE
EXCHANGE	Pearson Correlation	1	-.017
	Sig. (2-tailed)		.429
	N	2060	2060
KSE	Pearson Correlation	-.017	1
	Sig. (2-tailed)	.429	
	N	2060	2060

**Table 1.4 Granger Causality Test:**

Pairwise Granger Causality Tests

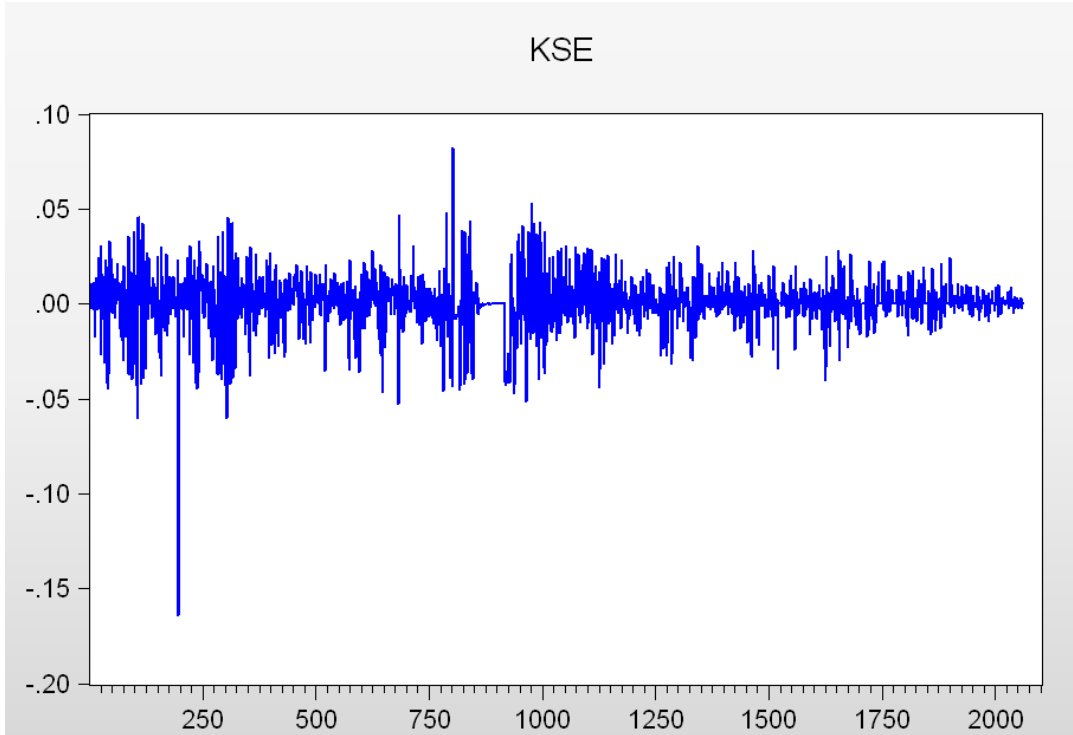
Date: 02/09/14 Time: 15:49

Sample: 1 5000

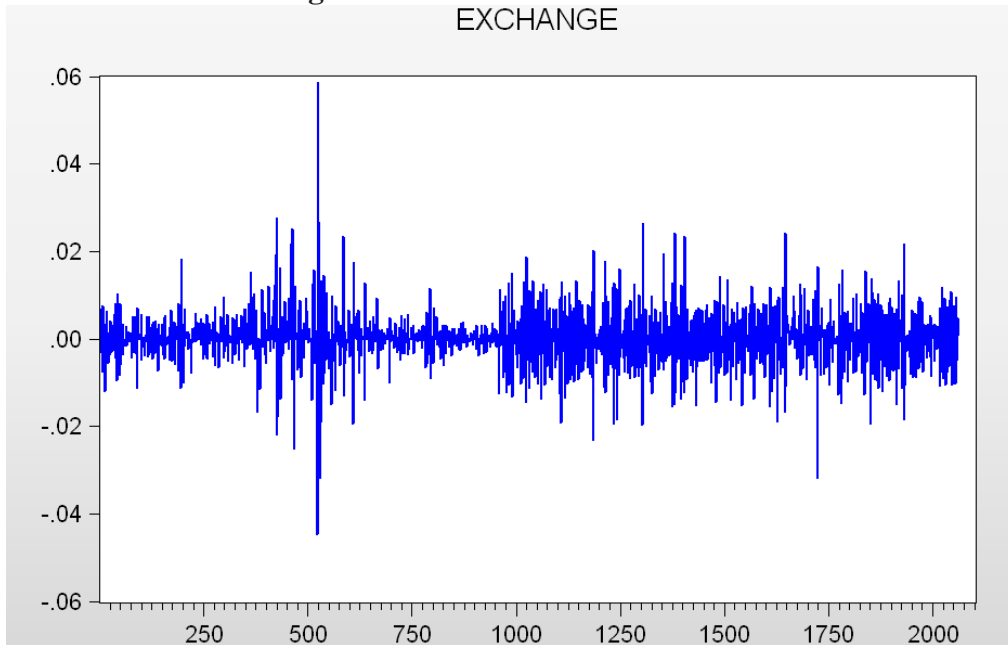
Lags: 1

Null Hypothesis:	Obs	F-Statistic	Prob.
KSE100 does not Granger Cause FX	2061	0.63367	0.4261
FX does not Granger Cause KSE100	0.61595	0.4326	

**Figure 1.1 Line Plot of KSE Return**



**Fig 1.2 Line Plot of Exchange Rate**



## THE ATTRACTIVENESS OF ROMANIA FOR VENTURE CAPITAL AND PRIVATE EQUITY INVESTORS

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**Abstract:** *This report examines Romania's attractiveness for investors in terms of each of the six key drivers suggested by Groh, et al (2010) study: Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture. The findings indicate that final position in Groh's - The attractiveness of 27 European countries for Venture Capital and private Equity investors - top is justified. Nevertheless, the Romanian decision-makers managed, through considerable efforts, by means of various programs developed together with several European and international institutions, to create certain opportunities of improvement of the Romanian entrepreneurial environment and stimulation of innovation. This paper has certain limits; therefore the future research in this field might lead to a more thorough analysis of the difficulties that Romania faces in attracting private equity investors. The methods employed have in view the results from the literature in this field regarding the research issue, the US Commercial Service's recommendations (Doing Business in Romania: 2013) and various statistics. Competent opinions in this field have been analyzed: investors, authorities, organizations, institutions.*

**Keywords:** *Private Equity, Venture Capital*

### 1. INTRODUCTION

The largest, most prominent, and most active institutional investors in the Venture Capital (VC) and VC/(PE) asset class are located in the US. This certainly contributes to the dominant role of the US Venture Capital and Private Equity market. The US is followed by United Kingdom. By comparison, the countries of the Central and Eastern Europe (CEE) represented only 2% entire capital allocated in the European economy of the 2009 year.

A brief analysis of the state of affairs of the Romanian entrepreneurial environment shows that banks and families are the main financing sources for the ordinary Romanian entrepreneur. Access to European private equity funds or capital market is considered sources of capital by company owners. But since the economic crisis, banks are selected more carefully the customers for the credit granting procedures and seek to avoid financing any risky business, as most of start-ups are considered.

“We are dealing with a new environment; the appetite for risk has reached another level. The banks are not investment funds, business laboratories or European institutions which subsidize entrepreneurs. At present the level of risk of the business it subsidises is the most important factor taken into account by a bank when deciding whether to grant a



credit or not”, declared Sorin Mititelu (2013), chief executive at BCR retail segments, with the occasion of the third edition of the Conference “Entrepreneur, looking for financing” organized by Wall-Street.ro, with the support of EY, Enterprise Investors and Erste asset Management. Mititelu (2013) also pointed out that entrepreneurs should not expect to get financing from a bank because they have a business idea. “There are certain financing products for start-up companies but they are based on the business’ assets, not on the business itself. You can’t get financing just because you have an idea. For this reason such companies manage to get financing only after the first year of activity, not at the beginning, and even so they receive only small amounts of money.” Sorin Mititelu (2013) concluded that the bank credit can no longer be considered the only tool for economic growth, as it was the case prior to the economic crisis.

The necessity to compensate the credit volume reduction forced companies to identify innovative financing solutions. Private equity is a financing alternative.

Under these circumstances, the research question of this paper is: Why is Romania Venture Capital (VC) and Private Equity (PE) activity close to zero?

The starting point in this report is the study by Alexander Peter Groh, Heinrich von Liechtenstein, Karsten Lieser (2010). They identified six main criteria that ultimately determine the attractiveness of an individual country for VC/PE investments: Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture and compared the attractiveness of 27 European countries (the EU-25 with Estonia, Latvia and Lithuania grouped as “The Baltic States”, plus Switzerland and Norway). In this first step, the 42 data series are combined into one single index to develop an attractiveness ranking of the European countries. The index structure allows for benchmarking, and a report showing the results for the first-ranked (United Kingdom), for the largest European (Germany), and for the last-ranked (Romania) countries.

Groh, et al (2010) study shows that “The top performers are the United Kingdom, Ireland, Denmark, Sweden and Norway. Germany, the largest European economy, ranks slightly above the average, while other large economies, like as France, Italy, and Spain have rather disappointing scores. Bulgaria, Greece, Slovakia, and are the least attractive European countries for VC and PE investors.”

The capital market turns out to be the most distinguishing feature between the UK and the other European countries. The UK is on par or only slightly better than the EU-25 average with respect to Economic Activity, Entrepreneurial Culture, and Human and Social Environment. It has a small disadvantage regarding Taxation. However, this disadvantage is more than compensated by Investor Protection and Corporate Governance and Depth of Capital Market.

Another finding of Groh, et al (2010) study is “..... Romania's scores regarding innovations are disappointing.”

Some countries attract investors with low corporate taxes. The Nordic countries are especially strong in Entrepreneurial Culture. The United Kingdom clearly dominates all the other countries regarding the Investor Protection and Corporate Governance, and Depth of Capital Markets. While their taxation score is below the European average, and the other criteria are on a par.

**The aim of the paper is** to thoroughly study the results to investigate the attractiveness of **Romania** for Venture Capital and Private Equity investors. The six main criteria identified by Alexander Peter Groh, Heinrich von Liechtenstein, Karsten Lieser (2010): Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture.

This report examines Romania’s attractiveness for investors in terms of each of the six key drivers suggested by Groh, et al (2010) study.

**Research questions:**

- How can Romania attract venture capital/private equity investors?
- Can Romania improve the classifications, the results of certain researchers regarding the level of attractiveness for investors?

Following the analysis of certain reports conducted by national, European, and world organizations, the markers of the criteria of Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture had been summarized in the table below:

**Table1. List of row data and their sources**

Key drivers	Markers	Accounting period					Source
		2008	2009	2010	2011	The latest data	
Economic Activity	Gross domestic product (€/capita)	6499	5509	5792			Statistical directory of Romania 2012
	Gross domestic product (% growth 2011-12)					0.4	World view
	Gross domestic product (per capita % growth 2011-12)					0.7	World view
	annual CPI inflation rate					4.95% (2012)	The report published by BNR -February 2013
	Unemployment rate	5.8%	6.9%	7.3%	7.4%	6.9%	Statistical directory of Romania 2012
	Foreign direct investment U.S. FDI In Romania (U.S. \$ Millions)		1,424	1,490	1,434		Doing Business.p.7
Key drivers	Markers	Accounting period					Source
		2008	2009	2010	2011	The latest data	
Depth of capital market	Stock market capitalization (% of GDP)					9.4 (2012)	World Development Indicators 2014

							(p.8)
	Debt and credit market - Domestic Credit provided by Financial sector (% of GDP)					54.3 (2012)	World Development Indicators 2014 (p.8) States and markets
	VC/PE activity (funds invested in % of GDP)					0.033	EVCA Central and Eastern Europe Statistics 2012
	VC/PE activity Annual investments in the Romania country (in € million)	294	221	119	66	27 (2012)	EVCA Central and Eastern Europe Statistics 2012
	VC/PE activity Number of companies receiving private equity investments	29	23	17	14	8 (2012)	
Taxation	Tax revenue collected by central government( % of GDP)					18.8 (2012)	World Development Indicators 2014 (p.8)
Entrepreneurial Culture	6.4. Enterprise stock activity Business entry density (per 1,000 people ages 15-64 <b>2012</b> )					4.12	World Development Indicators 2014 (p.8)
	Time required to start a business (days)					9 (june 2013)	World Development Indicators 2014

## 2. ROMANIA, A MARKET WITH POTENTIAL?

Following the 1989 revolution that ended communist rule, Romania's economy began a transition from state control. The country has worked to create a legal framework consistent with a market economy and investment promotion; it became a member of the European Union (EU) in 2007. Romania has a bilateral investment treaty with United States. Favored areas for U.S. investment include information technology and telecommunications, energy, services, manufacturing, and consumer products. Major Romanian exports to the United States include chemicals, steel and metallic items, plastics and rubber items, and clothing.

Romania is a market with potential, a strategic location, and a business environment that offers opportunities amidst some risks. To successfully seize the business opportunities while reducing those risks requires a careful evaluation of the market, patience, and commitment.

The poor condition of Romania's physical infrastructure -- including roads, rail, airports, and water and wastewater systems -- **affects business costs**, productivity, public safety, and the country's ability **to attract foreign investment**.

The country's connections to the rest of the EU's transportation infrastructure are underdeveloped, keeping Romania from realizing its full **potential for new investment**, trade, and tourism. Romania's membership in the European Union is one of its most persuasive advantages. As a member, Romania offers a sizable domestic market and a comparatively low-cost foothold for accessing the EU market as a whole. Most of the foreign investment in retail, and some manufacturing, have been based on these two elements. In addition to this larger market, Romania's membership makes it eligible for billions of euro in EU grant funding. The set of financial supports known as structural funds are available to support investment in physical infrastructure and many other types of projects.

Romania's location in Southeast Europe shortens the distance for export sales to areas such as Turkey, the Balkans, the Middle East, and markets such as Ukraine and Russia. Several foreign manufacturers have moved into Romania, despite its economic recession, for this reason. Romania's powerful concentration of high-end software development and services is almost entirely export driven, serving regional or global markets.

Romania's stage of development and its requirement to conform to the standards of the EU drive many of the business opportunities for U.S. firms. The U.S. Commercial Service (Doing Business in Romania: 2013 Country Commercial Guide for U.S. Companies) sees the best prospects for sales in the following sectors:

- Agricultural Machinery and Equipment
- Automotive Market
- Energy
- Environmental Technologies
- Healthcare
- Information Technology
- Packaging Equipment and Waste Recycling.

The EU has already allocated approximately €27.5 billion to Romania for projects in areas ranging from transport and rural development, to energy and the environment. However, **Romania has a dismal record of making full use of the funds**. One method for exploiting business opportunities is to find where one of the best prospect sectors intersects with the buyer's ability to access EU funding and arrange co-financing.

### **3. ECONOMIC ACTIVITY**

Actively seeking direct foreign investment, Romania offers 19 million consumers, a well-educated workforce at competitive cost, a strategic location, and abundant natural resources, making it an attractive marketplace.

Romania has taken steps to strengthen tax administration, enhance transparency, and create legal means to resolve contract disputes expeditiously. Mergers and acquisitions are subject to review by the Competition Council. Romania's accession to the

European Union (EU) on January 1, 2007 has helped solidify institutional reform. However, judicial, legislative, and regulatory unpredictability continue to negatively affect the investment climate.

About macroeconomics indicators

According to the **National Bank of Romania – NBR’s Inflation Report** published in February 2013, at end-2012, the **annual CPI inflation rate** stood at 4.95 %, down 0.38 percentage points from end-Q3. This places the inflation rate 0.95 percentage points above the upper limit of the target band set for year-end, but marginally below the NBR forecast of 5.1 % in the November 2012 Inflation Report. The difference from the previous forecast can be accounted for by steeper-than-projected decelerations in the dynamics of volatile food prices and fuel prices, partly offset by slightly faster rises in administered prices and tobacco product prices.

Unemployment officially stood at 6.9% in October 2012, representing 695,000 people, slightly lower than the 7.3% reported in October 2011. Underemployment is also a significant problem.

Foreign Direct Investment Statistics

According to data provided by the National Office of the Trade Registry, the cumulative net stock of FDI from January 1990 to October 2012 totaled USD 46.67 billion, about 24.5% of Romania’s GDP. Romanian direct investments abroad from January to September 2012 totaled USD 201.3 million.

**Table 2 Major sectors for foreign investment**

Industry	Major Companies
Automobile and automotive components	Renault, Daimler Benz, Ford, Siemens, Continental, Alcoa, Delphi Packard, Johnson Controls, Honeywell Garrett, Michelin, Pirelli
Banking and finance	Citibank, Société Générale, MetLife, Royal Bank of Scotland, ING, Generali, Volksbank, Raiffeisen, Erste Bank, Unicredit, Alpha Bank, National Bank of Greece, Intesa Sanpaolo, Millenium Bank, Garanti Bank, Credit Agricole, Allianz, AXA
Information Technology	Hewlett Packard, Intel, Microsoft, Oracle, Cisco Systems, IBM
Telecommunications	Orange, OTE, Telesystem International Wireless Services, Vodafone, Liberty Media/UPC
Hotels	Hilton, Marriott, Best Western, Howard Johnson, Sofitel, Crowne Plaza, Accor, Ramada, Radisson
Industry	Major Companies
Manufacturing	Timken, General Electric, Cameron, LNM, Marco, Flextronics, Holcim, Lafarge, Heidelberg, Plexus, Lufkin, Toro
Consumer products	Procter and Gamble, Unilever, Henkel, Coca-Cola, PepsiCo, Parmalat, Danone, Smithfield Foods
Retail chains	Metro, Delhaize, Dm Drogerie, Carrefour, Cora, Billa, Selgros, Auchan, Kaufland

Source: <http://www.state.gov/e/eb/rls/othr/ics/2013/204719.htm>

**Table 3 The largest amounts of investment in Romania come from the following countries**

Country	Total (billions USD)	% of Total	Industries
Netherlands	9.46	20.4	IT, banking, insurance, consumer products, food

Austria	6.52	14.0	banking, insurance, construction materials
Germany	5.69	12.2	insurance, food, machine construction, chemicals, cement
France	3.16	3.12	food, IT, automotive, manufacturing, cement, agriculture, banking, insurance, hypermarkets
Cyprus	2.78	6.0	banking, retail, services
Greece	2.41	5.2	banking, food, consumer products, retail
Italy	2.26	4.9	footwear, textiles, food, banking, insurance
Spain	1.41	3.0	manufacturing, consumer products, banking
Panama	1.36	2.9	services
Switzerland	1.30	2.8	food, manufacturing, consumer products
Luxemburg	1.25	2.41	retail, constructions, food
U.S.	1.06	2.3	IT, automotive, banking, insurance, hospitality, manufacturing, consumer products
U.K.	1.03	2.2	tobacco, pharmaceuticals, banking

Source: <http://www.state.gov/e/eb/rls/othr/ics/2013/204719.htm>

The strategies used by the U.S. companies in the Romanian market that can be considered good practice are the following:

U.S. companies establish a local presence in the Romanian market in several ways. Many sign distribution agreements with local Romanian firms, which bring experience, expertise and access to the partnerships.

Other firms cover Romania through a regional distributor or sales representative.

Still other American companies choose Romania as a base for manufacturing or distribution, and establish a subsidiary directly in the country.

The choice of strategy depends on the industry, the nature of the customer (government buyer or retail trade), and the business case. Companies relying on regular access to government authorities, or which have a significant service component, generally seek to establish a subsidiary, sometimes through acquisitions.

Investments involving the public authorities (central government ministries, county governments, or city administrations) are generally more complicated than investments or joint ventures with private Romanian companies. Large deals involving the government – particularly public-private partnerships and privatizations – can become stymied by vested political and economic interests, or bogged down due to a lack of coordination between government ministries. Although the Public-Private Partnership (PPP) Law was revised in 2011 to remove anticompetitive provisions, the law still lacks clear terms on risk sharing, PPP project management, and investment recovery. As a result, investor interest in PPPs has been weak.

The experts from Romanian Franchise Association believe that Romanian investors have become more cautious in deciding how to spend money, in the context of a generalized lack of liquidity. On the other hand, franchisors themselves have become more conciliatory and more willing to negotiate certain clauses in franchise contracts.

According to C.N.V.M. Register, on December 31, 2011, 1,053 out of the 1,200 investment companies registered are from Great Britain, 17 from Holland, 47 from Cyprus, ten from Norway, ten from Bulgaria, seven from France, three from the Czech Republic, four from Austria, six from Germany, three from Gibraltar, one from Poland,

three from Slovakia, two from Belgium, one from Denmark, one from Finland, three from Greece, 13 from Ireland, two from Italy, five from Luxembourg, three from Malta, and three from Spain.

#### **VC/PE activity**

The Romanian private equity market is in an incipient development stage. The statistical accounts of EVCA Ukraine (€43m) and Romania (€27m) showed lower levels of investment value in 2012 compared to 2011, with decreases of 32% and 60% respectively, due to less capital being invested in venture and growth deals. While the number of companies receiving private equity investments in the CEE region in 2012 compared to 2011 was driven almost entirely by a higher number of companies receiving venture financing, in Romania the trend is decreasing (-6).

Romania has the opportunity to improve these statistics. The European Investment Fund (EIU) allocated through the JEREMIE enterprise 10 million Euros for the Catalyst Romania investment fund. Managed by a local team belonging to 3TS Capital partners and with a target-capital of 30 million Euros, Catalyst will finance, through investments of 200,000-2 million Euros, the local medium and small companies whose activities are connected to technology, internet, media, communication and services. Catalyst will provide the business expertise and the necessary financing in order to support the growth and development of medium and small companies whose activities are related to innovation. The JEREMIE Romania enterprise led to the creation of several other financial tools for the medium and small companies which are currently active: Portfolio warranty (available through Raiffeisen Bank, BCR and Unicredit Tirioc Bank) which already enabled the grant of over 2,000 credits of over 180 million Euros with significantly diminished warranty requirements for medium and small companies,

The new lending tool with grant-aided interest through which the medium and small companies could access loans for investments and working capital of 120 million Euros, benefiting from a significantly low interest compared to the market level and diminished warranty requirements.

#### **Taxation**

According to the Doing Business report, high corporate tax rates are negatively associated with corporate investment and entrepreneurship.

In July 2010, Romania increased the standard value added tax (VAT) rate from 19% to 24%. Investors should be aware that due to budget constraints, the GOR has regularly delayed VAT reimbursements owed to foreign companies for extended periods of time, especially if the amount to be reimbursed is large. The country is fully integrated with EU customs, excise tax, and VAT transfer systems.

#### **Human and Social Environment**

##### **Bribing and corruption index**

The public sector is administered by a deep and inefficient bureaucracy, where few decisions can be made without several layers of approval. Even when fully authorized by their andantes, many Romanian government agencies seek a higher level of political approval, even informally, before making decisions. This phenomenon creates an environment in which fraud and corruption can occur.

There are signs, however, that the Romanian government is starting to take the EU's concerns about corruption seriously.

With the EU's criticism of lack of corruption law enforcement, the Romanian government has begun taking steps to improve the business environment.

### **Corruption**

Despite some improvement, corruption remains a serious problem. Romania was the fourth-lowest ranked among EU member states in Transparency International's 2012 Corruption Perception Index,

U.S. investors have complained of both government and business corruption in Romania, with the customs service, municipal officials, and local financial authorities most frequently named. In some cases, demands for payoffs by low- to mid-level officials reach the point of harassment.

Romanian law and regulations contain provisions intended to prevent corruption, but enforcement is generally weak. Corruption is currently punishable under a variety of statutes in the penal code. Prison sentences are sometimes imposed, but powerful and influential individuals have often evaded prosecution or conviction.

### **Labor**

The quality of work of Romanian craftsmen, engineers, and software designers is well regarded by foreign managers. With appropriate on-the-job training, local labor performs well with new technologies and more exacting quality requirements.

In January 2012, after extensive negotiations between unions, employers associations, and the government, the national minimum wage was set at 700 RON (about USD 196) for full-time employment of 169.333 hours per month, or approximately 4.13 RON (USD 1.156) per hour.

According to EUROSTAT, 40% of Romania's population was at risk for poverty or social exclusion in 2011, second only to Bulgaria among the EU countries.

In May 2010, a new Labor Code was passed, giving employers more flexibility to evaluate employees based on performance, and significantly **relaxing hiring and firing procedures**. The revised Labor Code eliminated national collective labor contracts, extended the maximum duration of temporary contracts from 24 to 36 months, and introduced new collective layoff regulations.

### **Entrepreneurial Culture**

#### General innovativeness index

According to the statistics, Romania can be labeled as a "modest innovator", together with Latvia, Bulgaria and Lithuania (the first scoreboard regarding The European Union's efficiency in the field of research and innovation requested by The European Commission's Directorate-General for Enterprise and Industry).

A short review conducted in this study within the consortium which implements the project "The creation of the national strategy in the field of research, technological development and innovation" shows that the public investment in the field of research, development and innovation rapidly diminished to over one third of the 1% target and remained at or below this level over the past few years. Moreover, the even more ambitious goals regarding the research backing and development of economic actors



were never accomplished, as the private investment in C&D remained under 0,2% of the gross domestic income.

Some of Romania's results after the implementation of the Research and Innovation Strategy 2007-2013 are the increase of the international visibility of Romanian research results, the infrastructure improvement, and, to some extent, the increase of the number of young Ph.D.'s and researchers. This strategy did not manage to stimulate the development and innovation based on research, to operationalize mechanisms which could lead to the increase of the private environment's contribution to the research investment, to harmonize the concurrent tendencies with the European average in the field of human resources from CDI.

Romania is still below the European average in terms of intellectual property – the number of EPO licenses reaches only 1.5% of the European average. The rate of annual average increase of the intensity of research within the business environment was negative for 2000-2011, and the capacity of merchandising of the research and innovation results continued to be low. Therefore, Romania ranks 25 in UE27 top in terms of research dynamics within the private economic environment (EC, Research and Innovation performance in Romania, p. 4.).

#### **Starting a business**

In the analyses and reports conducted by U.S. Commercial Service, the investors are presented the following alternatives to join the Romanian market: distributor agreement, subsidiary, joint venture, or acquisition. A local business presence is essential to success in the Romanian market. Investors are advised to have solid knowledge of Romanian law and relationships with other service providers, such as banks and accountants. Selling through a local Romanian partner is a standard element of most entry strategies. Therefore, a U.S. company's success can hinge on identifying, qualifying, and selecting a partner with the resources and expertise to help accomplish its objectives.

#### **Transparency of the Regulatory System**

Cumbersome and non-transparent bureaucratic procedures are a major problem in Romania. Foreign investors point to the excessive time it takes to secure necessary zoning permits, environmental approvals, property titles, licenses, and utility hook-ups. National and local officials often cannot provide potential investors with clear and comprehensive information on what permits or approvals are needed, or how they are to be obtained. Set fees for certain services, such as utilities, may not exist or may be subject to "negotiation" with local authorities or utility providers. Romania enacted a "Silent Approval" Law in 2003 to reduce bureaucratic delays, but it has yet to be universally enforced or recognized. Additionally, regulations can change frequently, often without advance notice or proper analysis of the impact the changes will have on the economy and business environment. Modifications can also be vaguely worded and/or poorly explained. These unforeseen changes **add to the costs of doing business** and can alter an investor's business prospects overnight.

#### **4. CONCLUSION**

Romania faces numerous difficulties regarding the analyzed criteria: Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture.

The final position in Groh's "The attractiveness of 27 European countries for Venture Capital and private Equity investors" top is justified. Nevertheless, the Romanian decision-makers managed, through considerable efforts, by means of various programs developed together with several European and international institutions, to create certain opportunities of improvement of the Romanian entrepreneurial environment and stimulation of innovation.

This paper also seems to support that some investors saw Romania as a market with potential, a strategic location and a business environment that offers opportunities amidst some risks. Romania's location in Southeast Europe shortens the distance for export sales to areas such as Turkey, the Balkans, the Middle East, and markets such as Ukraine and Russia. Several foreign manufacturers have moved into Romania, despite its economic recession, for this reason. These investors adjusted their strategies to the conditions of this market and managed to develop profitable business in various fields.

This paper has certain limits; therefore the future research in this field might lead to a more thorough analysis of the difficulties that Romania faces in attracting private equity investors.

The methods employed have in view the results from the literature in this field regarding the research issue, the US Commercial Service's recommendations (Doing Business in Romania: 2013) and various statistics. Competent opinions in this field have been analyzed: investors, authorities, organizations, institutions.

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## **THE SITUATION OF LOCAL PUBLIC FINANCES IN THE EU – CORRELATIONS WITH SUSTAINABLE DEVELOPMENT**

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**Abstract** *In the new context of actual society, namely the knowledge society, based on the autonomy of local government, the management of "public affairs" must be achieved by adapting to new requirements, identifying new ways and tools to ensure sustainable development in territorial. It is therefore important to identify on the base of local financial autonomy the correlation between local public finances in the EU and sustainable development of local communities.*

**Keywords** *local public finances, local financial autonomy, sustainable development, European Union, knowledge society.*

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### **1. INTRODUCTION**

Local governments can be considered as one of the main pillars of the democratic states and the main "engine" of efficient implementation of sustainable development. At the same time, one of the main goals of knowledge societies is sustainability and for this goal it is imperative to develop strategies at all levels, inclusive local, where decisions promote the integration of knowledge taking into account the goals of economic prosperity.

The implementation of local sustainable development is closely linked to real possibilities of local authorities to support programs or measures for their administrative-territorial units. On this background, the size of local public financial resources and local public expenditures and their correlation with sustainable development becomes essential.

The aim of this research paper is to provide an empirical context correlation between local public finance and local sustainable development in the EU, highlighting the channel and specific bivalent reports which demonstrate local finances supports sustainable development and local sustainable development support sustainable financial autonomy. So, following this introduction, next section presents an overview of sustainable development. The empirical results are set out and discussed in the second section of this research, and finally we offer some conclusions.

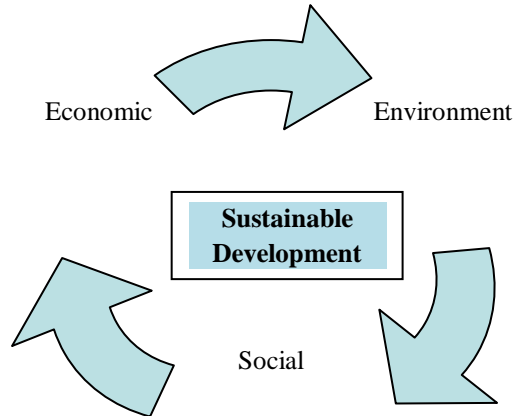
## **2. OVERVIEW OF SUSTAINABLE DEVELOPMENT**

One of the first definitions for sustainable development is “development that meets the needs of the present without compromising the ability of future generations to meet their own needs” (World Commission on Environment and Development, 1987). Sustainable development has been described as an „essentially contested concept” (Jacobs, 1999), and as a “discourse coalition” (Hajer, 1995). Relating to knowledge society, it can be seen as a “battlefield of knowledge” (Long, 1992) in which different participants disagree over who is entitled to produce the relevant knowledge for its interpretation, which knowledge is accessible and understandable for whom and how knowledge sharing and integration is to be negotiated (Bruckmeier, K.; Tovey, H., 2009).

The sustainable development was included in the Maastricht Treaty in 1997 as a political objective. In 2001, the European Council from Göteborg has adopted the Sustainable Development Strategy of the European Union, which was added an external dimension one year later (2002), to Barcelona. On 9 June 2006 the EU Council adopted “a renewed” Sustainable Development Strategy for an Enlarged Europe, with a unified and coherent strategic vision, having as objective the continuous improvement of quality of life for present and future generations through the creation of sustainable communities able to manage and use resources efficiently and to exploit the ecological and social innovation potential of economy to ensure prosperity, environmental protection and social cohesion. Thus, the concept of sustainable development is the result of an integrated approach to policy and decision makers, where the environmental protection and long-term economic growth are seen as complementary and interdependent.

Literature (Adams, 2006; Bruckmeier, K.; Tovey, H., 2009) establishes that the core of mainstream sustainability thinking has become the idea of three dimensions, environmental, social and economic sustainability. In this context, sustainable development is based on three strategic pillars: I) growth, II) social equity, III) a healthy environment.

**Figure 1 The dimensions of development sustainability**



*Source: computed by author after Adams (2006)*

Regarding how to measure the sustainable development, it was specifically mentioned to be drawn up a comprehensive set of Sustainable Development Indicators. EUROSTAT has developed a set of Sustainable Development Indicators, along with the help of a group of national experts known as the Task Force on Sustainable Development Indicators. A first set of indicators was adopted by the Commission in 2005 and then updated in 2007.

### **3. EMPIRICAL CORRELATION BETWEEN THE STATUS OF LOCAL PUBLIC FINANCES AND SUSTAINABLE DEVELOPMENT IN THE EU COUNTRIES**

In 2011, the total revenue of the European local public sector was unstable compared with 2010 (-0.2% in volume) to €1,48bn, i.e. 11.7% of GDP and 26.3% of public revenue. However, local tax revenue jumped markedly in 2011 compared with 2010 (+3.5%). Grants and subsidies account for overall stagnation; transfers to the local public sector dropped in 2011 (-4.9%), adding to the drop begun in 2010 (-0.6%). Some factors determined this situation, particularly the reforms affecting the local public sector. An example is certainly *Greece* where the transfer of competencies to the local public sector under the *Kallikratis reform*, particularly for social matters, had to be financed through new revenue. Local public sector revenue in *Greece* have increased nearly 15% in volume in 2011 (to reach 3.2% of GDP and 7.8% of public revenue) while they had plummeted by 23.4% in 2010 amid an economic backdrop that remains highly unfavorable.

There are numerous other examples where changes in revenue were largely determined by more structural reforms that affected the funding systems of local authorities (tax reform, equalization mechanisms, fee policies, etc.).

**Table 1. Revenue – Subnational and local public sector in the EU – Year 2011**

	€ bn	€ per capita	% GDP	% Public sector	% Revenue	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
GDP	12,629	-	-	-	-	-	-
Local public revenue	1,480	2,940	11.7	26.3	100.0	+2.1%	-0.2%
Local Tax revenue (own-source and shared)	529	1,050	4.2	16.1	35.7	+2.2%	+3.5%
Local Non-tax revenue	1951	1,890	7.5	40.4	64.3	+2.1%	-2.2%
Local Public balance	-26	0	-0.2	-	4.6	-	-
Local Public debt	743	5.2	5.9	8.3	7.1	+2.6%	+2.6%

Source: computed by author using Dexia – CEMR, 2012

Regarding local public expenditure, in 2011 they accounted for 11.9% of GDP and 24.3% of EU public spending.

**Table 2 Expenditure and investment –local public sector in the EU – Year 2011**

	€ bn	€ per capita	% GDP	% Public sector	% Expenditure	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
GDP	12,629	-	-	-	-	-	-
Local public expenditure*	1,506	2,995	11.9	24.3	100.0	+2.3%	-1.0%
Local direct investment	179	355	1.4	58.3	11.9	+1.2%	-6.0%
Local Public balance	-26	0	-0.2	-	4.6	-	-
Local Public debt	743	5.2	5.9	8.3	7.1	+2.6%	+2.6%

\*Excluding capital payments on borrowings

Source: computed by author using Dexia – CEMR, 2012

The differences between countries are depending by a lot of factors as country's geography, territorial organization, level of decentralization and the nature of competencies carried out by the local authorities. For example, high local spending has *Denmark* with 37.5% of GDP and 64.6% of public spending, but insignificant local spending has *Malta* and *Cyprus* because are countries whose local authorities have limited competencies the cause being their small size or *Greece* because it has historically been highly centralized country. The countries between these two extremes can be divided into four groups.

In the first group are countries for which the weight of local public expenditure as part of the national economy is significant (*Denmark, Sweden, Finland, Belgium*). In

*Denmark, Sweden and Finland* there are highly-decentralized forms of government. Also, there are included federal countries (except *Austria*). This high level comes from the fact that the ratio combines spending by the federated States with spending by the local public sector.

The second group comprised of *Italy, Austria, the Netherlands and Poland* has ratios that are close to the European Union average.

In the third group, ratios are lower than the European Union average. This group includes *France* and the *United Kingdom*, which are close to the three Baltic countries, *Romania*, the *Czech Republic* and *Hungary*. The majority of these countries are transitioning towards decentralization.

The last group includes countries as *Ireland, Luxembourg and Portugal* that are relatively centralized with ratios that are markedly below the European Union average.

This macro-economic viewpoint is imperfect. It does not always assess the real degree of decision-making power and action that local authorities have in terms of expenditure. Although, local government in several countries manage a significant sum of money, they often, in reality, have limited autonomy regarding the choice of how expenses are allocated, a choice merely steered or dictated by the State or are restricted by regulatory and budget standards.

At the end of 2011, outstanding debt of the local public sector totaled €743 bn in the EU 27. It accounted for 5.9% of GDP and 7.1% of public debt. These ratios are lower for the local sector and mostly come from the fact that the lion's share of local debt is allocated to financing investment ("golden rule") and that it is governed by strict prudential rules. Local public debt/GDP varies from 0.1% in *Malta* to 30.2% in *Germany*. Its weight in public debt ranges from 0.1% in *Malta* to 55.8% in *Estonia*, whose total public debt is the lowest in Europe, however (6% of GDP).

Local authorities as leading investors have one of the keys for returning to sustainable growth. As a public player, lastly, it is directly involved in the comprehensive effort to restore public accounts, which is an unconditional factor in providing a better tomorrow for future generations. In this respect, the crisis is an opportunity to redefine the role and the governance of the public sector across the central, regional and local levels.

#### **4. CONCLUSION**

Local sustainable development must be understood as a goal of local governments which can be supported partially by local public finances. Involving local finance-sustainable development is primarily the duty of local authorities whose activity must be oriented to develop financial mechanisms which are able to create own resources. To invoke the need for economic growth while asking for support from the central budget is less convincing if are not own efforts involved. The main conclusion highlighted by this research is that local finances are not yet able to support the real needs of growth and sustainable development in countries as *Romania, Hungary or Bulgaria*, requiring serious incentives for their strengthening, but sustainable development is a realistic one in *Great Britain, Denmark, Finland or Sweden*. Thus, setting mechanism "subsidies to attract non-



repayable financial assistance" can strengthen the local finance, creating realistic assumptions supporting policies aimed at sustainable development for the countries with this problem. Also, it is necessary an improvement of the management of local budgets to be efficient.

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## **APPROACHING THE CONCEPT OF COMPANY IN THE CONTEXT OF ECONOMIC AND FINANCIAL REGIONAL DEVELOPMENT**

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**Abstract:** *If we analyze things from an economic perspective, any company, regardless of its size, type of ownership and organization, produces goods and provides services with the purpose of obtaining a profit. Economic agents are individuals or groups of physical persons and/or juridical persons, which, in their capacity of participants to the economic life, fulfill certain roles and have similar economic behaviors (D et al., 1992). A company may stand out either through a unique administration and management, or through a financial independence of its own. The group of companies that are constituted in the conditions mentioned before bear the name of trading company. Such a company may join several of its subsidiaries and make undertake a series of activities in various geographic areas of the world.*

**Keywords:** *Company, economic, financial, concept, development, circuit, cost, price, transaction.*

### **1. INTRODUCTION**

From the point of view of the economic field, the company is the organizing link that combines production factors with the purpose of producing and trading goods and services in order to obtain the targeted profit. The company must have incomes superior to costs, only in this way the company is maintained successfully on this type of market.

Theoretically there are many definitions referring to the concept of company. Among the most significant ones, the following can be mentioned:

The company represents the economic agent that makes decisions regarding the use of production factors with the purpose of obtaining goods and services that sell on the market (B *et al.*, 2001).

A company is defined as a unit that uses production factors in order to produce goods and then sells them to other companies, consumers or to the government (L *et al.*, 1999).

This concept of company covers a variety of business organizations, from the sole owner to joint-stock company, and great variation in size, from the inventor that makes his own deliveries and that is financed with what she can get from a wavering bank manager, to large businesses, on a larger scale, having many thousands of shareholders (L *et al.*, 1999).

## 2. HIGHLIGHTING THE CURRENT EXPENSES AND INCOMES IN THE ECONOMIC CIRCUIT

According to current expenses and incomes in the economic circuit, companies can be grouped, from an institutional point of view, as follows:

*Non-financial companies* made of all companies that have as main objective the production of goods and services. This type of companies makes up the productive sector of any healthy market economy. Selling one's production implies making a profit.

The term "company" implies the existence of an economic entity characterized by joining and using in an efficient manner all available production factors. Members that constitute the company share the proceeds obtained by the respective entity. At the current stage of economic development, this type of company is most common.

According to the owner's responsibility, there are two types of companies, namely:

- Individual companies;
- Shared companies.

In the first category of individual companies, the entrepreneur is also the rightful owner of the invested capital.

The second category that of shared companies can be classified into:

- Commercial partnerships: general partnership and limited partnership;
- Companies based on joint stock: joint-stock limited partnership and joint-stock company;
- Limited liability companies combine certain characteristics both of partnerships as well as of companies based on joint stock.

The main flows generated by carrying on operations at company level are:

- Company expense flows are based on production factors input;
- Income flows are based on trading of goods and services provided by that particular company.

*Households* (households, families, farmers, etc.) are represented as economic agents what consumer goods of personal nature. With reference to households' income, they may come from different sources: either from these people's rightful salaries, either from owned titles of property, or by transfers made with the other economic sectors.

Insurance companies and credit institutions are those entities that ensure the role of financial agent for all the other categories of economic agents.

*Public administrations* have the role of redistributing incomes resulting from provided services, services of non-merchandise nature. These incomes are resulting from obligatory payments that come either directly or indirectly from various companies.

*Private businesses* (organizations, foundations, associations, etc.) contain those private bodies which do not have a lucrative purpose. The main sources of their incomes are the contributions, subscriptions, as well as other sources.

Multinational companies, more precisely their subsidiaries, located on the territory of the country in which the companies operate, are those companies with which local companies make business.

### **3. THE CONCEPT OF COMPANY IN THE CONTEXT OF ECONOMIC AND FINANCIAL REGIONAL DEVELOPMENT**

In fact, the company is defined as being that entity that possesses the greatest amount of the turnover and that owns the most well-known trademark in comparison with other companies. It is made of numerous individuals who have personal goals, the skill of the managerial team deriving from the harmonious association of these aspects, so that the individuals are fully motivated in order to take part in achieving company objectives, as well as their personal goals.

If we make reference to the paradigm objectives-performances, then one can notice that this a general approach for the entire set of factors that generate any company's performances. Thus, the type of market on which the company operates, influences, in a certain way, the quality of the managerial processes undertaken at company level. Managerial capacity, at its turn, determines the economical and financial performances of the company, the most conclusive <<barometer>> of an open confrontation with the market (B, 1993).

Another possibility to analyze the factors that determine the performances is the one offered by the theory of transaction costs, which gives the reasons for decisions made by the management of a company regarding the internalization or the externalization of certain company activities (F, 1998).

If the statements made by R. Coase are taken into consideration, the company has an intricate internal organization, implying that the development of any operation undertaken externally is much more costly than its achievement internally. This means that the trading company, through its managerial unit, adopts the decision of internalizing that particular activity. When the coordination of the managerial processes is done by the market, certain costs deriving from company activity can be avoided.

According to the same author, there are two types of costs, as far as the functionality of the market is concerned:

- Costs of knowing and of using the price system, that is informing companies of the conditions in which the market exchanges take place, these exchanges bringing forth both financial costs, as well as costs referring to the amount of allocated time;
- Costs for contract negotiation, that is the activities which generate certain costs are directly proportional with the number of contracts that have undergone a negotiation procedure.

The process by which the company is substituted to the market, involves the coordination of prices, which entails the internationalization of company transactions, based on organizational and contractual aspects. Due to market imperfections, from the point of view of information, we must mention the fact that companies tend to be substituted to the market, thus also improving considerably the amount of undertaken activities. Still, the internalization process has certain limits. This evolution is due to the interaction of a set of factors, which can be accounted for the decreasing performance level of company management in relation to company size.

The costs of making additional transactions, due to the internalization of certain activities increase proportionally with the size of the company; this size reaches an optimal level when the marginal cost becomes equal with that of the additional market transactions (G, 1999). However, this approach does not take into account an extremely important element, namely the transition costs. Due to this fact, this approach had a limited use in economic practice and theory.

Still, the foundations of this theory have been taken over by O.E. Williamson. He has tried to identify the main elements that make up transition costs. Williamson considers that determining factors of transition costs are the human factors (informational needs, sensible decision-making and the opportunism of the transactions) and the environmental factors of company's operations <<the uncertainty and a reduced number of parties involved in the transactions>> (W, 1975).

As far as informational needs are concerned, these differ according to the period of time they refer to, that is some of them are short-term: any purchasing contract of various intermediary goods, any purchasing contract of raw materials necessary for the optimal development of the production process, whereas others are long-term: the future orientation of company's productive activity.

Referring to a sensible decision-making necessary for concluding contracts, this can be of two types:

- Complete, that is the contractual parties can anticipate with accuracy all possible situations, the way in which these can influence the development of the contract, as well as the competent answers that will be given;
- Limited, it will be responsible for the real events occurring in the economic circuit, being based on the fact that not all possible events can occur on the development of company operations, as well as on the fact that the environment of a company's operations cannot be fully known, as this implies processing a huge amount of information.

Long-term contracts, which would be concluded in circumstances of complex rationality, are complete or conditional contracts <<decision "X" would be made on condition that event "Y" occurs>>; having a theoretical ground, this type of contracts would allow the market to coordinate the entire productive activity of the company (G, 1993).

With reference at incomplete contracts, these are long-term contracts, having a limited rationality, and, in the same time, taking place between participants to economic life. Incomplete contract thus set the foundation of a long-term collaboration between those having a part in the economic circuit. (Contracts referring to long-term operations also having great complexity, labor contract, etc.).

An increasing number of contracts in a company, that is an increased number of negotiations and concluded contracts, would increase company level of experience, allowing it to apply certain rules and procedures which determine both an increasing sensibility matching decisions made, and a decrease matching the uncertainties.

With reference to an opportunist individual behavior, the company must adopt specific measures to prevent the risk of an uncontrolled increase transition costs. Opportunist individual behaviors are based on a number of causes: asymmetry of information for the contractual parties, difficulties deriving from the exact assessment of goods and services

involved in transaction. The implementation of contracts involves a series of difficulties as far as control and accurate evaluation. Due to presented causes, the contracted agent can sometimes have, in the negotiation process an opportunist behavior, determined by the need to satisfy his/her own interests, this would determine an incorrect interpretation of certain contractual provisions, or of certain facts regarding the contract etc. (M, 1995).

Opportunist behavior can be prevented by various means:

- An increased level of substitution for the parties;
- Insuring a competitive background for those who offer goods and services on the market;
- Presence of compulsory provisions which prevent opportunist behavior in concluded contracts;
- Avoid an extremely narrowing qualification for company personnel;
- Avoid the purchase of extremely specialized machines, machinery and equipment.
- Analyzing the second category of factors, namely environmental factors, I notice: the reduction of uncertainties corresponding to contractual provisions by knowing the entire set of specific information, an increase of involved parties, implying an increase in the number of bidders.

Williamson considers that the company undertakes its activity based on a network of numerous contracts of specific nature. This network makes the object of control and coordination for company management, with the purpose of insuring high quality decisions for orientation, organization and coordination in concluded contracts.

However, Williamson's theory has been often criticized, because:

- The process of associating them with full rationality, as well as the lack of opportunist behavior would place them outside the economic circulation;
- The coordination of company activities is significantly narrowed, through contracts, it greatly contributes to the reduction of its relevance;
- It is extremely difficult to estimate the relevant costs.

Taking into consideration various criticisms caused both by Coase's theory and Williamson's theory, one can have a plausible theoretic starting point in the attempt to explain the generating factors corresponding to the vertical and horizontal integration process of the company. We must take into account that the internalization of the transaction undertaken at company level will occur only when their cost is below the level of the market costs.

Internalization of certain activities or even companies can occur horizontally – when in the functional and organizational structure of the company, one can find either complementary activities to the basic ones for the respective unit, or new activities for that unit, even other companies – or vertically – when a certain company takes over activities or units from downstream or upstream of the production course in which that company operates (K, 1997).

The internalization process unfolding at company level implies the externalization process of the activities towards other economic agents.

According to strategic objectives of the companies, they can simultaneously resort to, both the internalization of certain activities and the externalization of unprofitable activities.

Thus, a growing tendency on a global level is to further qualifications, a tendency to which large companies become committed also by the externalization of numerous activities towards small and medium-size companies, namely:

- Additional and serving (for example: in the companies performing process industries activities, maintenance and repairing operations, maintenance of periodic check-ups of measurement and control equipment, producing and providing utilities);
- Secondary activities and operations specific to certain fractions of the production processes (for example: making certain sub-assemblies, parts and components), in this case the final assembly of the finished good is the responsibility of the externalizing company (such is frequently the case of automotive industry, farming machineries, tractors, aeronautics, home appliances, electronics, etc.);
- Activities that cover a larger area of production processes, completely externalized into smaller companies or made in collaboration with these companies, in parallel keeping within the large companies of the upstream and downstream production activities (research and development and commercialization of products); this type of externalization can be found in large companies belonging to ready-made clothing manufacturing, which undertake design and commercialization activities of the products and transfer to some contracting companies, either entirely or partially the manufacturing activity (F, 1992).

#### **4. THE MAIN STAGES OF A COMPANY'S LIFE CYCLE**

A company's life cycle can be split in five main stages: existence, survival, success, expansion and maturity (C *et al.*, 1983).

Each stage of a company's life cycle will be briefly analyzed hereafter:

- The first stage linked to company's existence insures both the process of attracting customers, and the process of delivery products and services offered by the company. In case there is a significant amount of work, it is necessary to set a certain production level and to supervise the quality of the products released to the market. Company's organizational structure is simple since the entrepreneur ensures the entire management process, his/her main objective being company's survival. The company's forecasting system is extremely reduced, sometimes even completely inexistent.
- The second stage, company's survival, implies the existence of certain viability of the company; this means that the company has sufficient faithful clients to whom it may sell its products. At this stage, correct rapport between company incomes and company expenses is necessary. The businessman can choose for one of the two available variants, namely: to be content with achieved incomes or to try to develop the business some more.
- The third stage, company's success, implies achieving a high level of production, sales and incomes, thus company operations are performed efficiently and profitably. At this stage, the businessman also has two alternatives, namely: either

to use the company to increase his/her incomes, or to go to the next stage, company's expansion.

- The fourth stage, company's expansion, calls for ensuring a rapid development of the company, as well as the main methods of finalizing this development. The company is decentralized, there are special departments dealing with sales and production, and the managerial system, the decisional system, the organizational system, the informational system is in full development and expansion swing at company level.
- The last stage, company's maturity, is also called "resource maturity". In this stage, the businessman has two dilemmas: to go for the consolidation and efficient control of the profit made or to continue to benefit in the future of the advantage of a small business in which one has complete managerial freedom, on one side, actions and decisions' flexibility, on the other side. This stage is characterized both by operational separation, and by financial separation between the manager-entrepreneur and his/her company.

## **5. CONCLUSIONS**

The internalization phenomenon and the externalization phenomenon of the activities unfolded at company level have a significant contribution to the process of dynamicity of modern contemporary economies. A company will resort to externalization or to internalization, if it is efficient from an economical point of view.

If we pay attention to the development strategy adopted by Romanian small and medium size companies, then we can find a great number of particular situations. One can easily notice the fact that, within Romanian economy, still predominant are large companies, whereas the number of small and medium size companies is still reduced in comparison with the situation existing in developed countries. Among the most important ways of increasing the degree of competitiveness in national economy, I can mention: restructuring large companies with great loss, company specialization, and internalization of company activities and externalization of unprofitable activities.

The ways presented above create major opportunities that can contribute to: setting up new small and medium size companies, modernizing new companies, modernizing existing companies, sub-contracting certain activities unfolding in large companies, insuring the continuation process between the activity carried out by small and medium size companies and the activity carried out by large companies.

Thus, the most frequent ways to follow in order to increase the role of small and medium size companies within global economic activities are: taking over from large companies their external activities, manufacturing in small and medium size companies certain products or providing specialized services, consolidating professional associations of small and medium size companies according to sectors, industries and regions.

The company is the main producer of economic substance in any country, without which contemporary society would not exist; it creates jobs for the largest part of the population; its performances condition the status and the economic performances of each



country and the standard of living of the population, it is the place where economic growth is achieved (G, 1993).

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## **COMMUNICATION OPENNESS IN PERFORMANCE APPRAISAL SYSTEMS ENHANCING JOB SATISFACTION**

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**Abstract:** *The aim of this paper is to investigate the relationship between communication openness in performance appraisal systems and job satisfaction. A survey method was employed to gather data from employees who have worked in a privatized postal company in Sarawak, Malaysia. SmartPLS version 2.0 was used to determine the validity and reliability of instrument and test the research hypotheses. The outcomes of SmartPLS path model showed that explanation and feedback were positively and significantly related to job satisfaction. This result confirms that the ability of appraisers to clearly explain the performance appraisal practices and adequately provide feedback in determining performance scores have been important predictors of appraises' job satisfaction in the studied organization. Further, this study provides discussion, implications and conclusion.*

**Keywords:** *Explanation, feedback, job satisfaction*

### **1. INTRODUCTION**

Performance appraisal is a vital issue in management (Bacal, 2012; Daft, 2012), human resource management (Dessler, 2013; Mondy & Mondy, 2012), and organizational behaviour (George & Jones, 2012; Kreitner & Kinicki, 2013). It is often designed by employers to assess the ability of employees in performing duties and responsibilities, recording employee assessment results and providing solutions to enhance employee performance in organizations (Daft, 2012; Mondy & Mondy, 2014; Sabeen & Mehboob, 2008). Results of this appraisal system will usually be used by employers to build employees' strengths and minimize deficiencies, plan employees' career development, provide better recognitions to high performing employees, and make decisions about staff services such as promotion, demotion, termination, layoffs and/or

transfer (Kavanagh *et al.*, 2007; Mondy & Mondy, 2014; Noe *et al.*, 2014; Walsh & Fisher, 2005).

A recent literature on organizational management highlights that the design and administration of performance appraisal systems is much affected by employers' thoughts, namely classical management approach and contemporary management approach (Jabeen, 2011; Mondy & Mondy, 2014). In the early of industrial revolution in North America and European countries, the design of performance appraisal systems are much affected by a classical management approach as upheld by Taylor's (1856 to 1915) scientific management, Fayol's (1841 to 1925) administrative principles, and Weber's (1864 to 1920) bureaucratic organization. This classical approach emphasizes more on evaluating employee productivity based on objective measurements (Daft, 2012; Muchinsky, 2006). Under a performance appraisal based classical management approach, the nature of performance measurements is usually conducted using single-source feedback, non-participation style in decision-making, and boss centred approach. For example, appraisers (e.g., managers and/or supervisors) are given much power and authorities to assess employee abilities, identifying employees' strengths and weaknesses, determining the types of punishment and neglecting developmental aspects of employees (Daft, 2012; Erdogan, 2002; McCarthy & Garavan, 2001). Many scholars view that implementation of this appraisal system only suitable to measure employee productivity in organizations that operate in stable and less competition environments (Daft, 2012; Ismail *et al.*, 2013).

In an era of globalization, many employers have shifted the paradigms of performance appraisal from a single ratter to multiple ratter perspectives in order to obtain accurate and reliable information about employee performance (Daft, 2012; Erdogan, 2002; Noe *et al.*, 2014). This new appraisal system is strongly designed based on a contemporary management approach as upheld by humanistic perspective (i.e. human relations movement, human resources view, and behavioural sciences), system thinking and contingency view (Daft, 2012; Mondy & Mondy, 2014). This management approach gives more attention on the role of human needs, behaviour and attitudes, effect of interrelationship between subsystems in an organization, and adaptability with different situations as important factors in determining the effectiveness of management techniques (Daft, 2012). Under this management approach, the nature of performance appraisal systems allows appraisers to promote communication openness as an important instrument to increase transparency and decrease inequality gap among appraisers, as well as decrease unclear responsibilities and biasness among appraises and appraisers in determining employee scores. Further, this appraisal practice may lead employees to support organizational and human resource management's strategies and goals (Cloutier, & Vilhuber, 2008; Daft, 2012; Mondy & Mondy, 2014; Noe *et al.*, 2014).

A review of the workplace performance management literature shows that communication openness in performance appraisal systems consists of two effective components: explanation and feedback (Cook & Crossman, 2004; Kavanagh *et al.*, 2007; Mondy & Mondy, 2014; Noe *et al.*, 2014). Explanation is usually practiced by appraisers to deliver information about the goals, policies and procedures of the performance appraisal system using electronic and printed media to employees who work

in different job categories. The ability of appraises to clearly understand about the appraisal systems may enhance their appreciations about the process and systems of allocating performance scores, and motivate them to strongly support the implementation of appraisal systems in the workplace (Atiomo, 2000; Mondy & Mondy, 2014; Noe *et al.*, 2014; Obisi, 2011). Conversely, feedback is often practiced by appraisers to tell about appraises' performance scores, listen appraises' voices and justifications, discuss the appraisal outcomes and provide constructive advices to appraises about possible areas for improvement, problems that must be solved, and new responsibilities to be undertaken and involve appraises in setting up performance goals in an environment of respect and encouragement. The ability of appraises to clearly understand and accept the value of feedback that they receive from their appraisers may strongly motivate them to support the implementation of performance appraisal systems in organizations (Mondy & Mondy, 2014; Noe *et al.*, 2014).

Interestingly, recent studies in the workplace performance appraisal highlight that the ability of appraisers to properly implement communication openness in managing performance appraisal systems may have a significant impact on appraises' attitudes and behaviour, especially job satisfaction (Cloutier, & Vilhuber, 2008; Kavanagh *et al.*, 2007). According to an organizational behaviour perspective, job satisfaction is often related to employees' affective and/or cognitive attitudes about overall job and/or job facets may lead to induce their enjoyable feelings in organizations (Ambrose *et al.*, 2008; Judge *et al.*, 2009; Locke, 1976; McShane & Von Glinow, 2005; Maathis & Jackson, 2014).

Within a performance appraisal model, many scholars think that explanation, feedback and job satisfaction are different, but strongly interconnected concepts. For example, the ability of appraisers to clearly explain and adequately provide feedback in determining employees' performance scores can lead to an enhanced job satisfaction in the workplace (Sabeen & Mehboob, 2008; Sogra *et al.*, 2009). Although the nature of this relationship is interesting, not much is known about the role of communication openness as an important predicting variable in the workplace performance appraisal model (Cloutie & Vilhuber, 2008; Sogra *et al.*, 2009). Many scholars argue that the predicting variable of communication openness is given less attention in the previous studies because they have much described the general characteristics of communication openness, employed a simple correlation method to assess general respondent attitudes toward specific communication openness styles, and neglected to measure the magnitude and nature of the relationship between communication openness and appraises' attitudes and behavior in responsive organizations (Obisi, 2011; Sabeen & Mehboob, 2008; Sogra *et al.*, 2009). Therefore, this situation encourages the researchers to further discover the nature of this relationship.

## **PURPOSE OF THE STUDY**

This study has twofold objectives: first, is to examine the relationship between explanation and job satisfaction. Second, is to examine the relationship between feedback and job satisfaction.

## **2. LITERATURE REVIEW**

The role of communication openness as important predictor of job satisfaction is consistent with the notion of organizational behaviour theory. For example, Vroom's (1964) expectancy theory explains that a person who understands the value of outcome that he/she receive may result in positive behaviour. Besides that, Bies and Moag (1986) interactional justice theory suggests that a person heavily concerns about good or bad treatment that he/she receives from another person may affect his/her feelings of justice. The essence of these theories suggest that perceive high value of outcome and fair treatment will exist if appraisers able to clearly explain about the performance appraisal systems and adequately provide feedback in determining performance scores. The essence of these theories had gained strong support from performance appraisal research literature. For example, several extant studies were done using a direct effects model to investigate communication openness based on different samples, such as perceptions of 70 managers of the manufacturing organizations listed in Indonesian Capital Market Directory (Lau & Sholihin, 2005), perceptions of 77 staff at the faculty of medicine in UZ (Ndambakuwa & Jacob, 2006), perceptions of 2,377 public sector employees (Kavanagh *et al.*, 2007), perceptions of 297 Canadian workers (Cloutier & Vilhuber, 2008), perceptions of 229 workers of public listed companies in Klang Valley, Malaysia (Sudin, 2011) and perceptions of 133 employees of multinational companies in Malaysia (Darehzereshki, 2013). Outcomes of these studies found that perceived value of outcome and perceived fair treatment had increased when the appraisers able to clearly giving explanations about the appraisal system goals, policies and procedures, as well as adequately providing feedback in determining employee performance scores. As a result, it could lead to enhanced appraisers' job satisfaction in the organizations (Cloutier & Vilhuber, 2008; Darehzereshki, 2013; Kavanagh *et al.*, 2007; Lau & Sholihin, 2005; Ndambakuwa & Jacob, 2006; Sudin, 2011). Based on the literature, it was hypothesized that:

H1: There is a positive relationship between explanation and job satisfaction.

H2: There is a positive relationship between feedback and job satisfaction.

## **3. MATERIALS AND METHOD**

This study used a cross-sectional research design where it allowed the researchers to integrate performance appraisal research literature, the pilot study and the actual survey as a main procedure to gather data for this study. The main advantage of using this method may gather accurate data, less bias data and quality data (Sekaran & Bougie, 2010; Zikmund *et al.*, 2010). This study was conducted in a privatized postal company in Sarawak, Malaysia. The name of this company is kept anonymous for confidential reasons. The core business of this company is to provide day-to-day mailing services, courier and postal services for general public and retail customers. In order to maintain its competitiveness in a global economy, this company has implemented a performance appraisal related reward as a mean to improve organization and employee performance. Under this appraisal system, management employees (i.e., managers and supervisors) are

exposed with proper technical and human skill courses in order to enhance their abilities in communicating with employees who have different backgrounds that work in the various job categories. The ability of managers to clearly explain about the performance goals, policies and procedures and adequately provide feedback in determining performance scores are viewed as critical factors in attracting, retaining and motivating employees to maintain and support the organizational strategy and goals in an era of knowledge based economy. The achievement of this appraisal system is not recorded empirically and this situation has provided an opportunity to further explore its impact on employee outcomes in the organization.

At the initial stage of data collection, the survey questionnaire was drafted based on the information gathered from the workplace performance appraisal literature. Next, the pilot study was conducted by discussing the survey questionnaire with 10 managerial staff and experienced supporting staff who had worked in the organization. Their views were used to verify the content and overall format of survey questionnaire for an actual study. Hence, a back translation technique was employed to translate the survey questionnaires into English and Malay versions in order to increase the validity and reliability of research findings (Lovell *et al.*, 2004; Sekaran & Bougie, 2010).

The survey questionnaire consisted of three sections. Firstly, explanation had 4 items and feedback had 3 items that were developed based on the workplace performance appraisal literature (Brown *et al.*, 2010; Cook & Crossman, 2004). The dimensions used to measure explanation are clarification, praise, advice and rapport. Secondly, The dimensions used to measure feedback are suggestion, support, attention, and discussion. Finally, job satisfaction was measured using 5 items that were modified from Warr, Cook, and Wall's (1979) job satisfaction scale. The dimensions used to measure job satisfaction are supervision, job security, recognition, opportunity to use abilities in doing job, and promotion. All items were measured using a 7-item scale ranging from 'strongly disagree/dissatisfied' (1) to 'strongly agree/satisfied' (7). Demographic variables were used as controlling variables because this study focused on employee attitudes.

The unit of analysis for this study is employees who work in the organization. A convenient sampling technique was employed to distribute 300 survey questionnaires to employees who were ready to participate in this study. This sampling technique was chosen because the list of registered employees was not given to the researchers because of confidential reasons and this situation did not allow the researchers to choose randomly participants in the organizations. Of the total number, 129 usable questionnaires were returned to the researchers, yielding 43% response rate. Participants answered these questionnaires based on their own consent and on a voluntarily basis. This figure met the requirements of inferential statistics, therefore it could be properly analyzed to produce valid and reliable research findings (Hair *et al.*, 2010; Sekaran & Bougie, 2010).

The SmartPLS version 2.0 as recommended by Henseler *et al.* (2009) was employed to analyse the validity and reliability of instrument and test the research hypotheses. This statistical package is used because it can to produce latent variable scores, avoid small sample size problems, estimate every complex model with many latent and manifest variables, handle hassle-stringent assumptions about the distribution

of variables and error terms, and test both reflective and formative measurement models (Henseler *et al.*, 2009). The procedure of data analysis is: first, confirmatory factor analysis was used to assess the validity and reliability of instrument. Second, Pearson correlation analysis was employed to estimate the validity and reliability of constructs, and descriptive statistics were employed to measure the level of constructs. Third, test the hypothesized model. The outcomes of this test will clearly show the significant relationship between the independent variable and dependent variable if the value of t statistic larger than 1.96 (Henseler *et al.*, 2009). Then, a global fit measure is conducted to validate the adequacy of PLS path model globally based on Wetzels *et al.*'s (2009) global fit measure. The value of R<sup>2</sup> is used as an indicator of the overall predictive strength of the model. The value of R<sup>2</sup> is considered as follows; 0.19 (weak), 0.33 (moderate) and 0.67 (substantial) (Chin, 1998; Henseler *et al.*, 2009). Further, a global fit measure is conducted to validate the adequacy of PLS path model globally based on Wetzels *et al.*'s (2009) global fit measure. This result confirms that the PLS path model has better explaining power in comparison with the baseline values (GoF small=0.1, GoF medium=0.25, GoF large=0.36). If the results of testing hypothesized model greater than the cut-off value of 0.36 for large effect sizes of R<sup>2</sup>, showing that it adequately support the PLS path model globally.

#### 4. RESULTS

Table 1 shows that most respondents were males (76.7%), aged between 26 to 35 years old (29.5%), SPM holders (53.5%), served more than 18 years (27.1%), and non-management employees (54.3%).

**Table 1 Respondents' characteristic (N=129)**

Respondent Characteristics	Sub-Profile	Percentage
Gender	Male	76.7
	Female	23.3
Age	18-25 years olds	29.5
	26-35 years old	28.7
	36-45 years old	15.5
	More than 46 years old	26.4
Education	Diploma	11.6
	STPM	9.3
	SPM	53.5
	PMR	25.6
Length of Service	< 1 year	14.0
	2-5 years	25.6
	6-9 years	17.8
	10-13 years	8.5
	14-17 years	7.0
	> 18 years	27.1
Position	Management Group	45.7
	Non-Management Group	54.3

Note: STPM: Malaysian Higher School Certificate

SPM: Malaysian Certificate of Education

PMR: Lower Certificate of Education

The confirmatory factor analysis was conducted to determine the validity and reliability of instrument. Table 2 shows the results of convergent and discriminant validity analyses. All constructs had the values of AVE larger than 0.5, indicating that they met the acceptable standard of convergent validity (Barclay *et al.*, 1995; Fornell & Larcker, 1981; Henseler *et al.*, 2009). Besides that, all constructs had the values of  $\sqrt{\text{AVE}}$  in diagonal were greater than the squared correlation with other constructs in off diagonal, showing that all constructs met the acceptable standard of discriminant validity (Henseler *et al.*, 2009; Yang, 2009).

**Table 2 The results of convergent and discriminant validity analyses**

Variable	AVE	Explanation	Feedback	Job Satisfaction
Explanation	0.7200	0.8485		
Feedback	0.7725	0.6953	0.8789	
Job Satisfaction	0.6352	0.5731	0.5149	0.7970

Table 3 shows the factor loadings and cross loadings for different constructs. The correlation between items and factors had higher loadings than other items in the different constructs, as well as the loadings of variables were greater than 0.7 in their own constructs in the model are considered adequate (Henseler *et al.*, 2009). In sum, the validity of measurement model met the criteria.

**Table 3 The results of factor loadings and cross loadings for different constructs**

Construct/ Item	Explanation	Feedback	Job Satisfaction
<u>Explanation</u>			
b1	<b>0.875669</b>		
b2	<b>0.901223</b>		
b3	<b>0.849555</b>		
b7	<b>0.761224</b>		
<u>Feedback</u>			
b8		<b>0.889669</b>	
b9		<b>0.899210</b>	
b11		<b>0.847040</b>	
<u>Job Satisfaction</u>			
f3			<b>0.764096</b>
f4			<b>0.798345</b>
f8			<b>0.865447</b>
f9			<b>0.822733</b>
f20			<b>0.727280</b>

Table 4 shows the results of reliability analysis for the instrument. The values of composite reliability and Cronbach's Alpha were greater than 0.8, indicating that the instrument used in this study had high internal consistency (Henseler *et al.*, 2009; Nunally & Bernstein, 1994).

**Table 4 Composite reliability and Cronbach's alpha**

Construct	Composite Reliability	Cronbach Alpha
Explanation	0.911100	0.869392



Feedback	0.910565	0.852856
Job Satisfaction	0.896645	0.855193

Table 5 shows the results of Pearson correlation analysis and descriptive statistics. The means for all variables are from 5.1 to 5.3, showing that the levels of explanation, feedback and job satisfaction are ranging from high (4) to highest level (7). The correlation coefficients for the relationship between the independent variable (i.e., communication and treatment) and the dependent variable (i.e., job satisfaction) were less than .90, indicating the data were not affected by serious collinearity problem. Hence, all the constructs had value 1 that were shown in a diagonal, showing that these constructs met the requirements of reliability standard (Hair *et al.*, 2010; Nunally and Bernstein, 1994). Thus, these statistical results provide further evidence of validity and reliability for the constructs used in this study.

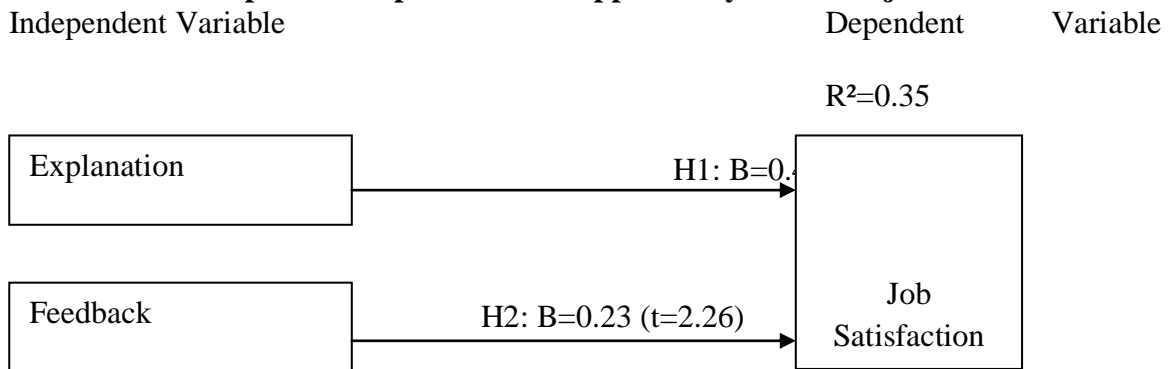
**Table 5. Pearson correlation analysis and descriptive statistics**

Variable	Mean	Standard Deviation	Pearson Correlation Coefficients		
			1	2	3
1. Explanation	5.2	1.3	1		
2. Feedback	5.1	1.3	.77**	1	
3. Job Satisfaction	5.3	1.1	.57**	.52**	1

Note: Significant at \* $p < 0.05$ ; \*\* $p < 0.01$  Reliability estimation is showed in a diagonal

Figure 1 presents the outcomes of testing a direct effects model using SmartPLS. It showed that the inclusion of explanation and feedback in the analysis had explained 35 percent of the variance in job satisfaction. Specifically, the result of testing this model displayed that explanation was positively and significantly related to job satisfaction ( $\beta = 0.42$ ;  $t = 3.91$ ;  $\beta = 0.23$ ;  $t = 2.26$ , respectively), therefore H1 and H2 were supported. This result demonstrates that communication openness does act as an important predictor of job satisfaction in the hypothesized model.

**Figure 2 The outcomes of SmartPLS Path Model Show on the relationship between communication openness in performance appraisal systems and job satisfaction**



Note: Significant at \* $t > 1.96$

In order to determine a global fit PLS path model, we carried out a global fit measure (GoF) based on Wetzels et al.'s (2009) guideline as follows:  $GoF = \sqrt{\text{MEAN}(\text{Communality of Endogenous}) \times \text{MEAN}(R^2)} = 0.50$ , indicating that it exceeds the cut-off value of 0.36 for large effect sizes of  $R^2$ . This result confirms that the PLS path model has better explaining power in comparison with the baseline values (GoF small=0.1, GoF medium=0.25, GoF large=0.36). It provides strong support to validate the PLS model globally (Wetzels et al., 2009).

## 5. DISCUSSION

This study shows that communication openness in performance appraisal systems does act as an important predictor of job satisfaction in the studied organization. In the context of this study, appraisers (i.e., managers and/or supervisors) implement performance appraisal systems based on their organization's policies and rules. According to majority respondents, the levels of explanation, feedback and job satisfaction are highly practiced in their organizations. This situation explains that the ability of appraisers to clearly explain about performance appraisal goals, policies and procedures, as well as adequately provide feedback in determining performance scores may lead to an enhanced appraisers' job satisfaction in the organization.

The implications of this study can be divided into three major categories: theoretical contribution, robustness of research methodology and practical contribution. In terms of theoretical perspective, the findings of this study show that explanation and feedback have been important predictors of job satisfaction in the studied organization. This result also has supported and broadened studies by Lau and Sholihin (2005), Ndambakuwa and Jacob (2006), Kavanagh *et al.* (2007), Cloutier and Vilhuber (2008), and Sudin (2011) and Darehzereshki (2013).

With respect to the robustness of research methodology, the survey questionnaires used in this study met the acceptable standards of validity and reliability analyses, this could lead to the production of accurate and reliable research findings. Regarding on the practical contributions, the findings of this study may be used as guidelines by management to improve the administration of performance appraisal systems in organizations. In order to achieve these objectives, some improvements need to be done in the particular aspects: firstly, training content and methods should be customized according to the organizational strategy and goals may help employees to understand, respect and obey the policies, rules, and work cultures practiced in the organizations. Secondly, recruitment and selection policies should give a priority to hire knowledgeable and experience people to hold management positions and their expertise may be used to coach junior managers and/or supervisors in planning and implementing performance appraisal systems in organizations. Finally, level of pay for individual and group performance should be revised based on external organizational competitiveness may help to capture employees' hearts and minds, as well as encourage them in achieving the interests of their organizations. If such suggestions are given attention this may strongly motivate employees to appreciate and support their performance appraisal goals.

## 6. CONCLUSIONS

This study suggested a conceptual framework based on the workplace performance appraisal research literature. The instrument used in this study met the acceptable standards of validity and reliability analyses. The outcomes of SmartPLS path model generally confirmed that the implementation of communication openness in performance appraisal systems does act as an important predictor of job satisfaction in the studied organization. This result also has supported and broadened the workplace performance appraisal literature mostly published in Western countries. Therefore, current research and practice within the performance management model needs to consider explanation and feedback as crucial elements in the workplace performance appraisal domain. These findings further suggest that the ability of appraisers to clearly explain the performance appraisal goals, policies and procedures, as well as positively and constructively provide feedback in determining performance scores will strongly induce positive subsequent employee attitudes and behavior (e.g., justice, commitment, performance, ethics, trust and teamwork). Thus, these positive outcomes may lead to maintained and enhanced organizational growth and competitiveness in an era of globalization.

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## **ANALYSIS OF CONCEPTUAL APPROACHES FOR THE FIRM IN DIFFICULTY**

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**Abstract:** *Beginning with simple delays in payments until the occurrence of bankruptcy, the notion of a firm in difficulty is extremely complex. The concept involves an economic component, but it cannot be separated from the legal component (for each country, given the legislation feature). Difficult situation of an enterprise requires the existence of vulnerable states in their activities, which upon reaching a critical threshold prevail against the forces of them, leading ultimately to the onset of insolvency process.*

**Keywords:** *business failure; decision rules; liquidation*

**JEL Classification:** *G33; G34*

### **1 INTRODUCTION**

Definitions of a company in difficulty vary significantly in the literature. For some authors, the term of Insolvency (Bankruptcy) is used as a general term, which presents companies in financial difficulty (Beaver, 1966; Deakin, 1972; D'Aveni 1989; Hambrick & D'Aveni, 1988; Neumair, 1998; Sheppard, 1994). Other authors consider the term "failed" (failure) equal to that of „bankrupt" (bankrupt) (Altman, 1968, 1984, 2007; Borucki & Barnett, 1990; Cameron, 1987; Ford & Baucus, 1987; Greenhalgh, 1988; Sutton & D'Aunno, 1989; Whetten, 1987; Wiseman & Bromiley, 1996). In all cases, we must keep in mind that bankruptcy is a process that begins financial and ends legal, while failure is not necessarily a legal component (Bickerdyke, 1999; Charitou, 2004; Stiglitz, 2002; Zavgren, 1983).

The exact determined moment of incurrance bankruptcy is hard to say, as the result of subjective decisions within the enterprise is prolonged economic difficulties. In general, legal action for opening insolvency belongs to the creditors; but in practice may exist situations, where for various reasons, they do not start this procedure (Bandopadhyaya, 1994; Blazy, 2004; Claessens, 2002; Prantl, 2003).

Other authors explain the failure from the financial perspective, taking into account the following conditions: negative net assets, cessation of payments to creditors, failure to repurchase the bonds, unable to pay bank loans, unpaid dividends on preferred shares. A company can continue operating in the short term, even in the above conditions. These companies are distinguished by reduced profitability, decreasing business volume, degradation of the social climate, the existence of an external

environment difficult (Argenti, 1976; Balcaen, 2006; Damodaran, 2007; Laitinen, 1999; Ross, 2008).

Next, we present the main views expressed in foreign literature on the definition of a firm in difficulty.

## **2. AMERICAN APPROACHES OF INSOLVENCY**

*Edward Altman* (2006) defines the difficult situation of a company either financially (the rate of return on capital invested in the company will be less than significant and continuous investment rates similar), legally (when a company is unable to meet its legal obligations to creditors) or in economic terms (undertakings shall cease operations due to bankruptcy or sale of assets). This may be the result of problems initially in the analysis, evaluation and approval of economic financial transactions could not be identified but, throughout the work, and have appeared. The exact moment when the difficulties arise for an enterprise is difficult to distinguish. Difficulties may stem from internal or external causes, both objective and subjective, acting independently or in cross-correlation.

*Richard Brealey & Stewart Myers* (2007) characterizes the firm in difficulty, based on the seriousness of the situation it faces: economic failure (if the income of a company shall not exceed the total costs, including capital costs); the failure of the firm (situation in which a company has ceased generating a loss to creditors), technical insolvency (current liabilities, as they become due are not met by the firm. The situation involves a lack of liquidity which may be only temporary. However, it gives creditors a signal of a fundamental problem, and they can react to increase guarantees to cover debts); insolvency to bankruptcy (when the total debt of a firm exceeds the market value of the asset sale. This is a more delicate situation than technical insolvency and in most cases; it ends with bankruptcy of firm); default (a term that covers all situations where the company has not fulfilled all contractual terms that lenders have advanced funds or assets of the company. Thus, in this situation include both technical insolvency firms and the insolvent bankrupt); legal bankruptcy (although often use the term broke any case of failure of a company, the legally a firm is bankrupt when: is the failure criteria established by bankruptcy law of the country, has been declared bankrupt by a court).

*Edith S. Hotchkiss* (2008) defines the situation of a firm being in difficulty depending on the size of the financial risk which it assumes into the economic activity. The difficult situation of an enterprise is presented as "the inability of the company to pay its debts or financial imbalance between funding sources and economic means to be covered in them". Finding such a situation, at a given time, it has the meaning of shortcomings of enterprise risk management in the sense that it was not considered a real prediction of such a condition. If risk management would be called a provisional analysis of the economic and financial situation of the company, it would have the effect of taking some progressive measures of the firm's recovery.

*Stephen Hillegeist* (2004) points out that the concept of an enterprise in difficulty is questionable reducing it to purely financial aspect of suspension of payments or financial imbalance. Motivation should be given to the causes underlying the difficulties

that may be encountered by an enterprise, they have meanings economic, financial or / and juridical. The causes difficulties can be connected thereby to any of the aspects of the entity. It may be related to production quality and volume, the technological level of fixed assets and their physical wear, mechanisms regulating the markets and / or supply of human resources of the quantity, but also quality and even priority, the quality management process.

### **3. FRENCH APPROACHES OF INSOLVENCY**

*Pierre Vernimmen* (2005) considers bankruptcy as the main instrument for reallocating inputs from the inefficient to the efficient firms. Every economic system needs mechanisms to ensure optimal use of resources. Theoretically, bankruptcy shades bad apples " from the distressed sectors and allow profitable groups to thrive. Without effective bankruptcy, financial crises would be longer and deeper. The bankruptcy can allow a company to reorganize, often requiring asset sales, changes of ownership and partial debt forgiveness from creditors. In other cases, lead to bankruptcy, liquidation, company death. Bankruptcy is triggered when a company cannot meet its short-term commitments, and thus face a liquidity crisis. However, the exact definition of financial hardship / bankruptcy may differ from country to country. Bankruptcy is a critical moment in the life of the company. Not only bankruptcy requires that each of the company's stakeholders to make specific choices, but the very possibility of bankruptcy has an impact on investment and financing strategies of healthy societies.

*Bernard Colasse* (2008) defines bankruptcy through the financial-economic equilibrium based on balance sheet indicators. The risk of bankruptcy, default or illiquidity, is a major risk because, unlike the risk of loss, he is legally sanctioned, a loss-making company can continue its activities as long as she is able to pay its debts rather, the fact that the payments cease her to enter into a legal process that could lead to its disappearance. Termination payments is considered in which the company unable "to meet its outstanding liabilities with assets". This state triggers a regulatory procedure that means financial bankruptcy court. According to established expression, the firm must to "deposit balance" at the court's jurisdiction. Following the judgment, which gives the judicial settlement, depending on the seriousness of the situation, there are two possible scenarios: recovery or liquidation. Even when you can complete in a recovery, the bankruptcy has bad consequences on owners, creditors, employees and managers, recovery may involve, indeed, final losses for owners abandonment of claims of the lenders, a reduction in the number of employees and changes in the management team.

*Bank of France* (2003) established that the strict definition of the state of financial difficulty, however, is not a weakness, because the manifestation in one way or another of the other functions of the company (production, trade, human resources, etc) propagates on the financial situation of the company. Into the company's activity, the payments stop to creditors is the final result of the problems it has.

An enterprise may have temporary difficulties caused, for example, by a claim within uncovering important or acceleration of payments in a period of economic growth in the case of payment difficulties is the expression of a financial imbalance which must



not jeopardize the balance economic and financial fundamentals and does not affect economic activity and image of the company in a great extent. Permanence of payment difficulties obligations expresses deep economic and financial vulnerabilities, formed over a longer period, which can generate serious cases, loss of the business.

#### 4. LEGISLATIVE APPROACHES OF INSOLVENCY

Given the importance of the firm in difficulty for the business environment and the generated implications, this concept is largely discussed into legislation.

*The European Community legislation (Regulation EC No. 794 of 2004 European Commission on state aid)* defines enterprise in difficulty as follows: when the firm is unable, either through their own resources or the resources that they can obtain from its owner / shareholders or creditors, to stem losses which, without outside intervention by the public authorities, will lead, in the short or almost certainly out of the economic market.

Specifically, a firm is regarded as being in difficulty, in principle and irrespective of its size, in the following circumstances:

(i) for enterprises of any legal form, when such organization meets the conditions to be subject to proceedings under the law on the procedure of judicial reorganization and bankruptcy.

(ii) for a limited liability company, when the cumulative conditions are fulfilled: the loss of 50% of the share capital and 25% is lost in the past year;

(iii) in the case of a company where at least some of the partners have unlimited debts to enterprise, when it has lost more than half of its own capital, as shown in the accounting records of the company and more than a quarter of capital has been lost over the preceding 12 months.

In Romania, the *Law No.85 of 2006 regarding insolvency proceedings* defines insolvency as the state of the debtor's assets, characterized by the evident failure of payment of debts due to the amounts of money available.

However, Romanian law distinguishes between the following concepts:

- Financially difficult situation (involves termination payments and the businesses they mainly cash difficulties. They are economically viable, but disregarding economic and financial balances, management mistakes, are healthy businesses, but vulnerable. If not proceed to reorganization measures, such enterprises are vulnerable by itself assuming risk of cessation of payments).

- Bankruptcy (in legal terms means the procedure whereby a company declared insolvent, will liquidate and stop economic activity. Bankruptcy is declared failure criteria established by legislation, and in financial terms can mean negative net assets, cessation of payments to creditors, failure to pay dividends on preferred shares).

*The Law nr.381 of 2009 regarding the concordat* characterizes the firm in difficulty as „the firm whose managerial potential and economic viability are in decreasing dynamics, but whose owner runs or is capable of performing duties due”.

This definition leads to many difficulties in practice for both the borrower (who needs to know the precise moment when his company is in difficulty, so you can request

the opening of proceedings or appointment of a trustee arrangement ad-hoc) and for the bankruptcy judge (who for to approve an arrangement, the borrower should note that the company is in difficulty).

An enterprise is considered to be in trouble if either of their specificities, such as: decreased turnover / net asset value / treasury or increase debt / loss / excessive inventory / tax obligations. In all cases, an enterprise is considered to be in trouble if he cannot recover, either with its own resources or with the funds it is able to obtain from its owners / shareholders or the market.

In order to be applied to ad-hoc mandate procedure or concordat, the company must either be characteristic of distressed company (ie the loss, turnover declining stocks too high, high debt and declining or negative net asset) or fails to recover its own resources or with funds provided by the owners / shareholders in the short or medium term is in danger of going out of business circuit, that disappears as the enterprise with adverse consequences on its stakeholders.

In Table 1 we have summarized the main definitions used in the literature.

**Table nr.1 Definitions of enterprise economic difficulty in the literature**

Author	Terms used	Definition
Altman	Bankruptcy	Those companies that have been declared legally bankrupt, have been declared insolvent or later approved reorganization
Bank of France	Defaillance	Registration at court of the bankruptcy demand
Beaver	Failure	The inability of a firm to pay its maturing obligations: inability bank loans or debentures along with the withdrawal of donor support, failure to pay dividends on preferred shares
Conan & Holder	Defaillance	Inability to pay debts into liquidation proceedings or an explicit agreement with creditors to reduce debt
Colasse	Defaillance	Defines bankruptcy through the financial-economic equilibrium based on balance sheet indicators
Deakin	Failure	Company entering in liquidation proceedings, insolvency or other reorganization
Elam	Bankruptcy	Reorganization under Chapter XI of the Federal Bankruptcy Act, consent of the shareholders to reorganize under bankruptcy law
Ohlson	Failure	Bankruptcy is defined as the business was liquidated following a court ruling
Taffler & Tishaw	Failure	Bankruptcy is the default entry, voluntary or forced liquidation based on the decision of the court or government action
Vernimmen	Defaillance	Defines bankruptcy as the main instrument for reallocating inputs from inefficient firms to the effective
Zmijewski	Failure	Specifying the conditions preceding bankruptcy: impossibility to pay current obligations, lack of financial resources for repayment of loans, collection of very late the counter products delivered, recording losses

Source: Anghel, I. (2002). *Bankruptcy. Radiography and prediction*, Ed. Economică, Bucuresti, 2002

## CONCLUSION

From our point of view we propose the following definition of enterprise in difficulty ”firm in difficulty is the company facing a lack of liquidity and difficulties

arising from the fulfillment of obligations outstanding financial previously contracted necessary for smooth running of its activity”.

The failure of a company is going in a certain period of time but may be the consequence of absolutely random events that the company failed to respond adequately. So, as stated in the literature, each firm has ”its own way to bankruptcy”.

Despite numerous definitions in the literature, it is worth noting, however, some essential concepts defining enterprise in difficulty: economic failure or firm insolvency or bankruptcy technique. Regarding the causes of the difficulties for the company, we believe that they can take many forms which frequently have a negative impact on performance to both internal and external forms.

It is wrong to say that a business with difficulties, economic or financial, is bankrupt. Bankruptcy is the final stage of a long evolution of economic and financial deterioration of the company, and is necessarily a legal constituent.

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## DETERMINISTIC METHODS USED IN FINANCIAL ANALYSIS

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**Abstract:** *The deterministic methods are those quantitative methods that have as a goal to appreciate through numerical quantification the creation and expression mechanisms of factorial and causal, influence and propagation relations of effects, where the phenomenon can be expressed through a direct functional relation of cause-effect. The functional and deterministic relations are the causal relations where at a certain value of the characteristics corresponds a well defined value of the resulting phenomenon. They can express directly the correlation between the phenomenon and the influence factors, under the form of a function-type mathematical formula.*

**Keywords:** *deterministic methods, factors of influence, financial rates.*

### 1. DEFINITION AND TYPOLOGY OF METHODS USED IN FINANCIAL ANALYSIS

The **method** means the research mode of a phenomenon or process. It is a theoretical, abstract process through which a certain conception regarding the studying mode of an objective is established in order to get knowledge regarding its form or its composition. The method is made up of the procedures used in reaching the objective. The **procedure** consists in the systematic mode of action in order to reach the desired objective. All the specific procedures define the **techniques**.

When classifying in classic and modern techniques, we guided ourselves after the principles mentioned by George Foster, professor of financial analysis at Stanford University (Foster, 1996).

The financial analysis uses several methods and techniques, which can be classified according to several criteria.

1. From the point of view of the sector they belong to, we can have:
  - methods specific to financial analysis;
  - methods borrowed from other sectors.
2. From the point of view of investigation methods of the phenomenon we can have:
  - qualitative methods, which aim at investigating the essence of the phenomenon, identifying the mechanisms of creation and action, and which are based on scientific abstraction;

- quantitative methods, which have as a goal to appreciate through numerical quantification the phenomenon, the mechanisms of creation and expression of factorial and causal relations, the mechanisms which influence and spread effects.

3. From the point of view of the manifestation form of the interdependence between economic phenomena:

- deterministic methods, where the phenomenon can be expressed through a form of functional relation of cause-effect type;

- statistic methods, where the phenomenon can be expressed through several relations of cause-effect type.

4. From the point of view of the research method of phenomena evolution, the methods can be:

- static methods, which analyze the characteristics of the phenomena at a given moment;

- dynamic method, which analyze the characteristics in their dynamics.

5. From the point of view of the moment they appeared in time:

- classic methods, appeared with the first researches, till the information revolution;

- modern methods, appeared after this period, which investigate the phenomena with advanced principles of calculation.

The classification in quantitative or qualitative methods is a delimitation a little bit forced, and it has at the basis a methodological predominance. In fact, the majority of methods are mixed.

## **2. MAIN DETERMINISTIC METHODS USED IN FINANCIAL ANALYSIS**

Main deterministic methods used in financial analysis are:

- balancing method;

- decomposition method of a phenomenon variation on factors of influence through iteration;

- method of marginal calculation;

- method of flows;

- method of rates.

These methods are not exclusive. They can apply more or less (under the initial form or a little changed) in the case of statistic relations. But their main utility is more emphasized in the case of functional deterministic relations.

### **2.1. Balancing method**

The balancing method allows reflecting the quantitative interdependences between the constitutive elements or the influence factors of the analyzed phenomenon, when between the elements of the studied phenomenon there are deterministic relations of the sum and/or difference type.

The general theoretical model of this type of relations is:

a) The simple model:  $F=A+B-C$

$$b) \text{ The aggregate model: } F = A + B - C = \sum_{j=1}^{\alpha} a_j - \sum_{k=1}^{\beta} b_k - \sum_{l=1}^{\lambda} c_l = \sum_{i=1}^n a_i + \sum_{i=1}^n b_i - \sum_{i=1}^n c_i$$

where: A, B, C are factors of influence;

a, b, c the constitutive elements of A, B, C factors of influence;

i = the number of constitutive elements, taken as the maximum of j, k, l in order to allow the appreciation.

An example of indicator from this category is the final balance of stocks (Sf), resulted by the addition of the initial balance (Si) to inputs (I) relative to the period and by the deduction of the outputs (E) relative to the same period.

$$Sf = Si + I - E$$

The influence of the change to the comparative basis is established depending on the modality the change is expressed.

## 2.2. Decomposition of a phenomenon variation on factors of influence through iteration

The method of decomposition of a phenomenon variation on factors of influence through iteration, respectively the quantification of factors of influence on the change of indicators had three development phases and it has the following methods:

- method of isolated influences of factors (M.I.I.F.);
- chain substitution method (M.S.L.);

It was developed on the basis of decomposition principles of indexes variation. The problem is to decompose the absolute or relative change of the indicator on two comparable periods of time (usually consecutive).

### 2.2.1. The method of phenomenon decomposition on the isolated influences of factors

The first method initially used was the method of isolated influences of factors (the method of un decomposed remainder).

The general theoretical model of the phenomenon (F) made up of factorial variables ( $f_i$ ) is:

$$F_t = f_t^1, \dots, f_t^i, \dots, f_t^n$$

According to the phenomenon made up of several constitutive elements, the complex variable directly put together is:

$$\sum F_t = \sum f_t^1, \dots, f_t^i, \dots, f_t^n$$

The order in which the factors are written according to the general principles used to build the indicators starts with the quantitative ones (which reflect the volume effect), continues with the structural ones, then the qualitative ones (from the same nature as the indicator), with the extensive ones to the intensive ones.

The method consists in decomposing the absolute increase of an indicator on factors of influence using weights only in the basic period, thus resulting an un decomposed remainder.

The method decomposes the variation of a phenomenon into  $2^n - 1$  influences, ( $n$  is the number of factors) from which:

- $n$  individual influences, of each factor in part;
- $[(2^n - 1) - n]$  simultaneous influences of factors taken together (the un decomposed remainder).

It implies the following working rules: (Van Horne & Wachowicz, 2005).

- the factors are arranged according to economic conditioning;
- the factors substitute themselves successively using weights only in the basic period;
- a substituted factor goes to the basic level;
- the last factor that results is the un decomposed remainder of the combined factors.

### **2.2.2. The method of chain substitutions**

The most used method to quantify the influence of changed factors on the indicators change, which assigns the un decomposed remainder to the qualitative factor, is the method of chain substitutions. It is used especially in the case of deterministic-type relations where the dependence of factors is materialized in mathematical relation of product or report.

The method of chain substitutions consists in: (Lala-Popa & Miculeac, 2012).

- identifying the factors which influence the deviation of the economic phenomenon;
- establishing the causal relations between factors and phenomenon;
- measuring the factors influence, establishing the sense and intensity of their action.

The method supposes to obey the following conventional working rules:

- the factors are arranged in the order of economic conditioning (quantitative-structural-qualitative or extensive-intensive);
- the factors substitute themselves successively; first the quantitative (extensive) factors, then the qualitative (intensive) ones;
- a substituted factor maintains itself at the effective level in the following operations;
- the last substituted factor is the qualitative-type factor.

The main restriction of this model is that it presupposes the successive change and then the maintenance of the factors at the effective level, which practically means that first a factor changes while the other remains constant, and then it remains at that level, waiting to change the indicator only on the basis of the second factor etc. This shortcoming is expressed by the allocation of the whole un decomposed remainder to the qualitative factor. This fact can be easily emphasized by applying the method of impact diagram for the example with two factors in relation of product.



### **2.3. The method of marginal calculation**

The method of marginal calculation reflects the changes that take place in a phenomenon as consequence of a change in a unit in another phenomenon. The method of marginal calculation is based on the use of several categories of indicators. The marginal changes are useful for the calculation of elasticity coefficients.

Depending on the elements taken into consideration, the marginal calculation may reflect: (Emery, et al., 2004).

- an association, when it reflects the change in a phenomenon compared to the change with a unit of another phenomenon;
- an influence, when it shows the phenomenon change caused by the change with a unit of a factor of influence;
- a possibility of substitution, when it shows the change of a factor compared to the change with a unit of another factor;
- an influence, when it shows the change of a factor compared to the change with a unit of the phenomenon.

The method facilitates the analysis of the dynamic evolution of the company's financial situation.

It lies at the basis of the calculation of alternative risks and decisions.

Depending on their place in the financial analysis, the most used are:

- additional expenses, incomes and profits generated by the change with a unit in the activity volume;
- the treasury variation which is obtained through the variation with a unit of the patrimony element (assets and liabilities);
- changes in gains generated by the change with a unit in the risk.

Its utility is relative to two aspects:

- the efficient dimension of the activity from the point of view of the activity volume and financial structure;
- the calculation of the operating, financial and total risk on the basis of activity volume and financial structure.

For this goal, the marginal indicators are submitted to the comparison with average indicators.

### **2.4. The method of flows**

The method was adopted in the theory and practice of financial analysis beginning with the '60, in Western countries, in Anglo-Saxon companies, which had to relate the nominal account (a dynamic instrument) to the balance sheet (a static instrument). It developed under various forms in different countries.

The method analyzes the dynamic evolution of a company's financial situation.

With this method are built the flows charts, which are modern instruments of the financial analysis:

- financing chart;
- treasury variation chart;

- financial flows chart.

In a company, as well as in the relations with the external environment, a series of complex economic flows are developed. Having a continuous activity and being permanently in contact with the environment, the company will permanently have flows inside and outside it. From these flows, the most important ones are with the company's stakeholders.

The financial flows represent all the movements that have an immediate or future impact on the company's results and liquidity. They are diverse, heterogeneous, being generated by operating, financial and investment activities. The totality of financial flows, their volume, dynamics and structure define, finally, in a sensitive way, the financial profile of the company.

## **2.5. The method of rates**

The financial rates represent a ratio between two logical and economical comparable measures, being used very frequently in financial analysis.

The main principle which lies at the basis of rates is that their informational value is greater than that of indicators taken separately and it allows a better comparison in time and space. A rate has a meaning when it brings together elements that can be associated from an economic point of view, and when these elements, acting together, reflect a phenomenon.

The main advantage of rates is that various measures with different economic content can be associated, in order to reflect an economic phenomenon. In practice, although various rates can be created, the rates which reflect the best the analyzed phenomenon must be found.

The method of rates makes possible a better evaluation of the company's status, performances and potential.

The rates represent a ratio between two coherent measures with logical economic content.

Although they are very useful in the comparisons used by financial analysis, there are specific criteria to evaluate rates, which must be taken into consideration for safety reasons, which can be materialized in the following aspects:

- the proportionality hypothesis which presupposes that reporting the values from numerator and denominator would reduce the differences related to the business dimension and reporting period, but there are parts of the dimension (such as large savings) which cannot be eliminated, and some elements do not evolve proportionally in reality (the stocks compared to the turnover);
- the basis of comparison must be unitary, while the interests of financial analysis users are different (high liquidity is in favor of short-term creditors, but for shareholders it may represent a bad management of money);
- the analyzed period must be unitary, the beginning and the end of the exercise is standardized at the level of the whole economy, giving not only a strong static character to the rates, but also a certain level of irrelevance (some activities are highly seasonal,

which makes the calculated rates irrelevant for the operating activity, endangering the relevance);

- the management techniques, which on one side should be unitary, fact valid only at the level of a company, within the sector they being various, and on the other side, they should not “cosmeticize” the financial situation;
- the accounting methods, whose periodical change together with financial techniques such as reevaluations of patrimony elements may distort the rates relevance at the company’s level as well as at the sector level;
- the unitary basket, which means that the average is made from all the constitutive elements of the phenomenon, fact which can distort the average value by the presence of negative numbers.

1.STRUCTURAL RATES		3.RELIABILITY RATES		4.MANAGEMENT RATES
PATRIMONIAL		GLOBAL		ASSETS
- of assets; - of liabilities;		SOLVENCY		- permanent; - current; - operating; - outside operating.
OPERATIONAL		LIQUIDITY		LIABILITIES
- of incomes; - of expenses; - of results.				- permanent; - current; - own; - debt; - on activity.
GLOBAL		<b>FINANCIAL RATES</b>		
- of financial flows.				
2.EQUILIBRIUM RATES				5.PROFITABILITY RATES
PERMANENT				PROFITABILITY
- of financing; - of flows.				- of incomes; - of expenses.
CURRENT		6.VALUE RATES		RETURN
- of financing; - on activities;		PATRIMONIAL		- of assets; - of liabilities.
GLOBAL		FINANCIAL		EFFICIENCY
- of financing; - of treasury flows.		TRADING		- trading; - non-trading.
		MIXED		

**Chart 1.The main categories of financial rates**

Financial rates are used to evaluate the status and the potential of a certain criterion used to analyze and diagnose the company’s status and potential. In this sense, their utility is limited at the criterion they evaluate.

The analysis with rates was initially conceived to supply information to the capital investors, especially to creditors and shareholders. Nowadays, the company’s management and other stakeholders benefit of the informational power of rates.

The goal of the rates analysis is to measure comparatively the profitability in correlation with the risk, in order to facilitate coherent management decisions, in current financial management and on medium and long term, especially on investments and credit.

Thus, depending on the informational power, the sector they refer to and the beneficiaries of information, we can talk about the following aspects as example: (Palepu, et al., 2010)

- investors (shareholders) are interested especially in the information supplied by the profitability rates and the financial profitability rates;
- creditors, depending on the term the credit is given, are interested in the equilibrium rates, especially in the reliability rates which refer to liquidity and solvency;
- managers are interested in all types of rates.

### **3. CONCLUSIONS**

The necessity to use the rates is a consequence of the need to standardize. Companies differ one from the other from the point of view of dimension, business volume, space of action, as well as from the point of view of concrete organization of business.

Thus it appears the need that at least for the companies belonging to the same sector may be issued value judgments on the basis of some indicators.

The main advantages of the use of financial rates are:

- it eliminates the differences of dimension between companies within the same sector;
- it allows to evaluate the status and potential on main areas of analysis and diagnosis;
- it ensures a good comparison in dynamics.

The main disadvantages of the use of financial rates:

- there are significant differences between sectors, regarding the setting of some optimum limits, and within the same sector, the industrial average or data related to the main competitor can sometimes be irrelevant;
- the fluctuations during a year and the seasonal phenomenon do not surprise, being based on the linearity hypothesis of factors which make up the indicator, fact caused by the moment the balance sheet and the additional annexes are made;
- the global (synthetic) evaluation of a company's financial situation on the basis of rates is more difficult, because the construction of indicators is limited to the specific criterion of analysis and diagnosis (disadvantage partially eliminated through factorial models built on the basis of explicative rates, or through the method of profile diagrams).

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## THE TRANSATLANTIC TRADE AND INVESTMENT PARTNERSHIP

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***Abstract:** The Transatlantic Trade and Investment Partnership is a project of exceptional importance which opens a new stage in the globalization process. Given its historical significance, this construction causes numerous debates and controversies. This article attempts to draft a few reflections regarding the main elements, dimensions, orientations, the basis values, objectives and the relevant actors (economic, political, formal and informal) of this greatest bilateral trade agreement. We will attempt a decrypting, on the basis of press articles, of political discourse, and of different analyses and comments, what are the social and economic effects, what are the consequences on democracy of this market project.*

***Keywords:** transatlantic market project, significance, actors, content of the treaty, critical points*

### 1. INTRODUCTION

The Transatlantic Trade and Investment Partnership – TTIP - which entered the fourth round of negotiations, is a project of exceptional size and importance which opens, as the Trans-Pacific Trade Partnership (TTP), a new stage in the globalization process.

Behind the terms designating a classical trade agreement hides, in fact, a project of radically different magnitude. It is a matter not only of reconfiguring the large structures of the global market, but also a crucial moment in the world geopolitics. Even though negotiations are in progress, given its special significance, this project causes numerous controversies and debates. Criticism targets not only the lack of transparency of the discussions, but also the content elements of the agreement. Thus, since the negotiation mandate was not published and since there are still question marks with respect to the true stakes, but also dangers, of this project, we attempt, on the basis of press articles, of different analyses of reflection groups (such as, for instance, Open Democracy, Corporate Europe Observatory/Transnational Institute, Center for International Policy), of comments from specialists, to draft a few reflections regarding the main elements, directions and ambitions of this historical construction. What is the need and how is this partnership justified, what are the implications, the economic and commercial advantages and disadvantages, which are the effects at the social or political level, what are the consequences on democracy? In other words, what are the true stakes and perspectives? The questions are even more pertinent as the information is split, inaccessible or difficult to access. We will attempt a decrypting of what is behind the

public discourse (political and media), by means of identifying the actors (political, formal and informal), by underlining the objectives and constraint of this greatest bilateral trade agreement ever to be negotiated.

## **2. THE EU-USA TRADE PARTNERSHIP: THE CONCEPT OF TRANSATLANTIC MARKET, ECONOMIC JUSTIFICATION, OBJECTIVES**

Following the mandate granted on June 14<sup>th</sup>, 2013 to the European Commission by the UE Council, starting with July 8<sup>th</sup>, 2013, the USA and the EU have inaugurated negotiations for a trade and investment agreement called the Transatlantic Trade and Investment Partnership. This bilateral free trade agreement draft also called the Great transatlantic market or TAFTA (Transatlantic Free Trade Agreement) is placed, as other projects of the same nature (such as, for example, NAFTA or the Asia-Pacific Partnership which is in the process of being negotiated) in the line of liberal and de-regulating policies of the IMF, WB, WTO. The negotiations, which are in their 4<sup>th</sup> cycle (March 10<sup>th</sup>-14<sup>th</sup>, Brussels), will have to be concluded in 2015. Although the integral content of these negotiations, as well as the mandate, have not been published, different sources, official or journalistic, made its main elements known (European Commission 2013a; Lagune 2014; Jennar 2014; Umucyo 2014).

### *2.1. The transatlantic market - concept*

The common transatlantic market is conceived as an expansion of the already existing economic liberties to a vast geographical area (the USA and the EU), which will comprise countries that concentrate half of the world GDP. Therefore, it represents the development of trade between the economies of the countries with a high development degree. The declared objective of the Trade and Investments Partnership is a greater liberalization of commercial and financial trade, accompanied by common judicial and security policies. Conceived to enter into effect in 2015, the transatlantic market presupposes the removal of any obstacles from the path of trade, of financial regulation. By eliminating the commercial obstacles, but also the regulatory ones, the target is a total mobility of goods, investments and capitals between the two continents. Through this agreement, the companies are free to invest, to produce, to delocalize within the free trade euro-Atlantic area, according to the already applied model of the European single market.

Even though there is talk of a free trade agreement and although, of course, the free trade component is central, still, this is not a usual trade agreement. It is not only a matter of eliminating customer barriers that still persist, but which are insignificant or of harmonizing technical regulations. It is a question of eliminating especially the internal sanitary, environmental, social, food etc., (non-tariff) barriers considered by the transnational enterprises as obstacles in the path of expanding their economic liberties and increasing their profits.

### *2.2. Economic justification*

The interests at stake are considerable. First of all, taking into account that the transatlantic trade relations represent the spinal column of world trade, this agreement will be not only the largest agreement ever signed between the US and the EU, but also the largest economic contract ever signed (*NewEurope2013a*).

In what concerns the expected benefits of this partnership, they are, on maturity (after approximately 10 years) evaluated at 100 billion euro for the respective GDP of the partners, which represents a significant amount. Concretely, in the bulletin of February 13<sup>th</sup>, 2013 of the European Commission, it is estimated that until 2027, as a consequence of this agreement, the European GDP will increase with 0.5%/year and with 0.4%/year in the US. Also, according to the studies of the European Commission, the EU exports could increase with 6%, while they would increase with 8% for the US - respectively 220 billion euro for the EU and 240 billion dollars for the US (European Commission 2013b). In the same optimistic note also falls a report of the Center for Economic Policy Research, which makes even more spectacular forecasts regarding the EU exports to the US, which would increase by 28% (Center for Economic Policy Research 2013). In addition, considering that the tariff barriers are already low – 4% on the average –, the main obstacles in bilateral trade are the divergences in regulations and standards, as well as the consumer protection regulations, such as their elimination could reduce the costs of imports with 10-12% (Lagune 2014). Still, even though, in reality, the benefits of this agreement seem to be considerable, it is regrettable that in this stage of the negotiations they are now known, or too little known, at least by the European public opinion.

### *2.3. Significance and objectives of the transatlantic market project*

The treaty to accomplish a Great transatlantic market is especially important due to the economic and political power of the two parties, the USA and the EU representing half of the world GDP and 1/3 of the international commercial trade. However, this project has stakes that exceed the euro-Atlantic framework. It falls into a global strategy, boosted by the US and supported by the EU, to conquer the world markets and to counter the economic offensive of the emerging countries, especially China.

The trade partnership between the US and the EU is part of the new wave of free trade agreements, as the recent Economic and commercial agreement between the EU and Canada, or the Transpacific Partnership concluded by the US with 12 countries in Asia (except China), as well as the numerous other free trade agreements, The agreements of this type of strategies for dividing the world in large economic and political blocks and which, from the strictly commercial point of view, short-circuit multilateralism and exceed the economic liberalism and the deregulation promoted by the WTO. These new commercial partnerships essentially target the expansion of the rights and powers of the large multinational enterprises which have become economic and political entities which, by dimensions and importance, rival the large national economies. Indeed, according to a ranking published by Global Trends for year 2012, 58% of the top 150 most important entities in the world are the multinationals. Among them, the main oil, natural gas and mining companies, banks and insurance companies, telecommunications and large distribution giants, car manufacturers and pharmaceutical enterprises. For instance, the most important multinational company is Royal Dutch



Shell, which in 2012 recorded a turnover that exceeded the GDP of 171 countries and which is the 26<sup>th</sup> economic power in the world (before Argentina and Taiwan), even though it has only 90,000 employees. In 2012, the cumulated turnover of the top 5 largest oil companies represented 2.6% of the world GDP, which indicated the tendency to concentrate capital at the global level and to strengthen the rights and advantages of the large transnational companies (UNHCR Global Trend 2013).

Example of last generation commercial treaty, the Euro-Atlantic Trade and Investments Partnership exceeds through ambitions and objectives what was targeted and achieved through NAFTA (the Free-trade agreement concluded between the USA, Canada and Mexico and which entered into effect in 1994) and GATT (WTO). Acting through industrial associations, lobbies, groups of experts and foundations, the multinationals put into practice, by means of this agreement, large projects targeting the concentration of the transnational economic, but also of the political power, in their hands.

Thus, the deep significance of this institutional construction is the transformation of the nature of power which passes from the local and national authorities to transnational forms of governance (private or public). Through this type of agreement, private power tends to replace public power, by delegating to the private sector the possibility to decide social, environmental or cultural regulations. Indeed, since the market is not a natural fact, but a political construction, it requires a harmonization of the legislations in the two spaces, which implies a mainly political transformation and specific institutions. This legislative reform in favor of private economic actors comforts the idea according to which the governments in the EU and the US tend to become the political instruments of transnational corporations (Marshall 2013).

#### *2.4 The basic idea and values: priority of the private interest and the end of the Providence State*

At the basis of this agreement model is the central idea of neoliberals, according to which the profits, the private interest, in general, are more important than the general interest. Indeed, the Transatlantic market privileges at all levels (economic, social, political, cultural etc.) the values and objectives of the large multination groups, such as: permanent competition, absolute profit, subordination of the political world to the economic world, the commodity-orientation of society (seeing social relations as commercial relations), privatization of goods and services, omnipotence of the market. Once adopted, these values imply the back stroke of opposite values: social values, ethical moral values, democratic values, in general the values connected to the general interest (social justice, solidarity), respect of the environment. In analytic terms, it is a matter of the triumph of the market over the State, more precisely, the end of the state paradigm and of the post-war Providence State, it is the triumph of neoliberals on the other possible models of economy and society, it is the „governance” paradigm within which power is quasi-totally unbalanced in favor of the private actors and of the economic interests.

In conclusion, it is a matter of a project of capital importance for the Western Euro-Atlantic economies and societies. The significance and stakes of the agreement exceed, however, this framework. Thus, according to the statements of Karel de Gucht, European commissioner for trade and one of the persons responsible for applying the future concrete negotiations, „this agreement will become the rule not only for our future bilateral agreements, but also for the development of the global rules that will define the future economic context of the world” (*NewEurope* 2013b).

### **3. GENESIS AND STAGES OF THE PROJECT, RELEVANT ACTORS**

The project of the transatlantic market has its origin in the far period of the Cold War, but is more clearly outlined in the 1990s. The agreement was elaborated within several official transatlantic meetings, but especially through an intense lobbying activity from the multinationals with the political leaders and members of the European Commission, within dialogue opportunities created under the patronage of the European Commission and of the US Trade Department.

#### *3.1. The start of the euro-Atlantic commercial project*

The project of the free trade agreement between the EU and the USA was publicly announced and saluted with unanimous enthusiasm by the officials, the business world and the media in February 2012, the first bilateral meeting taking place in July 2013.

Still, the real debut of the transatlantic integration process is in October 2011, when was established the „*High level working group in the field of labor force and growth*” (within the Enterprise and Industry Commission of the European Commission), a transnational study commission created by the US government and the European institutions and composed of a small group of European and American experts. The goal of this Working group was to „identify the policies and measures that must be put into practice in order to increase the commercial trade and transatlantic investments and to mutually support the creation of jobs, economic growth and international competitiveness, working closely with the public sector and the actors of the private sector and calling, in an appropriate manner, on the already existing relations and mechanisms” (European Commission 2012a). Therefore, the displayed objective was the analysis of the different modalities of political and legal action available in view of expanding transatlantic trade and the creation of a unified market on the two sides of the Atlantic (the Atlantic single market).

The final conclusions of this report of the Working group were published on February 12<sup>th</sup>, 2013. The sensitive points identified in the report referred to the trade of agricultural products (especially to the sanitary regulations); intellectual property rights; legal and ideological divergences with respect to the WTO (widely consumed in the USA). For the American part, the most important problems are those related to the entering of the American companies on the European market. According to the estimations and in spite of the critical points signaled by numerous analysts, the signing

of this free trade agreement anticipated, as indicated, an important increase of the European and American GDP, but also other economic advantages (*NewEurope2013c*).

*Several historical landmarks of the transatlantic integration process*

However, the project has a history. This agreement, which expresses the interests of the multinationals to concentrate the power of private capital, is not a new initiative, but the expression of a tendency that has been manifest for more than 20 years. Thus, between years 1995 and 1997, the MAI project (Multilateral Agreement on Investments), secretly negotiated within the OECD by the 29 member states was a similar attempt, which targeted the strengthening of the power of investors towards the governments (Henderson 1999). Also, dispositions of other treaties, such as, for instance, the FTAA (the Free-Trade Area of the Americas), but also certain negotiation cycles of the WTO, elaborated in the same ultraliberal vision, failed or were significantly modified (George 1999).

Thus, in order to understand the importance of the Transatlantic Partnership project in its current form and as can be seen from the conclusions submitted by the Working group, several historical landmarks are not without interest, since this agreement is the result of a long process of reflections and actions which, for the most part, took place in the backstage of power in Washington and Brussels.

The project origin is at the beginning of the 1990s, the first mention going back to 1991, hence immediately after the fall of communism, in the text of the *Transatlantic Declaration* - signed in 1991- (La Documentation française 2008). In this declaration emerge the current proposals to eliminate custom duties, but also the will to strengthen the political relations, the priority being, at that moment, the intensification of the transatlantic cooperation and solidarity. In year 1995, a *New Transatlantic Agenda*, adopted by Brussels and Washington, mentioned for the first time, formally, the creation of a transatlantic market and underlined the need for the EU-US closeness in numerous fields, from promoting world peace to establishing closer and more diversified economic relations, but also the establishment of cultural, social and scientific connections between the two areas. The materialization of these projects and intentions starts to become concrete through the establishment of contacts, formal and informal, between politicians and representatives of the business world, between the two blocks. The creation of the *Transatlantic Business Dialogue* group, the largest lobby of multinationals at the transatlantic level, is one of the expressions of these influence networks that have supported and sustained this project.

An important moment in the process of transatlantic integration was the signing, in May 1998, at the EU – US summit in London, of the *Transatlantic Economic Partnership*. This economic charter contains the essential of the elements to be found in the final report of the Working group of February 2013, namely: the creation of a common market of agricultural products; elimination of custom duties; legal equalization with respect to intellectual property; investments and electronic trade; liberalization of trade and investments. In other words, it is a matter of harmonizing the regulations for

goods and services, for the purpose of accelerating the economic integration process of the two blocks.

On April 30<sup>th</sup>, 2007 was created, following the agreements between George Bush (then president of the US), Angela Merkel, then president of the European Council and Juan Manuel Barroso (then president of the European Commission), the *Transatlantic Economic Council*, structure lead by the European trade commissioner, Karel de Gucht, and by Michael Froman, representative of the American side. The objectives of this Transatlantic Council, which meets once a year, are, in fact, the goals defined in 1990, namely the establishment of an application framework for the transatlantic partnership by harmonizing the regulation policies, for the purpose of increasing competitiveness compared to the emerging economies, especially China, and of limiting the possible protectionist deviations of different governments.

*The multinationals and the lobby groups: main actors of the production of legality and public policies*

The Transatlantic market project is the result of the initiative and action of the most powerful private enterprises, the political decisions that are at the basis of creating this market being the direct result of the lobby activity performed by these private companies which act either as official organizations, or informally.

In view of reaching their objectives, the multinationals have grouped in different pressure groups that integrated either as expert consultants in the transatlantic architecture (see the main role of the Transatlantic Business Dialogue), or as organizations external to this construction, but still very influent, such as, for instance, Transatlantic Policy Network. These lobby groups connected to the world of multinationals imposed as official partners of this political process, being an integral part of the transatlantic decision process. Even though they are extremely numerous and varied as profile and importance, we shall limit to presenting the most active and influential.

Thus, among these lobby groups, a dominant, but not singular, position is held by the *Transatlantic Business Dialogue*”, already mentioned as being the lobby group that established the project priorities and objectives. The members of this group are exclusively the multinationals that imposed on the treaty a purely and exclusively commercial logic to the detriment of the social (work, decent wage, social security) or environmental policies, these important problems not being present on the transatlantic agenda. This strong interest group does not act alone. At the beginning of year 2013, it merges with another lobby of private companies (*European American Business Council*) and forms the *Transatlantic Business Council*, an organization representing 70 multinationals and which displays compatibilities with other lobby groups, among the most known being the American Chamber of Commerce, the Federation of German Industries, Business Europe (the European federation of the business world), but also a series of reflection groups (*think tanks*), such as, for example, the Council Atlantic, Marchall German Fund, the Peterson Institute for international economic relations.

Another very strong interest group is the *Transatlantic Policy Network*, Euro-American institution created in 1992. Composed both of businessmen and politicians (American and European parliamentarians), the group is at the same time supported by numerous *think tanks* such as the Aspen Institute, the Council for Foreign Relations or the Brookings Institute. If we refer to the business component, the group represents the interests of the especially American multinational companies such as, for example, AT&T, BASF, Bayer, Nestle, Hewlett Packard etc. the other half is composed of 60 European deputies and American congressmen. The fact that 8% of the European parliamentarians are members of this multinational network shows that the European political world was influenced in its decisions by the arguments of this lobby group, Transatlantic Policy Network being a net illustration of the fact that the interference between the political sphere (American and European), the analysis and university circles and the business world is total (Nikonoff 2014).

Another lobby group very active within the influence networks in favor of the transatlantic market is *Business Alliance for TTIP*, created, discreetly, in May 2013, and composed of Euro- Atlantic companies. Acting as „network of networks”, this group is the spokesperson for the multinational enterprises with the official negotiators of the agreement. This group is established of owners’ federations, of the most representative American and European chambers of commerce, and includes the two lobby-s mentioned above - Transatlantic Business Council and Transatlantic Policy Network- (Gatines 2014).

In conclusion, the project is boosted and supported by an ensemble of corporations dominated by think tanks and large business organizations. Collectively, these institutions form the „transatlantic corporatist complex” (Marshall 2013), a both formal and informal structure, which reunited the elites of the large corporations, of the big banks, foundations, universities and political circles that through reports, articles, analyses, meetings, has a determinant role in establishing the political agenda and in supplying expertise in formulating the Euro-Atlantic objectives and strategies.

#### **4. CONTENT OF THE TREATY, ORIENTATION AND CRITICAL POINTS**

##### *4.1. Dimensions and orientation*

The future agreement has three main pillars (three negotiation fields), but in other fields (energy and raw materials, royalty and others), the proposals will be outlined in the future rounds of negotiations which will take place until the summer of 2014.

Thus, if we refer to the main subjects, first of all it is a matter of opening the public and private markets, at all power levels and in all fields: industry, agriculture, commerce, services. In principle, the regal functions (army, police, and magistrates) should be excluded, but to the extent to which in the US the army and police are already partly privatized, there is no real guarantee that these services will remain public. Practically, all activity sectors and especially the public services can be co-modified and opened for international competition.

The second field of negotiation refers to the elimination of the tariff and non-tariff barriers. If we refer to tariff barriers, they are important in certain sectors, such as, for example, agriculture. The implications for the European agriculture will be important and, according to the opinion of several specialists, rather negative. Facing the American competition, which takes advantage of a strongly industrialized agriculture, hence, with reduced production costs, the impact on the agriculture of countries such as France, Romania or Poland will be considerable.

The elimination of non-tariff barriers is the critical point of the agreement. All social, environmental regulations, the entire legislation affecting the economic and social life and which implies society choices that pertain not only to the economy, will have to be reviewed depending on a single criterion, which is the facility of trade in favor of private interests. The legislations will have to align to the least constraining rules, namely the American regulation, in all fields: regulations regarding the exploitation of shale gas, regulations regarding the use of chemical products in industry, food and phyto-sanitary regulations, labour law, regulations regarding health, those referring to medicines, to social protection or those regarding environmental protection (European Commission/Trade 2013). In the conditions in which in the US have not signed the largest part of international conventions of the International Labor Organization or the Kyoto protocols on climate, or even the international conventions regarding children's rights, we can estimate the magnitude of changes for Europe, as well. Other important provisions refer to the financial services which are not excluded from the general deregulation, the free travel of capitals going to be guaranteed, which will lead to the increase of speculations and the states' indebteding degree.

However, the project key refers to investments, more precisely to their protection system. For this purpose, the agreement establishes the creation of a mechanism for regulation the investor/state litigations (which is already functioning within NAFTA), by means of which the multinationals will gain exceptional power, in the sense of substituting the public law with the private law of an arbitration tribunal (which refers only to investors' rights). Thus, a private investor that estimates that its present or foreseen profits are threatened by laws, regulations or projects of a state, which it considers „unreasonable, arbitrary or discriminatory” and which, in its vision, „would cancel or compromise the advantages deriving from this agreement”, could constrain that state, under the threat of applying large penalties, to modify its laws to the detriment of the collective interest and of the fundamental rights of its population (CEO/TNI Report 2014 ; Romanet 2014). In this sense, it is worth mentioning that there are already in the world 518 complaints of this type of compensations, extremely burdening on the respective States and their citizens.

In conclusion, these provisions of the agreement will allow the attacking in justice of a state that does not comply with the neo-liberal rules – meaning they will allow the companies to request compensations from the states for the loss of benefits due to the national policies in the field of health, environmental protection and financial regulation. We can estimate the magnitude of the negative effects this agreement can bring forth, one of the anticipated consequences of these penalties being a rapid increase of the debt of

states that would refuse to abandon their constitutional right to pass legislation (UNCTAD 2011; IMF 2012).

*Other several lines of the treaty*

We mention, without elaborating, other important aspects targeted by this agreement. Thus, the government will no longer have authority in matters of regulating the exports of oil or natural gases to the member states, which will bring forth an intensive drilling process throughout the European Union. In the same sense, the agreement establishes that the large corporations in the field of energy will be able to export natural gases into and from any member state without the national governments to be able to issue approvals with respect to the consequences on the environment and the economy of the local communities or on the national interest. Other provisions target the forbidding of taxes in financial transactions, while other directions refer to royalties, such as, for instance, the monopoly in the field of patents in the medicines sector, which will reduce or block the circulation of generic medicines. Another negotiation chapter targets the monitoring and control of activity over the internet. Also, in the name of the fight against terrorism (whose definition is arbitrary), the EU and the US legalize the control and spying on citizens, by means of exchanging the personal data files (Jennar 2013; European Commission 2013c).

*Constraints of the Treaty*

The entire legislation necessary to promote the values of the business world and the interest of the private capital are just as many constraints and threats for the democratic systems and the general interest. This project risks having important negative consequences in several fields: finances and public services, the increase of social inequality, increase of pollution, the limiting of social movement, the breach of fundamental liberties. In other words, the transatlantic commercial values endanger the general interest social and democratic conditions and values.

If we refer to the social consequences of the agreement to achieve the transatlantic market, the treaty, as the European economic and monetary Union, does not establish the harmonizing of the social and fiscal legislation in the transatlantic space, each state being free to set its choices in the matter. Still, since the economic liberties grant to the multinationals and the financial markets the right to move, they can also exercise pressures for the modification of the social and fiscal legislations that represent, in their vision, a cost for them and a profit-reducing factor (Wallach 2013 ; Jennar 2014). Already applied in the European single market, this social and fiscal dumping dynamics will strengthen on the transatlantic market, threatening the labor conditions, the level of salaries or the financing of social security. The conclusion is difficult to avoid: this agreement may lead to the elimination of thousands of jobs occupied by the middle class, but also to the destruction of sustainable agriculture and of proximity trade. Instead of ameliorating the European social model, which could serve as reference to the transatlantic project, on the contrary, the social conditions in the less developed and

poorer countries will become standard and reference, bringing forth the deterioration of this model (deterioration of the social environment and of the fiscal conditions). The single transatlantic market will lead to the precarious situation of most vulnerable persons, while social inequality will deepen. Although this logic of become more precarious will especially effect the developed European countries, with high social standards, the privatization policies and the co-modification will apply on a wider scale in all EU states, implying the de-structuring of public services, and transforming education, public transports, culture, health, in a merchandise like any other, subjected to the logic of profit maximization.

## **5. DEMOCRATIC DEFICIT AND SHORTCOMINGS OF THE EUROPEAN DEMOCRATIC MODEL**

Apart from the social, cultural or environmental consequences implied by the agreement, directly or indirectly, question marks are raised by the aspects related to the observance of the democratic principles. The first observations regarding the breaching of these fundamental lines refer to the non-transparent character of the negotiations, the mandate granted to the European Commission being inaccessible or difficult to access for the entirety of European citizens. Under the pretext indicated by the EU officials, according to whom these information contains aspects of the negotiation strategy which, known by the partners, would weaken the EU position within the negotiations, the trade union organizations or the representatives of the civil society have been practically excluded from these arrangements.

Other elements, such as, for example, the political marginalization of the European citizens in decisions regarding public interest fields or the breaching of provisions of European treaties are just as many reasons for alert and concern.

### *5.1 Lack of transparency and the political marginalization of the EU citizens*

A first breach of the democratic principles is connected to the secret, opaque character of the negotiations. As in the case of the North-American Free Trade Agreement (NAFTA) or in the case of creating GATT (Global Agreement on Tariffs and Trade) become WTO, there was no real public consultation with respect to the content of the treaty and, especially, to its potential consequences. In fact, for several years now, NGO's and citizens' organizations in the EU have been criticizing the EU trading policies for the lack of transparency, democratic deficit and the pro-multinationals partisanship which characterizes the decisional process (Stichele, Bizzari and Plank 2006).

Also in the case of the current trading Partnership, even though the Commission claims that the viewpoints of the civil society play a crucial role in the decisional process, the lack of openness and public participation raise question marks and have generated critical positions of the social forces, associative, political but also trade unions. Even though, faced with these actions, the European Commission initiated a vast public relations campaign, in what concerns the transparency of the preparatory documents and the accountable behavior of the European officials, numerous organizations of civil



society and careful observers of the process have highlighted the lack of democratic control and public debate with respect to the stake of the negotiations.

Thus, Corporate European Observatory reveals the content of a Commission internal document which shows that for the preparation of the negotiations regarding the transatlantic trade agreement, the General Trade Directorate had, in 130 meetings with the parties involved, at least 119 meetings with the large enterprises and their lobby groups compared to only a few with the trade unions and consumers' associations. Moreover, the CEO report shows that these reunions with the business world, which represent 93% of the total consultations, occurred behind closed doors (CEO Report 2013).

Other elements highlight the lack of transparency of the European Commission's actions and the non-democratic tendency to reduce to a maximum the citizen debates, as, for example, the different documents referring to public consultations and the appeal for contributions of April 2012, September 2012, and October 2012. Thus, for instance, the public consultation achieved in February 2012 had an extremely discreet character, as well as the subsequent public consultations – April, September, and October 2012, when persons and interest groups involved or interested in this project were invited to answer several public questionnaires. The questionnaires were published on websites well known by the citizens. Thus, between February and April 2012, 48 answers reached the European Commission, divided as follows: 34 from industrial and financial lobby-s; 5 from private enterprises; 4 from individual persons; 2 from citizens' lobby-s; 2 from countries (Latvia and Denmark); 1 from an attorney association. This division highlights the lobby domination and the over-representation of multinationals. In the same sense, the questionnaire of September 2012 comprised 12 questions with industrial and commercial character, and only 3 questions with civic character and 3 general ones. So, 12 questions (out of 18), meaning 66%, are strictly commercial questions, which shows not only the quantitative unbalance, but also the qualitative unbalance of the questions. By contrast with the questionnaire addressed to the economic groups, the questions focused on civic interest were less elaborate and more closed (multiple-choice questions that allow a quantitative analysis of the answers) and only 2 open questions, the goal and real finality of this manner of formulating the questionnaires being the hiding of the negative effects and the underlining of the positive effects of the agreement (European Commission 2012b; 2012c). It derives the fact that the privileged addressees of the public questionnaires were the private companies whose interests were considered with priority in defining the negotiations agenda aiming for the change of the legislation (which is the essence of democracy), on the basis of these answers being drafted the official report that constituted the basis for launching political negotiations in 2013.

#### *Shortcomings of the European democratic model*

The procedures for concluding the agreement, more precisely certain details related to the procedure for giving a mandate and its main elements, highlight several shortcomings of the European democratic model. Thus, the mandate, which was adopted with the unanimity of the member states, has three directions, one being the „decision of

the EU member states to authorize the Commission to negotiate, in their name, the dispositions of the EU/US Transatlantic trade and investment partnership that do not pertain to the EU competences". On the grounds of this direction, the Council approved the start of the discussions with the US in view of concluding the free trade agreement (Council of the EU 2013). However, this direction contradicts a major provision of the Lisbon Treaty regarding the „division of competences between the Union and the member states", as clearly expressed by art.207/6 a TFUE (*Journal officiel de l'UE*2008), article that directly refers to the procedure requested for the conclusion of international agreements such as TTIP. It means that the Union not only breached the Treaty for the Functioning of the EU, but even the Treaty on the EU which stipulates in art.13/2 that „Each institution shall act within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions and objectives set out in them" (*Journal officiel de l'UE* 2010). Or, this breach of the fundamental treaties by the EU is comparable with the breaching of the constitution by a state, which raises question marks and unrest coming from an organization that presents itself as an authentic defender of democracy within and outside the Union (Umucyo 2013).

Numerous observers and analysts have noted other aspects related to the negotiation mandate which emphasize the weaknesses and the democratic deficit at the EU level. Thus, the mandate given on June 14<sup>th</sup> was published only in English breaching the obligation to publish official documents in all European languages and, fact already underlined, it was difficult to access. The pretext given by the European officials is that this information contains aspects of the EU negotiation strategy which, thus known by the partners, would weaken the EU position during the negotiations (European Commission 2013d). Or, thus expressed, the reasons for the lack of transparency do not suggest a matter of a „partnership" whose purpose is to obtain mutual advantages for all parties (EU, USA and their citizens) and these reasons are in disagreement with the statement made by Ignatio Garcia Bercero, EU chief negotiator, who gave assurances that „ it's very important (...) to communicate as clearly as possible to our citizens, say what is the position that each one is taking in the negotiation, and that's the reason why the European Union will have made an effort to make as many position papers public, where we indicate in each of the different negotiating areas which are the objectives that we are pursuing in the negotiation and our doors are always open to discuss with any interested stakeholder any issues which are a matter of concern" (USA-Department of State 2013).

## 6. CONCLUSION

*Beyond the economic and commercial significance – a project with geo-political and geo-civilizing ambitions*

Behind the discourses and analyses about the economic growth, jobs and competitiveness, the medium and long term ambition of such an alliance is to unify the two continents in a political and cultural block, which, from San Francisco to the eastern borders of Europe (namely, until Russia) will constitute a unified world – the western world. Moreover, this project whose objectives exceed the economic field, target the consolidation of western leadership and especially of the USA. Thus, the Transatlantic

Partnership is, in fact, a project with strong stakes which, through the complete reconfiguration of the world commercial order, aims at reconquering the geo-strategic position of the US which, in the last decade, in the conditions of increased influence of emerging countries (BRICS), and especially China, but also of the anti-liberal revolutions in Latin America, lost the statute of single super-power.

This objective is in fact clearly stated in a common communication in which it is considered that this agreement constitutes for the US and the EU the possibility not only to develop trading and investment relations, but also to contribute to the elaboration of world rules that would consolidate the multilateral commercial system (European Commission 2013e). In another statement, the US president compared the transatlantic partnership with an „economic alliance as strong as the diplomatic and military alliance that is NATO” (*Le Monde* 2013, *The Wall Street Journal* 2013).

At the basis of this large geostrategic and civilization project are the common – namely western – values (economic, socio-cultural, and historical), the binder being the neo-liberal Anglo-Saxon ideology. In other words, it is a matter of an EU-US integration process, process which will lead to the political and cultural uniformization of the two areas (Paye, 2009).

In order to understand the magnitude of the project and its considerable concrete consequences, if it will be achieved in the currently foreseen form, several observations with implications on the European integration process are not without interest.

First of all, the transatlantic unification will be achieved according to the North-American economic-cultural model, which will affect the affirmation of a European identity. In fact, the American influence Europe is present for many years and strongly visible through the large number of *think tanks*, such as, for example, German Marshall Fund, The Chatham House or the Bertelsmann Foundation, but also of other supra-continental institutions, out of which NATO is the most representative. Secondly, the transcontinental institutional influences induced by a single market will also play their part, first directly, on the social and environmental policies, which, from the point of view of many criteria, are very different and even divergent in the two areas, and then indirectly, in the increasingly accentuated limiting or even losing of sovereignty by the European democracies. With respect to the immediate influences, related to the European social and environmental policies and regulations, the debates focused on the agriculture based on genetically modified organisms (GMOs) or on the problems generated by the exploitation of shale gases emphasize their strongly controversial character.

The few observations underline to need to think this transatlantic construction from two distinct perspectives, the economic and the political one. The putting into practice of numerous laws which to harmonize the regulations regarding the traded goods and services and which to lead to the creation of a large unified transatlantic market is only one facet of the integration process. As for the European integration process, the creation of a single market in a first stage will lead, in time, to the creation of a political union, of a transatlantic Federation having as basis a common defense (which exists *de facto* with NATO) and unified monetary regulations. In fact, in a resolution of the European Parliament from April 25<sup>th</sup>, 2007, is mentioned that the „existing inter-parliamentary exchanges will have to be gradually transformed in transatlantic parliament

(...)”(Réseau Voltaire 2009). Or, this transatlantic partnership, regrouping members of the US Congress and of the European Parliament, will be able to constitute, if achieved, the first concrete expression of the creation of a transatlantic Federation. Also, the perspective to have a common transatlantic currency, which could be called euro-dollar, represented one of the points discussed in the meeting of the Transatlantic Economic Council of May 13<sup>th</sup>, 2008 (Hillard 2009). Such a monetary union would be, as in the case of the European integration, a logical consequence of the creation of a unified common market and of putting into practice certain transatlantic political institutions. Such a possible and probable evolution could be reasonably anticipated if we take as model the European construction started in the 1950s. We remind that the European integration project started with an economic union (the creation of the European Community of Coal and Steel in 1952) which lead then to a progressive economic and political integration (the Treaty of Rome in 1957 and the following original treaties) and which, in its turn, lead to a monetary union (adopting the euro in 1999). Thus we have several indications that the transatlantic integration will, most probably, follow the same trajectory regardless of the social and cultural consequences.

This agreement has a special global importance, is the „decisive force that shapes the world politics” (Hillard 2009, 2-3), is a turning point in the world geopolitics, is an „economic NATO” in progress (Gray 2013). Even though today it is difficult to anticipate the final form of the agreement, still, given the forces involved, it is to be expected the conclusion of a concrete treaty, in accordance with the objectives of the large multinationals, but with the ignoring or minimizing of the social, environmental and cultural implications, and especially of the a fundamental democratic principles. This seems to be the stake and the main challenge of the next year, both for the western democracy and at the level of analyses, theories and debates in the field of social sciences and European studies.

1 Transatlantic Business Dialogue is, according to the official website, a transatlantic cooperation framework between European and American companies. It is a coalition of American and European leaders, especially heads of more than 100 multinationals, whose main objective is to stimulate trade and transatlantic investments. This interest group is the first of the Euro-Atlantic institutional family that, in fact, targets the integration on term between the US and the EU. At the origin of the creation in 1995 of the already mentioned New Transatlantic Agenda, starting with 2003, the group becomes much more offensive in promoting the transatlantic market project, objective officially adopted since 2004, in the US-EU summit. It can be considered that through the adoption in 2007 of the Framework Agreement for the Promotion of the Transatlantic market, this project becomes official (Transatlantic Business Dialogue Official website).

2 Today, in within the two, the pending procedures in issues of general interest (medical patents, anti-pollution fight or laws on climate and fossil energy) bring forth for the multinationals petitions for compensations of 14 billion dollars. Among the examples, we can refer to the Philippines which had to return to the German operator Fraiport 58 million dollars, which is the equivalent of the wages of 12,500 teachers or the vaccination of 3.8 million children. Or, within ALENA, Mexico had to pay the American company Metaclade an indemnity of 15.6 million dollars for the refusal to open a site of toxic products which was contaminating the water. Also within ALENA, Canada was already targeted 30 times by North-American companies for the health and environment regulations, with penalties of 226 million dollars in total (UNCTAD, 2013). Other sources show that in the last 20 years, the number of arbitration cases increased from 38 cases in 1996 to 450 in 2011. Also, there is noted a considerable increase of the amounts

involved. Thus, in the years 2009/2010, of the total cases there are 151 arbitration cases in the field of investments in which the companies are asking states at least 100 million dollars (CEO/TNI Report2014).

3 Of course, the emerging countries do not yet represent an organized global power structure, still they manifest as a world economic and political actor, reminding through certain traits and positions of the Movement of the non-aligned countries in the years 1960 and 1970. Within this ensemble, China occupies, through its dimension, but also through its political regime, a special position. Thus, the objectives of the US geo-strategy and geo-economics are to control the increase of the economic and political power and influence of China. This surrounding will be achieved on the one hand through the Trans-Pacific Partnership, and on the other hand through the Transatlantic Trade and Investments Partnership. According to the specialists, it is very probable that TTP will be concluded before the Transatlantic Agreement, which means that the US will be in a stronghold towards the European partners to impose on the EU standards already negotiated within TTP, and which already apply within the North-American Free Trade Agreement (NAFTA).

4 We also remind that NATO is not an organization with exclusively military calling. Article 2 is essential and sends to the targeted economic objectives: The parties “will seek to eliminate conflict in their international economic policies and will encourage economic collaboration between any or all of them” (NATO Official text). Thus, the purpose is clear: the disappearance of all protectionist barriers. For this purpose, the two blocks on either side of the Atlantic each developed a free trade space (the EU, respectively NAFTA).

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## PUBLIC GOVERNANCE AND STRATEGIC RESPONSIVENESS

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**Abstract** *In the actual context, where globalization is moreover dynamic, the concept of solid state, well defined and territorialised is becoming diffuse while the traditional social connections (labour relations, community solidarity) are becoming weaker and more fragile. The economic individualisation, migration and cultural fragmentation hold a devastating impact upon the living environment, namely significant growth of anonymity, distrust and discontent. As effect of those realities, the governments are searching responses to these processes of “social liquefaction”. Taking into consideration the fact that the governance tools based on authority, hierarchy and bureaucracy are becoming useless due to the lack of effectiveness and legitimacy, we witness the emergence of new modes of public governance, in light to reconfigure solid ground, adequate for interventions. The design of a new type of governance should take into consideration its dual character. One component aims accountable community, as the traditional society has demonstrated that it is not able to generate spontaneously neither trust nor social capital. The second component is focused on identifying those strategies providing that accountability should be taken jointly by the public authorities and the other actors such as companies, third sector organisations and citizens. The accomplishment of such a model means to overcome several challenges. On the one hand, are the members of the community aware of the importance of their commitment? Are they truly motivated to participate in such a structure? On the other hand, how prepared are the political representatives and public authorities to accept cooperation with various categories of actors at community level? The space of strategic responsiveness introduced by the current research provides a possible scenario for responding to the above questions. Additionally, the research attempts to provide an answer to a special question, namely: how prepared is the Romanian actual society to adopt such a space in view to develop new perceptions on objectives, new modalities of analysis, innovative measures, aiming to provide an institutional response on liquefaction of modern social life. The research methodology will comprise bibliographic syntheses, comparative studies as well as social empirical researches.*

**Keywords** *globalization, strategic responsiveness, dynamic capabilities, networks as innovative forms, meta-organization*

### 1. INTRODUCTION

The financial crises, the ideological changes towards the market, globalization, as well as the social changes, constitute the strong contextual landmarks for the current stage. (Pierr and Peters, 2000, John, 2001).

The financial crises through which states are going are the result of having run government policies by means of which was attempted the satisfying of the highest possible number of citizens' needs, on the basis of an absence of budgetary income increase (the increase of taxes and fees being considered, from the social point of view, unacceptable). The re-discussing of the role of the state has become more pressing, in the



conditions of changing the ideology towards the market, but also of imposing certain simplifications, often associated with the contextual framework of governance (Stoker, 2000).

The possibilities and conditions for selecting the domestic policies have radically changed, and the traditional instruments for their implementation and control have evolved towards new forms of government. For example, the putting into application of the public-private partnerships represents one way of controlling the state budget, but also a modality of demonstrating that the state's resources are not sufficient to answer satisfactorily to all development needs of society.

Certainly, these substantial changes create frustrations among certain categories of citizens, dissatisfied by the shift from traditional government to governance.

Governance can be interpreted as a political strategy whose attractiveness is based on: (1) the creation of a framework favorable to the involvement of citizens in supplying public services and the preservation thereof, even in the conditions of the existence of serious budgetary restrictions; (2) a better understanding of the *need to reduce expenses*, due to the new arrangements of participative nature, which lead not only to collaboration, but also to citizens' awareness;

Governance presupposes that the interest and analysis of the aspects listed previously pass beyond the formal strategies of the elected institutions and authorities (Lowndes and Wilson, 2001).

Pragmatic perspective to solve numerous complaints expressed by citizens highlights the need to rebuild confidence in key democratic institutions existing at national and European level. The answer to these turbulences involves formulating a new vision regarding the role and importance of officials in government process, which involve new paradigms of thought and behavior. This new vision consists in the assumption of strategic approaches focused on increasing efforts towards abandoning traditional hierarchies generating corruption, in favor of innovative structures into a strategic responsiveness space, where citizens play an active role.

## **2. NETWORKS AS INNOVATIVE FORMS**

The transformation of the traditional hierarchy into a network structure leads to the creation of some common places to express the problems and look for solutions and where a variety of ideas can be expressed. In these 'real battle fields' a sufficient number of actors are involved, each one representing different objectives, visions and interests. The degree of attendance and action methods of every actor participant in the network is different. Thus, compared to the unitary organizations or the classical hierarchies, these structures are characterized by flexibility.

In the last decade of the last century, the network structure was also promoted at the level of governing systems as an opportunity to involve 'the voice of community' but also other entities participants in the process of elaboration of the compartmental public policies, as F. Fukuyama stated (2004).

The model of the network structure is completely different from the one of the bureaucratic-democratic organization in which the power source is unique, the principles

of the hierarchy of functions and different authority levels imply a methodical system of domination and subordination and in which there is a strict supervision from the superiors.

Hufen and Ringeling (1990) consider the network-structured systems as being social systems where characters develop interaction and communication models that present a certain continuance and are oriented towards political issues and programmes. Briefly, these systems represent real 'governing structures'.

Similar to organizations, the political systems in network can be seen as mixed structures of vertical and horizontal interdependence. The expansion of the role of other actors participants in the network does not imply the reduction of the role of the administration, but the development of some supplementary decision-making forms as a reply to the increase in complexity and interdependence. In this context, the meaning of the concept of political decision receives extremely complex dimensions. The decision-making process follows a model of communication, accession, coordination, negotiation, compromise, exchange, delegation and leaves the decision-making to the groups involved. As a result, these governmental processes are more vague, abstract and complicated; and somehow less efficient than in the case of the traditional hierarchical governance.

### **3. THE CONCEPT OF STRATEGIC RESPONSIVENESS**

A key characteristic of democracy is the continuing *responsiveness* of the government to the preferences of its citizens, considered as political equals. (Robert A. Dahl., 1972, p. 1) Maximizing social welfare depends on improving distribution, as well as increasing the average level of responsiveness. A government or some other public authority *is responsive* if it makes some effort to identify and then meet the needs or wants of the people who will benefit from pro-poor growth. Yet administrators and scholars alike tend to treat responsiveness as at best a necessary evil that appears to compromise professional effectiveness, and at worst an indication of political expediency if not outright corruption. Rourke's recent assessment is illustrative: The growing demand for responsiveness in government policy-making puts the survival of a professional outlook characterized by independence of judgment and indifference to political pressures increasingly at risk in the corridors of American bureaucracy (Rourke, 1992, p. 545).

From the perspective of systemic studies, responsiveness can be defined as the outcome that can be achieved when institutions and institutional relationships are designed in such a way that they are cognizant and respond appropriately to the universally legitimate expectations of individuals responsiveness refers to a kind of *organization behaviour*; for example, whether the organization anticipates or reacts to discontinuities in the environment. The responsiveness approach is not only a technical measurement and implementation issue - it is also a political problem where changes are connected to government activity and, in the end, to society activity.

Responsiveness is a generic concept that applies to the relationship between a public service and the citizenry, and to the relationship between the state and civil

society. The fundamental concern is the improvement of the quality of life in society, including within that broad concept the quality of citizen/state relations. The achievement of responsiveness in this sense is likely to re-establish the public's trust not only in the particular public services concerned but also more broadly in the state and system of governance. Thomas and Palfrey (1996) argue that citizens are clients and main beneficiaries of public sector operations and thereby should be involved in every process of performance evaluation. In their study, responsiveness of the public sector to citizen's demands is mentioned as an important part of performance control since it refers to the speed and accuracy with which a service provides replies to a request for action or for interactions. In other words, the development of a new type of relationship between public service providers and their beneficiaries /users is necessary.

Responsiveness in higher education refers to the myriad expectations—some tangible other intangible—that are applied to university by stakeholders. Some students, for example, demand a strong institutional commitment to quality teaching. In addition, they want a safe and enjoyable campus environment and the prospect for gainful employment to other opportunities upon graduation. Some students want the institution to be respectful and responsive to broader social and political issues.

Politicians and oversight agencies want assurances that educational institutions are contributing to some definition of public good (e.g. economic development) as well as complying with law and procedural regulations. Alumni want assurance that the reputation of their alma mater is being advanced so that the value of their degree continues to grow. Special interest groups continuously demand institutional policies and practices that are responsive to their needs. (Kevin Kearns, 1998).

In the current context, turbulent and discontinuous higher education institutions are forced to abandon the old paradigm for the adoption of strategic approaches able to offer them the opportunity to anticipate and respond to challenges. To meet the next challenge, the higher education institutions must prepare to respond to student's needs and expectations.

In a global economy, competitiveness and future job prospects will depend on what people can do with what they know. Young people are the future, so every country must do everything it can to improve its education system and the prospects of future generations..."-(Angel Gurria, OECD Secretary General, December 2013).

#### **4. BUILDING THE STRATEGIC RESPONSIVENESS SPACE**

From the beginning of the 90's, resource related strategies were elaborated through the concept of distinct capability or core competence. Both core competencies and distinct capability can be thought as advanced-creating resources based on the synergistic combination of knowledge and other resources which create barriers to both imitation and mobility.

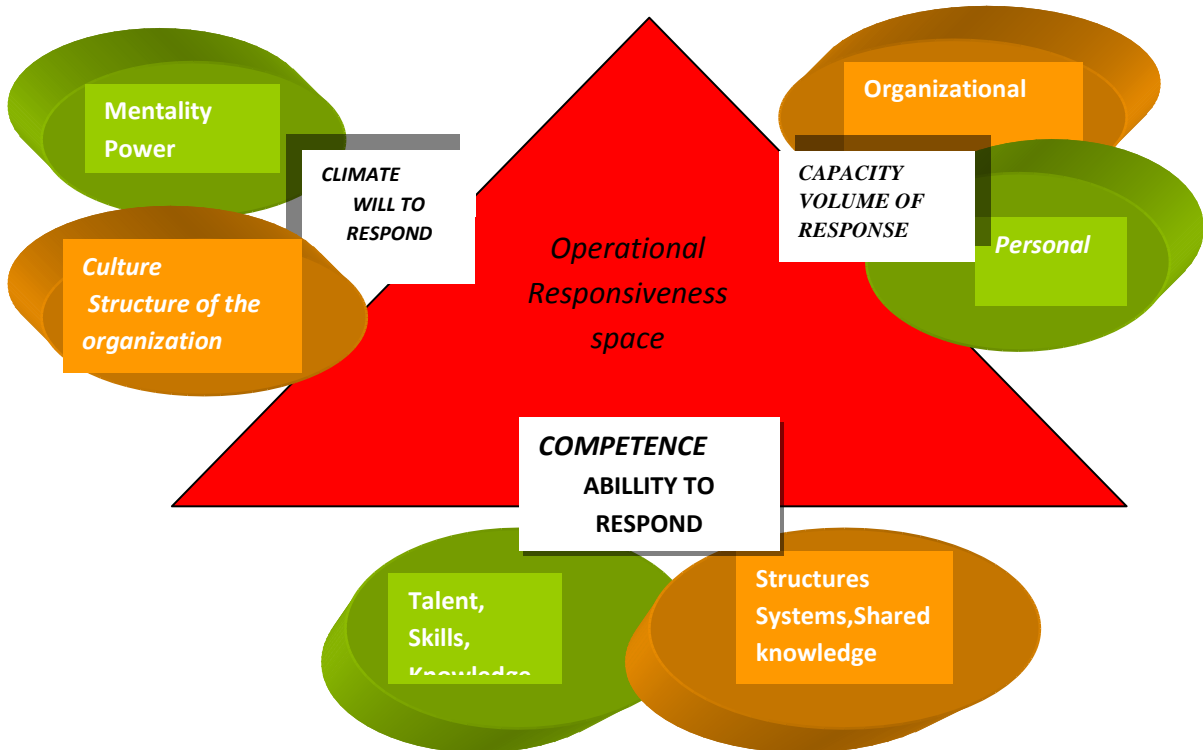
Igor Ansoff and E. McDonnell (1990, p.270) consider responsiveness can be described by three capability attributes: *climate, competence and capacity*. Each of the three is determined on the one hand by managers and on the other by the organization through which they work.

- *Climate* is the management propensity to respond in a particular way, for example to welcome, control or reject change;
- *Competence* is the management's ability to respond. For example, to anticipate change in a complex environment, the organization needs a sophisticated environmental surveillance system.
- *Capacity* is the volume of work that general management can handle. Its adequacy is related to the type of response used. For example, the number of general managers needed for change controlling management by exception is very much smaller than for vigorous change generating strategic development.

Based on these considerations, we represented the space of operational responsiveness in Figure 1, and define responsiveness according to equation (1):

$$R_{operational} = f(\text{capability}) \quad (1)$$

**Fig.1. The architecture of Operational Responsiveness space**



Such as shown in Figure.1, the Responsiveness Operational Space separates improvements in responsiveness into three categories and improving each of these areas simultaneously presents a challenge. According to that, it "will provide an affordable capability to promptly, accurately, and decisively position and operate national assets in

public space. Responsiveness space is a vision for transforming future public, integration, and acquisition, all at a lower cost.

As it is built, Responsiveness Space is the result of convergence of managerial and organizational capabilities. For example, major determinants of climate are the mentality/culture and power position/structure of the organization. The competence is determined by the abilities of the managers on the one hand, and the systemic abilities of the organization on the other hand. Organizational capacity can be measured by multiplying the work capacity of individual managers.

Managerial and organizational efforts focusing only on "*decrypting the present*" gives *operational feature* to the responsiveness space (Figure.1). In such an area, the organization mobilizes both managerial and organizational capabilities to meet short term targets and possibly medium term ones. This approach, although necessary, is insufficient and is not able to develop and maintain response capabilities required for sustainable public service offered to consumers, especially long-term ones.

The concept of capacity helps explain a part of resistance of planning problem which was encountered in introducing strategic planning into the organization.

The new strategic work was "*dumped*" on top of the operating workload, which already fully occupied the general manager's time. This conflict is typically resolved in favour of the operations work. This low priority granted to the strategic work appeared as resistance.

The concept of competence helps explain another cause of resistance to planning. It has been common to introduce strategic planning by means of one-day seminars during which general managers were converted into instant strategic planners. Since a majority had no prior experience in strategic analysis, the quality of their plans was, at best, marginal. The poor quality of plans produced ineffective actions which again was perceived as resistance to planning.

The third source of resistance was the historical climate of the organization. Since at the time of introduction of strategic planning the climate was typically change controlling, both managers and organization reject the change –generating strategic management as irrelevant to way things ought to be done. (Igor Ansoff and E. McDonnell, 1990, pp.264-265.)

We believe that one way to reduce and eliminate these resistances is building a strategic responsiveness space. What became clear is that successful organizations of public services invest heavily *dynamic capabilities* to enhance their operations. Not all enterprise-level responses to opportunities and threats are manifestation of dynamic capabilities. As Sidney Winter (2003, p. 991) notes "ad-hoc problem solving" isn't necessarily a capability. Nor is the adoption of a well-understood and replicable best practice likely to constitute a dynamic capability. Implementing best practices may help an enterprise become or remain viable, but best practices that are already widely adopted cannot by themselves enable an enterprise to earn more than its cost of capital, or to outperform its competitors in a competitive market situation. If an enterprise possesses resources/competences, but lacks dynamic capabilities, it has a chance to make a competitive return for a short period, but superior returns cannot be sustained. (Teece, 2009, p.88).

Market dynamics have created challenges for public organizations, with the emergence of the global economy, advances in technology, increased societal demands, and the need to provide more social services with fewer resources. (K. Kernaghan and D. Siegel, 1999, p. 3). As well, a widespread desire for increased organizational scrutiny has increased the pressure for change; given more accessible globalizes information systems and heightened media attention critical of government inefficiencies in service delivery. Response mechanisms have emerged within the private market to meet these recent challenges, but government organizations have been slower to respond. However, a new approach, which incorporates modern strategic management tools, is necessary for the public sector to achieve improved performance and overall service quality. In this context, development of dynamic capabilities building Strategic responsiveness space and institutionalizing the strategic responsiveness is absolutely mandatory.

Dynamic capabilities refer to the particular capacity business enterprises possess to shape, reshape, configure, and reconfigure assets so as to respond to changing technologies and markets. Dynamic capabilities relate to the enterprise's ability to sense size and adopt in order to generate and exploit internal and external enterprise specific competences and address the enterprise's changing environment. (Teece, 2009, p.89), As with previous considerations on the operational dimension of the responsiveness, we can imagine a *strategic responsiveness space* defined by dynamic capabilities, and we will define the strategic responsiveness according to equation (2):

$$R_{strategic} = f(\text{dynamic capabilities}) \quad (2)$$

Continuing this logic, *organizational responsiveness space* will be configured for two areas: operational and strategic, as shown in Fig. 2.

**Figure 2 Organizational Responsiveness Space**



In the normal resources constrained world, decisions regarding the appropriate combination of capability components are critical to maintain strategic responsiveness. These decisions are especially crucial given the long lead times and considerable expenses involved in making significant changes or establishing new capabilities in these components. Trying to find out the correct mix to maintain strategic responsiveness, the HEI must determine requirements based on national education strategy, national interests, challenges and threats in the mid-term and long term time frames.

Responsiveness of the higher education sector to student's demands is mentioned as an important part of academic performance control since it refers to the speed and accuracy with which a service provides replies to a request for action or for interactions.

The situation in the Romanian system is different as reflected in the Quality Barometer: "when they are considered aims of the system, the resulting image is largely a

system centred itself. It is rather the perception of a system whose links with the environment are insufficiently explored and analyzed, the system follows its own logic, coherent but is less involved in society and this rather disconnected reveals” ( Quality Barometer-2010 ). To recover this reality, the development of a new type of relationship between university and their stakeholders is necessary.

In the Romanian higher education system, unfortunately, we notice a relative disposition of the university by their students. Consequently, the general view of students is that the university is not an institution to generate senses or provide directions. Thus, “students appear to be alone and insecure in the face of uncertainty in relation to the type of training they receive in the university” (Quality Barometere-2010, p.22). The importance towards the actors in the network gives this type of approach.

It is a point of view completely different from the traditional strategic approach similar to the push system in (on) which only the managerial efforts of pushing the processes are intended to lead to goal achievement.

Achievement means giving up old paradigms and acceptance of some innovative approaches in which costumers are, at the same time, co-participants in the innovation of the higher education system they benefit from. Moreover, the new managerial approaches related to strategic responsiveness impose closer attention paid to results. Guskin calls this overall process “outcomes” thinking. Our need is twofold: “to reduce student costs and increase student learning” (1994, p. 25)

Focusing on results expresses the need for the creation of a strategic vision of the expected finality, vision which exceeds the orders of the organization and which takes into consideration, on one hand the fruition of the positive influences from external factors, and on the other hand reduction (elimination) of threats coming from them. Such an approach would lead to ease tensions that currently exist in the Romanian system:” Employers shall adopt a relatively neutral position, there also an important gap between the current levels of skills necessary for graduates in the minds of employers. In contrast, a substantial majority credited university lecturers or university system with much more confidence in its ability to provide labour market quality graduates.

The images contrast the two types of actors, the academics are much more positive than employers. Solving this tension is crucial for social engagement system higher education, which otherwise risks losing contact with the labor market and cause a significant deterioration of its image in the future” (Quality Barometer-2010, p.15). “To address the relationship between the academy and employment is to risk, at least in some quarters of academia, being seen as an apologist for anti-intellectualism, for the erosion of academic freedom and as proposing that higher education should be about training graduates for jobs rather than improving their minds. However, the ‘New Realities’ facing higher education are about responsiveness – not ‘downgrading’ higher education to training. On the contrary, in a rapidly changing world, graduates need to be lifelong learners. The primary role of higher education is increasingly to transform students by enhancing their knowledge, skills, attitudes and abilities while simultaneously empowering them as lifelong critical, reflective learners (Harvey L., p.1)

Achievement means giving up old paradigms and acceptance of some innovative approaches in which services beneficiaries/users are, at the same time, co-participants in



the innovation of the educational service they benefit from. In other words, the development of a new type of relationship between universities- educational services providers and their stakeholders is necessary. “The employer-higher education interface is a complex nexus that needs to address organizational structures and missions on the one hand and graduate attributes on the other”(L.Harvey ,2000, p.10)

Moreover, the new managerial approaches related to strategic responsiveness impose closer attention paid to results. Focusing on results expresses the need for the creation of a strategic vision of the expected finality, vision which exceeds the orders of the organization and which takes into consideration, on the one hand the fruition of the positive influences from external factors, and on the other hand reduction (elimination) of threats coming from them.

Consequently, the responsiveness space of higher education institution according to these coordinates becomes possible only when a *meta-organization* which the university – provider of educational services, beneficiaries/users of educational service interested in outputs and other categories of stakeholders interested especially in results are part of, can be achieved.

*The meta-university*, a flexible network-type structure, is built in such a way that it ...”goes beyond a single focus on an educated work force for economic competitiveness. It sees a well-educated and trained population as necessary for future economic prosperity, promotion of innovation, productivity and economic growth, cultivation of community life, social and political cohesion and the achievement of genuinely democratic societies with full participation” (L. Harvey, 2000, p.12). . Higher education

institutions have many stakeholders and target groups; these have multiple actions and intentions and sometimes clarity when expressing their own information needs. Moreover, “Not all nations or systems share the same values and beliefs about what constitutes ‘quality’ in tertiary institutions, and ranking systems should not be devised to force such comparisons” (International Ranking Expert Group, 2006, principal number 5).

This construction represents a potential *solution based on co-operation between all the actors that the metaorganization consists in to the building of the responsiveness space.* ”Cooperative solutions are required, not only in the form of co-operation between governments but also through co-operation between governments (centrally, regionally, locally), civil society associations and other stakeholders such as media and business.”(C. Pollitt, G. Bouckaert, E. Loffler, 2006, p. 3.) One of the main characteristic of the strategic responsiveness space is transparency. Transparency in this context relates to the need to provide information on higher education institutions’ efforts and performance in their various fields of activity. It is also related to the concept of quality assurance. If the latter is perceived as a set of activities intended to provide proof of quality to higher education institutions’ external stakeholders, then creating transparency entails providing the information which these stakeholders need in order to form judgements and take decisions.

Such decisions can range from students choosing between specific educational programmes to public or private agencies awarding research contracts and governments

deciding on accountability issues relating to funding. Therefore, transparency instruments are information tools designed to communicate information on higher education institutions' efforts and performance to external stakeholders (Vught, F.A and Westerheijden F.D, pp.3-4).

In addition, strategic responsiveness space represents a good opportunity for the concept of university ranking. This concept is rapidly becoming one of the most important tools used by both students and academic professionals across the world. Universities use them to define their performance, professional reputation and status, whilst students use them to choose their future place of study and research. With the higher education sector widely acknowledged as one of the essential drivers of economic growth, this places an ever greater importance on the systems for assessing and comparing the higher education options available. More than a consumer product, these international rankings have become both a manifestation and a driver of global competition for excellence, therefore placing an ever greater importance on the system for assessing and comparing the higher education options available. Recognising the need for greater clarity, last year the European Commission implemented its initiatives *U-Multirank* and *U-Map* - independent from public authorities and universities. Seeking to offer a multidimensional, user-driven approach to international rankings of higher education institutions, U-Multirank is due to publish its first results imminently. It is hoped that a comprehensive ranking system will assist policymakers in developing longer term strategies as part of the broader higher education modernisation agenda.

Whilst universities and policy makers play an important role in establishing a vision for university ranking systems, students should also contribute to the process.

Strategic responsiveness expresses a differentiation and adaptation driven by demand from environment, and from this perspective we are able to examine a variety of strategic organization behaviours for example, whether a higher education institution anticipates or reacts to discontinuities in the environment. By contrast, in the freeze universities, there are positioned managers who "just look carefully where they go, but never at the sky." They are only interested in the present, but completely ignore the future. Such managerial behaviour demonstrates lack of strategic vision, and, obviously, the lack of performance. In this new context a high degree of flexibility and adaptability of higher education systems gives the opportunity to meet societal demands in real time, demands which are in constant change. To outline of a new entrepreneurial management context based on results first means the necessity to create new models of inter-relations development between and within institutions. Secondly, there is an imperative demand for structural changes within the universities, in order to maximize efficiency (so that they become compatible with flexible structures – network type) and increase the capability in decision-making through involvement of students/customers and representative interest groups for communities.

## **5. CONCLUSION**

Conclusively, firstly the configuration of the responsiveness space implies the need for a new strategic and innovative thinking in the relationship between the central

administration and the half-administrative organizations (regional, local), between administrations and citizens of local, regional communities, between administrations and different groups of stakeholders.

Secondly, there is a great urgent demand to make the central and local administration structures more efficient (for them to become compatible with the flexible structure of the metaorganization) and to restrict the decision-making capacity of the administrations by involving citizens and interest groups representative for the community in the decision-making process.

Pragmatically, the achievement of such a structure implies overcoming a variety of challenges. On the one hand, are the members of the community aware of the importance of commitment? Are they truly motivated to take part in such a structure? On the other hand, how prepared are political representatives and public authorities to accept co-operation with different categories of stakeholders?

First of all, lack of a *strategic responsiveness culture* with all the actors of the meta-organization (specifically the culture of the members of the community) is one of the major difficulties to overcome in reaching the success of this construction. The responsibility of both political and public authorities to enable this structure to become functional must be focused on the development of this type of community culture. Only when community members become aware of the benefits of the innovation of public services through quality and are willing to commit themselves in different forms will the meta-organization be substantial.

Achieving the responsiveness space in public services as this paper sees it is impossible without an informed and active community truly involved in the 're-innovation' of public services'.

Mutually, the members of the community cannot reach the level of responsiveness culture that implies commitment and attendance if the responsible agents at the central, regional or local level do not focus their efforts towards both stimulating the members of the community to commit themselves to innovating public services and revealing the advantages of '*listening to the customer's voice*' rather than '*listening to the hierarchy voice*'.

In these circumstances, the traditional purely judicial relationship between consumer and provider is replaced by a creative co-operational and collaborative one between the actors of the meta-organization. Moreover, the contradictions between the concepts of consumer and provider; and the cooperation and creative dialogue relationships between actors within the meta-organization must be revealed. The strategy of consulting traditional stakeholder organizations should be complemented by an open and inclusive system that allows citizens to engage one another in an on-going discussion of the impact and relevance of their membership in a variety of social and cultural networks. Citizens need a forum in which they can debate, discuss, define and develop their collective and individual understanding of diversity. They must be free to explore, one-on-one, one-to-many and many-to-many, their common history.

New institutions and practices are needed to build and support the changing patterns of social and cultural organization. A key task is to create the kind of public

space that will encourage and facilitate their efforts to engage one another in on-going debate and cooperation.

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## ANALYSIS OF THE BANKING SYSTEM THAT QUOTES AT BUCHAREST STOCK EXCHANGE

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**Abstract:** *This study analyses three important banks quoted at Bucharest Stock Exchange: Banca Transilvania SA, BRD – Groupe Société Générale SA, Banca Comercială Carpatica SA. The scope is to identify which is the best to invest in. We follow the instruments give us by the fundamental analysis: Price/Earning ratio, Capitalization, Return on Assets, Return on Equity, Debt to Assets, Debt to Equity. Fundamental analysis presumes the future prospects of a security are best analyzed through a proper assessment of the intrinsic value of the underlying company. The risk is within us. In the end, the financial risk does not lie in what types of investments have we done, but in what type of investor we are.*

**Keywords:** *banks, capitalization, stocks, fundamental analysis*

**Jel Classification:** *G32*

### 1. INTRODUCTION

In general terms, banks make profits by selling liabilities with one set of characteristics (a particular combination of liquidity, risk, size, and return) and using the proceeds to buy assets with a different set of characteristics. This process is often referred to as *asset transformation*. For example, a savings deposit held by one person can provide the funds that enable the bank to make a mortgage loan to another person. The bank has, in effect, transformed the savings deposit (an asset held by the depositor) into a mortgage loan (an asset held by the bank). Another way this process of asset transformation is described is to say that the bank “borrows short and lends long” because it makes long-term loans and funds them by issuing short-dated deposits.

The process of transforming assets and providing a set of services (check clearing, record keeping, credit analysis, and so forth) is like any other production process in a firm. If the bank produces desirable services at low cost and earns substantial income on its assets, it earns profits; if not, the bank suffers losses. (Miskin, 2004)

The Bank is a functional-institutional economic unit, whose main function is to collect, transfer and distribute the financial availabilities. (Milca, 2001)

The role of the banks is to relate on a commercial basis the economic units in search of funds to the ones in search of investments. They have the quality of principal

intermediary in the relation economies-investments, which is a primordial relation for the economic growth. The main characteristic feature of banks is the transformation of the non-monetary assets into currency.

The major operations performed by banks are: to accept deposits, to contract credits, to discount commercial papers, to make payments and settlements of accounts, to issue warranties, to transfer funds, to perform transactions either in their own account or in the clients' account, to provide financial-banking consultancy, to intermediate and place securities. (Suciu & Nedelcu, 2003)

Deposit banks are commercial banks which get their financial resources from the monetary market, by their clients' deposits. Based on them and on their own capitals, the commercial bank offers either long- or short-term credits to the applicants who meet the general conditions of financial reliability.

Three commercial banks quote at the Stock Exchange of Bucharest: Banca Transilvania, Banca Română pentru Dezvoltare and Banca Comercială Carpatica. We want to figure out which of these three banks is more attractive to investors.

Banca Transilvania, (TLV) financial-banking institution established in 1994, is ranked third among the Romanian banks at the end of the first quarter of 2013, based on their assets. The purpose of the bank is to support the development of the business environment, by offering innovating products and services. Banca Transilvania is the first Romanian bank to have been listed at the Stock Exchange of Bucharest, in 1997.

The capital of Banca Transilvania is held by Romanian and foreign stock-holders, as follows: 23,34% of the shares are held by natural persons; 62,04% of the capital is held by juridical persons; and the remaining 14,61% of the shares are held by BERD.

Banca Română de Dezvoltare (BED) was established as a financial company with State-owned capital in 1990, after it had taken over the assets and liabilities of the former Banca de Investiții, which had held the monopoly during the communist period. In 1998, BRD was privatized and the group Société Générale bought 51% of the shares. BRD - Groupe Société Générale was listed at the Stock Exchange of Bucharest in 2001 and is ranked second among the Romanian banks, based on its assets, in late 2012.

The capital of BRD – Groupe Société Générale is held by numerous stock-holders, as follows: Société Générale – 60,16%, SIF Transilvania – 4,55%, SIF Banat Crișana – 4,20%, SIF Muntenia – 3,99%, Fondul Proprietatea – 3,64%, SIF Oltenia – 3,36%, SIF Moldova – 2,30%, juridical persons – 14%; and natural persons – 3,80%.

Banca Comercială Carpatica (BCC) is an institution established in July 1999, headquartered in Sibiu. The share capital is of 314 629 049 lei and is wholly private-owned; Romanian and foreign companies are stock-holders of great financial force. The structure of the shareholdings is the following: 80,47% natural persons and 19,53% juridical persons. Two natural persons hold together 52% of the shares.

## **2. FUNDAMENTAL ANALYSIS**

Fundamental analysis presumes security prices are based on the intrinsic value of the underlying company. The fundamentalist believes that with time, stocks will move up to minimize the disparity between their present value and their perceived intrinsic value.

Thus, fundamental analysis presumes the future prospects of a security are best analyzed through a proper assessment of the intrinsic value of the underlying company.

In pursuit of value, the fundamentalist collects, analyzes, and models company information, including earnings, assets, liabilities, sales, revenue, and other information required to evaluate the company. Assumptions of the fundamentalist include a belief that markets are not completely efficient and that all necessary information is available to the public, but the company may not always be efficiently priced. Overall, fundamentalists are concerned with what the price should be according to their valuation models.

While price can be observed with certainty, no one can ever be sure what constitutes true value. Although it may be difficult to determine current value, in the light of hindsight it is clear that price does tend to revolve around it. Several indicators have been developed which purport to measure value.

Price/Earnings ratio is calculated by dividing current price by the latest 12 months earnings per share. Dividend yields and P/E ratios are highly correlated since they both relate a measure of company performance to the same variable- the price of a stock. Dividends to have one notable advantage: stability. Earnings fluctuate seasonally. Company management seek to moderate these fluctuations by maintaining a dividend payout proportioned to the long run prospects of the company. Distributing cold cash to stockholders requires a hard economic decision- once paid out is irretrievable.

In the long run earnings mean nothing to stockholders unless they are ultimately paid out in dividends. A company can go on exclusively reinvesting earnings in future growth only so long. Price/Earnings ratios become distorted during severe economic contractions. Under normal conditions a persistent decline in prices relative to earnings results in a falling P/E. A low Price/Earnings ratio is generally bullish. (Fosback, 1992)

**Table 1 PER**

PER	Banca Comercială Carpatica	Banca Transilvania	BRD – Groupe Société Générale
2011	-2.79	18.27	11.64
2012	-3.86	18.33	12.15
2013	9.82	11.36	18.94

(Source: BSE, Monthly bulletin, December 2011-2013)

When PER is high, the share is over-evaluated and its sale is recommendable. One can see that in 2011 and 2012, TLV was over-evaluated as the financial market was optimistic and wagered on that company, and in 2013 it was the turn for BRD to be over-evaluated.

**Table 2 Capitalization**

Capitalization	BCC	TLV	BRD
2011	178394671	1567913730	7463815257
2012	123334587	2416863864	5651871310

2013	212689237	3640619934	6272113662
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(Source: BSE, Monthly bulletin, December 2011-2013)

The stock market capitalization was on the increase for TLV; whereas for BRD and BCC, the year 2012 was a regression. This way, capitalization for TLV rose in 2012 as against 2011 by 64%, and in 2013 as against 2012, by 66%.

Debt to Assets describes the proportion of other peoples money to the total claims against the assets of the business. The higher the ratio, the greater the likely risk for the lender. The formula is: total debt/ total assets.

**Table 3 Debt to Assets**

Debt to Assets	BCC	TLV	BRD
2010	0.92	0.88	0.88
2011	0.91	0.92	0.87
2012	0.90	0.90	0.88

As regards the indicator Debt to assets, BCC is ranked last, and BRD is ranked first. This shows that BCC and TLV resort to a greater extent to loans.

Debt to Equity is the ratio of total debt, normally the sum of current liabilities and all types of long-term debt to total owners equity, or net worth. The debt to equity ratio is an attempt to show, in another form, the relative proportions of lenders claims and of ownership claims and is used as a measure of debt exposure. It is expressed as either a percentage or as a proportion. The formula is: total debt/ net worth (equity). (Helfert, 1987).

**Table 4 Debt to Equity**

Debt to Equity	BCC	TLV	BRD
2010	6.42	9.98	7.63
2011	11.36	10.12	10.12
2012	11.97	13.31	9.67

Because owners of a bank must know whether their bank is being managed well, they need good measures of bank profitability. A basic measure of bank profitability is the return on assets (ROA), the net profit after taxes per dollar of assets: The return on assets provides information on how efficiently a bank is being run, because it indicates how much profits are generated on average by each dollar of assets.(Miskin, 2004) *ROA is Net profit/Total assets.*

**Table 5. ROA**

ROA	BCC	TLV	BRD
2010	-5.26	0.45	1.05
2011	-0.82	0.88	0.96



2012	-0.45	1.08	-0.69
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In terms of the indicator ROA, TLV has positive results and is above its competitors. Furthermore, one can see that the values of these indicators rise every year. This way, in 2011, economic profitability was on the rise as against 2010 by 43%; and, in 2012, it rose by 20% as against 2011. These increases are due to the rise of the net profit at a higher rate than the one of the total assets. Likewise, BCC marked yearly improvements with respect to this indicator. Conversely, for BRD, this indicator diminished every year during the analyzed period.

However, what the bank's owners (equity holders) care about most is how much the bank is earning on their equity investment. This information is provided by the other basic measure of bank profitability, the return on equity (ROE), the net profit after taxes per dollar of equity (bank) capital. ROE is Net profit / common equity.

**Table 6 ROE**

ROE	BCC	TLV	BRD
2010	-37.49	5.12	8.97
2011	-10.21	9.85	7.96
2012	5.94	11.89	-6.00

As regards ROE, in the case of TLV, it rose in 2011 as against 2010 by 51%, and in 2012 as against 2011, by 82%. BRD was in regression for each analyzed year, and BCC yearly improved its financial performance, from -37.49 to 5.94.

### 3. CONCLUSIONS

Following the analysis of the three banks, Banca Transilvania yields far better results.

Graham recommends the defensive investor to follow the rules below when selecting the stock: the adequate dimension, solid financial status, uninterrupted payment of dividends over the last 20 years, no loss during the last 10 years, the increase by at least one third of the profit per stock over the last 10 years, the price no higher than 15 times the average profit for the last 3 years. (Graham, 2010)

To make a decision for transacting, one must keep the financial information of the company in sight and use it as the basis for the intrinsic evaluation of the stocks to buy when the price is below that margin and there are perspectives for growth in the future. In the same time, one must take into account the evolution of the stock price in the past and to use elements of technical analysis to determine the best moment to enter or exit the market. The investors should be ready when, due to a major downfall, the market is under evaluated and to be cautious and limit their acquisitions through stop orders after a long period of growth.

The risk is within us. If we over estimate our ability to really understand an investment or to come out clean after a dramatic price period, it doesn't matter what our

portfolio contains or what happens on the market. In the end, the financial risk does not lie in what types of investments have we done, but in what type of investor we are. For this, there are five types of investor profiles: very conservative, conservative or moderate, balanced, growth oriented and dynamic or aggressive. Practically, the last two are suitable for a stock market broker.

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# **LAW**



## **THE EVOLUTION OF THE ACCESS TO JUSTICE FOR PERSONS EXCLUDED FROM A POLITICAL PARTY IN THE JURISPRUDENCE OF THE CONSTITUTIONAL COURT**

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**Abstract:** *The dynamics of social life, the continuing challenges arising at different levels of society, normative pressure and the European jurisprudence determine the constitutional control court to reconsider its position on certain issues. It is the case of the art. 16, paragraph 3 of the Political Parties Law no. 14/2003 which the Constitutional Court initially considered to be consistent with the constitutional provisions, and later to limit the access to justice of the person dissatisfied with the decision of the party which made him/her lose the membership of a party, thus violating the Constitution. According to the Constitutional Court, the change of opinion is due to extremely serious consequences arising from the loss of membership of the party of a person who is also a local or county councilor, namely the termination of mandate for the local elected and the high number of requests addressed to the Constitutional Court, by the objection raised to the courts, on the mentioned legal text.*

**Keywords:** *local elected, jurisprudence, Constitutional Court, political party, law, access to justice.*

### **1. INTRODUCTION**

The right of free access to justice of a person excluded from a political party has been the subject of numerous complaints of the constitutional court, and in most cases, the Constitutional Court dismissed these complaints considering the initiators' arguments of unconstitutionality as inconclusive and therefore, the access to justice of the person excluded from a political party not affected. Despite this situation, by Decision no. 530/12 December 2013 (DCC (952), 2009), on the plea of unconstitutionality of art. 16, paragraph 3 of the Political Parties Law no. 14/2003 (Law (14), 2003), the Constitutional Court has reconsidered its position, claiming that the evoked legal provisions are unconstitutional because they affect the very substance of the right of access to justice and they contradict the provisions of Article 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms and the European Court jurisprudence of Human Rights on the right to a fair trial.

The right of free access to justice is regulated in the Constitution in art. 21 which states that "any person can go to court to protect their legitimate rights, freedoms and interests", and that "no law may restrict the exercise of this right." The doctrine (Muraru *et al.*, 2008) stressed that the rights, freedoms and legitimate interests shall be

ensured either by direct action in court or by any procedural means, including the exception of unconstitutionality. The change of attitude towards the access to justice for persons excluded from a political party will be analyzed in this article, with the highlight on Constitutional Court's both previous arguments, and those from their final decision which changed the jurisprudence on the topic.

## **2. PREVIOUS VIEW OF THE ROMANIAN CONSTITUTIONAL COURT ON THE ACCESS TO JUSTICE FOR PERSONS EXCLUDED FROM A POLITICAL PARTY**

Constitutional Court, as the guardian of the constitutional provisions, is entitled to verify if the laws, ordinances or other legal provisions are in consonance with the constitutional text, otherwise the texts in manifest contradiction with the constitutional provisions being declared unconstitutional.

This role of the Constitutional Court was analyzed in the doctrine (Muraru *et al.*, 2008) and it was considered that "within the constitutional justice, the justice organ *states the law*, like any other organ of jurisdiction, but not referring to the rights and interests of a person, which is characteristic for the jurisdiction court, but to the constitutional legitimacy of the law, its validity as a document subordinated to Constitution, depending on the manner in which the legislator has complied with the constitutional supralegality on which, in fact, it was based."

One of the situations in which the Constitutional Court "states the law" is when ruling on the objection raised before the courts. The exception of unconstitutionality enters the subsequent control of the Constitutional Court and concerns the control of laws and Government ordinances in force. It provides indirect access, mediated by the courts, of the legal issues to the Constitutional Court (Muraru *et al.*, 2008).

Among the regulations that have constituted the subject to several unconstitutionality exceptions were those stipulated in the art. 16, para. 3 of Law no. 14/2003 on political parties, which stated that "the acquiring or loss of membership of a political party is subject only to the domestic jurisdiction of that party, according to their statute." These provisions were set prior to the adoption of Decision No. 530/ 12 December 2013, in an inadmissibility issue for all the applications to the court of the people who have lost their quality of party members.

The Constitutional Court was requested to pronounce in connection with the provisions of art. 16, para. 3 of the Law on political parties eleven times since 2009, in ten decisions arguing that these provisions are constitutional and, therefore rejecting the invoked unconstitutionality exception, whilst the eleventh revealed a fundamental change, the court embracing the author's argument exception.

Critical opinions on art. 16, paragraph 3 of the Law on political parties refer to the violation of art. 21 of the Basic Law on access to justice, sustaining that the solutioning of appeals against expulsion from the party of a member lies within the exclusive competence of judicial organs of the political parties, thereby excluding legal proceedings before courts.

Prior to Decision no. 530/ 12 December 2013, the Constitutional Court has developed a jurisprudence which argued that the provisions of art. 16, paragraph 3 of the law on political parties do not violate Constitution. Constitutional Court Decision 952/ 25 June 2009 (DCC (952), 2009), Decision no.1.255/ 6 October 2009 (DCC (1255), 2009), Decision no. 197/ 4 March 2010 (DCC (197), 2010), Decision no. 399/ 13 April 2010 (DCC (399), 2010), Decision no.958/ 6 July 2010 (DCC (958), 2010), Decision no.1.461/ 8 November 2011 (DCC (1461), 2011), Decision no.283/ 27 March 2012 (DCC (283), 2012), Decision no. 649/ 19 June 2012 (DCC (649), 2012), and Decision no. 65/ 21 February 2013 (DCC (65), 2013) provide the following reasons: courts are not entitled to carry justice regarding breaches of internal discipline within political parties, as their responsibility is not governed by legal rules of common law, but by their own ethics rules; courts do not have the power to censor the decisions of the so-called "domestic jurisdiction of parties decisions", which are political acts; when checking the conditions required for the legal establishment of political parties, the court may determine whether the statutory procedures regarding sanctions provides the person dissatisfied with a party decision the right to effectively and efficiently support their cause. Thus, in Decision no. 197/4 March 2010, the Constitutional Court argued that political parties are associative groups operating under their own statutes containing rules created and supported by their members and that courts are not entitled to exercise their function of justice regarding breaches of internal discipline within political parties, as their responsibility is not governed by legal rules of common law, but by their own rules of ethics and deontology, which their members have been committed to respect ever since they freely consented to joined this type of political associations. The Court also notes that "it is natural that the disciplinary responsibility of the party members to be determined by internal organs, which are the only ones to appreciate, depending on the ideology that directs the actions of that party, to what extent the behaviour of its members is consistent with the statutory rules outlining the specific role that they decided to play in the social and political life of the country and whether this behaviour is consistent with the specific modalities of action agreed by each party, and thus by each of its members.

It is not without interest that the constitutional control authority specified that the defining function of the courts is to ensure compliance with the law, the term "law" being understood in a broad sense, not just as the act adopted by the Parliament under this title, but any normative act, which therefore has a legal content. The Court considered that the rules contained in the statutes of the political parties do not have legal nature in the sense discussed, but they represent internal rules of conduct whose observance is necessary for the proper functioning of the party associative structure. This is why the courts have no power to censor the decisions of the so-called "domestic jurisdiction" of the parties, decisions that are political acts, issued under their own statutes.

As regards the complaints related to the existence of certain limits to the right of the access to justice, the Court states that the solution of appeals against the exclusion of a member of a party is the exclusive attribute of arbitration commissions, which are covered by parties statutes, excluding legal procedure before courts whose jurisdiction, under Article 126, paragraph. (2) of the Constitution, is provided only by law, which is not, however, to prejudice the free access to justice. This is because art. 21 paragraphs (1)

and (2) of the Constitution should be interpreted in a broad sense, i.e. prohibiting only the restrictions that would break the very substance of the free access to justice, without excluding the possibility that, by law, to set certain conditions for the its exercise. Moreover, the European Court of Human Rights stated in its jurisprudence that free access to justice is not an absolute right, but it requires, by its very nature, a regulation from the state, which has a certain appreciation extent in setting some limitations, as long as they do not affect the very substance of this right.

The conclusion of the allegations of the Constitutional Court prior to the adoption of Decision no. 530/ 12 December 2013 is that the provisions of the art. 16, paragraph 3 of the law on political parties is constitutional and therefore not in breach of article 21 of the Constitution on free access to justice. Constitutional Court in their ten decisions insist that documents from the governing bodies of the political parties, including those applying sanctions, are political acts resulting from the political will of those governing organs and, therefore, a possible analysis of their legality can only be made by the internal jurisdiction organs of the parties, their censorship by the court leading to a mixture of justice in the activity of the political parties.

### **3. CURRENT VIEW OF THE CONSTITUTIONAL COURT RESULTING FROM DECISION NO. 530/ 12 DECEMBER 2013 ON THE ACCESS TO JUSTICE OF A PERSON EXCLUDED FROM A POLITICAL PARTY**

By Decision no.530/12 December 2013, the Constitutional Court has fundamentally changed their view on the access to free justice for the person who has lost, by expulsion, their party membership and has determined that the provisions of art. 16, paragraph 3 of the law on political parties are unconstitutional, thus enabling the person dissatisfied with the decision of expulsion from the party to appeal to the administrative court in order to annul the decision which (s)he considers unfair and unfounded.

By this decision the Constitutional Court qualify the act of excluding a person from a party as a legal act, status conferred by the party statute as well. If prior to the adoption of Decision No. 530/2013, the political party status and the acts of the political party governing bodies considered political acts, acts that include ethical norms of the political parties, by the mentioned decision the nature of the acts is hereinafter regarded as also legal, not just political. The Court argues that the rules contained in these documents are legally binding and fall within the definition of "law", as an autonomous concept shaped according to the European Court of Human Rights.

The Constitutional Court also cites in support of their solution the procedure that a political party must follow at its registration, which includes the obligation to attach to the registration application sent to the instance the statute of the party, a document that, in case of admission of the registration application, becomes binding law and must be strictly respected by the members of the political party and by its governing bodies. In



case the rules contained in the statute are violated, there arises the responsibility of applying penalties, the most severe one being the exclusion from the party.

The Court finds that the provisions of article 16, paragraph (3) of Law no. 14/2003, establishing the exclusive competence of the party's jurisdictional organs to appreciate the statutory compliance by their party members, eliminate, in fact, the judicial control on the compliance of these organs of their own status, thus preventing free access to justice. As a matter of fact, the Court sustained that the question of constitutionality of the provisions of article 16, paragraph (3) from Law no. 14/2003 must be approached with the utmost stringency, since the loss of membership of a party can be the expression of subjective assumptions or of the arbitrary. The loss of the party membership also draws, if that person is a local elected as well, the termination of their mandate as locally elected officials, according to art. 9, paragraph 2, lit. h<sup>1</sup>) from Law no. 393/2004 (Law (393), 2004) on the status of the elected officials, which leads to the conclusion that the exclusion from a party triggers extremely serious legal outcomes, namely the termination of the mandate. Therefore, the impossibility to litigate before court such a measure, without checking the compliance with the statute and statutory procedures, is contrary to the right of free access to court, which makes the enunciated rights be free of the legal content guaranteed by the law and democratic states.

The change of the view is substantiated also by invoking the provisions of the Convention for the Protection of Human Rights and Fundamental Freedoms and the jurisprudence of the European Court of Human Rights. In this regard, the Court considers that the provisions of art. 16, paragraph 3 of the law on political parties affect the very substance of the right of free access to justice and they are in total contradiction with the provisions of art. 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms and of the European Court of Human Rights on the right to a fair trial (ECHR, 1983; ECHR, 2005).

By granting the exclusive competence of the party's jurisdictional bodies to analyze the acts of sanctioning its governing bodies, thus eliminating the judicial control of these acts, i.e. their effective examination by an impartial and independent judge, free access to justice is not only limited, but completely annihilated.

Based on this argument, as well on the fact that the number of unconstitutionality exceptions having as object art. 16, paragraph 3 of the law on political parties has increased considerably, the Constitutional Court appreciated, by Decision no. 530/2013, that the analyzed provisions are unconstitutional, as the complaint of the member who was sanctioned with expulsion from the party can never be considered by a court, thereby breaching the art. 21 of the Constitution, which provides that no law may restrict the exercise of the right of every person to go to court to protect their rights, freedoms and legitimate interests, and the provisions of art. 126, paragraph 1 on the jurisdictional plenitude of the courts.

The Court states that judicial control can only apply to the statute and to the regularity of conducting statutory procedure before the jurisdictional organs of the party, and not to whether the penalty imposed is fair or not. Thus, the court invested to solution a complaint challenging the penalty of exclusion from a party is to analyze the compliance with statutory norms on establishing and applying the sanction and to verify

if the right to defense and opinion was actually provided. In addition, prior to the effective realization of the judicial control, the plaintiff must first follow the procedure of the domestic courts of the party, solicit the party organs to comply with statutory provisions and, only if (s)he considers that these organs have violated the statute, further address to the court.

#### **4. CONCLUSIONS**

The change of view of the Constitutional court on the access to justice for persons excluded from a political party has practical consequences, materialized in the increasing number of litigations against the political parties who took the measure of excluding their members, in most cases those persons being also locally elected officials (local and county councilors), but also in the way parties actually apply sanctions, i.e. aiming to fully comply with their statutory procedures when penalizing a member. Most requests ask the court just to annul the sanctioning act, only few of them requesting compensation for moral damages.

It can be concluded, from the present analysis, that the approach of the Constitutional Court regarding access to justice for persons dissatisfied with their exclusion from the party evolved from limiting the access only to domestic jurisdiction of the political party to the possibility of the person affected to exercise their right to address court and not just the internal bodies of the political parties.

Therefore, Decision no.530/12 December 2013 can be considered as a judicial turnaround or, on the contrary, as an adaptation of the Constitutional Court approach to the requirements of the European law, based on normative, jurisprudential acts.

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## **THE ESTABLISHMENT OF ASSOCIATIONS UNDER ROMANIAN LAW - A BRIEF ANALYSIS FROM A LEGAL POINT OF VIEW**

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**Abstract** *In the last years, we witness an unprecedented growth and diversification of non-profit legal entities in Romania. Considering the complexity of this phenomenon in our country, especially regarding the associations, we believe that a brief analysis of the substantial and procedural aspects concerning the establishment of associations might be useful, as the non-profit sector is, sometimes, overlooked.*

*This study is intended as a vademecum into the Romanian legal framework regarding associations. We aim to highlight the most important steps in the procedure of establishing associations, extra-judicial, as well as the judicial ones.*

**Keywords:** *association, non-contentious procedure, incorporation act, bylaws.*

An overview of the legal framework concerning associations in Europe points out that the Romanian legislator, unlike the French or the Italian one, has chosen to regulate associations in a particular statute, dedicated to the most important non-profit entities, while the provisions of the Civil Code cover the entire spectrum of legal entities.

In other words, the association is regulated by Government Ordinance no.26/2000 on associations and foundations. According to the provisions of art.4, the association is defined as „a legal entity of three or more people, based on the agreement to put together without the right to refund material contribution, knowledge and labor for carrying out activities in the general interest, that of the community or, if appropriate, in their own non- personal interest”.

The legal definition places the association, *ab initio*, among the subjects of law, which, in the Romanian civil law, can be either natural persons or legal entities. Therefore, *de facto* associations seem to be excluded, as they do not benefit from legal personality. In comparison, under Italian law, people can freely join or establish collective entities which do not have legal personality, wherever the means of achieving the aims of the entity is compatible with the association (Roppo, 2010). This form of association has limited legal capacity.

We find a similar provision in Government Ordinance no. 26/2000, art.5 parag.2, according to which „On the grounds of the constitutional right of association, natural

persons can join together without establishing a legal entity, whenever the purpose allows it”.

Although the Romanian legislator has expressly regulated the associations without legal capacity, it does not grant them the right to be part of a contract or to make legal acts, to hold a patrimony or to receive liberalities (both heritage and donations). In Italian law, despite the fact that unrecognized associations cannot own property, the law offers them this vocation, in case the legal capacity is obtained. Nevertheless, these particular associations may acquire real property by adverse possession (Mascia, 2007).

We find the Romanian legislator’s choice to be criticisable and meaningless, as not acknowledging *de facto* associations leads, as a main consequence, to the lack the content of the freedom of association. We believe that *de facto* non-profit entities, of general interest, should be given the right to enroll in a special register similar to the one kept for non-profit moral entities by the lowest-in-rank court (for associations and foundations) or by the tribunal (for federations). Thus, their existence would be opposable to third parties, even if associations would not be genuine legal subjects in the sense of the civil law. Conferring a certain degree of patrimonial autonomy (the establishment of a common fund, own management, assigning a tax ID) after the Italian legal pattern is, however, needed in order to conduct any kind of activity.

Lowering the minimum number of members from twenty according to the previous regulation - Law no. 21/1924 on associations and foundations, to three, has represented an important premise in the process of diversifying and increasing the number of associations in our country. As a consequence, the number of associations has, literally, exploded. Therefore, in 2012, according to the National Register of NGOs kept by the Romanian Ministry of Justice, in Romania were over 57,000 associations and in June 2014, 67,646 associations.

We wonder what were the Romanian legislator’s reasons for stating that an association must have at least three founding members. Why an association cannot be created by only two people, after the Roman (Berger, 1991) or the French legal model? We believe that a possible motive lies in the association’s inner decision-making. Whenever there are three members, a majority of two is enough to pass a particular issue regarding the legal person. On the other hand, if there are only two founding members, the decisions can only be taken unanimously, which could create obstacles or blockages in the entity’s activity. Although the association can increase its members’ number, until that time, it is in the best interest of the legal person to have a simple decision-making procedure. As such, we believe that the choice of the Romanian legislator regarding the minimum number of founding members is justified.

Usually, an association can be established by natural persons and/or legal entities, as the Government Ordinance no. 26/2000 does not regulate specific rules regarding the nature of the founding members. Nevertheless, the texts of law concerning a certain type of association can stipulate additional legal conditions regarding who can set up a specific form of association. For instance, a particular association in terms of the heterogeneity of its founding members is the so-called Local Action Group - LAG. (named GAL in Romanian legislation). In what concerns the LAG, the Government Decision no. 224/2008 which represents the general legal framework for implementing

measures co-financed by the European Agricultural Fund for Rural Development through the Rural Development Programme 2007-2013 offers a definition. According to art. 2 parag. (1) lettre o) a LAG is "a local partnership set up by representatives of public institutions and authorities, private sector and civil society constituted under the provisions of Government Ordinance no. 26/2000 on associations and foundations, approved with amendments by Law no. 246/2005, with subsequent amendments." As we have already pointed out, according to art. 4 of Government Ordinance no. 26/2000, which is, for non-profit entities, the common law, an association can be established by "three or more persons". From a literal interpretation of the legal text, we conclude that, in general, in the process of establishing an association, the legal nature of the members is not relevant (public bodies or private law legal entities or individuals). In comparison, in what concerns the LAG, the legislator has imposed a heterogeneity of membership which, in consequence, makes the LAG a special form of association.

A LAG is, primarily, a tool for accessing external funds provided by the European Commission. According to the National Rural Development Programme 2007-2013, they were intended, *exempli gratia*, to increase the competitiveness of agriculture and forestry, to improve the environment and the quality of rural areas, to stimulate the formation of partnerships to support local innovation, training and ensuring the implementation of local development strategies, to diversify the rural economy. In other words, in order to benefit from these funds, public institutions and authorities, private entities and individuals had to set up private partnerships intended to their purpose. This is the essence of the Local Action Group.

Regarding the members of a LAG, they can be subsumed into three categories:

- Public sector - representatives of public administration and public services;
- Private sector – for-profit entities (joint stock companies, limited liability companies), collective entities which operate in the financial-banking sector (banks, credit institutions), in agriculture (cooperatives, producers` associations), organizations of entrepreneurs and community service companies - cultural, radio, TV, non – cultural services;
- civil society - non-profit legal entities, individuals and groups of people not officially registered (in other words, those collective entities without legal personality).

The proportion of members from public or private sectors, as well as the importance of their votes differs, depending on the specific requirements of each funding program. For example, in LEADER program, private and civil society representatives should represent more than 50%, while members from public institutions and authorities are less than half.

Analyzing the three categories of LAG`s members, we notice that, despite the fact that the term *civil society* is redundant nowadays, its use is likely to cause confusion. The attempts to define the *civil society* have many drawbacks due to the complexity of this phenomenon (Seligman, 1992), which refuses to be confined to words (Edwards, 2009). Perhaps the best known and embraced opinion on *civil society* belongs to Jürgen Habermas, according to whom it "is made up of more less spontaneously created associations, organizations and movements that find, take up, condense and amplify the

resonance of social problems in private life, and pass it on to the political realm or public sphere” (Habermas cited in Anheier, 2004). In the same manner, Nicolae Manolescu defined the civil society as ”a solidarity and a spontaneous responsiveness of individuals and groups of individuals against state decisions and, more generally, to all that is happening in the country`s every-day life.” (Manolescu, 2002).

The creation of a LAG is governed by the provisions of Government Ordinance no. 26/2000, as it is, basically, an association. However, if, in most cases, an ordinary association may carry out its activity after having obtained its legal personality, the LAG must, afterwards, receive the approval of the Ministry of Agriculture and Rural Development. This qualifies the LAG as an association whose activity is subject prior authorization. In case the LAG starts its activity before having obtained the administrative approval, it can be dissolved, as stated in art.14 of Government Ordinance no.26/2000.

Regardless of the entities` name, in terms of obtaining legal personality, in the absence of special provisions, associations are subject to the Government Ordinance no. 26/2000 on associations and foundations. Granting legal personality is conditioned, according to art.5 parag.(1) of the Ordinance, by the registration of the association in the Register of Associations and Foundations kept by the lowest - ranking court in whose jurisdiction the entity has established its headquarters. After having admitted the association`s demand for legal personality, the court issues the Certificate of registration of the non-profit entity, in which are mentioned the name, the headquarters, the period (determined or undetermined) of the association, as well as its particular number of registration.

The form of the demand of legal personality is provided as an Annex to Order no. 954/b/c/2000 on approving the Regulation on the organization of the Register of Associations and Foundations, the National Registry of Federations and the Registry of Non-profit Legal Persons.

The demand is filed to the lowest - ranking court within the jurisdiction of which the headquarters of the association are located. In addition, must be submitted at the same time, the fiscal certificates of the founding members, valid at the date when the demand is analyzed by the judge, the proof of the headquarters (contract of free loan, lease, deed), the proof of the patrimony, proof of the name`s availability, as well as the constitutive documents (incorporation act and bylaws), authenticated or certified by a lawyer.

Government Ordinance no. 26/2000 does not mention among the documents necessary for obtaining legal personality the fiscal certificates. The courts demand them as a result of the Decision of the High Court of Cassation and Justice no. 18 of June the 18th, 2012, according to which ”the fiscal certificate is mandatory for new members affiliated to an association / foundation only when they acquire the status of legal representatives, as they are designated by law, by the incorporation act or bylaws, to act in legal relations with third parties, either individually or collectively, on the behalf of the legal person”. However, some courts require fiscal certificate even for the censor, applying by analogy the Decision of the High Court of Cassation and Justice. We believe that this solution is criticizable. The censor`s role is, mainly, to verify the associations`

financial records and to present its findings to the General Assembly, attributions which do not imply a mandate to act on the behalf of the association.

The incorporation act and the bylaws must be authenticated (this requirement can be identified in Italian law, as well) or certified by a lawyer. This is an *ad validitatem* condition, in case of non-compliance, the legal sanction is absolute nullity. Article 6 parag.(2) of Government Ordinance no.26/2000 lists the content of the incorporation act, namely:

- the identification dates of the founding members;
- the manifestation of will to associate and on the purpose of the legal person;
- the name of the entity;
- the address of the headquarters;
- the duration of the association;
- the initial patrimony under the condition that the value of the assets, which may consist of contributions in nature and / or in money to be at least a minimum gross salary per economy at the date of the incorporation;
- the name of the members of the management, administration and control bodies of the association;
- the person or persons authorized to perform the procedure for acquiring legal personality;
- the signatures of the associates.

The law prescribes, also under the sanction of absolute nullity, the elements of the bylaws. These are contained in the incorporation act, except the identity of the members of the management, administration and control bodies and the person authorized to obtain legal personality. Additionally, the bylaws should contain the detailed purpose and objectives, the means of acquiring or losing the status of associate, the rights and the obligations of the members, the categories of economic resources of the association, the powers of the management, administration and control bodies, as well as the destination of the entity's property in case of dissolution.

We note that the elements of the incorporation act, with two exceptions, are the same as those of the bylaws. The question that arises is what is the role of the incorporation act and of the bylaws and whether they could be incorporated into a unique document. The advantages are, undoubtedly, numerous: less money, time, unity of documents etc. We believe that the incorporation act is the contract in which the associates express their intention to form the association and to carry out its mission, purpose that they share and to which achievement they consent by participating in forming a initial patrimony of the entity. The incorporation act can be modified only by the parties of the contract, who are the founding members. The bylaws, on the other hand, is similar to an "internal constitution" for the association. This is an act governing the existence of the association and not its creation, as the incorporation act does. The bylaws can be modified by the General Assembly or, in same situations, such as the modification of the headquarters, by the Board of Directors (only if this right is expressly mentioned in the bylaws). Therefore, the bylaws cannot be confused or replaced with the incorporation act, nor vice versa. Considering the above mentioned reasons, we believe that the incorporation act and the bylaws should remain two separate documents.



The legal procedure of granting legal personality is a non-contentious one, regulated by Chapter III of the Code of Civil Procedure entitled *The Juridical Non-contentious Procedure*. In comparison, in French legislation, the procedure is administrative. An explanation might be that the French administrative procedure is tributary to tradition, as the establishment of legal entities has always been the prerogative of the state and not that of the judge. In our country, only the court can settle such demands. The hearings take place in the council's chamber (not in a public hearing), after having or not, at the judge's appreciation, summoned the applicant. The decision is, always, a juridical closure which is enforceable and it can only be subject of appeal in 5 days from the court's pronouncement for those who were present at the last hearing or from the communication of the decision for those absent. Nevertheless, any interested party can file appeal even if it has not been summoned when settling the application, in which case the term of appeal starts from the moment when it has found out about the court's closure, but not later than one year from the court's pronouncement.

By admitting the application filed by the founding members, the court orders the registration of the association in the public registry. Therefore, the newly formed entity acquires legal personality and can be part of the legal circuit according to the principle of specialization (the association can conclude only the legal acts that are necessary in order to achieve its purpose). Also, the association is granted active or passive procedural capacity, being represented in court usually by the President or by the Director, as legal representative.

The establishment of associations according to the Romanian legislation has many particularities. Some are salutary, such as the dichotomy incorporation act - bylaws, the legislator's choice to shorten the appeal term from 30 days to 5 days, while others can be improved, *exempli gratia*, the purely formal consecration of *de facto* associations. All in all, the procedure is rather simple and this has an important impact on the non-profit sector, which becomes stronger and more capable of responding to those social needs that seem to overwhelm, sometimes, the state.

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# **CONSIDERATIONS ON THE EXPRESS REGULATION OF THE BONA FIDE PRINCIPLE IN THE CONSTITUTION OF ROMANIA AND IN THE NEW ROMANIAN CIVIL CODE AFTER THE MODEL OF ENCODINGS ON THE EUROPEAN LEVEL\***

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**Abstract** *This article examines the significance of the bona fide concept as a particularly complex notion and timely constant on both European regulation level and the national level, both in the Constitution of Romania and in the new Romanian Civil Code. The study hereby describes the way the new Romanian Civil Code comprehends to provide an express regulation of the bona fide principle, as a novelty and great interest for the Romanian civil law, this analysis aiming to be an opening study that would lead to new guidelines.*

**Keywords** *bona fides, the new Romanian Civil Code, Constitution of Romania, general principle, constitutional principle.*

## **1. INTRODUCTION. GENERAL CONSIDERATIONS**

Bona fides is a comprehensive concept, with a deep moral content, implying as constituent factors generally recognized moral values. With this moral content, bona fides is a concept that goes beyond the sphere of civil law, being a general principle of law, applicable to the whole system of law, with echoes infiltrating also other branches of law. Beyond the constitutional dimension of the bona fide principle, which offers it a supreme power, generally applicable and in relation to any person, and although it was known as a principle applicable to the whole system of law even in the absence of express consecration, through this express regulation in the new Romanian Civil Code, this principle acquires applied and tangible value, achieving a tangible dimension by its raising at the level of efficient, applicable emphasizing principle a particular type of behavior, characterized by loyalty, sincerity, honesty (new Romanian Civil Code – Law no. 287/2009 was published in the Official Gazette of Romania no. 511 of 24 July 2009, it was amended by Law no. 71/2011 and rectified in the Official Gazette of Romania no. 427 of 17 June 2011 and in the Official Gazette of Romania no. 489 of 8 July 2011. Law

no. 287/2009 was published in the Official Gazette of Romania no. 505 of 15 July 2011–based on the Article 218 of Law no. 71/2011 for the enforcement of the Law no. 287/2009 regarding the Civil Code, published in the Official Gazette of Romania no. 409 of 10 June 2011- and rectified in the Official Gazette of Romania no. 246 of 29 April 2013.)

Bona fides is seen as an apparent panacea that embodies the measuring unit of the morality in the legal framework; within the forum of justice, this meta-legal concept has the role of a benchmark to set the low and high ethical values of the behavior of the law subjects (Ruen, 2011).

## **2. THE CONSTITUTIONAL DIMENSION OF THE BONA FIDE PRINCIPLE**

According to the provisions of Article 970 of the former Civil Code, the agreements must be executed in good faith while they force not only what is expressly provided, but all the consequences which equity, custom or the law determines.

Under the provisions of Article 1899 of the former Civil Code bona fides is always assumed, these provisions referring to the assumption of usucapio of the immovable property by possession in good faith (10-20 years). Although bona fides referred only to a particular hypothesis, the doctrine expanded the significance of the application of this principle, thus becoming a general principle.

It can be seen that good faith, traditionally analyzed as a principle specific to civil law, is elevated to the rank of constitutional principle as it finds its place in the Constitution of Romania revised in 2003, in Article 57 (respectively in Article 54 before revision), as well as in Article 11 (on the exercise in good faith of the obligations belonging to Romania of treaties to which it is a party). Note that the principle of bona fides had been enshrined in the constitutional texts even before it received specific regulation in the new Civil Code, although the principle of bona fides has always been recognized as a general principle applicable to the whole system of law.

Article 57 of the Constitution of Romania on the exercise of constitutional rights and freedoms, of the chapter referring to fundamental duties, stipulates that Romanian citizens, foreigners and stateless persons shall exercise their constitutional rights and freedoms in good faith, without any infringement of the rights and liberties of others.

This obligation is abstract and applies to everybody not just to a subject of law or a specific category or a specific area or branch of law (Gîrbovan, 2008, 62).

Good faith (*bona fides*), traditional principle of civil law and concept of a great moral value by its enshrining in the Constitution, becomes a binding constitutional rule; the principle of bona fides has a supreme legal force and an intrinsic value of moral principle which aims at the exercising of rights and freedoms per se. (Tănăsescu in Constantinescu et al, 2004, 114).

In addition to the express consecration of the principle of bona fides, Article 57 of the Constitution establishes an outward limitation regarding the exercise of rights and constitutional freedoms by the express enshrining of the principle of respecting the rights and liberties of others.

The mechanism of bona fides involves getting over the first stage in the consciousness of the individual where it refers to the desire to act within its rights and another stage related to the relationships with others, consisting of the externalization under the form of certain attitudes or activities that do not affect the rights of others (Gîrbovan, 2008, 62).

The limitation of the right or liberty of a person is determined by the right or the freedom of the other holders and the social dynamics could not function in the absence of compliance with this principle of universal value (Tănăsescu in Constantinescu et al, 2004, 114). Article 57 requires the exercise of rights and freedoms in good faith, but also describes a pattern of conduct considered in good faith, ie that conduct that does not harm the rights and liberties of others (Gîrbovan, 2008, 63).

It may be inferred that the principle of bona fides acquires a social dimension, by relating a person's own behavior to society in general and to other individuals in particular.

### **3. THE EXPRESS REGULATION OF THE BONA FIDE PRINCIPLE IN THE NEW ROMANIAN CIVIL CODE. DEFINITIONS OF BONA FIDES. BONA FIDES ON THE EUROPEAN LEVEL**

In terms of dictionary definitions, bona fides is the obligation to a correct behavior that the parties must follow at the conclusion and execution of contracts or, in the case of states, to comply to the treaties, respectively the belief of a person that it acts according to the law, and according to the law or what is appropriate (DEX, 2012); an act carried out in good faith is one carried out honestly and good faith is implied by law into certain contracts (Martin, 2003); good faith is synonymous with sincerity and honesty (DEX, 2012; Collin, 2004; Blackwell, 2008), lack of deceit and with a sincere intention to do what is promised (Blackwell, 2008).

A novelty brought by the new Romanian Civil Code (NCC) and of great interest for the Romanian law consists in the express regulation of the bona fide notion in Article 14, under which any natural or legal person shall exercise the rights and perform its civil duties in good faith, in accordance with the public order and morality. The provisions of Article 11 NCC are taken into consideration as they state that one cannot be derogated by agreements or unilateral acts from the law of public interest or from morality.

The legal order and the social relations stability are based on the bona fide people who behave honestly in the legal relationships, being animated by sincerity and loyalty, and the entire system of civil obligations and the exercise of the civil rights is based on trust and fairness and not on the intent to deceive; therefore, the presumption of good faith, known from the Roman law (*bona fides praesumitur*), is presented in some civil codes as a general rule, inserted in the chapter on the general principles of civil law, logical system and necessary as a legislative technique (Gherasim, 1981, 46), aspect that was taken also by the new Civil Code which regulated this institution expressly. It mentions that the former Civil Code applies the text regarding the presumption of bona fides, which was placed on the usucapio matter on the immovable property through the

short possession of bona fides, but which, due to the way it was drafted, it was considered as a standalone text and of general application to all civil obligations.

Starting from the presumption of good faith (*bona fides praesumitur* principle) already applicable in our legal system even before the implementation of the new Civil Code, following the model of the provisions set by Article 2805 of the Civil Code of Quebec according to which good faith is always presumed, unless the law expressly requires that it be proved, the new Romanian Civil Code in Article 14 paragraph (2) expressly provides that good faith is presumed until proven otherwise.

General presumption of good faith is the foundation of civil legal relationships based on the right intention in opposition to distrust or fraud, and by this regulation the new Romanian Civil Code aligns to the majority of civil laws (Civil Code of Germany, Switzerland, Portugal, Spain, Poland, etc.) which enshrines the legal presumption of good faith until proven otherwise (Uliescu, 2011, 362).

It was argued that, while bona fides is a rule of conduct, a standard and presumed abstract, not subject to probation, which envisages the ideal attitude of a reasonable and balanced person, bad faith is no longer a standard but it characterizes certain conduct, that which is specifically in the possession of the holder of right and that is why it is subject to probation (Neculăescu, 2011).

The new Civil Code defines the notion of good faith and the effects it has on a contractual level. Thus, according to Article 1170 NCC, the parties must act in good faith both regarding negotiation and conclusion of such contract and throughout its execution, without being able to remove or limit this obligation. It is noted that the new Civil Code sets these aspects within a mandatory standard, without the ability of the parties to cancel or bring amendments to it, which means that it seeks to outline a certain type of bona fide conduct prescribed or imposed by the legislature.

As an update of Article 970 of the former Civil Code (under which agreements must be performed in good faith), the new regulation of the notion of good faith in Article 1170 NCC extends the meaning of Article 970 in the old regulation both in the negotiation (information requirement) and in terms of its execution period (contractual solidarism) the rule being compulsory, without the possibility of derogation from its effects (Piperea, 2011, 240; Dimitriu in Atanasiu et al, 2011, 448).

Article 1183 NCC provides a specific application of the bona fide principle regulated in Article 14 NCC (Dimitriu in Atanasiu et al, 2011, 451). According to Article 1183 NCC parties must act in good faith regarding negotiations: the parties have the freedom to initiate, expand and terminate negotiations, without being held accountable for their failure but are held (required) to comply with the bona fide principles in negotiations.

The fact that a party who engages in a negotiation is required to comply with the requirements of good faith is a mandatory rule that can not be removed by agreement between the parties by limiting or excluding this obligation. As an argument in this regard, we must note the wording of Article 1183 paragraph (2), second thesis of the new Civil Code, which states that parties can not agree to limit or exclude observance of good faith, which gives this legal provision a mandatory feature.

Article 1183 paragraph (4) NCC refers to a situation that is contrary to the requirements of good faith, ie the hypothesis where a party initiates, continues or terminates negotiations without complying with the bona fide principle, in which case the party will be liable for the damage caused to the other party. In this case, the damages caused to the other party may consider the expenses incurred for the negotiations, any waiver by the damaged party from other offers or any other similar circumstances, which determine the existence of an injury.

The text of Article 1183 paragraph (4) NCC which refers to a situation contrary to the requirements of good faith is comprehensive because it presents all the situations with this kind of behavior contrary to good faith: when the party starts, continue or break off negotiations. Offers that are impossible to be admitted may be drafted, although this is known from the beginning, that there may be a change in the engagement or in the initial obligation execution; information necessary may be omitted when taking an informed decision in the negotiations; relevant information to negotiating can be partially presented or misleading and so on, including the violation of the duty of confidentiality imposed by pre-contractual negotiations of Article 1184 NCC.

In the pre-contractual stage, good-faith must exist so that there are no parallel negotiations, negotiations conducted without consideration or under unreasonable conditions or the parties' unaccountable refusal to conclude the final document (Noşlăcan, 2008: 282). In order to negotiate a contract in good faith, it was stated that the following rules should be observed: the correct information of the potential partner as to the relevant evaluating elements of the envisaged contract, the lack of any propositions which should be manifestly unacceptable and bring about the termination of the negotiations, the prompt communication of the decision to terminate negotiations, the observance of the deadlines established for the conclusion of the different stages of the negotiations, the parties' collaboration so that the negotiations do not exceed a reasonable duration, the non-conduction of parallel negotiation and the observance of the confidentiality of the communicated information (Noşlăcan, 2008: 282).

In what concerns bona fide negotiations it was argued that it is a concept pretty unclear being difficult to define what is acceptable, although the participating parties in the negotiations can be sanctioned for a behavior in "bad faith" used in negotiations (Reilly, 2009, 30). All situations that will invoke breach of the bona fide principle must be justified; in this regard we note the difficult role of the courts which will have to decide whether or not requirements of good faith were respected the and it remains to be seen how they would act on these highly sensitive issues.

The vision of the new Civil Code marks an evolution in the field; the direction chosen by the legislature is for the purpose of giving a practical and effective aspect of the application of these provisions as the party that used time and resources to negotiate a contract that is not concluded because of non-compliance with the requirements of good faith may reclaim the damage caused in this way.

The legal literature in United States considers that the recognition of the bona fide principle and fair conduct on a contractual level brings coherence and assures unity in the matter of contract execution (Mason, 2000, 94).

Bona fide is based on the equity of certain psychological facts of moral conscience with the external manifestations under the form of words and commitments, asserting that honesty, form of manifestation of the conscience, within moral norms, enters the structure of bona fides; there were materialized a number of four virtues (moral values) components of honesty: loyalty, prudence, order and temperance (Gherasim, 1981, 9-10). Another opinion, although it supports the author's point of view quoted above regarding the moral foundation of bona fides, specific notion of the legal language, considered that honesty cannot be a moral value totaling several virtues, its place being alongside the other four elements (Cotea, 2007, 5). It can be sustained that the components of good faith, as a notion belonging to the matter of law, is based on honesty, as a manifestation of conscience within moral norms, translated as a value that entails the compliance of individual life with the moral norms. In order to invoke bona fides all its attributes must be found both anterior and simultaneous with the moment when the agreements meet to perfect a legal act, and subsequently for its execution (Dobrilă, 2014, 231).

The opposite of good faith is bad faith, as a mood characterized by the absence of all or at least one of the attributes of good faith, it requires the existence of opposing values to the moral values (non-moral values) (Fotea, 2007, 18). Bad faith, considered to be a form of guilt, expression of deception, fraud and serious misconduct, with the common denominator of trickery, deception and obviously deliberate omission, is manifested also within criminal law (Pungă, 2000, 98). Civil bad faith is likely to acquire a criminal feature when it is able to satisfy the seriousness of social danger required by the criminal law for the deed to be an offence (Pop, 2002, 68). Where the parties have the purpose of deceiving the other party on the terms of the contract, we are no longer in the presence of good faith as the deceptive intention, manifested by cunning maneuvers and reluctance, outlines the bad faith, and these deceptive actions which are likely to mislead the reality influence in a less or greater extent the right intention, in that it vitiates the legal will of one of the parties being able to achieve even the offenses of cheating in agreements. (Dobrilă, 2014, 235).

Good faith is considered as a fundamental principle and is always presumed and protected, regardless of the legal relationship referred to, and in the legal relationships the subjects of law are always supposed to be animated by the sincere intention to behave with honesty and according to the law (Gîrbovan, 2008, 60; Pungă, 2000, 98).

Good faith was defined by Cicero as sincerity in words (*veritas*) and fidelity (*constantia*) in commitments, it can be said that the psychological acts – generators of good faith, create two conditions of concordance or compliance: on the one hand, the conformity between what a man thinks and what he says (sincerity in words), and on the other hand, the conformity between words and his acts (fidelity in commitments) (Gherasim, 1981,7).

The legal approach to the contractual good faith and bad faith during the last two and a half millennia sought a permanent interaction between law and social or religious morals which infiltrate into it; the legal rules are often a side of social vision from the moment of their implementation, requiring flexible general concepts such as good faith



and bad faith, which allow the connection of contractual law to the evolution of morals and social-economic necessities (Floare, 2013).

Types of modern encodings like Unidroit Principles, the Principles of European Contract Law (P.E.C.L.) or the Common Frame of Reference (DCFR) establish a vision with objective content to the concept of good faith in contractual matters, considered close to the classical Roman vision of *bona fides* or the German concept *Treu und Glauben* (Floare, 2013).

The program to develop a common frame of reference for European Contract Law presented as guiding principles of the European Contract Law (PECL – Principles of European Contract Law) the contractual freedom, contractual security and loyalty with respect to the contract matter (Fauvarque-Cosson, Mazeaud, 2008, 421-571). According to PECL there is a general obligation of good faith and fair behavior (Articles 0-301), in the sense that the parties must act in good faith and fairness from the beginning of the contract negotiations until all of its provisions are executed, to which the requirement of good faith during the execution of obligations is added (Articles 0-302) (Fauvarque-Cosson, Mazeaud, 2008, 572). Therefore, Contractual Fairness implies both general duty of good faith and fair dealing (Article 0-301), and Performance in good faith (Article 0-302) (Fauvarque-Cosson, Mazeaud, 2008, 515-570).

Article 0-301 on General duty of good faith and fair dealing provides that „Each party is bound to act in conformity with the requirements of good faith and fair dealing, from the negotiation of the contract until all of its provisions have been given effect. The parties may neither exclude this duty, nor limit it”. Article 0-302 on Performance in good faith provides that „Every contract must be performed in good faith. The parties may avail themselves of the contractual rights and terms only in accordance with the objective that justified their inclusion in the contract. Each party is required not to do anything that prevents the performance of the contract or that infringes the rights that the other party acquires from the contract. Where one of the parties, without compromising the performance of the contract, has acted in such a way as to reduce the benefit that the other party could legitimately expect from the contract, the party is required, at the request of the other party, to renegotiate the contents of the contract”.

According to the Draft of a Common Frame of Reference (DCFR), which contains Principles, Definitions and Model Rules of European Private Law, the Study Group on a European Civil Code and the Research Group on Existing EC Private Law identified three main principles: contractual freedom (*liberté contractuelle*); contractual security (*sécurité contractuelle*); contractual loyalty (*loyauté contractuelle*), as a duty to act in conformity with the requirements of good faith and fair dealing, from the negotiation of the contract until all of its provisions have been given effect, a prohibition on using contractual rights and terms in a way which does not respect the objective that justified their inclusion in the contract and a duty to co-operate so far as necessary for the performance of the contractual obligations (von Bar et al, 2009, 11-12).

According to DCFR Model Rules (Article I.–1:103 Good faith and fair dealing in Book I General Provisions) „the expression good faith and fair dealing refers to a standard of conduct characterized by honesty, openness and consideration for the interests of the other party to the transaction or relationship in question” (paragraph 1)

and „it is, in particular, contrary to good faith and fair dealing for a party to act inconsistently with that party’s prior statements or conduct when the other party has reasonably relied on them to that other party’s detriment” (paragraph 2).

For a good development of the contractual relationship, according to Article III. – 1:103 (Good faith and fair dealing) of the Book III (Obligations and corresponding rights) „a person has a duty to act in accordance with good faith and fair dealing in performing an obligation, in exercising a right to performance, in pursuing or defending a remedy for non-performance, or in exercising a right to terminate an obligation or contractual relationship” (paragraph 1), without the possibility to remove or limit the obligation of good faith („The duty may not be excluded or limited by contract or other legal act, according to paragraph 2). „Breach of the duty does not give rise directly to the remedies for non-performance of an obligation but may preclude the person in breach from exercising or relying on a right, remedy or defence which that person would otherwise have” (paragraph 3).

Also Unidroit Principles, characterized as general rules that actually contain guidelines of the contract law recognize along with contractual freedom also the binding force and the principle of bona fides (Macovei, 2005, 112).

The express regulation of the principle of good faith in the new Romanian Civil Code marks a novelty in our civil law, which led to the statement that the new Civil Code is both modern and European (Uliescu, 2009, 4). Thus, the bona fide principle is established expressly as a general title in contract law both at the negotiation and conclusion of the contract and throughout its execution. The principle of good faith experience many applications throughout the contractual procedures in that the good faith dominate negotiations (pre-contractual stage) the execution in “good faith” of the contract, followed by the parties’ duty of collaboration and obligation of consistency, requirements of the principle of contractual loyalty (Uliescu, 2009, 9).

The consequences of the express regulation regarding the principle of good faith in the new Civil Code will be relevant not only in terms of civil law, but also in terms of criminal law, for example, the offense of deception, and in terms of other branches of law, requiring the judge to take into account the definition of the new Civil Code and to determine both on the exercise of the rights within bona fides and on the consequences of its violation (Dobrilă, 2014, 238), regardless of the area of action, the concept of good faith is applicable as a universal principle.

#### **4. CONCLUSIONS**

Defined probably also by the modern encodings such as Unidroit Principles, the Principles of European Contract Law (PECL) or Common Frame of Reference (DCFR), the option of the Romanian legislature to expressly regulate the principle of good faith in the new Civil Code confirms, once again, the importance of the bona fide principle to our legal system. Beyond its consecration as a constitutional principle, bona fides is reaffirmed and reinforced as a general principle, aiming thereby to ensure a more effective protection of this principle.

With a deep universal feature, the bona fide concept has a versatility determined by the many-sides and meanings, depending on the angle of view, no such angle being sufficiently to embrace the whole substance or to cover its whole complex content.

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## **PARTNERSHIP ROLE IN THE MANAGEMENT OF EUROPEAN STRUCTURAL AND INVESTMENT FUNDS**

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**Abstract:** *This paper highlights the importance of the Code of Conduct on the Partnership, as partnership is a basic principle in the programming of European structural and investment funds, from conception, management and implementation to their monitoring and evaluation, a principle that adapts the actions to be taken to regional and local needs and priorities. Partnership encourages close cooperation between public authorities in the member states, at national, regional and local level, with the private sector and other stakeholders.*

**Keywords:** *European funds, absorption capacity, partnership, programming, effectiveness*

### **1. INTRODUCTION**

Attracting and managing the European funds is one of the problem the states of the European Union confront with. All local, regional and national levels of public administration should intensively cooperate in the direction of coherent and integrated approach of the European funds (Catană & Ștefănescu, 2011). Local and regional authorities are considered to be the nearest to the effective use of these funds, playing a major part in order to achieving the objectives of the Europe Strategy 2020 (European Commission, 2010) and realizing the economic, social and territorial cohesion.

The extent to which these authorities get involved into attracting and managing the European funds is influenced by the institutional framework specific to each member state, but especially by the legal and budgetary competences of different territorial levels. At national level, the member states can choose to use some existent associations and groups of regional, sub-regional and local authorities, as they can offer a large representation and practical experience.

### **2. PROBLEMS AND PROGRESS REGISTERED IN THE IMPLEMENTATION OF PROJECTS FROM EU FUNDS**

National reports prepared by member states provided information on the different contexts in which programs for the programming period 2007-2013 were executed. Regarding the system's obstacles in rapid implementation, member states have identified the following key issues (European Commission, 2011a):

- delays in the approval of the EU budget, delayed adoption of the regulations, of the Community Strategic Guidelines (CSGs) and the subsequent negotiation of programmes (in Austria, Germany, Spain, Lithuania);
- changes in financial control procedures were perceived as the most frequent source of delays in the implementation, while member states were adapting to the new control

system (in Austria, Belgium, Cyprus, Czech Republic, Germany, Denmark, Estonia, Greece, Spain, Ireland, Italy, Portugal, Slovakia, United Kingdom);

- the complexity of managing overlapping programming periods (in Austria, Estonia, Greece, Spain, Finland, Ireland, Italy, Hungary, Portugal, United Kingdom);
- unclear task distribution at national level, insufficient experience, lack of administrative capacity in case of both the managing authorities and beneficiaries, processes of local government internal reorganization (in Bulgaria, Romania, Lithuania);
- A group of member states also consider the impact of growing restrictions on public funding, at national or local level (Germany, Spain, Finland, Lithuania, Latvia, Malta).

An aspect emphasized in most of the national reports was related to overcoming or counteracting the difficulties interfered in applying the operational programs by adapting some measures. For this purpose examples of good practices (European Commission, 2011a) meant to outline certain successful factors in applying the programs were offered:

- Member states and The European Commission must cooperate in order to fulfill the regulations and directions;
- Strong relations having positive results must be realized between the objectives of cohesion policy and sectoral reform, taking into account various fields (education, science/research, medical system and business sector);
- The latest technologies in the field of information and telecommunication should be used;
- Take into account the positive effects of the investment plans and extended national reforms
- National and/or regional procedures must be simplified
- Promoting adaptability meant to lead to sustaining the entrepreneurship and approaching some missings on the labour force market.

In case of Romania and Bulgaria, as member states that joined the Union in 2007, the plans should be associated with approaching some problems related with social inclusion, upgrading economy and institutions and reinforcing capacities, aspects also mentioned in the strategical reports of the states that entered in 2004. Other national strategical reports mention the role of governance at many levels and partnership in planning funds, aiming at mobilizing and coordinating different levels in administration, but implying civil society and business interest in integrating various objectives.

Even since 2010, based on the *Strategic report* (for the year 2010) *on the programmes implementation for the period 2007-2013* (European Commission, 2013), which represented a synthesis of national reports submitted by the member states, these states have been required to improve programmes implementation, to use the money given through the cohesion policy in the optimum way possible, for key projects in the energy and environmental field, as well as for social inclusion. The report, presented by Johannes Hahn (Regional Policy Commissioner) and László Andor (Commissioner for Employment, Social Affairs and Inclusion), evaluated for the first time the rate of the progress registered in each country, in terms of their reaching the agreed EU objectives (Apostolache M.A. & Apostolache M.C., 2013).

### 3. THE ROLE OF ASSESSMENT IN ATTRACTING AND MANAGING EUROPEAN FUNDS

Within the System of European Structural and Investment Funds (ESI Funds), the member states have the opportunity to use the funds in order to develop their national infrastructure, economic, social and public structures. Exercising this opportunity implies a huge responsibility of the management structure of the Structural Instruments System, especially in terms of EU rigorous financial and administrative procedures.

The management structure of the Assessment System for Structural Instruments, in order to carry out this goal, have to use all available management practices. Such a practice is assessment, which aims at identifying the existing problems, multiple links and the development needs of the analyzed structures. Assessment also constitutes a compulsory activity for the programmes financed by means of structural funds, originally requested by Regulation EC 1083/2006, and then by EU Regulation No 1303/2013, which repealed the first.

In the member states, there has been conducted an analysis of the Assessment System for Structural Instruments, on several levels, in order to identify the development needs. The period 2007-2013 represented a pilot period for this system, the real challenges being expected in 2014-2020. The number of completed projects did not allow the use of the most advanced assessment techniques and, as a result, the system reached only part of its potential.

The overall objective of the evaluation is to improve the relevance, quality, efficiency, effectiveness and consistency of project implementation, taking into account, where appropriate, changes occurring in the current socio-economic context, changes in the labour market of the member states, and other changes in the implementation system, which may have an impact on the implementation of the operational programmes (KPMG, 2011).

The assessment should provide an objective and well justified opinion on the management and implementation system of the programmes for the period under review. Initially, the evaluation was carried out according to the four key principles set out in Council Regulation (EC) no.1083/2006, further described in Working Paper No. 5 of the European Commission (*Indicative guidelines on evaluation methods: mid-term evaluation during the programming period*): proportionality, independence, partnership, transparency.

In order to analyze *relevance*, the activities include a review of the priorities and objectives of the operational programme, starting from the current socio-economic context (different from the one existing at the beginning of the implementation of the operational programme), as well as the relevance (and / or consistency) of the indicative operations, of the eligible activities and of the indicators set, for example, by linking them with the purpose and objectives of the programme.

In case of the efficiency criterion, the carried out activities have determined an analysis on the efficiency of the OP implementation, at the level of Managing Authorities and Intermediate Bodies, taking into account the evaluation and selection of projects, the contracting process, the monitoring system of the operational programme and the financial management system.

Regarding the *efficacy* criterion, there were analyzed a series of issues such as the efficacy of:

- the information and publicity measures planned, inter alia, in order to increase awareness and to provide guidance to potential beneficiaries;
- the evaluation and selection of applications submitted for financing within different requests proposals for the launched projects;
- the way in which the internal monitoring system at the project level provides the information necessary to support an effective monitoring of the operational programme as a whole;
- the way in which monitoring answers to the specific reporting needs of the operational programme;
- the way in which beneficiaries understand the monitoring indicators, clearly and evenly;
- the way in which beneficiaries considered horizontal themes and objectives of the operational programme when elaborating their applications for financial assistance and when implementing the projects;
- internal and / or external factors / characteristics that influenced / influences / will influence the implementation of the operational programme.

In Romania, a major problem encountered in all operational programmes (excepting major projects with a specific system of preparation, submission and approval) is the relatively long period of projects evaluation and selection, from the submission of a project to the notification sent to the beneficiary of the outcome of the appraisal itself, usually passing between 6 and 10 months (especially for operations where requests for funding far exceeded estimates in terms of both number and value of the solicited assistance (Analysis Report of the Current System Evaluation, 2011).

The analysis carried out within each state indicated a number of development needs, of which most can be explained by the existence of common problems and by the low rate of achievement. If development needs are not met, the System of Structural Instruments may not use evaluation as a management tool, which is absolutely necessary to increase the effectiveness and absorption of EU funds. Given the fact that planning the 2014-2020 programming period began in 2012, the lessons learned due to evaluation had a more important role by contributing to the planning of activities.

**Recent evaluations proved that the member states achieved their responsibilities and made efforts in reporting directly and exactly the progresses made. The aspects related to the experience gained will be found in the way of making the national reports, which will be more concisely and concentrated on the realizations, results and strategical evolutions. Also, it is necessary that the states use systematically the public presentations and debates.**

But only a partial image of the policy impact was obtained, as the field of applying the strategical reports limited to the programs between 2007-2013. Assessment carried out in the member states represents a promising basis for building a deeper assessment of performance, giving an impetus to a more results-oriented policy.

The “Europe 2020“ Strategy for smart, sustainable development, in favour of inclusion, was launched by the European Commission in March 2010 and approved in



June 2010 by the Heads of State and Government of the member states. The document set concrete goals that would be achieved over a period of ten years, in areas such as employment, education, energy and innovation in order to overcome the economic crisis and to get Europe back on track growth.

The “Europe 2020” Strategy proposed three priorities (European Commission, 2010):

- *smart development*: developing an economy based on knowledge and innovation;
- *sustainable development*: promoting a more efficient economy in terms of resource use, ecology and competitiveness;
- *inclusive development*: encouraging an economy with a high rate of employment, that may ensure social and territorial cohesion.

Through partnership contracts agreed with the Commission, member states will take the commitment to reduce their range of investment priorities in line with these objectives. The legislative package also harmonizes the regulations on different package funds, dedicated among other others to rural development and maritime affairs and fisheries, in order to increase the coherence of EU action (European Commission, 2011b). After the conducted assessment it was found that using *the principle of partnership* could lead to the elimination of disparities and imbalances in the access, implementation and monitoring of projects from EU funds.

#### **4. PARTNERSHIP, A STATE-LEVEL SOLUTION OF STRENGTHENING ABSORPTION CAPACITY AND MANAGEMENT OF EU FUNDS**

Each operational program (OP) as ”a strategical document of managing the European funds, that includes a coherent set of priorities, is elaborated by a collective process which the authorities at the local, national or regional and European levels, social partners, and organizations of the civil society take part at” (West Regional Development Agency of Romania, 2007). This partnership can be applied to all stages of the planning process, starting from *conception, managing, and implementation, to monitoring and evaluation* (European Commission, 2011b), taking into account the state of regional and local needs and priorities the respective action had to be adapted to.

Ever since 2012, the European Commission introduced guidelines (Commission Staff Working Document, 2012) on the principles that should guide EU countries so that to ensure appropriate participation of the partners involved in the use of funds. The document laid the foundation for a future *”European Code of Conduct on Partnership”* and was elaborated on the proposals for regulations adopted by the Commission on 6th October 2011, 12<sup>th</sup> October 2011 and 2<sup>nd</sup> December 2011.

The European Parliament, Committee of the Regions and the Economic and Social Committee have published a series of resolutions, opinions and white papers that appealed to strengthen the partnership principle in the implementation of funds (EESC, 2010). The Commission proposal for the funds (the Common Strategic Framework – CSF) answered therefore to the need to apply a more coherent partnership principle (European Parliament, 2011).

Taking into account all these considerations, in accordance with Article 5 (3) of Regulation no. 1303/2013 of 17 December 2013 of the European Parliament and of the

Council ("Common Provisions Regulation - CPR") laying down common provisions on the European Regional Development Fund (ERDF), European Social Fund (ESF), the Cohesion Fund (CF), the European Agricultural Fund for Rural Development (EAFRD) and the European Fund for Fisheries and Maritime Affairs (EMFF) and repealing Regulation (EC) Nr. 1083/2006, the European Commission adopted on 7<sup>th</sup> January 2014 (European Commission, 2014a) a delegated act under Article 142 of the new Regulation which provides the *European Code of Conduct to support member states and to facilitate the organization of the partnership*. This includes a *common set of standards* meant to improve consultation, participation and dialogue with partners such as regional, local, urban and other public authorities, trade unions, employers, NGOs and bodies responsible for promoting social inclusion, equality between women and men and non-discrimination in the planning, implementation, monitoring and evaluation of projects financed by the ESI funds.

One can, therefore, assert that Regulation no. 1303/2013 of the European Parliament and of the Council have established the *European Code of Conduct on Partnership* for partnership agreements and programmes supported by the ESI Funds. Regulation has not yet entered into force, being subject to law of the European Parliament and of the Council to express objections within two months of its adoption, in accordance with Article 290 (2) of the Treaty on the Functioning of the European Union (European Commission, 2014b).

After the entry into force of the provisions of the Common Provisions Regulation of the European Structural and Investment Funds, the Commission was empowered to adopt the Act on the European Code of Conduct, so that it may assist member states in organizing partnership.

The Regulation on the Code of Conduct is accompanied by a working document on the collection of best practices regarding the implementation of the partnership principle in EU Structural Funds programmes and investment funds. Code of Conduct is intended to provide a framework for partnership in accordance with institutional and legal frameworks of the member states, taking into account their national and regional powers. The commission elaborating the document is also to establish best practices specified by Article 5 (3) of the CPR of the ESI Funds.

The principle of partnership is one of the key principles in the management of EU funds and partners – be they local, regional, economic and social partners, civil society organizations - must be actively involved throughout the cycle of the cohesion policy (preparation, implementation, programme evaluation). From the time of its establishment, in 1988, this principle has experienced a slow and discontinuous application. The process has involved civil society organizations (especially social partners). It was noticed that the principle was accepted more easily in countries where partnership has been an intrinsic part of the decision making process and was reinforced when the Commission had a greater direct responsibility as far as the cohesion policy and community initiatives (such as EQUAL and LEADER) were concerned. However, in many cases, partnership existed only formally. In the 2007-2013 programming period, the partnership was not actively promoted (Community of Practice on Partnership in the European Structural Funds, 2008), even if, the parallel stakeholder participation has become one of the

cornerstones of implementing the Lisbon Strategy. EU cohesion policy has faced new challenges when new different countries, 10 countries in 2004, followed by Bulgaria and Romania in 2007, adhered to the Union.

They have been registered some implementation deficiencies, identified by the European Commission, and failures have been criticized by civil society partners. The focus was to disseminate good practice, as a natural reaction to the changing relations between member states and the Commission, in terms of the management of EU cohesion policy (EESC, 2012). Given the fact that structural fund programming for the period 2014-2020 has already begun in several member states and regions, the European Commission should actively disseminate the code so that it can be used by relevant stakeholders. The European Economic and Social Committee (EESC) urge its members to actively encourage the organizations they represent to participate in projects and programmes of EU cohesion policy, based on the Code of Conduct.

Partnership also envisages close cooperation between public authorities at national, regional and local level in the member states with the private sector and other stakeholders. So far, although an integral part of the cohesion policy, from comments (Community of Practice on Partnership in the European Structural Funds, 2008) submitted by interested parties, there results that the implementation of the partnership principle varies greatly from one member state to another, depending largely on institutional and political culture of each state, more or less favorable to consultation, participation and dialogue with relevant stakeholders. It has been noticed that the efficiency of the partnership principle also depends on strengthening the technical capacity of all members to get significantly involved into the process.

Partnership should be viewed in connection with the approach based on multilevel governance and with the principles of subsidiarity and proportionality. Multilevel governance is a coordinated activity of the European Union, of its member states and their local and regional authorities, based on partnership, which aim to develop and implement EU policies (Committee of the Regions, 2009). The assessment taken into account drew attention to the benefits and to the added value that partnership can bring in the implementation of funds (Network of experts for ESF evaluation, 2011), in strengthening collective commitment and in the ownership of EU policies, in enhancing knowledge, skills and views available for the development and implementation of strategies, while ensuring greater transparency in decision making. Multilevel governance contributes to reducing disparities in terms of coordination and of the capacity to elaborate policies on information, resources, funding and administrative fragmentation and the related policies (OECD, 2009).

Regulation (EU) no.1303/2013 sets out the principles to be applied by the member states, but it provides great flexibility in terms of organizing the practical details so that relevant stakeholders may be involved in different stages of programming.

For the partnership contract and for each programme respectively, a member state reaches an agreement with the following partners:

- a) regional, local, urban and other public authorities;
- b) economic and social partners;

c) bodies representing civil society, including environmental partners, non-governmental organizations, and bodies responsible for promoting equality and non-discrimination.

However, practice proved that the member states apply the partnership principle differently, due to the institutional regulations and traditions of the parties implied. The capacity of the partners implied in the process may also influence the efficiency of the partnership.

By means of its provisions, the *European Code of Conduct regarding the partnership principle* requests that "the member states strengthen the cooperation between the national authorities responsible with spending the EU investment and structural funds and the project partners in order to facilitate the exchange of information, experience, results and good practices during the planning between 2014-2020" (European Commission, 2014a), thus sharing their contribution to guaranteeing the efficient spending of these funds. Thus "we want to ensure that member states work together, within constructive partnerships, with representative stakeholders so that they plan and implement programmes that use European structural and investment funds in order to maximize the impact of these funds", declared Commissioner László Andor (Andor, 2014).

The Code of Conduct, which takes the form of a Commission regulation, that is legally compulsory, sets objectives and criteria meant to ensure that member states implement the partnership principle. Therefore they have to comply with the following obligations <sup>1</sup> (Article 5 of Regulation EU 1303/2013 Common Provisions Regulation, "CPR"):

- to ensure the transparency of the process of selecting partners representing regional, local and other public authorities, social partners and businesses, as well as bodies representing civil society, that are to be appointed full members in committees monitoring programmes;
- to provide adequate information to partners and to give them enough time, which is a prerequisite for a proper consultation process;
- to ensure that partners will be involved in virtually all stages of the process, from preparation and throughout the implementation phase, including monitoring and evaluation of all programmes;
- to support the consolidation of partners' capacity to improve their skills and abilities in order to actively involve in the process;
- to create platforms for mutual learning and exchange of good practice and innovative approaches.

In the period 2014-2020, according to the Commission's proposals for funding Common Strategic Framework (CCS), member states will be obliged to organize a partnership, but establishing specific procedures for the involvement of relevant stakeholders in the different stages of the programming will be up to their national authorities. The *European Code of Conduct on Partnership* (CECP) provides the minimum requirements necessary to achieve a high quality partnership in funds implementation, while at the same time, it ensures the flexibility of the member states' actions in terms of organizing the participation of different partners.

According to the Commission proposal for Common Provisions Regulation (CPR), the partnership agreement should establish measures to involve partners and their role in the partnership contract preparation. It can be considered that CECP completes CPR, asking that both the contract of partnership and the programmes should specify in particular:

- the list of partners involved, their responsibilities and the extent of their involvement;
- how the partners were identified and how the principles of transparency and accessibility have been applied;
- the measures taken to facilitate wide involvement and active participation of partners;
- the coordination structures and procedures within the programme and in relation with other operations of the CSF Funds;
- how technical assistance resources will be used to promote partnership (nature of support services, the level of available resources and the management of the planned agreements);
- partners' opinions on the implementation of the partnership principle, expressed clearly and open.

Based on the principle of partnership, the member states will achieve, overall, the reformed cohesion policy, which will provide up to 351.8 billion EUR to invest in the regions, cities and the real economy in Europe. The target of these funds is achieving the objectives of the strategy Europe 2020: job creation and economic growth, approaching the problem of climate change and energy dependence, reducing poverty and social exclusion. In addition to this, the key-priorities of the European Fund for Regional Development will have a special contribution, more exactly the support given to small and medium-sized enterprises, the objective being to double the support, from 70 to 140 billion EUR during the seven years. All European structural and investment funds that stimulate good projects will be more results-oriented and will focus on a new backup performance (European Commission, 2011b).

## **5. CONCLUSIONS**

The partnership principle must be always analyzed in strong connection with a multi-level governing approach, without neglecting the role played by the principles of subsidiarity and proportionality. Each governing level must have a well defined role, and decisions, proportional to objectives, must be made at the appropriate level. A range of possible benefits from the way of conceiving and applying some strategies regarding the management of European funds has been distinguished, thus guaranteeing a greater transparency in decisional processes. A contribution to these benefits comes from implying the partners, common reinforcement, engagement and right of possessing the European policies, obtaining knowledge, expertise and available opinions.

For each member state, the successes and experience gained in the previous programming period provides a solid basis, but also a source of information. The conclusions derived from the experience of each state, included in the evaluation reports, can be applied in the process of elaborating strategies, and thus can demonstrate to the EU that a member state will use the funds more productively in the future period. Involvement of the partners can contribute to reduce the gaps in coordination and in the

policies application capacity at different levels of government, in terms of information, resources, financing, etc.

In these circumstances it is vital that Romania mobilize and consider the priorities set for the 2014-2020 funding period, by following best practices imposed by the principle of partnership, since the current funding period represents one of the biggest challenges for the public sector, as there are numerous priorities and significant budgetary constraints.

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## **THE MISLEADING AND COMPARATIVE ADVERTISING: EFFECTS AND PERSPECTIVES**

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**Abstract:** *Advertising constitutes a phenomenon that is spreading more and more in our society.. Most of the times, the ad is the one that sells the product and has an impact on consumers' behaviour. Under these circumstances, one cannot ignore the impact that advertising has on competition and competitive nature. The evolution of the communication means has an important impact on advertising, especially through the development of internet, social networks, forums and blogs. The development of new advertising practices generates a series of issues that needs to be settled so that a high level of protection for users can be guaranteed.*

**Keywords:** *Unfair competition, advertising, consumer.*

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### **INTRODUCTION**

The International Chamber of Commerce of France drew up in 1937 The International Code of loyal practices in terms of advertising that was justified by the globalization of economy and a more intense competition. The code is conceived as a self-discipline tool. Within the meaning of the Code, advertising is defined in broad terms, as 'any manner to promote products or services, no matter the media means used'.

Commercial advertising constitutes a special type of advertising, which is characterized by its purpose of economic nature and constitutes all the specific ways and tools that are used in order to facilitate the familiarity with and the appreciation by consumers of certain products or services that are subject to supply and to sale respectively. The commercial advertising constitutes a way to provide consumers with a message with respect to a certain product or service or to the company itself.

The purpose of advertising refers to the formation of a favourable opinion of consumers with respect to a certain product or service or to its manufacturers. The role of advertising needs to be analysed on two coordinates: the issuer and the consumer. The issuer of advertising seeks to make the name of his/her company famous, to launch a new product, to increase the sales of an existing product, to differentiate his/her products from those of his/her competitors or to build an image of his/her company (Arn, 2001). A good

ad induces to consumer non-existing needs or awakes into this one hidden desires and, implicitly, makes him purchase things.

For consumer, advertising constitutes, above all, a source of information with respect to the qualities and use of a certain product, that shall allow this one to make the best decision with respect to the buying action. The consumer of advertising becomes one that is informed in a correct and complete way, so that he/she may choose those products or services matching his/her needs and making him/her feel safe (Maxim, 2007).

The expansion of advertising methods leads to an interesting phenomenon as far as advertising is concerned. In order to capture consumer's attention, issuers feel tempted to use more and more aggressive methods. These are an inevitable consequence of a market that is based on increased consumption and free competition. By commercial advertising the consumers of a good custom may be misappropriated, causing the economic decline of competitors and even their removal from the relevant market.

### **THE ASSESSMENT OF THE LEGISLATIVE FRAMEWORK**

Directive 84/450/EEC has constituted, for a long time, the main community regulation in the unfair competition field. If we were to report upon the evolution of the unfair competition law, we would realize that, as a matter of fact, Directive 84/450/EEC would set minimum and objective requirements thanks to which one could establish that advertising is misleading. Directive would impose a minimum level for the protection of the public interest, in general, of consumers and of the persons that are in a competition relationship. The member states were free to adopt rules ensuring a stricter protection.

Directive 84/450/EEC was replaced by Directive 2006/114/CE that sees to ensure competitors' protection against misleading advertising and its unfavorable consequences, as well as the fixing of those circumstances under which comparative advertising is allowed. Unlike the former regulation, the protection of consumers and population no longer constitutes a goal in itself. The European Council Directive no. 2006/114 highlights in a special way the fact that the distortion of competition constitutes a consequence of illicit misleading and comparative advertising. The Directive has been transposed into the national laws by all the European Union member states.

In the Romanian law, The European Council Directive no. 2006/114 was taken over through Act no. 158 of July 18, 2008 with respect to misleading advertising and comparative advertising.

The European Parliament and European Council Directive no. 2005/29 of May 11, 2005 with respect to the companies' unfair commercial practices on the internal market towards consumers was adopted in order to harmonize the provisions related to the protection of consumers, both natural persons and legal entities, inside the joint market, so that they can make the best of the possibility to purchase things from other countries than the residence one. At the same time, the legislative framework with respect to misleading advertising is completed through the introduction of some clauses meant to fight against aggressive commercial practices. Act no. 363/2007 transposes into the Romanian law the provisions of Directive 29/2005.

## **MISLEADING AND COMPARATIVE ADVERTISING: GENERAL PRESENTATION**

With a view to establishing the misleading character of advertising, we have to analyze all the elements that make it up (Goicovici, 2009). The provisions of art.5 of Act no. 158/2008 show that one may establish the misleading nature of advertising only if one takes into account all its issues, especially the information regarding:

- the features of goods and services, such as: availability, nature, execution and packing manner, composition, manufacturing or supply method and date, extent to which these ones match the intended purpose, destination, amount, technical-functional parameters, manufacturer, geographic or commercial origin or the outcomes of tests and trials on the goods or services, as well as the outcomes that are expected from these ones;
- the price and manner of calculating the price, as well as the circumstances under which the products are distributed or the services are supplied;
- the nature, attributions and rights of the trader that advertises, such as: his/her identity and goods, the qualifications and possession of industrial, commercial or intellectual ownership rights or his/her prizes and awards.

The comparative advertising is licit if it complies, in a cumulative way, with the requirements stipulated in art. 6 of act no. 158/2008:

- is not misleading, according to the provisions of art. 3 let. b) and art.5 of the present law, as well as of art.5-7 of Act no. 363/2007;
- compares goods or services that comply with the same needs or are intended for the same purposes;
- compares, in an objective manner, one or several basic, relevant, verifiable and representative features of the respective goods or services, that may include the price as well;
- does not undermine or denigrate the marks, trade names, other distinctive signs, goods, services, activities or status of a competitor;
- as far as products with origin name are concerned, it makes reference, in every case, to products with the same name;
- does not take advantage in an unfair way of the reputation of a trade mark, of a trade name or other distinctive signs of a competitor or of the origin name of the competitive products;
- does not present goods or services as imitations or reproductions of those goods or services wearing a trade mark or protected trade name;
- does not create any confusion between traders, between the one that advertises and a competitor or between trademarks, trade names, other distinctive signs, goods or services of the one that advertises and those of a competitor.

## **MISLEADING AND COMPARATIVE ADVERTISING IN ROMANIA. CASE STUDIES**

Due to the legislative severity, the cases in which the economic operators soar to use unfair advertising forms are low. To illustrate this situation, we shall analyse some advertising spots for which the National Council of Audio-Video Material drew the

conclusion that these ones contain statements that may mislead the audience, in its capacity as consumer.

Therefore, for the spot promoting the mineral water Aqua Carpatica, which promotes itself as “The only non-nitrate mineral water in the world” the provisions of art. 3 letter b) and of art. 5 of Act no. 158/2008 are breached, as they contain statements that may mislead the audience with respect to the accuracy of presented information and features of mineral waters sold on the market, in general, and of the mineral water promoted, in particular. The statement promoting the mineral water Carpatica creates confusion with respect the actual features of the composition of the soda mineral water “Aqua Carpatica”, as nitrates may be naturally found in mineral waters and may only constitute a risk factor for consumers, when the maximum admitted limits are exceeded.

The advertising spot “Viziunea PCC pentru viitorul Oltchim” (The PCC vision for the future of Oltchim) breaches the rules of correct advertising and of objective information of the audience, as its contents conveys a doubtful message, from where it does not come out very clearly whether one wishes to promote or to denigrate the company Oltchim.

As as far ING advertising spot for refinancing loan, the members of the National Council of Audio-Video Material stated that the rules for correct information and loyal competition were breached. The promotion of the services offered by ING by statements such as “somebody told me that ING has loans with the best interest”, that can be neither checked or proved may directly harm consumers’ financial interests and affect, at the same time, a correct competition on the market of bank loan services.

We may find a similar situation in the case of the advertising spot for Duck Perfumed Bands, promoting the deodorants for toilet bowls. “Have you ever noticed that the toilet cleaning devices are bigger and more full of germs? Let us introduce to you the new perfumed bands offered by Duck...” These statements come with images where a plastic device used for cleaning the toilet where germs live is extracted with a crane from the toilet bowl. The comparison leads to the idea according to which the product promoted in the spot totally removes the germs from the toilet bowls, unlike the plastic devices that only keep them.

## **CONCLUSIONS**

Advertising constitutes a key factor in a company’s business strategy, an element that really matters for the commercial success, as it allows traders to present their goods and services. The legislative framework ensures a protection for companies against unfair practices. Misleading and comparative advertising generates lack of functionalities on the market, distorts competition and harms the consumer’s decision-making process. Within this context, there is a need for a close monitoring of the advertising means. Within the same line of thoughts, The European Commission drew out a deep analysis of all the issues in relation with the trading practices and came to the following conclusions: the Directive regarding the misleading and comparative advertising offers a regulation framework that is sold enough for an important part of the advertising market between companies. Nevertheless, the persistence of certain fraud methods on a large scale shows that the overall existing norms at the EU level and self-regulation norms need to be

consolidated in order to fight against certain types of clearly identifiable frauds. Small companies are most affected by such practices, as their vulnerability degree is not very different from the consumers' one.

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## **CURRENT TRENDS IN PUBLIC EXPENDITURE ON EDUCATION**

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**Abstract:** *This article emphasizes the importance of investment in education, an old trend but current as it was before. The results recorded by Romania in the period 1990-2014 in the education sector and, consequently, the per capita income segment are highlighted and in terms of human development index.*

**Keywords:** public expenditures, Public expenditures on education, HDI

**JEL:** H50 – General, H53 - Government Expenditures and Welfare Programs

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### **INTRODUCTION**

The main argument to justify the analysis of education from the perspective of economic theory was based on its direct economic effects. Although it is generally accepted that education effects extend beyond purely economic character, the most important effects of education are those that take the form of cash income.

Economics is a branch of education (research area) relatively young economics, marked a significant development in recent decades. Most economists have defined it through the analysis on the resources allocated to education, especially financial ones. Mainstream of economic research in education, neoclassical inspiration is based on human capital theory, created in the laboratories of the University of Chicago in the late 50s. Although the concept of human capital, "is known since Adam Smith (in his *Wealth of Nations* appreciated:,, a man whose training is more work and time spent must demonstrate a high level of skill and ability, can be so expensive but compared to any car performance ... ") being introduced in economic theory and other trade economists from the early eighteenth century, major works related to human capital and the economics of education is relatively recent.

Term "human capital" was used in the economic literature in 1961, article in *Human Capital Investment* of Nobel Laureate Theodore W. Schultz. Subsequently, many economists, the most prominent of which turned out to be Gary S. Becker (Nobel Prize winner), were outlined and based economic theory of human capital. Relationship education is integrated human capital specific research education economy in terms of investment in human capital. In parallel, we are witnessing the development of macroeconomic research aimed at integrating education inputs in production functions

used in the study of economic growth. Arguments are the fact that countries whose populations had high levels of education and training were the most productive in economic terms. Therefore, education can be conceptualized not only with respect to consumption, but rather as an investment.

The main driving force that can, where appropriate, foster or, conversely, inhibit the activity of training and / or vocational adjustment is the so-called investment in human capital. More broadly, it is the view of most authors, "... any activity designed to ensure an increase productive qualities of the human factor ...".

Since investment in labor specialization and improvement is similar to investment in physical capital in terms of production efficiency, skills acquired are called "human capital". Creating these skills requires an investment of time and money to be gained, and once acquired, they bring increased income to their owner for a period of time. Defined as investment in human capital includes not only expenditure made formal and retraining of the workforce, but also the costs allocated for health, the affected job search and, not least, the efforts of family, nature very different, made both before entering the formal education system and beyond.

In the narrow sense, human capital is produced primarily through formal education and training in the workplace, and the experience gained during the work.

By analogy with investment in physical capital, investment in human capital takes into account current expenditure on education made by a person, a family, an organization or even society as a whole, in anticipation of obtaining gains, not only in terms of professional performance, the ability and skill, but also in the possible additional revenue in the future.

Expenditures for social and cultural activities have an influence on the economy, on economic development as they contribute to the maintenance, restoration and development work capacity of individuals to training and raising their qualifications, the reproduction of labor.

### **CURRENT TRENDS IN PUBLIC EXPENDITURES ON EDUCATION. OLD NEW**

Between spending on social and cultural activities and the country's economic development are inter-relationships: a developed country in economic terms will have large financial resources and will be able to turn a large part of it to finance these actions; in turn, shares of education, health, culture, social security will lead to the training and qualification of individuals to preserve the health of the population or its restoration, creating conditions conducive to the participation of labor productivity increased business development and social or will provide (or increase) income of disadvantaged persons.

Social-cultural actions are social services that create national income, thus proving a productive character (help social and economic development). For example, schools participating in the economic development of the number of qualified mid-level or higher, of different specialties that annually enter into activity, so it produces skilled labor. As the national economy of machinery, energy, consumer goods etc. are satisfied in the branches of material production as the economy demands skilled labor training education are met; so it provides a "production" of a special kind. It works on fixed capital under constant modernization and refurbishment and contributes to an increased

production, modern and competitive and increased income for both these workers and the economy.

Thus, in 1960, the UNESCO General Conference adopted a resolution in which, for the first time, education is treated not only as a social and cultural force, but as a factor of economic development. Sometime later, the World Bank decided in the General Assembly to agree to lend covering education, especially developing countries, to underdevelopment, utilizing appropriate their wealth, natural resources available and achieving economic and social progress.

Another aspect of the influence of education on economic development is the phenomenon "brain-drain" (brain drain). Many studies on this issue highlight the huge losses suffered by countries of specialists, higher skilled workers emigrate (representing losses as expenses incurred for their preparation and the benefits that would result from the activity that would be wrought in these countries) and impressive profits obtained immigrating countries. For example, the United States obtained in 1979 from immigrant professionals, revenues of 3.7 billion. Dollars in conditions not spend anything for their preparation.

Judged from this point of view, spending on social and cultural activities can be considered as a particular investment, called "investment in human resources." Their content is given by "all costs leading to increased mental and physical skills of individuals taken as productive agents or prospects".

In other words, investment in human resources comprises expenses incurred for individual growth and complex development of a person. Corresponding intellectual investment spending for education and training, made for the purpose of education, training and workforce skills. These charges are the advancement of the national income as financial resources for education is not consumed completely, but find themselves in another form, the high quality of training of members of society.

Unlike tangible, which is reflected in the components of fixed capital, intellectual investment improves the skills of persons enrolled in education, arming them with the skills and professional knowledge capable of providing high labor productivity.

Milton Friedman says: "professional and specialized education is a form of investment in human capital as an investment like machinery, buildings or other non-human capital. Its function is to increase the economic productivity of the human being. If you succeed, the individual is rewarded, in a society based on free enterprise, by obtaining a higher gain than would be achieved otherwise. "

In terms of temporary, tangible is achieved in a relatively short period (1-3-5 years), while the intellectual have the character of long-term investment, lasting 10-15 years or even more. Material investment result - Fixed capital - is subject to physical and moral wear now, after a period of time not too long, technically outdated. Intellectual investment long term effects practically during the active life of the investee and to scientific and technical progress, it can be corrected by using recycling knowledge, their systematic enrichment to the needs of the economy and the development of science and technology. In other words, education gives individuals the flexibility necessary to adapt to the new requirements of economic standing through retraining, specialization. Finally, unlike tangible economic effect of which is peremptory and relatively easy to determine



if the effects of intellectual investment outcomes are multiple, non-economic, social, human and are more difficult to quantify.

Assessment of the "investment in human resources" social-cultural spending is different, some authors consider that only one of them can be considered investments in human resources (those designed to achieve the material and technical basis of the action, capital expenditure and part of current expenditure) and others recognize the investment nature of all human resources action directed towards education, culture, health.

These issues are of particular importance when calculating efficiency as they affect sizing "effort." In the first case, are taken into account only expenditure on investment in social and cultural activities and some of the running costs (such as for education, current expenditure on technical education, economic, professional and a share of 25% -50% of current expenditure on education remaining.) In the second case, taking into account the whole volume of social and cultural costs, regardless of economic nature, considering that activity in these areas form, shape and adapt the human factor and its behavior in society, contributing to the growth of social labor productivity and national income growth.

Investments in human capital are considered as "allies" of the policies needed to ensure sustainable economic growth. They help mitigate the worst consequences of poverty: disease and malnutrition, and provides opportunities for individuals to improve their living conditions. The annual report World Bank for the year 2012 shows that investments in health, education, food, contribute to individual productivity and overall national economic growth. Certainly, combining their economic efficiency and contribute to reducing human suffering make investments in human capital a powerful weapon in the fight against poverty.

Nature of investment spending for education, health, culture and advertising their treatment in terms of efficiency resulting from their use. Social-cultural actions are, on the one hand, "consumer goods" that meet individual needs (eg, to learn is to eat, to satisfy your intellectual needs through direct certain knowledge they assimilate), on the other hand they have an important economic role, represented by the contribution of socio-cultural to increase national income.

The research of renowned authors in the field (G. Becker) tried to quantify the contribution of human capital to increase social welfare. It put out so that if in 1946, the UK human capital provides about half of the welfare of this country, in 1989 about 80% of the wealth of developed countries ensured on human capital contribution (Table 1).

Table 1 The contribution of human capital to GDP in developed countries

	Pre-industrial times to 1900		Industrial maturity period				Period of modern economics	
			1920-1929		1954-1960			
USA	-	-	73	27	81	19	83	17
Western Europe and other developed countries	54	46	70	30	75	24	80	20

Note: columns 2,4,6 and 8 is the contribution of human capital to GDP  
columns 3,5,7 and 9 is the contribution of physical capital formation PIB  
Source: Gary Becker – Human Capital, Publishing All, Bucharest, 1997, p.32

It should be noted that although it is considered that the transition to the knowledge economy was launched in the USA, this process is underway in several developed countries (Japan, Canada and several European countries developed). The illustrative example is Japan, which, in less than 50 years, has become one of the major forces in the global economy because of the special qualities of the human capital stock divided into a growing seriousness and commitment to work and the existence of a training system well developed.

A number of studies have shown that disparities between different countries in the world in terms of levels of development - quantified, usually by disparities in the GDP / capita - can be explained by differences in factor endowment and especially in human capital endowment. In this regard, some authors have found that the biggest factor endowment differences existing between countries lies in the large differences in educational capital per capita indicator. Thus, if the coefficients of variation obtained for GDP / capita and physical capital / capita are relatively close (1.21 and 1.24 respectively), human capital / worker coefficient of variation is higher (1.78). This is also highlighted by comparing extreme cases. The United States has a GDP / capita of over 30 times higher than India, differences in terms of physical capital stock is relatively close (in the USA it is 25 times higher). It should be noted also that there are big differences between the two countries in terms of human capital embedded in physical capital has been estimated at 44% in the USA compared to only 6% in India.

Conversely, if the stock of human capital, the differences are much larger (by 186 times). These results are confirmed by other studies even if the methodology was different. This was estimated coefficient of elasticity compared with the input to the output in human capital 0.472 (much higher than the corresponding physical potential that was 0.263).

This discrepancy in human capital endowment, coupled with a greater sensitivity to changes in the output of human capital compared to that recorded in relation to physical capital, highlights once again the great importance that education should give countries development.

In Romania, the effects of investment in human capital in the 90's and so far can be summarized with the help of human development index calculated by UNDP. HDI is a summary measure for assessing long-term progress in three basic dimensions of human: a long and healthy life, access to knowledge and a decent standard of living. As in the 2011 HDI segment "a long and healthy life" is measured by life expectancy. Access to knowledge is measured by: i) average years of schooling of the adult population; ii) the number of years of expected schooling for children of school age. Standard of living is measured by gross national income (GNI) per capita.

Table 2 shows the progress made by Romania in each of the HDI indicators. Between 1980 and 2012, life expectancy at birth in Romania increased by 4.6 years, mean years of schooling increased by 2.5 years and expected average years of schooling

increased by 3.1. Romania GNI per capita increased by about 41 percent between 1990 and 2012.

Table 2 Romania's HDI trends based on consistent time series data, new component indicators and new methodology

	Life expectancy at birth	Expected years of schooling	Mean years of schooling	GNI per capita (2005 PPP\$)	HDI value
1980	69,6	11,4	7,9		
1985	69,6	11,9	8,6		
1990	69,4	12,3	9	7,822	0.706
1995	69,4	11	9,5	7,158	0,694
2000	70,5	11,9	9,9	6,786	0.709
2005	72,4	13,6	10,1	9,280	0.756
2010	73,8	14,5	10,4	10,747	0.783
2011	74	14,5	10,4	10,889	0,784
2012	74,2	14,5	10,4	11,011	0.786

Source: UNDP - <http://hdr.undp.org/sites/default/files/Country-Profiles/ROU.pdf>, page 2

Thus, there is significant progress in the education sector. The average number of years of schooling increased by almost 4 years and the average life expectancy by almost five years. It also can be seen as income per capita increases consistent.

## CONCLUSIONS

Tend to invest in education is not new though, remains a topic of interest at any time of the evolution and development of society. In Romania, there is a permanent concern for the education sector and macroeconomic results achieved are among the most notable. Fundamental problems that persist in our state are the same as in the 90s. The first is related to the exodus of young people educated in universities, secondary, post-secondary excellence by developed countries such as Spain, Italy, England etc. These countries, without even one Euro investments in youth education work will use the ability, creativity and intelligence of young educated Romans. The second problem, as serious and implications for government policy, consists of poor funding of the education system. Level of education funding promised by 6% of GDP remained a dream until the year 2014, nearly 25 years after the revolution of 1989.

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## THE INFLUENCE OF ECONOMIC CONDITIONS IN ROMANIA ON THE RELATION BETWEEN INFLATION AND THE RON EXCHANGE RATE

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**Abstract:** *The exchange rate is a factor that influences economy and is used by some countries to correct certain disequilibria that occurred as a result of the financial crisis which affected many countries that were previously considered to be infallible. The negative effects of the financial crisis can be found in the decrease of the volume of goods involved in international commercial exchanges as a result of the drop in net exports and gross domestic product. The exchange rate regime in Romania is pegged float and the Central Bank intervenes to support the RON exchange rate since significant changes in the exchange rate of a currency “are not good to a small and exposed economy such as Romania’s one”.*

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### **INTRODUCTION**

Anticipating the evolution of a currency is complex and its volatility corresponds to the situations in the macroeconomic environment. Thus, the exchange rate of a currency may be even influenced by rumours, be they confirmed or not, or reactions to declarations made by certain reputed figures in the economic, political or financial field. The difficulties pertaining to the anticipation of the exchange rate show in the emergence of a series of determination models for the exchange rate that are distant to the results obtained in an empirical manner. Although the application of these models was disappointing in practice, many of them continue to be used to explain the behaviour of the exchange rate (Stein, J. L., *The NATREX Model*, Appendix: International Finance Theory and Empirical Reality, in *Fundamental Determinants of Exchange Rates*, Oxford: Stein and Associates, Clarendon Press, 1995, p. 182).

According to Richard Meese and Kenneth Rogoff (1983), macroeconomic variables play a small role in explaining the short-term exchange rate. But on the other hand, market analysts believe that the fluctuations of the exchange rate owe to the developments at the macroeconomic level.

Excessive volatility in the exchange rate is associated to currency depreciation, and low volatility to periods in which the national currency shows an appreciation trend (Kabor, A., Szekely, I., *Foreign Exchange Market Volatility in EU Accession Countries in The Run-up to Euro Adoption: Weathering Uncharted Water*, Economic Systems, vol.28, no.4, 2004, pp.337–352).

Some models that explain the determination of the exchange rate attribute the feature of fundamental factors to certain variables such as currency offer (money supply), the real economic growth (or the change of the gross domestic product corrected with inflation), exchange rates, inflation rate or the external balance of payments (Ahmet, Can Inci, Lu, Biao, *Exchange rates and interest rates: Can term structure models explain currency movements?*, „Journal of Economic Dynamics & Control” no.28, 2004, pp.1595–1624, www.elsevier.com). A great amount of the literature of the field acknowledges the influence that fundamental factors have on a currency’s exchange rate, yet it is also admitted that the intensity of the relation between variables is weak. The poor performance of models that include significant factors does not draw on econometrics (small or irrelevant samples for the entire population), but the irrationality of the participants on the market, economic cyclicality, team spirit and others are also considered; moreover, the last factors are not easy to integrate in an econometric model (Ehrmann Michael, Fratzscher, *Exchange Rate and Fundamentals: New Evidence from Real-time Data*, „Journal of International Money and Finance” no.24, 2005, pp.317–341, www.sciencedirect.com).

Beckmann, Belke and Kuhl argue that there should not be any determination models of the exchange rate that lack the integration of a main factor of influence, considering that the long-term equilibrium relation between significant factors and exchange rates is not commonly accepted (Ehrmann Michael, Fratzscher, *Exchange Rate and Fundamentals: New Evidence from Real-time Data*, „Journal of International Money and Finance” no.24, 2005, pp.317–341, www.sciencedirect.com).

The macroeconomic model influences the national currency’s exchange rate. Against the background of economic growth, perspectives of financial stability, steady prices, low unemployment rate, the currency displays an appreciation tendency. However, the deterioration of the economic environment, the increasing budget deficit, a high unemployment rate, etc. contributes to greater uncertainties for a specific currency.

## **THE RELATION BETWEEN INFLATION AND THE EXCHANGE RATE IN CENTRAL AND EASTERN EUROPEAN COUNTRIES**

The transition period from market economy was characterised by a high inflation which reached the top in the first years. In 1997, in the context of price liberalisation in agriculture and energy, the inflationist phenomenon reached 180%. Restrictive monetary policies lowered price levels to 33% in February 1999. The drop occurred due to significant fiscal deficits and the rapid and continuous rise in salaries, thus leading to the decrease of external competitiveness.

The International Monetary Fund emphasizes the importance of workforce remuneration and the increase of inflation owing to the practice of salary levels that are not correlated to labour productivity growth.

Price liberalisation in Romania was a long and unceasingly postponed process. In 1997, there was a price liberalisation which whose effects led to the increase of inflation. However, some prices continue to be administered or contain subsidies from the state.

Monetary policies adopted proper inflation policies, hence the decrease of the inflation level to 6% in 2006. From that moment on, the central bank has targeted

inflation and managed to create an internal and external environment of stability by preventing and finally stopping the degradation of the purchasing power for the national currency and the increase of international reserves. Thus, Romanian deflation is a result of the rise of volatile prices.

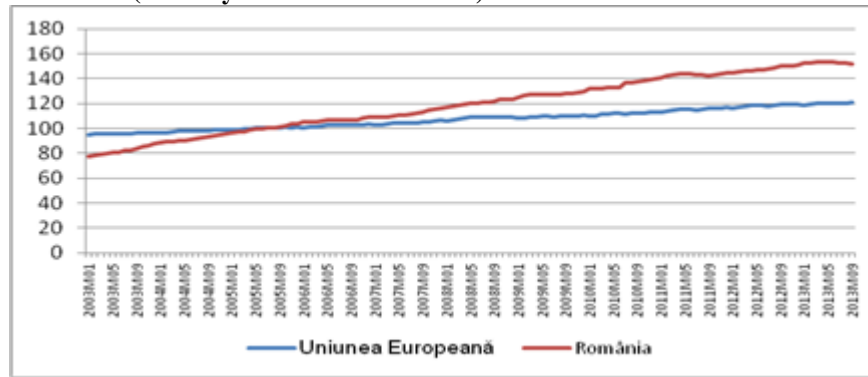
Inflation is considered by some authors that draw on monetarist models of exchange rate determination, a significant factor that influences the exchange rate. For instance, for 1973 – 2000, M. Frommel proved that for three currencies, the inflation differential led to the change of their exchange rates. Moreover, it was shown that inflation was the most important factor in the macroeconomic context (Beckmann, Joscha, Belke, Ansgar, Kuhl, Michael, *The Dollar-Euro Exchange-Rate and Macroeconomic Fundamentals: A Time-Varying Coefficient Approach*, Rev. World Econ., 2010, DOI 10.1007/0290-010-0074-6).

For countries with emergent economies such as the Central European and South-Eastern countries, the exchange rate is a key feature in the policy of central banks to control the evolution of inflation. For those states that aimed at increasing their exports' volume, a more permissive volatility of the exchange rate was preferred, so as to ensure an increased competitiveness of national products. Maintaining competitiveness without compromising stability became the main theme of monetary policy for most states in the region. David Barlow analysed the exchange rate and inflation in Hungary for 1991 – 2002 and proved that, before announcing the crawling pegs in 1995, the depreciation of the national currency responded to the change of inflation, and after 1995, the exchange rate recorded a diminished depreciation trend. Roberto Golinelli and Riccardo Rovelli showed that in 1991, inflation rates in The Czech Republic, Hungary and Poland recorded the following values: 57 %, 35 % and 70 %, respectively. Their value has dropped until 2001 under 8%, the deflationist process influencing the exchange rate of the national currency (Barlow, David, *The Hungarian Exchange Rate Over Transition*, „Economic Systems” no. 29, 2005, pp. 87 – 97, [www.elsevier.com](http://www.elsevier.com)).

## **EMPIRICAL ANALYSIS BETWEEN INFLATION AND THE EXCHANGE RATE FOR ROMANIA**

The BNR policy aimed at ensuring steady prices that would contribute to the decrease of inflation 2003–2007. Against the background of the financial crisis, value added tax was increased, the exchange rate was depreciated in the context of expression of an increasingly higher number of prices in the European currency, taxes grew and, at a microeconomic level, serious disequilibria were noticed. All these mutations were reflected in the increase of the inflation rate. Graphically speaking, the evolution of inflation in Romania and the European Union has the following trajectory between January 2003 and October 2013:

**Graph 1 Evolution of annual inflation in Romania and the European Union (January 2003 – October 2013) - index 2005 = 100 -**



Source: ec.europa.eu/eurostat

The inflation rate in our country is high as compared to other EU countries. In the past years, the appreciation of the exchange rate sustained the deflation in our country, in the context of pay rises in the budgetary system and pensions and budget deficit, mainly by lowering prices to exported products. In the context of recession, present economic conditions contribute to the decrease of inflation and price rises for certain products with a high weight in inflation assessment (energy, fuels) and raising taxes might be influence factors in this sense.

Based on the results obtained, we decided that it was better to use several variables in a model meant to explain the volatility of the national currency starting from basic variables related to the gross domestic product – cumulated volume of imports and exports, external assets, intermediate monetary base M2, as follows:

- *economic openness degree* – this indicator reflects the commercial policy of the state and the likely barriers against it; it is calculated as the relation between cumulated volume of imports and exports in total GDP
- *weight of net foreign assets in total GDP* – against the background of the difficulty to calculate net foreign assets at the level of the financial system, we will analyse the net foreign assets of the banking system reported to GDP;
- *development level of the financial system* – is quantified by means of a series of indicators that supply information on the degree of development and efficiency of the banking system and the capital market, respectively; it may be calculated as weight of the monetary aggregate M2 in total GDP (Altar, Moisă, *Impactul liberalizării contului de capital asupra cursului de schimb și a competitivității economiei românești*, Institutul European din România, Studii de impact PAIS III, pp.43–44).

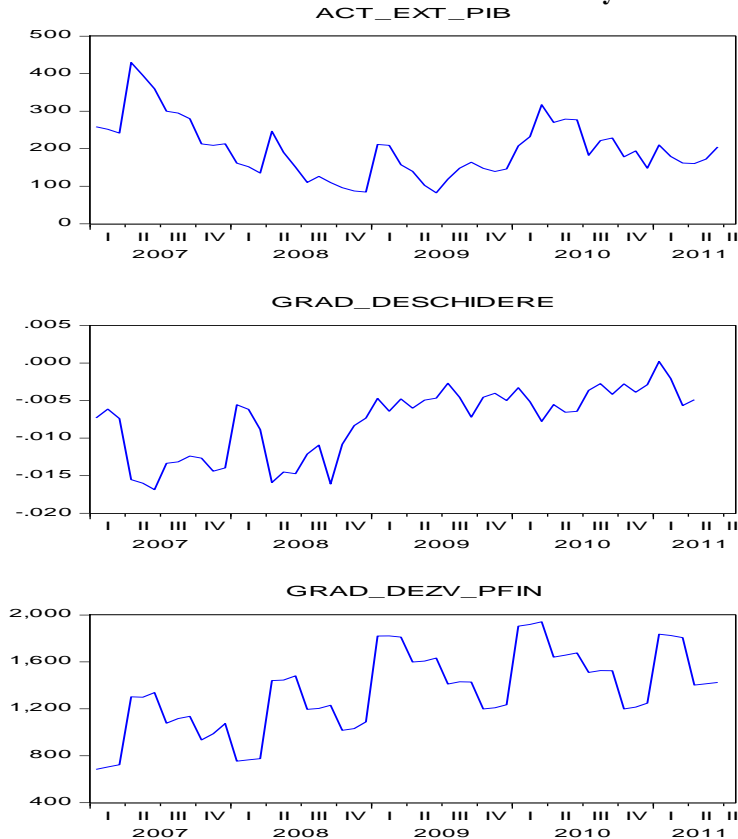
The relation to be obtained from the regression analysis is the following:

$$D(CSM) = -0.001 + 2.345e-009 * D(ACT\_EXT) + 4.13E-09 * D(DIF\_I) + 0.0319 * D(DIF\_R) + 3.679 * D(GRAD\_DESHIDERE) + 0.00055 * D(GRAD\_DEZV\_PFIN) + 0.033123 * D(M\_MON) + 4.786e-006 * D(PIB) + 0.000195 * D(ACT\_EXT\_PIB), \text{ where:}$$

- *csm* – monthly exchange rate average;
- *act\_ext* – net foreign financial assets;

- *dif\_i* – inflation differential between Romania and the Eurozone;
- *dif\_r* – interest rate differential between Romania and Eurozone;
- *grad\_deschidere* – openness degree of Romanian economy;
- *grad\_dezv\_pfin* – development degree of the financial market;
- *m\_mon* – monetary base;
- *pib* – gross domestic product;
- *act\_ext\_pib* – net foreign financial assets as fraction of GDP.

**Graphs 2–4 Weight of net foreign assets in total GDP, economic openness degree, and development degree of the financial market in Romania between January 2007 – June 2011**



Source: Data processed based on the basic series available on [www.bnro.ro](http://www.bnro.ro) and [www.insse.ro](http://www.insse.ro)

Out of all the factors used in the regression analysis, the following are significant: *gross domestic product*, *development degree of the financial market (strong relation)* and *monetarybase (weakerrelation)*, respectively. The determination report points out an approximately 44% influence of the factors included in the model.

At the level of Romanian economy, the exchange rate was influenced by BNR interventions, being an instrument used in stopping inflationist pressure in our country. However, its evolution could not ignore the changes in the level of real economy and



financial market during the present crisis, thus recording a depreciation tendency towards the European currency.

## CONCLUSIONS

Protecting a domestic currency with residual monetary sovereignty means that all existent divergences in international institutions and financial markets should be dealt with. This also holds true for a floating exchange rate system, irrespective of the fact that floatability in itself implies a certain protection or not. As a result, it is necessary for the new global financial system to be able to contribute to economic development without determining central banks to go into payment default or an entire currency to be overcome. Governments, banks and enterprises in developing countries should avoid short-term demand loans or short term loans in strong currency. Capital flows to developing countries should preferably come as direct investments or personal capital. Furthermore, developing countries should draft financial regulations to encourage modern national systems and foreign currencies. The International Monetary Fund should focus on its primary function, i.e. providing the main source of liquidity to its members.

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