Contemporary Legal and Economic Issues III

Editors
Ivana Barković Bojanić and Mira Lulić

Publisher
Faculty of Law Osijek, Josip Juraj Strossmayer University of Osijek, Croatia

Printed: Grafika Osijek, Croatia

CIP record is available in the electronic catalogue of the City and University Library of Osijek under the number 120714058.

ISBN 978-953-6072-43-9

Publishing of this book is authorized by the Senate of the Josip Juraj Strossmayer University of Osijek at its 7th Session in the academic year 2010/2011 held on 23rd May 2011.

The book is indexed in the EBSCO Publishing, Ipswich, Massachusetts, USA and ProQuest Research Library, Ann Arbor, Michigan, USA.

Contemporary Legal and Economic Issues III

Editors
Ivana Barković Bojanić and Mira Lulić

Josip Juraj Strossmayer University of Osijek
Faculty of Law Osijek, Croatia
2011

- TABLE OF CONTENTS -

Editors' Word

The book "Contemporary Legal and Economic Issues III" represents an international forum on major legal and economic problems confronting a contemporary society. It is organized in relatively rare format of a short monograph based on a set of 18 scientific papers in the field of law and in the field of economics, which is an advantageous way to construct a promising framework, to offer some scientific and practical comments and to arouse readers' interest in the overall approach, without having to carry the burden of the necessity to strive for completeness or detail. Contributions to the book are made by 25 authors and co-authors coming from Croatia, Poland, Italy, Romania, France, India, Germany, Nigeria, Russia and Mexico who are providing an international perspective to various economic and legal issues, whereby economic and legal principles are applied to real problems. The authors are students and professors who individually or as a joint effort contributed an article that deals with legal or economic issues often proving in their texts that law and economics are two scientific fields that are in many cases highly inter-related.

The book promotes scientific writing as the primary tool of academics and scholars to disseminate thoughts, ideas, research results and boldly present them to the professional and lay public for discussion, praises and critiques; it promotes cooperation between students and professors, i.e. mentorship, which is rewarding for both students and their professors by uniting them in a joint effort to produce a work where each invests effort, knowledge and enthusiasm to the best of their potential and benefits from the synergy effect; it promotes international cooperation between individuals and institutions taking part in this project pointing out that the distances in geography no longer represent an obstacle in establishing and developing the international cooperation and making the world of science truly global; it proves through topics covered that nearly all issues, in this case related to the law and economics, have left the strict realm of purely domestic jurisdiction. The book is intended as teaching and learning material in particular courses since it offers a reflection of current topics dealt in the fields of law and economics, as well as it can be very instructive text for wider audience who find legal and economic issues challenging.

A lot of effort has been invested in this book by authors, editors and reviewers and thus we hope that it will be beneficial to its intended audience.

Ivana Barković Bojanić and Mira Lulić

In Osijek, 20th April 2011

ICELAND AND THE EU: BITTER LESSONS AFTER THE BANK COLLAPSE AND THE ICESAVE DISPUTE

M. Elvira Méndez-Pinedo, Ph.D.
Associate Professor
University of Iceland, Faculty of Law
Iceland
e-mail: mep@hi.is

Abstract

This study addresses the relations between Iceland and Europe in the aftermath of the bank collapse and financial crisis. While summarising some legal issues of the so called "Icesave" dispute between the UK, Netherlands and Iceland which took place in the framework of a tense economic and political context during 2008, 2009 and 2010 the goal of the research is twofold: 1) to unveil and explain the deeper consequences of this unresolved dispute for the relations between Iceland and Europe; and, 2) to assess the tension between law, justice, economic governance and globalisation that this dispute brought to the European legal landscape. A parallel is drawn with the novel "Chronicle of a death foretold" by G. García Marquez, in the sense that "Icesave" killed the attraction of the EU accession for a big part of Icelanders as ordinary citizens lost their faith in the European legal order.

Keywords: *Iceland, European Union, Icesave, State liability, European law.*

Introduction

Chronicle of a Death Foretold by García Márquez, Nobel Prize in Literature,[1] tells the story of Santiago Nasar's murder. The novel, however, develops with an unusual structure....because the plot moves backwards. In the first chapter, we find exactly who killed the victim. The rest of the book explains why.

The story of the accession of Iceland to the European Union looks today remarkably similar to this novel. How do we explain the paradox of an official accession request and, at the same time, the majority of Icelanders opposing

[1] In 1982, García Márquez received the Nobel Prize in Literature "for his novels and short stories, in which the fantastic and the realistic are combined in a richly composed world of imagination, reflecting a continent's life and conflicts". See http://nobelprize.org/nobel_prizes/literature/laureates/1982/

precisely the same idea in 2010? While the financial crisis struck Iceland and even challenged the existence and survival of the European Economic Area (EEA) legal order, it is my opinion that the Icesave dispute seems to have killed the European Union in Iceland in the beginning of accession negotiations, a fact that seems to be ignored by the EU institutions. But why?

This study provides an overview of the relations between Iceland and the EU articulated on the basis of the Icesave dispute. It is both a descriptive and analytical work from a broad perspective of social sciences. For the sake of convenience, the main facts and arguments can be summarised in some pages but this should not confuse the readers. The details and arguments of the dispute are, in fact, extremely complicated because they touch upon new issues of EU/EEA law that remain grey areas to be discovered and discussed in the field. For this very reason, there are very few doctrinal studies on the subject. All legal issues are approached from a wider economic, political and sociological context.[2]

1. ECONOMIC BACKGROUND: ICELAND WAKES UP IN THE NIGHTMARE OF THE FINANCIAL CRISIS IN OCTOBER 2008

The banking collapse in Iceland is the first case of a systemic bank failure in a country in Western Europe since the Great Depression. Iceland is also the first case of cross-border insolvency leaving an impressive number of victims in other EU countries (estimated more than 400.000). Iceland is also unfortunately the first case where, in order to comply with a Directive and EU law, a nation is risking national bankruptcy and jeopardising its economic sustainability as a small populated country. Presumably because the whole financial stability of Europe was at risk in the autumn 2008, Iceland had no other choice to nationalise the debt created by private companies without considering any other legal options.[3] For these and many other reasons, Icesave has become in fact a paradigm of the gaps and failures of the European internal market of financial services. [4]

A systemic bank failure occurred in Iceland in October 2008. A dramatic series of events finished with three commercial banks being put under receivership and liquidation. The opinion polls done by the newspaper Fréttablaðið in November

[2] This paper is an adapted and updated version of the lecture given by the author at the European University Institute on 4 May 2010. Most legal sources and legal analysis comes from different documents not always published but available online.

[3] Center for European Reform, "Beyond banking: What the financial crisis means for the EU". Policy brief, October 2008, available at www.cer.org.uk. As the Center for European Reform puts it, "the crisis has exposed the weakness in the EU regulatory system and has reinforced the case for a serious reform of the institutions of global economic governance".

[4] In his new book, Howard Davies from the London School of Economics argues the that Icelandic example will lead to a revision of the bank regulatory system in Europe. See Davis, H., The Financial Crisis : Who is to Blame?, Polity Books, 2010.

2008 reflected then that approximately 60% of the Icelandic population favoured the accession of Iceland to the EU. No other economic alternative seemed feasible at that time. As the situation evolved later, the financial and banking issues related to the crisis and the Ice-save dispute and subsequent agreements resulted in diplomatic rows between the UK, Holland and Iceland; the overthrow of the Icelandic government in January 2009, new legislative elections in April 2009 with a new coalition government; a fierce debate over the legal basis of the obligation to compensate the depositors of Ice-save bank, an agency of the Landsbankinn in the UK and Holland; and, last but not least, the transfer of what is in essence a European legal problem created within the internal market to the field of public sovereign debt by means of bilateral diplomatic relations between these three countries.

2. THE ICESAVE AGREEMENTS: A BITTER DISPUTE EVOLVING INTO A CONSTITUTIONAL CRISIS IN 2010

2.1. The Icesave dispute: facts

As stated before, the financial crisis in Iceland led to the insolvency of the three main commercial banks within a week.[5] Relative to the size of its economy, Iceland's banking collapse is still the largest suffered by any country in economic history. An Emergency Act was adopted by the Parliament (Act no.125/2008)[6] and the Financial Supervision Authority took control of the main three commercial banks. The old banks were put into liquidation while three new legal entities were created to continue operations in Iceland. One of those banks, Landsbanki, had taken retail deposits from more than 400,000 British and Dutch customers

[5] On the specifics of the Icelandic financial crisis in English, see Robert Wade, "The crisis. Iceland as Icarus", Challenge May/June 2009, p. 5. Doc. Available at http://www.challengemagazine.com/extra/005_033.pdf

[6] Summary from the Icelandic Government Information Centre on Bank Reform:
"As an emergency measure the Parliament of Iceland on October 6, 2008 enacted a law, Act no.125/2008, authorizing the Treasury to provide capital for establishing new banks or to acquire ailing banks, partly or wholly, given the extraordinary situation in the banking sector because of the international financial crisis. The emergency legislation also gave far-reaching powers to the Icelandic Financial Supervisory Authority (FME) to intervene in the affairs of ailing banks under the prevailing extraordinary circumstances.
The provisions of the new law were quickly put to use. The Ministry of Finance established in October three new banks, wholly owned by the Treasury. After the Boards of the three main banks, Landsbanki, Glitnir Bank and Kaupthing Bank, had decided that they were not able to continue in business and had requested the FME to intervene on the basis of Act no.125/2008, FME decided to do so in order to secure the continuation of vitally important domestic banking services and to safeguard the public's bank deposits. It was also seen as important to down-size the banking sector to a level more in line with the size of the economy."
See http://www.iceland.org/info/iceland-economy/restructuring/nr/6449

through its branches in London and Amsterdam, through a product known as "Icesave". Icesave was an online savings brand that offered savings accounts with higher interest. In order to assure the economic and financial system of the country a double solution was articulated. All deposits in Iceland were transferred to the new banks and all deposits abroad were given priority in the bankruptcy liquidation process as secured creditors.

The liabilities of the Depositors' and Investors' Guarantee Fund (The Icelandic Fund) were called into question to compensate depositors in Europe under Directive 94/19/EC. In order to avoid a bank run, a political declaration was made by the Prime Minister who declared that the Government would guarantee all depositors in Iceland in full, although no legislation was adopted to that regard so that the normal guarantee limited to 20.887 established by European law would apply. However, depositors in Europe could never access their deposits as the process of receivership and liquidation of Landsbanki had started. Due to the vast amount of claims to cover, the Icelandic Fund became obviously unfit to face so many claims and the questions about State guarantee of the fund, the State liability for breach of EEA law and the principle of non-discrimination in the reconstruction of the Icelandic financial system came under discussion. Strong disagreement soon appeared between the UK, Holland and Iceland for the resolution of this problem.

2.2. Issues of European Law: grey areas and fresh new problems of EU/EEA law

Some important issues of European law are essential to understand the context of the Icesave dispute and to approach the topic from an Icelandic perspective:

- The principles of State liability for breaches of EU/EEA law and the principle of non-discrimination of EU/EEA law as applicable to the Ice-save depositors in Holland and the UK.
- The civil and eventual criminal responsibility of Icelandic banks and the failure of the Iceland State as reflected in the Report of the Special Investigation Committee (SIC) published on the 12 April 2010[7] .
- The aims of the European integration process and the fundamental rights for citizens within the internal market as defined in the new EU Treaties and the EU Charter of Fundamental Rights and the role of all actors involved in the aftermath of Icelandic financial crisis in the EEA legal order: EU/EEA institutions, other EU/EEA Member States.
- Other social and economic issues related to the international context of the dispute such as the criticism to the neoliberal approach to capitalism and

[7] Report of the Special Investigation Committee available at the website www.althingi.is . See executive summary in English at the link http://sic.althingi.is/pdf/RNAvefKafli2Enska.pdf

the movement of global justice in connection with the protests of Icelandic citizens during the winter 2008/2009.

2.3. Main claims in EU/EEA law: State guarantee and State liability of Iceland under Directive 94/19/EC and the principle of non-discrimination in the reconstruction of the Icelandic financial system

From a legal point of view, the negotiations between Iceland, Holland and the UK concerning the Icesave deposits in the last two countries refer to different legal issues in European Union law that can be summarised on two essential points: 1) the interpretation of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (DGS) concerning the final responsibility/liability of the Icelandic Government as a last resort[8] and 2) the application of the principle of non-discrimination in EU/EEA law with regards to the Icelandic legal measures of nationalisation of Icelandic banks adopted after the financial crisis (State aid).[9]

2.3.1. The case for State Guarantee of Iceland

Arguments defended by the UK and Holland are based on their interpretation of the law of the European Economic Area (EEA), and around two positions in particular:

1) that the Icelandic Government was obliged to assume responsibility and provide as a last resort the minimum guarantee at least €20,887 for Icesave depositors of Landsbanki in the UK/Holland; and

2) that Iceland's legal actions adopted after the financial crisis by the Icelandic Financial Services in order to re-structure, recapitalise and re-establish the new Landsbanki and the other Icelandic banks were discriminatory under EU/EEA law against creditors and depositors non-resident in Iceland.

The Opinion of the EFTA Surveillance Authority (from now on ESA) in the formal notice (infringement proceeding) sent on 24 May 2010 concludes that Iceland is obliged to ensure payment of the minimum compensation to Icesave depositors in the United Kingdom and the Netherlands, according to the Deposit Guarantee Directive. [10] Basically, the ESA argues that the obligation to reimburse the minimum guarantee to depositors in Europe is a consequence of the effectiveness or "effet utile" of the Directive:[11]

---

[8] Incorporation of the Directive 94/19/EC to the European Economic Area legal order by Decision 18/94 of the EEA Joint Committee No. 18/94 amending Annex IX (Financial Services) to the EEA Agreement.

[9] Article 4 of the EEA Agreement which prohibits "any discrimination on grounds of nationality".

[10] EFTA Surveillance Authority. Press release following the letter of formal notice sent to Iceland on 26 May 2010. Doc. Available at http://www.eftasurv.int/media/internal-market/LFN-Icesave.pdf

[11] Ibid.

"The EFTA Surveillance Authority has the task to ensure that Iceland, Norway and Liechtenstein comply with the terms of the EEA Agreement. The Deposit Guarantee Directive forms part of that agreement. According to the Directive, Iceland was obliged to guarantee for EUR 20.000 per depositor after Landsbanki and its Dutch and British branches, called Icesave, collapsed in October 2008.

While the Dutch and British authorities stepped in to compensate most deposit holders in Icesave's Dutch and UK branches, the Directive designates Iceland as being under the obligation to provide the minimum compensation of EUR 20.000 per depositor.

The Icelandic Government has in a letter to the Authority argued that it considers setting up a guarantee scheme to be enough to fulfill its obligations under the Directive. It has also argued that that the Directive may not be applicable if deposits are unavailable because of a major and general banking crisis. The Authority disagrees on both points.

The Deposit Guarantee Directive ensures that depositors are guaranteed compensation of up to 20 000 Euros if their bank fails. Each state must make sure that depositors are protected. That protection is essential for bank customers to have confidence that their deposits are safe, says Mr Per Sanderud, president of the EFTA Surveillance Authority.

Both the UK and Dutch authorities took action so that depositors could file claims to the deposit guarantee scheme in each country shortly after the Icesave collapse. In the UK, about 300.000 depositors received a total of GBP 4.5 billion of which 2.1 billion fell within the responsibility of the Icelandic scheme. The Dutch Central Bank paid reimbursements totaling EUR 1.53 billion to 118.000 account holders, of which EUR 1.34 billion was within the Icelandic responsibility.

In its emergency response to the banking crisis in October 2008, the Icelandic Government made a distinction between domestic depositors and depositors in foreign branches. Domestic deposits continued to be available after they were taken over by New Landsbanki, whereas the foreign depositors lost access to their deposits and did not enjoy the minimum guarantee. It is not possible to differentiate between depositors to the extent they are protected under the Directive. By acting as it did and leaving the depositors in Icesave's Dutch and UK branches without even the minimum guarantee, Iceland acted in breach of the Directive.

The Icelandic Government is invited to submit its answer to the letter of formal notice within two months. Sending a letter of formal notice is the first stage in infringement proceedings.

The Authority knows that Iceland, the United Kingdom and the Netherlands have tried to negotiate a solution to this problem. If such a negotiated solution is reached, the Authority would consider that no further action on its part is necessary, says Mr Sanderud."

The European Commissioner on the internal market has supported the interpretation of the ESA against the arguments defended by Iceland.12

2.3.2. The case against State Guarantee of Iceland.

The Iceland Government tried to state its case during the autumn 2008 but abandoned the legal arena due to diplomatic pressure. These are however the arguments that many specialists in European law have presented in the media on multiple occasions.

1) It can be argued that the State liability for Iceland for breach of EEA law in the Icesave dispute is not clear.13 It is possible to argue both in the affirmative and in the negative. Directive 94/19/EC does not require it and Recital 24 of the Directive expressly mentions that nothing in the Directive implies State guarantee for the Insurance Fund. The new Directive 2009/19/EC keeps silent on this issue14 and the jurisprudence of the Court of Justice of the European Union (from now on ECJ) seems contradictory and unclear for the resolution of this case.15 While the ECJ states that a guarantee of 20.887€ must be given to depositors, the Court declares that defective supervision by financial authorities does not confer rights to individuals. Furthermore, the European Commission has recognised that EU Member

[12] Interview given by EU Commissioner to the Norwegian ABCNyheter media on 28.7.2010.

[13] Articles published by Professor Stefán Már Stefánsson in the Icelandic newspaper Morgunblaðið on the 12th, 13th, 14th and 15th January 2010. See also Report by law firm Mishcon de Reya to the Icelandic Parliament 19 December 2009, not published, on the second Icesave agreements negotiated between Iceland, the UK and Holland. Report available at the website www.island.is. This was explained in the interview with MEPs Eva Joly and Alain Liepitz on Icelandic TV, programme Silfur Egils, 10 January 2009.

[14] New Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance) OJ L 68, 13.3.2009. Different documents have been produced by or under the supervision of the European Commission on the necessary reform of the Directive 94/19/EC where the liability of the State for the sufficient provision of funds under the DGS home country national scheme is never stated: - the Working Paper from 14 July 2005 (Ref DGS 001/2005); - the initial Communication from 28 November 2006 (Press release IP/06/1637); - the Report on DGS efficiency done by the Joint Research Centre in Ispra from May 2008; - the Memorandum with an Overview of national rescue measures and DGS compiled by the Commission and offered as a MEMO/08/619 on 14 October 2008; - the Consultation Document on the Review of the Directive 94/19/EC - Doc COM (2009) 114 of 4 March 2009; - the Draft Minutes of the Informal Experts Roundtable on DGS on 31 March 2009 in Brussels. All these documents referring to the necessary amendment of the DGS are available at the website of the European Commission: http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm
See also document on the proposed reform of the Directive 94/19/EC as evaluated by the European Parliament on its Report of 27 November 2006 (Doc. INI/2007/2199) which is also silent on that fundamental issue of liability/immunity of the State in case of systemic failure of the banking system and the inability of the DGS to provide sufficient funds to depositors.

[15] ECJ, case C-222/02 Peter Paul v Bundesrepublik Deutschland ECR [2004] Page I-09425.

States cannot offer in a permanent way State guarantees because this goes against EU competition and State aid rules.16

2) Neither the European Union Treaties, nor secondary law, nor the EEA Agreement, provide for a role or the competence of the EU in relation to national measures designed to nationalise, bail-out or restructure domestic banks in emergency situations such as the one which arose in Iceland.[17] Furthermore, tax and economic national policies are so related to national sovereignty that they are considered as extremely sensitive areas within the European integration project. It is extremely important to clarify the competences of the EU regarding national rescue measures in response to the financial crisis. The principle of non-discrimination should only be applied and justified under EU/EEA law in cases where competences have been transferred to the European level.[18]

The reconstruction of the economic and financial system of a country after a systemic bank collapse, which is to be financed by the public treasury, is an area that belongs to the competence of national governments. For this reason, it could be argued that 1) the re-creation of Icelandic domestic banks after the crisis falls outside the scope of EU/EEA law, and that 2) the principle of non-discrimination of EU/EEA law does not come into play. [19] In this process, all deposits in Iceland were transferred in full to the new entities. Discrimination by nationality did not occur. All European depositors were treated like Icelanders if they had the deposits in Iceland. All Icelandic depositors were treated like Europeans if they had the deposits in the UK/Holland. It can be held that discrimination followed territorial reasons as depositors in Iceland and in Europe were deemed not to be in comparable situations (the protection of branches in the UK/Holland does not

[16] European Commission, Communication on state aid guidelines of 13 October. Press release. Doc. IP/08/1495 Document available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

[17] All these legal uncertainties were known to the UK financial authorities. See UK, Report of the Financial Markets Law Committee April 2008 on banking reform and depositor protection available at http://www.fmlc.org/papers/Issue133depprot.pdf and http://www.citysolicitors.org.uk/FileServer.aspx?oID=353&lID=0

[18] On the distribution of competences between the EU and Member States see European Parliament, Report on the Treaty of Lisbon 20.2.2208 available at http://europa.eu/lisbon_treaty/library/index_en.htm

[19] This is the position defended by Professor Stefán Már Stefánsson in the Icelandic newspaper Morgunblaðið on the 12th, 13th, 14th and 15th January 2010. The following summary done by the European Central Bank on the national measures adopted during the crisis does not contain one single time the term "discrimination". See Petrovic, A. And Tutsch R., National Rescue Measures In Response To The Current Financial Crisis, European Central Bank. Legal Working Paper Series no. 8 /July 2009. Available at the website http://www.ecb.int/pub/pdf/scplps/ecblwp8.pdf

have a systemic relevance to the Icelandic financial system which is the criteria requested by the European Commission in the Irish case).[20]

It has to be remembered that, under EU Treaties, the principle of non-discrimination applies only when the issues fall under the scope of EU law. The same applies mutatis mutandis to EEA law. Does the territorial scope of the Icelandic Emergency Act and the distinction between domestic deposits and non-domestic deposits for the purposes of re-establishment of the new Icelandic banks violate European Law? This is the key question when the Insurance Fund goes bankrupt and the State must intervene with tax-payers money.

From a legal point of view it is possible to argue different pleadings, reaching different conclusions. [21] It is unclear whether the principle of non-discrimination by territory is a ground covered by EU/EEA law in extreme circumstances due to the extreme seriousness of a world financial crisis and the collapse of the Icelandic banking system.[22] It is also unclear whether there is an influence of EU/EEA law and a prohibition of indirect discrimination on territory when Member States recreate their financial system after a systemic crisis.

3) The focus on the effectiveness on the Directive 94/19/EC only deviates the attention from the real problem that falls outside the scope of EU/EEA law. The ESA has recognised that the Emergency Act adopted by Iceland was necessary for the preservation of economic and financial life in the country: [23]

"The EFTA Surveillance Authority (ESA) presented its preliminary findings in a letter dated 4 December 2009 on a complaint raised by a group of general creditors of the Icelandic banks Glitnir bank, Kaupthing bank, Landsbanki Islands, SPRON and Sparisjodabanki Islands. The complaint concerned actions by Icelandic authorities on the basis of the so-called "Emergency Act" (Act No 125/2008). The preliminary findings of ESA concluded that the provisions of the Emergency Act, in particular as regards provisions giving depositors priority over other unsecured creditors and various decisions of Icelandic authorities on the basis of the Act, are

[20] European Commission, State aid Commission approves revised Irish support scheme for financial institutions. Press release. Doc. IP/08/1495 , 13th October 2008 . Document available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

[21] On emergency measures see the article by Van Aake, A. and Kurtz, J., "Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law", *Journal of International Economic Law*, 2009, vol. 12, no. 4, pp. 859-894.

[22] Petrovic, A. And Tutsch R., National Rescue Measures In Response To The Current Financial Crisis, European Central Bank. Legal Working Paper Series no. 8 /July 2009. Available at the website http://www.ecb.int/pub/pdf/scplps/ecblwp8.pdf.

[23] See Opinion of the EFTA Surveillance authority on the Emergency Act No 125/2008. This Opinion does not refer to the deposits in Icesave. From the website: http://eng.forsaetisraduneyti.is/news-and-articles/nr/4072

compatible with the provisions of the EEA-Agreement. ESA specifically states that its preliminary findings do not deal with compatibility issues under EEA law regarding the difference in treatment between domestic deposits and deposits held in branches of Icelandic banks in other EEA States. The following is a brief summary of the main considerations regarding the compatibility of the Emergency Act and measures there under with EEA law:

a. Discrimination under Article 40 EEA: It is the preliminary finding of ESA that the Emergency Act does not constitute direct discrimination on the grounds of nationality, residence or the place where capital is invested, as the measures were not expressly based on such grounds. As regards the claim that the measures amount to indirect discrimination of other unsecured creditors and guarantee holders by giving claims by depositors a higher ranking order than claims by other unsecured creditors or guarantee holders, ESA argues that depositors on the one hand and other unsecured creditors and guarantee holders on the other hand were not in comparable situations with regard to the emergency measures. Consequently, the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

b. Non-discriminatory restrictions**:** ESA examines whether actions taken by Icelandic authorities adversely affected the flow of capital. The letter examines whether the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings might dissuade the provision of unsecured credit by financial institutions to other financial institutions and consequently be considered to be restrictive of the free movement of capital. In short, ESA takes the view that, in principle, the coverage of the complaining banks was not affected by the transfers of assets and, therefore, the measures do not constitute restrictions to the free movement of capital under Article 40 EEA.

c. Justification: Although having reached the above conclusion, ESA examined, for the sake of completeness, whether a hypothetical restriction on the free movement of capital in the EEA would be justified. On this question, ESA concludes that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society."

4) A final question still unresolved is the connection of the dispute with the provisions of the European Directive on winding-up of credit institutions and the principle of home country control that is the basis for the banking directives. [24] Under this Directive, if a credit institution with branches

[24] European Parliament and Council Directive 2001/24/EC on the reorganisation and winding-up of credit institutions. OJ L 125 of 05.05.2001.

> in other Member States fails, the winding-up will be subject to a single bankruptcy proceeding initiated in the Member State where the credit institution has its registered office (known as the home State) and will thus be governed by a single bankruptcy law.

The UK and Holland not only disregarded the principle of universal jurisdiction of Iceland in the winding-up procedures by adopting several unilateral measures; they have also refused to approach the dispute by claiming directly the assets of Landsbanki in the UK/Holland and asking a guarantee from Iceland just for the rest. So the question still remains, why is a State guarantee for the full Icesave debt needed? A quote from Martin Wolf, Chief Economist Commentator, Financial Times:

> "Asking a people to transfer as much as 50 per cent of GDP, plus interest, via a sustained current account surplus is extraordinarily onerous. Against this, the UK government argues that it is offering a lengthy grace period and an interest rate that is close to the cost of funding for the UK Treasury. It also argues that as much as 90 per cent of the repayment it seeks could come from liquidation of Landsbanki's assets.
>
> Yet the obvious answer to the latter point is this: if the assets of the bank are that valuable, why not write off the debt, in return for the claims on these assets?"

Notwithstanding the value of all precedent arguments, the most serious criticism from this author is the methodology used to solve this dispute which is not based on the rule of law but rather on the rule of politics.

2.4. A constitutional crisis develops and a national referendum called

While the role of all actors involved in the collapse of the financial services sector within Iceland and all criminal responsibility issues are researched by a special prosecutor helped by the French/Norwegian expert and Member of the European Parliament Mme. Eva Joly; it is important to remember that the Icesave dispute is a very complicated problem whose resolution affects the macroeconomic stability of the whole European financial system and the future of the internal market of financial services.

The Icesave dispute has been referred to as one of the most important issues ever debated by the Icelandic nation after the cod-wars with Britain. The early diplomatic approach used in the autumn of 2008 ended in financial agreements negotiated and signed by the Ministries of Finances of the three countries affected during 2009. Two different agreements were signed by the Government and presented to the Icelandic Parliament for approval; the Icesave 1 agreements (Bill 96/2009), approved in August 2009 but rejected by the UK and Holland, and

the Icesave 2 agreements (Another Bill reforming the Bill 96/2009), signed in December 2009 but never entered into force.[25]

The Financial Times covered this dispute in many articles. One economic commentator, Jón Danielsson from the London School of Economics, summarises well the events concerning the Icesave bills 1 and 2:

"The original deal

The original agreement between the three countries in June was too good to be true for the UK and the Netherlands. They employed a professional negotiating team achieving almost all of their demands against a politicised and inexperienced negotiating team from Iceland. It is as if a local football team in Iceland was playing Manchester United. It was, however, a pyrrhic victory.

The Icelandic government then attempted to ram this agreement through its parliament last year, apparently on the basis of a 20 line press release, without disclosing the actual agreement, citing confidentiality. When the government was forced to provide more information, the flaws in the agreement became clear, with legal and financial specialists identifying fundamental failings. Opposition to the agreement has been significant and growing since then.

Responding to this, the Icelandic parliament in August attached preconditions to the deal, such as limiting repayments to 6 per cent of gross domestic product and reserving the right to challenge its obligations in a court of law. These preconditions were accepted by a majority of the Icelandic parliament, but rejected by the UK and Dutch governments who instead amended the previous agreement to include a diluted version of some of the preconditions.

Icesave 2

Eventually, a much watered-down bill in line with the amended agreement was hotly disputed and only narrowly passed parliament in December, but the president did not sign it. Unless Iceland manages to reach a new agreement with the UK and the Netherlands in the very near future, this Icesave bill is heading for a near certain defeat in an Icelandic referendum next month.

Future settlements

At that point the future of the current Icelandic Government will be uncertain and with parliamentary elections looming in the UK and local elections in the Netherlands shortly afterwards, it is unlikely that any settlement will be reached for the foreseeable future."

[25] Summary of Icesave deals 1 and 2 as well as events from Jon Danielsson, Reader in Finance at the London School of Economics, Icesave: A Potential Solution? Article post at the economic forum in Financial Times on February 9, 2010 http://blogs.ft.com/economistsforum/2010/02/icesave-a-potential-solution/

While the Icesave dispute was pending during 2009, it is a fact Iceland was provided with no further financial assistance by the International Monetary Fund (IMF) which rejected further discussions on Iceland until the Icesave dispute was settled with the terms requested by the UK and Netherlands. Following a declaration of intent by the Icelandic Government concerning the payment of the Icesave debt with interest, on 16 April 2010 the IMF agreed to complete its second review under the stand-by arrangement for Iceland, extending the arrangement and approving a US $160 million disbursement.[26]

While it is also a fact that the Icelandic Government and the Icelandic Parliament have both accepted that Iceland will comply with its European obligations, the agreements reached with the UK and Holland have raised deep resistance and serious concerns in Iceland. Opponents argue that they have been negotiated under duress, that they force Iceland to waive its economic and legal sovereign immunity and they compromise seriously the economic and environmental sustainability of the country. Defendants hold that, even if the agreements are not perfect, it is essential for Iceland to move forward into the path of European economic integration as the damage for non-signing is higher than the cost of the agreements themselves.[27]

But all in all, the majority of Icelanders resented the diplomatic strategy and the position taken by the UK and Holland during these negotiations and a constitutional crisis without precedents opened the year 2010 as 23.3 % voters requested the President not to ratify the second bill (Icesave 2) and to call for a national referendum according to the Icelandic Constitution. On January 2010, the President made a public declaration accepting this request.

In a referendum held on the 6th March 2010, 134,397 voters rejected the entry into force of the new Icesave legislation (Icesave 2) or 93.2 percent of those who voted. Only 2,599 voters, 1.8 percent, wanted the legislation to remain in force. As the situation stands today, the three governments have agreed to start renegotiations in order to sign new Icesave agreements (Icesave 3). Following the referendum, the group Indefence still campaigns for Iceland to honour this debt but requests a reasonable agreement. [28]

---

[26] IMF, Iceland: Staff Report for Second Review Under Stand-By Arrangement and Request for Extension of the Arrangement, Rephasing of Access and Establishment of Performance Criteria, 20 April 2010. Doc. Available at http://www.imf.org/external/pubs/ft/scr/2010/cr1095.pdf

[27] This position is represented by Professor of Economics of the University of Iceland Þórolfur Matthíasson who has contributed greatly to the debate in the Icelandic and even Norwegian media. See, for instance, article from 2.2.2010 in the newspaper Aftenposten in Norway at http://www.aftenposten.no/meninger/article3497865.ece

[28] See website www.indefence.is

In the declaration of intent made to the International Monetary Fund on 16th April, the Government of Iceland promises to repay in full the cost of Landsbanki's Icesave deposits to the British and Dutch states, in addition to "normal" interest rates. Opponents argue that the Government cannot compromise Icelandic budget without the approval of the Parliament (Althingi).

2.5. Icesave in numbers

According to the group Indefence, these are the figures that we should take into account when approaching this dispute.[29]

UK and Dutch claims against Iceland: €3.91bn
Interest rate: 5.55%
Icelandic Population (the size of a small city in Europe): 317,000
Expected obligation per Icelandic family: €48,000 and interest of 2,000€ per year
Obligation as a percentage of Icelandic GDP : 50%

3. GAPS AND LACUNA OF THE INTERNAL MARKET OF FINANCIAL SERVICES IN EUROPE

the financial crisis and the Icesave dispute have casted light on several gaps and lacuna of the internal market of financial services in Europe. Only now, the deficiencies of the European financial system are painfully visible. The free provision of financial services in other EU/EEA countries under the "home" supervision rule has proved to offer a defective system of consumer protection in the "host" countries. The internal market of financial services created in Europe lacked a European supervisor/regulator and a lender of last resort. The EU achieved the first part of the internal market in this sector but the rules were not complete for emergency situations from a cross-border perspective. This becomes evident when the financial sector of one country can quickly export problems to the other EU/EEA depositors and create insolvency. In practice we had a "federal" internal market for free movement of capital but without the "federal" back up, collaboration and security procedures between European regulators when financial risks and insolvency cases spread from one country to another. No security rules, no obligations to coordinate and help, no lender of last resort (we should think about the euro and the regulations of the Economic and Monetary Union as a comparison). This second part, necessary for the financial services, was never created because of the reluctance of some EU States to go into a federal/centralised direction (principle of subsidiarity defended by countries such Germany). EU institutions and Central Banks of Europe have acknowledged this fact. It is a classic methodology to compare EU law with the USA federal system. The EU chose to trust national regulators in a decentralised

[29] Ibid.

system but the cross-border aspects were left as gaps and *lacunæ* of this internal market plan.[30]

When the crisis hit Iceland and the Icelandic banks became insolvent in one week.... there were simply no procedures available for this kind of emergency situations. The UK had to resort to the use of a terrorist legislation because it lacked proper legislation in cases of cross-border bank insolvency. Fundamental and ethical issues that have pointed out by Ms. Eva Jolie and J. Stieglitz in their visits to Iceland still remain unresolved and prove that justice and fundamental rights in the European market are a challenging, never-ending and sometimes elusive task. The result is sad and bitter: nationalisation of what was originally private debt, tax-payers are left to pay the bill while the EU insists that this is strictly a bilateral issue between Iceland and the UK/Holland and while the determination of the part of responsibility at international/European levels is left unresolved (public/private institutions– European/national supervision authorities).

During 2009 this author argued publicly that the EU not only has the right to help in the solution of this dispute, it has the obligation to do so because it is strictly related to the functioning and future of the internal market of financial services, as the Brussels guidelines showed in November 2008.[31] Without an active EU role, Icelandic citizens feel that they have been left behind to pay the final bill for the failures of the bankers and their own State and that the European integration is not about solidarity for citizens but only about markets, finances and economics. The sociological support necessary to bring them closer to Europe and to the European legal, political and economical integration disappears. This is clearly shown by the most recent surveys among the Icelandic population.[32]

4. FUNDAMENTAL RIGHTS AND ECONOMIC SUSTAINABILITY VS. STABILITY OF THE INTERNAL MARKET OF FINANCIAL SERVICES

At the same time, it is almost a paradox that the EU has announced that the protection of fundamental rights is a strong and renovated duty in the construction

[30] Andenas, M., *Financial Markets in Europe: Towards a Single Regulator, Kluwer Law International, 2003; International Monetary Fund, Fonteyne, W., EU: From Monetary to Financial Union. Overcoming the remaining hurdles to financial integration in Europe, June 2006. See also Garcia G. and Nieto, M., Bankcrupcy and reorganisation procedures for cross-borders banks in the EU: Towards an integrated approach to the reform of the EU safety net, working paper 16 December 2008 and also in the Journal of Financial Regulation and Compliance* (in press) available at http://fmg.lse.ac.uk/upload_file/1161_Nieto.pdf

[31] On the Brussels guidelines, see Annex 2 of this paper.

[32] Eurobarometer. Survey no 73 2010 for the European Commission. Doc. IP/10/71 26.08.2010. Doc available http://ec.europa.eu/public_opinion/standard_en.htm

and regulation of the internal market, especially after the entry into force of the Lisbon Treaty which makes the EU Charter of Fundamental Rights legally binding for all EU institutions and EU Member States when applying EU law.

While the protection of fundamental rights is strengthened in the new EU Treaty, reality is far more complicated when national agendas and financial interest collide as the recent Icelandic example of reconstruction after bank collapse proves. As Icelanders have experienced, the use and abuse of economic freedoms within the internal market, combined with a lack of proper financial supervision and imperfect rules, can even lead to the violation of fundamental rights of citizens and small nations.

Following the crisis, citizens have lost life-savings deposited in different instruments created and promoted by the banks, jobs are lost on a permanent basis, families struggle to pay inflation-indexed and foreign mortgages… and, due to the duress exercised by the EU, UK and Holland, it seems that Iceland has been deprived of direct access to justice before the ECJ or the EFTA Court as the EEA legal order does not contemplate a direct action for such cross-border disputes.[33]

The bitter lessons from the Icelandic crisis show that the rules on the internal market on financial services, based on a neo-liberalist approach of weak decentralised supervision that was taken to the extreme in Iceland, just freed capitalism from its social responsibilities leaving the financial consequences of the collapse for the citizens.[34] As Stieglitz has pointed out, markets are not at all efficient when evaluating social justice and fundamental rights.[35] Markets respond to numbers and economic data, not to justice, discrimination, fundamental rights, nor to the economic sustainability of a country. Economic freedoms and efficient markets do not carry per se justice.[36]

Taking into account the lack of direct access to justice for Iceland and Icelanders before the European Court of Justice/EFTA Court and the strong debates within the society; one may look at the constitutional crisis and referendum in Iceland as the result of a direct call from the citizens asking for fundamental rights, direct

[33] No EEA Court is competent on cross-border issues such as the Icesave dispute. The ECJ has no competence over EFTA countrires. The EFTA Court has no competence over EU countries. Agreement on the European Economic Area. Official Journal No L 1, 3.1.1994, p. 3; and EFTA States' official gazettes available at http://www.efta.int/content/legal-texts/eea and EFTA Court and EFTA Surveillance Authority Agreement available at http://www.efta.int/content/legal-texts/esa-eftacourt. See also Méndez-Pinedo, M-., *EC and EEA law*, Europa Law Publishing, 2009.

[34] Conference of J. Steiglitz, University of Iceland, September 2009 at http://www.economicdisasterarea.com/index.php/video/joseph-stiglitz-at-the-university-of-iceland-video/

[35] Steiglitz, J., *Making globalisation work*, Penguin Books, August 2006.

[36] Sunstein, C., 'Why markets don't stop discrimination', in: *Free markets and social justice*, Oxford University Press, Oxford, 1997, p. 165.

democracy, the rule of law and access to justice in the European legal order. A call requesting that social justice and citizen´s rights are taken into account in the present and future construction of the European internal market.[37] Icelanders expected this from Europe because the criminal investigations still need a long time to bring fruitful results.

5. SOCIAL CRITICS TO THE NEOLIBERALIST APPROACH TO CAPITALISM AND GLOBAL JUSTICE ACTIVISM

What is interesting to note is that events in Iceland are strongly connected to the global justice movement that is surging around the world.[38] A number of Icelanders, maybe without fully realising it, simply requested a new agenda for social justice and fundamental rights for the EU in the aftermath of the financial crisis.[39] In this perspective, it can be held that the movement of global social justice activism born in 1999 (Seattle) represented by activists/writers such as Susan George[40] and Naomi Klein[41] came to Iceland. But it is also worrisome for the European integration that flags and banners against the EU are displayed during some of the Icelandic regular protests. The latest survey done by Eurobarometer in May 2010 showed how little support had the EU among Icelanders.[42]

6. ICESAVE METHODOLOGY AS AN EXCEPTION TO AND FAILURE OF THE EUROPEAN LEGAL COOPERATION MODEL

This crisis has disrupted the functioning of the internal market in Iceland, a member of the European Economic Area and a candidate country to the EU. This crisis also proved that Europe is missing an historic opportunity to show leadership in the reconstruction of the international financial system. In opinion of the author, the concept of social justice is essential in the aftermath

---

[37] See Petersmann, E-U., *Shaping Rule of Law Through Dialogue*, Europa Law Publishing, Groningen, 2009, foreword on the development of a transnational rule of law based on the principles of justice and respect for freedom, equality, and fundamental human rights.

[38] Foran, J. and Bhavnani, K-K., *On the Edges of Development: Cultural Interventions*, Volume 18 of Routledge studies in development and society, Taylor& Francis, 2009, especially chapter 10.

[39] On new social movements, justice and governance in Europe see Allegri, G., "New Social Movements and the Deconstruction of New Governance: Fragments of Post-Modern Theories in Europuzzle", *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-17 available at http://hdl.handle.net/1814/10212, and Hendry, J., "Governance, Civil Society & Social Movements. Re-Claiming 'the Common', *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-12 available at http://hdl.handle.net/1814/10218.

[40] George, S., *Another Word is Possible if*, Verso, 2004.

[41] Klein, N., *The Shock Doctrine*, Metropolitan Books, 2008.

[42] Eurobarometer. Survey no 73 2010 for the European Commission. Doc. IP/10/71 26.08.2010. Doc available http://ec.europa.eu/public_opinion/standard_en.htm

of the financial crisis in Europe. European economic freedoms should not lead to injustice. While Icelanders acknowledge the failure of the Icelandic state and institutions concerning some essential issues, the solidarity of European nations in the resolution of this dispute between Iceland, UK and Holland should not be forgotten either. European law was created precisely to avoid this kind of politically sensitive bitter disputes between European countries. The European model offers integration through law and European integration should work first of all in the benefit of all European citizens.

It is a sad fact that Iceland cannot solve this dispute before a European court of justice in the framework of direct infringement procedures without the consent of UK and Holland. However, the dispute might come before the ECJ or the EFTA Court in the framework of indirect proceedings related to national litigation either in EU law or in EEA law. Access to justice in the Icesave dispute is a paradigm of the failure of the EEA legal order which did never contemplate a proper legal remedy for cross-pillar disputes (disputes between EFTA-EEA and EU countries) due to the exclusive competence of the ECJ in the interpretation of European law.[43]

It is also a sad fact that, from the time the Icesave agreements were presented to the Icelandic Parliament and to the public in June 2009 until present, a majority of Icelanders seem to have turned their back on the European integration model. The situation can reverse in the future but the point needs to be made: Icesave chosen methodology, excluding law and using politics, is a failure of the EEA legal cooperation model. Contrary to EU law, EEA states do not have the obligation to solve their disputes within the EEA framework.

7. CONCLUSIONS

While European integration was created to secure peace and solidarity between nations in the benefit of citizens, the financial crisis, the national rescue measures that followed and the methodology adopted to resolve the Icesave dispute challenged 1) fundamental principles of both the EEA and EU legal orders (ie: access to justice for citizens and small states, the right to a fair and independent trial and the rule of law v. diplomatic use of force); 2) new and fresh problems of the European internal market of financial services (nationalisation of private debt incurred by Landsbanki in the UK and Netherlands for economic and political reasons); and 3) most importantly for Icelanders, the principle of solidarity between European nations as the compliance of European law jeopardises the sustainable economic future of a small populated country (just the Icesave debt equals 48.000 € per family without taking account of the rest of the debt left by the banks).

[43] See Méndez-Pinedo, M-E, *EC and EEA law*, Europa Law Publishing, 2009.

Iceland is the most dramatic example of a country brought to its knees by the financial crisis. While the responsibility of the Icelandic banks and the Icelandic State are not denied and were made public in the Report of the Parliamentary Committee published on the 12th April 2010, the aftermath of the financial crisis has shown 1) that nationalistic feelings and protectionism trends are still well alive in Europe and 2) the European legal order can be left aside by diplomatic intervention with little justification. The paradox is that European law still provides the best framework for dispute resolution for States and citizens. Without the European rule of law, disputes between States can degenerate quickly into bitter negotiations confronting opposed financial interests and justified by different national narratives. Why was a diplomatic approach deemed better than the rule of law in this case? The European legal order can provide solutions to most problems, softening extreme national perspectives and narratives in the interest of both States and citizens. Why should we not look for a European solution to the Icesave dispute based on the rule of law and justice for all parties involved? Why does Iceland have to accept bilateral financial agreements under UK law, waiving up sovereign rights such as access to courts?

What happens to the European integration project when citizens find that Europe does not respond to their ideas and demands of social justice? Unfortunately, the EU has become a sort of "collateral damage" of the Icesave dispute in Iceland, resulting from a combination of unfortunate events such as the world financial crisis; the failure of the Icelandic model of banking and State supervision; and, last but not least, the diplomatic approach followed to solve a legal dispute. The most bitter lesson of both the banking collapse and the Icesave agreements looks much like the novel "Chronicle of a death foretold" by G. García Marquez, in the sense that Icesave killed the accession project of Iceland to the EU as citizens lost their faith in the European legal order. The quiet revolution of hope that Icelanders sparkled early in 2009 was left without direct reply by the European institutions.

In opinion of the author, it is very important to look beyond the technical details of the Icesave dispute as it affects the whole European integration process and the place of Iceland and Icelanders in Europe. Reality affects life, society and conflicts in a rich world made of facts and collective images to which law does not escape. And here we could end with the quote referred in a book where the nobel prize García Marquez and his friend Plinio Apuleyo Mendoza discuss G. Marquez´s novels: [44]

> PA: 'The way you treat reality in your books... has been called "magical realism". I have the feeling your European readers are usually aware of the magic of your stories but fail to see the reality behind it...'

[44] Apuleyo Mendoza, P. and García Márquez, G., *The Fragrance of Guava*, Verso, 1983, p. 54.

To which García Márquez replies:

GM: 'This is surely because their rationalism prevents them seeing that reality isn't limited to the price of tomatoes and eggs.'

BIBLIOGRAPHY

Books, Articles and Documents

Allegri, G., "New Social Movements and the Deconstruction of New Governance: Fragments of Post-Modern Theories in Europuzzle", *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-17.

Andenas, M., *Financial Markets in Europe: Towards a Single Regulator*, Kluwer Law International, 2003.

Apuleyo Mendoza, P. and García Márquez, G., *The Fragrance of Guava*, Verso, 1983.

Center for European Reform, "Beyond banking: What the financial crisis means for the EU". Policy brief, October 2008.

Danielsson, J., Reader in Finance at the London School of Economics, Icesave: A Potential Solution? Article post at the economic forum in Financial Times on February 9, 2010 http://blogs.ft.com/economistsforum/2010/02/icesave-a-potential-solution/

Davis, H., *The Financial Crisis : Who is to Blame?*, Polity Books, 2010.

EFTA Surveillance authority. Opinion on the Emergency Act N0 125/2008. Doc. Available at http://eng.forsaetisraduneyti.is/news-and-articles/nr/4072

EFTA Surveillance authority. Letter of formal notice to Iceland for failure to comply with its obligations under the Act referred to at point 19a of Annex IX to the EEA Agreement and Article 4 of the EEA Agreement of 26 May 2010. Doc. Available at http://www.eftasurv.int/media/internal-market/LFN-Icesave.pdf

Eurobarometer. Survey no 73 2010 for the European Commission. Doc. IP/10/71 26.08.2010. Doc available http://ec.europa.eu/public_opinion/standard_en.htm

European Commission. Documents referring to the necessary amendment of the Deposit Guarantee System at

http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

European Commission, Communication on state aid guidelines of 13 October. Press release. Doc. IP/08/1495 Document available at

http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

European Commission. Documents referring to the necessary amendment of the Deposit Guarantee System at

http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

European Commission, State aid Commission approves revised Irish support scheme for financial institutions. Press release. Doc. IP/08/1495 , 13th October 2008 . Document available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

European Parliament, Report on the proposed reform of the Directive 94/19/EC of 27 November 2006 (Doc. INI/2007/2199).

European Parliament, Report on the Treaty of Lisbon 20.2.2208 available at http://europa.eu/lisbon_treaty/library/index_en.htm

Foran, J. and Bhavnani, K-K., *On the Edges of Development: Cultural Interventions*, Volume 18 of Routledge studies in development and society, Taylor& Francis, 2009.

Garcia G. and Nieto, M., *Bankcrupcy and reorganisation procedures for cross-borders banks in the EU: Towards an integrated approach to the reform of the EU safety ne*t. Working paper 16 December 2008 and also in the *Journal of Financial Regulation and Compliance* (in press) available at http://fmg.lse.ac.uk/upload_file/1161_Nieto.pdf

George, S., *Another Word is Possible if*, Verso, 2004.

Hendry, J., "Governance, Civil Society & Social Movements. Re-Claiming 'the Common', *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-12.

Icelandic Government Information Centre. Bank Reform. Doc available at http://www.iceland.org/info/iceland-economy/restructuring/nr/6449

Indefence. Documents relating to the Icesave dispute available at http://www.indefence.is/?m=6

Klein, N., *The Shock Doctrine*, Metropolitan Books, 2008.

International Monetary Fund, Fonteyne, W., *EU: From Monetary to Financial Union. Overcoming the remaining hurdles to financial integration in Europe*, June 2006.

International Monetary Fund (IMF), Iceland: Staff Report for Second Review Under Stand-By Arrangement and Request for Extension of the Arrangement, Rephasing of Access and Establishment of Performance Criteria, 20 April 2010. Doc. Available at http://www.imf.org/external/pubs/ft/scr/2010/cr1095.pdf

Méndez-Pinedo, M-E, *EC and EEA law*, Europa Law Publishing, 2009.

Petersmann, E-U., *Shaping Rule of Law Through Dialogue*, Europa Law Publishing, Groningen, 2009.

Petrovic, A. And Tutsch R., National Rescue Measures In Response To The Current Financial Crisis, European Central Bank. Legal Working Paper Series no. 8 /July 2009. Available at http://www.ecb.int/pub/pdf/scplps/ecblwp8.pdf

Robert Wade, "The crisis. Iceland as Icarus", *Challenge* May/June 2009, p. 5. Doc. Available at http://www.challengemagazine.com/extra/005_033.pdf

Special Investigation Committee, Report on the Icelandic banking crisis. April 2010. Doc. available at www.althingi.is . Executive summary in English at http://sic.althingi.is/pdf/RNAvefKafli2Enska.pdf

Steiglitz, J., *Making globalisation work*, Penguin Books, August 2006.

Stefán Már, articles on Icesave published in the Icelandic newspaper Morgunblaðið on 12th, 13th, 14th and 15th January 2010.

Sunstein, C., 'Why markets don't stop discrimination', in *Free markets and social justice* , Oxford University Press, Oxford, 1997.

Iceland. Documents on the Icesave dispute available at

http://www.island.is/endurreisn/stjornvold/adgerdir-stjornvalda/samantekt-adgerda/icesave-samningurinn/

http://www.island.is/endurreisn/stjornvold/adgerdir-stjornvalda/samantekt-adgerda/icesave-samningurinn/skjol-vegna-icesave-samningsins/

Thórolfur Matthíasson, "Et nei vil koste Island dyrt", Article from 2.2.2010 in the newspaper Aftenposten in Norway at http://www.aftenposten.no/meninger/article3497865.ece

UK, Report of the Financial Markets Law Committee April 2008 on banking reform and depositor protection available at http://www.fmlc.org/papers/Issue133depprot.pdf and http://www.citysolicitors.org.uk/FileServer.aspx?oID=353&lID=0

Van Aake, A. and Kurtz, J., "Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law", *Journal of International Economic Law*, 2009, vol. 12, no. 4, pp. 859-894.

Legislation

Agreement on the European Economic Area. Official Journal No L 1, 3.1.1994, p. 3.

Directive 94/19/EC to the European Economic Area legal order by Decision 18/94 of the EEA Joint Committee No. 18/94 amending Annex IX (Financial Services) to the EEA Agreement.

Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance) OJ L 68, 13.3.2009.

Case-law from the Court of Justice of the European Union

ECJ, case C-222/02 *Peter Paul v. Bundesrepublik Deutschland* ECR [2004] Page I-09425.

Annex 1 – Description of events according to the group Indefence
A complete collapse of the Icelandic banking system

"The autumn of 2008 will long be remembered in Iceland. During the first days of October it became apparent that the three largest Icelandic banks were in grave danger of collapsing due to insufficient liquidity. Collectively, these three privately owned companies accounted for about 85% of the Icelandic banking system. Among them was the Landsbanki bank, responsible for the high interest Icesave accounts that had become very successful in Holland and the United Kingdom. On Monday October 6th the government reacted urgently by passing legislation, enabling the Icelandic financial service authority (FSA) to effectively nationalize the banks if they were deemed to be on the brink of collapse. This was conceived as an emergency measure to guarantee national security and permit the government to maintain the financial infrastructure necessary to keep Icelandic society functioning through the impending crash.

On that same day, Icesave depositors in Holland and the United Kingdom were unable to gain access to their funds, allegedly because of technical problems, but more likely because of liquidity problems of Landsbanki. On Tuesday October 7th the Icelandic government seized control of Landsbanki, which it deemed had gone beyond the point of no return. The next day the British government invoked the Anti-terrorism, Crime and Security Act of 2001 to freeze the assets of Landsbanki, the Central Bank of Iceland and the Government of Iceland in the United Kingdom. The aim of this draconian and unprecedented action was apparently to protect the interests of British Icesave depositors. The Dutch government took similar, but less stigmatizing, steps to freeze the assets of Landsbanki in Holland. A few days later all three of the main Icelandic banks had collapsed. The terrorism stamp destroyed what little faith the outside world had in many Icelandic businesses and blocked off numerous economic lifelines, making it effectively impossible to transfer funds between Iceland and the outside world for several months.

A year later, the Icelandic economy is still in a state of deep freeze, with a weak currency and national debt and unemployment both soaring. Help is on the horizon from the International Monetary Fund (IMF) and associated loans from many of Iceland's neighbours and allies. However, this help is currently being blocked by the British and Dutch governments, through their considerable influence in the IMF, until the Icelandic state agrees to reimburse them for compensating British and Dutch Icesave depositors. The collusion of the IMF in this blackmail has been publically acknowledged on many occasions by the Prime, Foreign and Finance Ministers of Iceland and was admitted by Gordon Brown in the British Parliament on May 6th 2009. As a result, the Icesave dispute has become one of the most serious political and economic problems the Icelandic nation has faced since it became sovereign in 1944."

Annex 2 - Iceland, Icesave and the EU – Chronology of events[45]

The EU and the Icelandic Government have held that the Icesave dispute and the accession of Iceland to the EU are two separate issues. However, from a political, economical and sociological point of view, they are linked together. It is my conviction that the methodology chosen to solve the Icesave dispute has affected the support of Icelanders for joining the EU during 2009 and 2010 as Icelanders expected solidarity from the EU in spite of the failures of their own political and economical elite.

October 2008

Financial crisis in Iceland and insolvency of the three main commercial banks in a week. Relative to the size of its economy, Iceland's banking collapse is the largest suffered by any country in economic history. An Emergency Act is passed and the three banks are put into liquidation while three new legal entities are created to continue operations in Iceland. The liabilities of the Depositors' and Investors' Guarantee Fund (The Icelandic Fund) are called into question to compensate depositors in Europe under Directive 94/19/EC.

November 2008

The Brussels Guidelines of 15 November 2008 are agreed between all parties to solve the Icesave dispute. Iceland confirms that the Directive 94/19/EC has been incorporated into its national legal order (which does not specify either State guarantee of deposits nor State liability). It is also agreed that the resolution would take into account the unprecedented situation of Iceland and enable the restoration of its economy. However, the exact terms of the repayment of the loan are not finalized at the time, and negotiations continue into 2009.

1. The Government of Iceland has held consultations with the EU Institutions and the Member States concerned regarding the obligations of Iceland under the EEA with respect to the Deposit Guarantee Directive 94/19/EC. All parties concluded that the Deposit Guarantee Directive has been incorporated in the EEA legislation in accordance with the EEA Agreement, and is therefore applicable in Iceland in the same way as it is applicable in the EU Member States.
2. The acceptance by all parties of this legal situation will allow for the expeditious finalization of negotiations underway concerning financial assistance for Iceland, including the IMF. These negotiations shall be conducted in a coordinated and

[45] All information available at the Ministry of Foreign Relations website http://www.mfa.is/eu/, at the Icelandic Parliament website www.althingi.is and the NGO Indefence website www.indefence.is. InDefence is a grassroots organisation that was founded in October 2008. It organized a petition to protest the use of the Anti-Terrorism Act by the UK Government against Iceland. This is the largest petition in Icelandic history and the group handed in 83,300 signatures (quarter of the population) to the British Parliament in March 2009.

consistent way, and shall take into account the unprecedented difficult situation of Iceland and therefore the necessity of finding arrangements that allow Iceland to restore its financial system and its economy.

3. The EU and the EEA Institutions will continue to be involved and consulted on this process.

January 2009

Following one week of intense but mostly peaceful protests in front of the Parliament and strong pressure from the public as a result of the financial crisis, the Government falls and a new coalition takes power (Social-Democrats and Green-Left Party) while general elections are called.

26 April 2009

New parliamentary elections two-years ahead. New coalition of the Social Democratic Alliance and the Left-Green Movement is formed with a simple majority in the Parliament.

28 May 2009

The Minister for Foreign Affairs, Ossur Skarphedinsson, puts forward a proposal for a parliamentary resolution on application for accession to the European Union, at the Althingi Icelandic Parliament. This is in accordance with the Government coalition co-operation statement from 10 May 2009. The Social Democrats favour Iceland´s accesion to the EU, the Left-Green oppose accession but agree to start negotiations and organise a national referendum on the basis of a draft accession treaty.

16 July 2009

The Parliament of Iceland votes in favour of applying for membership to the European Union after a very difficult debate and with a simple majority. Among the major parties represented in the Parliament, only the Social Democratic Alliance (SDA) has consistently advocated Iceland's membership in the EU.

23 July 2009

Minister for Foreign Affairs submits Iceland's formal application for EU membership to Carl Bildt, the President of the EU Council. Sweden announced that it would prioritise Iceland's EU accession process.

27 July 2009

Foreign Ministers of the European Union invite the Commission to prepare an opinion on Iceland's request to enter negotiations on accession to the European Union.

28 August 2009

Bill on State guarantee for Icesave loans passed as law by the Parliament of Iceland (Act 96/2009 or Icesave 1).

This is a law regarding authorisation for the Minister of Finance, to issue a State guarantee of the loans granted by the governments of the UK and the Netherlands to the Depositors and Investors Guarantee Fund of Iceland, with some reservations agreed by all political parties concerning the economic future development of Iceland and protection against national bankrupcy.[46] These safeguards were subsequently rejected by the UK and Netherlands so another bill would be presented by the Government to the Parliament in December 2009 (Icesave 2).

September 2009

European Commissioner for Enlargement, Olli Rehn, presents a questionnaire by the European Commission to the Icelandic Prime Minister, Johanna Sigurdardottir. The questionnaire is to assess Iceland's readiness to fulfil EU membership obligations.

Spanish Foreign Minister visits Iceland to discuss the Icelandic application and the membership progress. Spain holds the EU Presidency during the term January-June 2010.

21 October 2009

The Icelandic Government submits answers to a Questionnaire from the European Commission as part of ongoing preparations for Iceland's application for membership of the EU. The answers will form the basis for the Commission's opinion to the European Council regarding Iceland's readiness for formal candidate status.

2-4 November 2009

The Minister for Foreign Affairs appoints Ambassador Stefan Haukur Johannesson to serve as Iceland's Chief negotiator in the upcoming accession negotiations with the European Union and nominates the Icelandic negotiating team.

30 December 2009

Final acceptance by the Parliament of the second bill for a sovereign guarantee for Icesave loans from October 19th 2009, amending Law No. 96/2009 (Icesave 2) with a simple majority.

[46] Further information from the Prime Minister's Office concerning this bill can be found here: eng.forsaetisraduneyti.is/news-and-articles/nr/3859

2 January 2010

InDefence grass roots activist group meet with the President of Iceland to deliver a petition signed by 56,089 Icelanders (23,3% of Icelandic voters). This is the largest petition that has ever been delivered to the President of Iceland. To give a better idea of scale, this is comparable to a petition signed by 11 million UK or 3 million Dutch citizens.

Indefence group requests an Icesave agreement in reasonable terms, an agreement that Iceland can pay in practice. The petition asks the President to veto the highly controversial legislative bill (Icesave 2) on the grounds that it poses a huge risk for the economic future of the Icelandic nation. The petition states that all projections based on realistic assumptions about economic growth, income in foreign currency, population growth and debt levels showed without doubt that Iceland would be unable to meet the payments stipulated by the Icesave loan agreements as set out in the disputed legislation.

5 January 2010

Icelandic President Ólafur Ragnar Grímsson declares that he would not sign the bill Icesave 2 and calls for a national referendum on the legal basis provided by Article 26 of the Icelandic Constitution. The referendum is the first to be held in Iceland since independence in 1944, and requires special legislation

24 February 2010

The European Commissioner for Enlargement and European Neighbourhood Policy recommends to the Council of the European Union to start accession negotiations with Iceland.

The Commission publishes its Opinion on Iceland´s application for membership of the European Union in a Communication from the Commission to the European Parliament and the Council (DOC COM (2010) 62).

6 March 2010

In a referendum 93% Icelanders vote against the entry into force of the second bill on Icesave and less than 2% vote in favour. The message is interpreted by the Government as voters rejecting the second Icesave agreement but still accepting to reimburse the claim of 3.9€bn as the first Icesave bill is then still in force (the one rejected by the UK and Holland).

March –April 2010

On 22 April 2010, the German Parliament approved EU accession talks with Iceland. This is the first time that a national parliament has voted on the application of an aspirant member of the EU, but the Bundestag adopted new legislation to that end after the ratification of the Lisbon Treaty.

Icesave negotiations must continue. Spanish Foreign Minister Miguel Ángel Moratinos, on behalf of the Presidency of the European Union, declares that the Icesave dispute does not impact Iceland's application.[47] David Milliband, British Foreign Minister, has reaffirmed the UK's continued support for Iceland's EU application.[48] Additionally, the Netherland's Foreign Minister stated that while the opening of negotiations will not be blocked by the Icesave dispute, it must be resolved before Iceland's accession.[49]

On 8 March, new Enlargement Commissioner Štefan Füle declares before the European Parliament that the issue of whether Iceland should reimburse the UK and the Netherlands €3.9bn lost by British and Dutch savers in the Icesave crash is a bilateral one and should not affect the country's EU accession prospects.[50]

On 14 April 2010 the vulcano Eyjafjallajökull resumes erupting after a brief pause, this time from the top crater in the centre of the glacier, causing meltwater floods and throwing volcanic ash several kilometres up in the atmosphere which led to the closure of airspace over most of Europe.

On 16th April, the International Monetary Fund discloses that the government of Iceland has promised to repay in full the cost of Landsbanki's Icesave deposits to the British and Dutch states, in addition to "normal" interest rates in a declaration of intent. Following this declaration, the IMF board agreed to review its economic stabilization program which enabled the disbursement of loans.

26 May 2010

The EFTA Surveillance Authority (ESA) sends a letter of formal notice to Iceland for failure to comply with its obligations under the Act referred to at point 19a of Annex IX to the EEA Agreement and Article 4 of the EEA Agreement. In this letter, the ESA failing to ensure payment of the minimum amount of compensation to Icesave depositors in the Netherlands and in the United Kingdom provided for in Article 7(1) of the Act referred to a point l9a of Annex IX to the Agreement on the European Economic Area (Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposirguarantee schemes) within the time limits laid down in Article 10 of the Act,Iceland has failed to comply with the obligations resulting from that Act,

[47] Icenews 9 January 2010. See http://www.icenews.is/index.php/2010/01/09/skarphedinsson-and-moratinos-icesave-has-no-impact-on-eus-treatment-of-application/

[48] Ibid.

[49] Euroactiv 19/3/2010. See http://www.euractiv.com/en/enlargement/dutch-vow-not-block-iceland-s-eu-talks-news-358341

[50] Euroactive 09/3/2010. See http://www.euractiv.com/en/enlargement/commission-icesave-doesn-t-prevent-iceland-starting-accession-talks-news-322398

in particular Articles 3,4,7 and 10, and/or Article 4 of the Agreement on the European Economic Area. At the time of writing, the Government of Iceland has still not replied to the formal notice.

1 June 2010

A new poll is released by Gallup. To the question "Are you for or against Icelandic entry into the EU?" 60 percent Icelanders said they are against, 14 percent have yet to decide and 26 percent are for.

17 June 2010

The European Council decided that negotiations should be opened for Iceland's accession to the European Union. The decision follows a positive opinion by the European Commission in February 2010 on Iceland's application.

6 July 2010

On 6th July 2010, Icelandic Ministry of Foreign Affairs Össur Skarphedinsson, Minister for Foreign affairs of Iceland, makes an official visit to Croatia. He met in Zagreb with Gordan Jandrokovic, Minister for Foreign Affairs of Croatia and Ivo Josipovic, President of Croatia. Mr. Skarphedinsson also visited the Croatian Parliament and met with Luka Bebic, Speaker of the Parliament. In their meeting the ministers discussed bilateral relations between the countries, Iceland's and Croatia's application for membership of the EU and cooperation within international organizations, e.g. the United Nations and NATO. Mr. Skarphedinsson discussed the Icelandic economic programme and Iceland's cooperation with the IMF. At the end of their meeting the Ministers signed a double taxation agreement between the two countries.

7 July 2010

The European Parliament backs Iceland´s application for EU membership with some reservation due to the fishing of whales which is allowed in Icelandic waters.

27 July 2010

Iceland's accession negotiations with the European Union are formally opened at the first intergovernmental conference Iceland-EU in Brussels.

28 July 2010

Norwegian news ABC Nyheter published its 28th July news a story describing the position Barniers Michels, European Commissioner for the internal market in the European Commission, on the opinion delivered by ESA and Icesave case. The EU Commissioner's declares that there is no legal provision for State

guarantees of bank deposits in the European Economic Area (EEA). However, the Commission considers, referring to the opinion of the EFTA Surveillance Authority given in May, that Iceland is a special case due to the misimplementation of the Directive and the risks taken by the Icelandic banking system as well as a violation of the principle of non-discrimination in the different treatment of domestic and non-domestic depositors.

Annex 3

Public opinion in Iceland regarding accession negotiations with the EU and joining the eurozone

Various polls have been taken on public opinion regarding starting accession negotiations, joining the EU and adopting the euro, thus joining the eurozone.[51]

Date	Poller	Question	Yes	No	Unsure
August 2005	Capacent-Gallup for The Federation of Icelandic Industries[1]	Start negotiations	55%	37%	8%
		Join	43%	37%	20%
		Adopt Euro	37%	54%	9%
February 2006	Fréttablaðið [2]	Join	34%	42%	24%
September 2007	Capacent-Gallup [3]	Start negotiations	59%	26%	15%
		Join	48%	34%	18%
		Adopt Euro	53%	37%	10%
February 2008	Fréttablaðið [4]	Join	55.1%	44.9%	-
		More reasons than last year	54.7%	7.3%	38.1%
24 November 2008	Fréttablaðið [5]	Application	60%	40%	-
January 2009	[6]	Join	38%	38%	24%
	[7]	Application	40%	60%	-
March 2009	[8]	Start negotiations	64%	28%	8%
5 May 2009	Capacent Gallup [9]	Start negotiations	61%	27%	12%
		Join	39%	39%	22%

[51] This chart and information is provided by wikipedia.org so the usual disclaimer applies concerning this non-scientific sources.

30 July 2009	Fréttablaðið [10]	Start negotiations	51%	36%	13%
4 August 2009	Capacent Gallup [11]	Join	34.7%	48.5%	16.9%
15 September 2009	Capacent Gallup [12]	Join	32.7%	50.2%	17%
5 November 2009	Bifröst University Research Institute[13][14]	Join	29.0%	54%	17%
		Start negotiations	50.5%	42.5%	7%
28 February 2010	Capacent Gallup [15]	Join	33.3%	55.9%	10.8%
5 March 2010	Capacent Gallup [16]	Join	24.4%	60%	15.5%
14 June 2010	MMR [17]	Withdraw EU application?	57.6%	24.3%	18.1%
26 August 2010	Eurobarometer. Survey in May 2010 [18]	Would Iceland benefit joining the EU?	29% yes	-----	71% no

1. ^ Meirihluti hlynntur aðild að ESB, Samtök iðnaðarins, 01.09.2005 (Icelandic)
2. ^ Iceland cool on EU membership, EU Observer, 02.22.2006
3. ^ Euro support in Iceland hits five-year high, SI(Samtök iðnaðarins (Association for Icelandic industry)), 09.11.2007 (Icelandic)
4. ^ Majority of Icelanders Wants to Join EU IcelandReview, 02.26.2008
5. ^ Minnkandi áhugi á ESB-aðild
6. ^ http://www.si.is/media/althjodlegt-samstarf/esb-almenningur-panelkonnun-2009-01.pdf
7. ^ "Meirihluti andvígur ESB", Visir.is, 26 January 2009. http://visir.is/article/20090126/FRETTIR01/140609051/-1
8. ^ "Bourse - Poll: 64% Of Icelanders Favor Talks On EU Membership". Easybourse.com. 2009-03-09. http://www.easybourse.com/bourse-actualite/marches/poll-64prc-of-icelanders-favor-talks-on-eu-membership-630187. Retrieved 2009-07-22.
9. ^ Mikill meirihluti vill viðræður RÚV, 5.06.2009
10. ^ Majority for EU application
11. ^ Most Icelanders opposed to EU membership
12. ^ Fleiri andvígir en hlynntir ESB-aðild
13. ^ 29% vilja ganga í ESB

14. ^ Könnun: ESB yrði kolfellt í kosningum
15. ^ Pressan.is | Ný könnun Bændasamtakanna: Meirihluti svarenda andvígur aðild að ESB / 33% hlynntir
16. ^ Gallup poll for SI
17. Markaðs- og miðlarannsóknir (MMR) framkvæmdu könnunina fyrir vefsíðuna Andríki.is at http://www.mbl.is/mm/frettir/innlent/2010/06/14/meirihluti_vill_draga_umsokn_um_adild_til_baka/
18. According to Eurobarometer, the survey shows that public support for EU membership is low in Iceland: only19% of respondents in Iceland believe it would be a good thing and 29% believe their country would benefit from EU membership. Respondents in Iceland are, for the moment, quite reluctant to accede to the European Union.

BIBLIOGRAPHY

Books, Articles and Documents

Allegri, G., "New Social Movements and the Deconstruction of New Governance: Fragments of Post-Modern Theories in Europuzzle", *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-17.

Andenas, M., *Financial Markets in Europe: Towards a Single Regulator*, Kluwer Law International, 2003.

Apuleyo Mendoza, P. and García Márquez, G., *The Fragrance of Guava*, Verso, 1983.

Center for European Reform, "Beyond banking: What the financial crisis means for the EU". Policy brief, October 2008.

Danielsson, J., Reader in Finance at the London School of Economics, Icesave: A Potential Solution? Article post at the economic forum in Financial Times on February 9, 2010 http://blogs.ft.com/economistsforum/2010/02/icesave-a-potential-solution/

EFTA Surveillance authority, Opinion on the Emergency Act N0 125/2008. Doc. Available at http://eng.forsaetisraduneyti.is/news-and-articles/nr/4072

European Commission. Documents referring to the necessary amendment of the Deposit Guarantee System at

http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

European Commission, Communication on state aid guidelines of 13 October. Press release. Doc. IP/08/1495 Document available at

http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

European Commission. Documents referring to the necessary amendment of the Deposit Guarantee System at

http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

European Commission, State aid Commission approves revised Irish support scheme for financial institutions. Press release. Doc. IP/08/1495 , 13th October 2008 . Document available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1495&format=HTML&aged=0&language=EN&guiLanguage=en

European Parliament, Report on the proposed reform of the Directive 94/19/EC of 27 November 2006 (Doc. INI/2007/2199).

European Parliament, Report on the Treaty of Lisbon 20.2.2208 available at http://europa.eu/lisbon_treaty/library/index_en.htm

Foran, J. and Bhavnani, K-K., *On the Edges of Development: Cultural Interventions*, Volume 18 of Routledge studies in development and society, Taylor& Francis, 2009.

Garcia G. and Nieto, M., *Bankcrupcy and reorganisation procedures for cross-borders banks in the EU: Towards an integrated approach to the reform of the EU safety ne*t. Working paper 16 December 2008 and also in the *Journal of Financial Regulation and Compliance* (in press) available at http://fmg.lse.ac.uk/upload_file/1161_Nieto.pdf

George, S., *Another Word is Possible if*, Verso, 2004.

Hendry, J., "Governance, Civil Society & Social Movements. Re-Claiming 'the Common', *European Journal of Legal Studies*, vol. 1, no 3, 2008, pp. 1-12.

Icelandic Government Information Centre. Bank Reform. Doc available at http://www.iceland.org/info/iceland-economy/restructuring/nr/6449

Klein, N., *The Shock Doctrine*, Metropolitan Books, 2008.

International Monetary Fund, Fonteyne, W., *EU: From Monetary to Financial Union. Overcoming the remaining hurdles to financial integration in Europe*, June 2006.

International Monetary Fund (IMF), Iceland: Staff Report for Second Review Under Stand-By Arrangement and Request for Extension of the Arrangement, Rephasing of Access and Establishment of Performance Criteria, 20 April 2010. Doc. Available at http://www.imf.org/external/pubs/ft/scr/2010/cr1095.pdf

Méndez-Pinedo, M-., *EC and EEA law*, Europa Law Publishing, 2009.

Petersmann, E-U., *Shaping Rule of Law Through Dialogue*, Europa Law Publishing, Groningen, 2009.

Petrovic, A. And Tutsch R., National Rescue Measures In Response To The Current Financial Crisis, European Central Bank. Legal Working Paper Series no. 8 /July 2009. Available at http://www.ecb.int/pub/pdf/scplps/ecblwp8.pdf

Robert Wade, "The crisis. Iceland as Icarus", *Challenge* May/June 2009, p. 5. Doc. Available at http://www.challengemagazine.com/extra/005_033.pdf

Special Investigation Committee, Report on the Icelandic banking crisis. April 2010. Doc. available at www.althingi.is . Executive summary in English at http://sic.althingi.is/pdf/RNAvefKafli2Enska.pdf

Steiglitz, J., *Making globalisation work*, Penguin Books, August 2006.

Stefán Már, articles on Icesave published in the Icelandic newspaper Morgunblaðið on 12th, 13th, 14th and 15th January 2010.

Sunstein, C., 'Why markets don't stop discrimination', in *Free markets and social justice* , Oxford University Press, Oxford, 1997.

Iceland. Documents on the Icesave dispute available at

http://www.island.is/endurreisn/stjornvold/adgerdir-stjornvalda/samantekt-adgerda/icesave-samningurinn/

http://www.island.is/endurreisn/stjornvold/adgerdir-stjornvalda/samantekt-adgerda/icesave-samningurinn/skjol-vegna-icesave-samningsins/

Thórolfur Matthíasson, "Et nei vil koste Island dyrt", Article from 2.2.2010 in the newspaper Aftenposten in Norway at
http://www.aftenposten.no/meninger/article3497865.ece

UK, Report of the Financial Markets Law Committee April 2008 on banking reform and depositor protection available at http://www.fmlc.org/papers/Issue133depprot.pdf and http://www.citysolicitors.org.uk/FileServer.aspx?oID=353&lID=0

Van Aake, A. and Kurtz, J., "Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law", *Journal of International Economic Law*, 2009, vol. 12, no. 4, pp. 859-894.

Legislation

Agreement on the European Economic Area. Official Journal No L 1, 3.1.1994, p. 3.

Directive 94/19/EC to the European Economic Area legal order by Decision 18/94 of the EEA Joint Committee No. 18/94 amending Annex IX (Financial Services) to the EEA Agreement.

Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance) OJ L 68, 13.3.2009.

Case-law from the Court of Justice of the European Union

ECJ, case C-222/02 *Peter Paul v. Bundesrepublik Deutschland* ECR [2004] Page I-09425.

THE RIGHT TO GOOD ADMINISTRATION IN THE LIGHT OF ARTICLE 41 OF THE CHARTER OF FUNDAMENTAL RIGHTS OF THE EUROPEAN UNION

Kamila Milecka
Ph.D. student
Nicolaus Copernicus University in Toruń
Faculty of Law and Administration
Poland
e-mail: kamila.milecka@gmail.com

Abstract

The purpose of the paper is to present the content of the right to good administration, which is regulated in Article 41 of The Charter of Fundamental Rights of the European Union as one of the fundamental rights. At the beginning, the paper explains the status of the Charter in the legal order of the EU as since the entrance into force of the Lisbon Treaty it has been legally binding. Next, it refers to the personal scope of the Article 41 – that is who is entitled and obliged by its provisions. The most important part of the paper focuses on determining the substance of particular elements of the right to good administration, namely: the right to have his or her affairs handled impartially, fairly and within a reasonable time, the right to be heard, the right to have access to his or her file, the obligation of the administration to give reasons for its decision, the right to compensation for damage caused by EU institutions or by its servants and the right to write to EU institutions in one of the languages of the Treaties.

Keywords: *right to good administration, the Charter of Fundamental Rights of the EU, access to file, statement of reasons, right to be heard, correspondence with EU institutions.*

1. INTRODUCTION

The individuals are weaker parties in administrative proceedings because administration disposes of administrative power. To compensate this disproportion, it was necessary to give individuals particular guarantees which would help them to protect their rights and interests. Therefore, the right to good administration was granted.

In the legal system of the EU, the right to good administration was regulated in Article 41 of the Charter of Fundamental Rights of the EU[1] (later: the Charter or the CFREU). However, it does not constitute *novum* because certain elements were developed in the case-law of the Court of Justice of the EC/EU[2] or have their source in the Treaty on the Functioning of the European Union[3] (later: the TFEU) and in the Treaty on European Union[4] (later: the TEU).

2. LEGAL STATUS OF THE CHARTER OF FUNDAMENTAL RIGHTS AFTER ENTRY INTO FORCE OF THE LISBON TREATY

The Charter of Fundamental Rights is a very important document respecting individuals' rights in the European Union. The representatives of the European Parliament, the European Commission and the Council of the EU officially proclaimed it on the 7th of December 2000 during summit in Nice. However, it was not legally binding and it was only an inter-institutional agreement. In the meanwhile, the Court of Justice invoked the Charter in its judgments several times[5].

The change of status of the Charter in legal order of the EU was caused by the entry into force of the Lisbon Treaty. On the basis of Article 6 paragraph 1 of the TEU Charter acquired the same status as Treaties which means that it has been incorporated into primary law of the EU[6].

It should be mentioned that such a status of the Charter has certain legal consequences. Firstly, its provisions take precedence over conflicting regulations of the national law. Secondly, the violation of the Charter's legal norms by secondary legislation acts (regulations, directives and decisions) can lead to annulment of the latter based on Article 263 of the TFEU. Thirdly, the provisions of the CFREU have direct effect which means that individual can invoke rights followed from the Charter before the courts and administration, on condition that these rights are precise, clear, unconditional and they do not remand any

[1] Official Journal of the EU, C 83, 30.03.2010, pp. 389-403.

[2] After coming into force of the Lisbon Treaty name of the Court of Justice of the EC was changed to the Court of Justice of the EU. The Court of Justice of the EU comprises of the Court of Justice, the General Court and the Civil Service Tribunal.

[3] Official Journal of the EU, C 83, 30.03.2010, pp. 47-200.

[4] Official Journal of the EU, C 83, 30.03.2010, pp. 13-46.

[5] See e.g. Case C-540/03, European Parliament v Council of the EU, ECR 2006, p. I-5769, para. 38 and Case C-244/06, Dynamic Medien Vertribes GmbH v Avides Media AG, ECR 2008, p. I-505, para. 41.

[6] See M. Muszyński, *Karta Praw Podstawowych po Traktacie lizbońskim. Charakter prawny i granice związania (The Charter of Fundamental Rights After the Lisbon Treaty. Legal and Binding Character)*, Przegląd Sejmowy, 1/2009, s. 59. p. 61. The author argues that the Charter has the status of primary law de facto rather than de iure.

additional measures, either national or the EU[7]. Fourthly, legal norms of the Charter may be applied indirectly[8]. As it is known, the national courts are obliged to interpret the national legislation in accordance with the law of the EU. Now, the Charter is part of the EU law and it means that national law must be interpreted in accordance with its provisions. Lastly, the Court of Justice of the European Union safeguards compliance with the Charter's provisions[9].

3. THE RIGHT TO GOOD ADMINISTRATION IN ARTICLE 41 OF THE CHARTER – GENERAL DESCRIPTION

The catalogue of protected rights in the Charter is very wide and modern in comparison to the other acts defending human rights (e.g. the Convention for the Protection of Human Rights and Fundamental Freedoms) because it was developed later. As a result the progress which had been made in the field of human rights was taken into consideration[10]. Among these fundamental rights there is a right to good administration which was codified thanks to the efforts and activity of the European Ombudsman, *Jacob Söderman*[11].

The right to good administration is regulated in Article 41. It refers to different guarantees which can be used by individual during administrative procedure and consequently is divided into four paragraphs. According to paragraph 1 every person has the right to have his or her affairs handled impartially, fairly and within a reasonable time by institutions, bodies, offices and agencies of the EU. In paragraph 2 it is stated that this right includes: a) the right of every person to be heard, before any individual measure which would affect him or her adversely is taken, b) the right of every person to have access to his or her file, while respecting the legitimate interests of confidentiality and of professional and business secrecy and c) the obligation of the administration to give reasons for its decisions. Next paragraphs (3 and 4) of Article 41 regulate the right to

---

[7] K. Kowalik-Bańczyk, M. Szwarc-Kuczer, *Traktat z Lizbony - reforma czy jej pozory? (The Lisbon Treaty – Reform or Its Simulation?)* , Studia Prawnicze, 1/2008, p. 23. Compare M. Jeżewski, *Karta Praw Podstawowych w Traktacie Reformującym Unii Europejskiej (The Charter of Fundamental Rights In the Treaty Reforming the EU)* [in:] C. Mik, K. Gałka (ed.) *Prawa Podstawowe w prawie i praktyce Unii Europejskiej (The Fundamental Rights In the EU Law and Practice)*, Toruń 2009, p. 28 and 29.

[8] A. Wyrozumska, *Karta Praw Podstawowych – polskie obiekcje (The Charter of Fundamental Rights – Polish Objections)*, Sprawy Międzynarodowe, 4/2007, p. 63.

[9] Ibidem.

[10] V. Matsokina, *Karta Praw Podstawowych Unii Europejskiej a Europejska Konwencja o Ochronie Praw Człowieka i Podstawowych Wolności (The Charter of Fundamental Rights of the EU and the Convention for the Protection of Human Rights and Fundamental Freedoms)* [in:] *A. Wróbel (ed.) Karta Praw Podstawowych w europejskim i krajowym porządku prawnym (The Charter of Fundamental Rights In the European and National Legal Order)* , Warszawa 2009, p. 194.

[11] B. Grzeszick, *Das Grundrecht auf eine gute Verwaltung – Strukturen und Perspektiven des Charta-Grundrechts auf eine gute Verwaltung, Europarecht*, Heft 2/2006, p. 164.

compensation for damages caused by the EU's institutions or its officials and the right to correspondence in one of the languages of the Treaties.

The content of Article 41 replicates both the case-law of the European Courts[12] and provisions of the Treaties[13]. In case-law have been formulated and developed: right to be heard[14], right to access to file as part of right to defend[15], obligation of care[16], the right to have decision within a reasonable time[17], obligation to give reasons for decisions[18]. Wording of the latter comes from Article 296 of the TFEU. The source of the right to write to the institution in one of the languages of the Treaties can be found in Article 24 paragraph 4 of the TFEU whereas the right to compensation for damage caused by the EU's institutions or its servants is equivalent to Article 340 of the TFEU.

It seems that Article 41 has general character because it guarantees only basic procedural rights[19] which should protect individuals' rights and interests in situation when institutions, bodies and agencies of the European Union take an administrative action against individuals[20]. Therefore, the right to good administration cannot be limited to Article 41. Its provisions determine only fundamental guarantees which are immanent and essential part of the right to good administration.

4. THE ENTITLED PERSONS PROVIDED BY ARTICLE 41

The right to good administration is situated in Chapter V of the Charter titled "Citizens' Rights". However, it does not limit the range of entitled persons to the citizens of the EU because Article 41 is addressed to each person regardless of citizenship. The right to good administration is a fundamental right so it cannot

[12] For example Case C-269/90, Technische Universität München v Hauptzollamt München-Mitte, ECR 1991, p. I-5469 and Case T-167/94, Nölle v Council of the EU and Commission of the EC, ECR 1995, p. II-2594.

[13] See J. Mendes, *Good Administration in EU Law and the European Code of Good Administrative Behaviour*, EUI Working Papers, 09/2009, p. 4.

[14] Case C-32/95 P, Commission v Lisrestal, ECR 1996, p. 5373, para. 21.

[15] Case T-30/91, Solvay SA v Commission of the EC, ECR 1995, p. II-1775, para. 59.

[16] Case C-255/90 P, Jean-Louis Burban v European Parliament, ECR 1992, p. I-2253, para. 7.

[17] Case C-282/95 P, Guérin automobiles v Commission of the EC, ECR 1997, p. I-1503, para 37.

[18] Case 222/86, Unectef v Georges Heylens and others, ECR 1987, p. 4097, para. 15.

[19] Compare A. Jackiewicz, *Prawo do dobrej administracji jako standard europejski (The Right to Good Administration As European Standard)*, Toruń 2008, p. 58.

[20] M. Lais, *Das Recht auf eine gute Verwaltung unter besonderer Berücksichtigung der Rechtsprechung des Europäischen Gerichtshofs, Zeitschrift für Europarechtliche Studien*, Heft 3/2002, available online at: www.archivjura.unisaarland.de/projekte/Bibliothek/text.php?id=179 .

treat individuals variously[21]. Sometimes could happen that the citizen of third country can be participant of administrative procedure before administration of he EU[22].

The right to good administration can be enjoyed by legal persons. It would be irrational to exclude the legal persons from the range of entitled because according to Article 43 of the Charter they have the right to refer to the European Ombudsman cases of maladministration in the activities of the institutions, bodies, offices or agencies of the EU. The European Ombudsman, who deals with complaints about maladministration, decides whether the right to good administration has been violated or not[23].

It can be concluded that the persons entitled are natural as well as legal persons. However, the personal scope of Article 41 is not as broad as to include all individuals as some of its provisions predict additional conditions to be met when natural or legal person invoke one of the procedural rights.

In Article 41 paragraph 1 is used term *"his or her affair"* which could mean that the right to have affairs handled impartially, fairly and within a reasonable time is addressed only to parties to administrative proceeding. However, in the light of the aim of the regulation and the case-law[24] third person cannot be excluded from the range of entitled[25]. Therefore, the right to impartial, fair and timely treatment refers to the individuals who have their own interest in affair.

The right to be heard refers to person, towards whom individual measures which would affect him or her adversely were taken. *"Adverse effect"* means that decision causes negative consequences for individual e.g. the obligation to pay financial penalty. Individual measure must not be addressed to person, who invokes the right to be heard, but it must affect this person adversely[26]. Therefore, this procedural right can be enjoyed not only by addressee of measure but also by third person, when it affects his/her rights or interest adversely.

In relation to the right to access file some languages versions (e.g. English, Polish, Spanish, Italian, Estonian, Hungarian and Lithuanian) of the Charter use the term *"his or her file"*. However, in other languages versions of the CFREU

---

[21] M. Lais, *op.cit., Paragraph: Grundrechtsberechtigung, and A. Jackiewicz, Prawo do dobrej administracji w świetle Karty Praw Podstawowych (The Right to Good Administration In the Light of the Charter of Fundamental Rights)*, Państwo i Prawo, 7/2003, p. 70.

[22] P. Sander, *Von der good governance zum Recht auf eine gute Verwaltung Verfahrensgrundrechte in Europa*, Krems 2005, p. 32.

[23] M. Lais, *op.cit., Paragraph: Grundrechtsberechtigung.*

[24] See Case T-167/94, Nölle v Council of the EU and Commission of the EC, ECR 1995, p. II-2594, para. 76.

[25] K. Kańska, *Towards Administrative Human Rights in the EU. Impact of Charter of Fundamental Rights*, European Law Journal, Volume 10, No. 3, May 2004, p. 310.

[26] K. Kańska, *op.cit.*, p. 316.

(e.g. German, French, Czech, Slovak, Danish and Bulgarian) it is predicted that individual has the right to access to the files, if they concern him or her[27]. Therefore, it is difficult to determine, whether the right to be heard is addressed only to party to the administrative proceeding – because it is her/his file - or can be enjoyed by both parties to administrative procedure and third persons, if file concerns them.

The obligation of the administration to give reasons for its decisions concerns the person, to whom the decision is addressed. Person who has been suffered damage caused by the EU institutions or its officials can invoke the right to compensation for damages.

It must be noted that the right to correspondence in the light of Article 52 paragraph 2 and Article 24 paragraph 4 of the TFEU is addressed only to EU citizens[28].

The EU Member States are not able to invoke the right to good administration based on Article 41 of the CFREU in relations with EU because it refers to relations between individuals and the EU[29].

5. OBLIGED ENTITIES PROVIDED BY ARTICLE 41

According to Article 41 institutions, bodies, offices and agencies of the EU are responsible for applicant of its provisions. Article 13 of the TFEU lists the seven institutions: the European Parliament, the European Council, the Council of the European Union, the European Commission, and the Court of Justice of the EU, the European Central Bank and the European Court of Auditors. In the light of Explanations relating to the Charter[30] the term *"bodies, offices and agencies of the EU"* should be referred to all authorities established on the basis of the Treaties or the acts of secondary legislation.

In Article 51 paragraph 1 of the Charter it is predicted that its provisions are addressed to the institutions, bodies, offices and agencies of the Union with due regard to the principle of subsidiarity and to the Member States only when they are implementing Union law. Therefore, the question is raised - is Article 41 addressed to the bodies of Member States when they are implementing EU's law - because the Charter keeps silence on this point. There is no consistent point of view in the literature in relation to this question. Some writers claim that Article

---

[27] Compare H.D. Jarass, *Charta der Grundrechte der Europäischen Union. Kommentar*, München 2010, pp. 333 and 334.

[28] See more K. Kańska, *op.cit.*, p. 321 and H.D. Jarass, op.cit., pp. 337 and 338.

[29] See more R. Bauer, *Das Recht auf eine gute Verwaltung im Europäischen Gemeinschaftsrecht*, Frankfurt am Main 2002, pp. 141 and 109-110.

[30] Explanations relating to the Charter were initially provided by the Presidium of the Convention which drew up the Charter. See Official Journal C 303, 14.12.2007, pp. 17-35,

51 paragraph 1 has a horizontal character so it should be applied with reference to all provisions of the Charter. It means that, even if Article 41 does not refer to Member States implementing the EU law, it should be accepted that they are obliged entities[31]. However, other writers argue that if Article 41 does not regulate clearly that issue, it should be assumed that Member States implementing the EU law are not obliged to observe the right to good administration[32].

In my opinion Article 41 paragraphs 1 and 2 obliges the Member States implementing Union's law because the right to good administration is a fundamental right and as such it should be guaranteed at all levels. However, the paragraphs 3 and 4 are addressed only to institutions of the EU[33].

6. THE RIGHT TO IMPARTIAL, FAIR AND TIMELY TREATMENT

In accordance to Article 41 paragraph 1 of the Charter every person has the right to have his or her affairs handled impartially, fairly and within the reasonable time by the institutions, bodies**,** offices and agencies of the Union. Impartial, fair and timely treatments are very crucial features of the administrative procedure which influence relations between individuals and administration and build individuals' confidence in administration[34].

Impartiality means that actions are free of pressure, partiality or interest[35] and implies "absence of discrimination"[36]. Impartiality requires that administration does not act arbitrarily. Moreover, there should be no doubts to objectivity of officials who take part in decision-making process[37]. Their actions cannot be determined by personal, family, financial and national interest and must be free of political influences. Otherwise the official cannot take part in further proceeding and must be excluded[38].

Article 41 paragraph 1 requires fair treatment by the institutions, bodies, agencies of the EU. It is the effect of the European Ombudsman's activity, who has postulated that all citizens should have the right to have their affairs handled

---

[31] See more R. Bauer, op.cit., p. 142 and M. Lais, *op.cit., Paragraph: Grundrechtsverpflichtung.*

[32] See H.D. Jarass, *op.cit.*, pp. 325 and 327.

[33] R. Bauer, *op.cit.*, p. 142.

[34] M. Szydło, *Prawo do dobrej administracji jako prawo podstawowe w unijnym porządku prawnym (The Right to Good Administration as Fundamental Right In the Union's Legal Order)*, Studia Europejskie, 1/2004, p. 95.

[35] Ibidem.

[36] J. Ponce, *Good Administration and Administrative Procedures*, Indiana Journal of Global Legal Studies, Volume 12, Issue 2, Summer 2005, p. 567.

[37] H.D. Jarass, op.cit., p. 329.

[38] G. Krawiec, *Europejskie prawo administracyjne (The European Administrative Law)*, Warszawa 2009, p. 108.

properly, fairly and quickly[39]. Fair treatment is difficult to define. There are no doubts that proceeding as well as the final decision should be fair[40]. Moreover, the right of fair treatment obliges administration to respect the provisions of Article 41 paragraph 2[41].

Impartial and fair treatment requires from administration to comply with principle of proper administration and principle of care. It means that administration must take decision on the basis of all information which might have bearing on the result[42]. It must take into account all factual and legal information available at that time of decision-making[43]. Moreover, administration needs to take into account all information even if they are unfavourable for the party[44].

The obligation of handling affairs in reasonable time means that bodies, institutions and the agencies of the European Union must avoid delay and indolence in all administrative proceedings. Reasonable time is preserved when the affair is handled quickly without delay[45]. It "must be determined in relation to the particular circumstances of each case and, especially, its context, the various procedural stages (…) the complexity of the case"[46], the conduct of the parties in the course of the procedure[47] and importance for the various parties involved[48]. It means that reasonable time cannot be specified *in abstracto* and must be assessed case by case[49].

Unjustified delay, prolongation and chronicity of proceeding constitute a violation of the right of treatment in reasonable time and lead "to the annulment of the decision however only in so far as it also constituted an infringement of the rights of defence "[50].

---

[39] B. Grzeszick, op.cit., p. 176.

[40] See more M. Szydło, *op.cit.*, p. 97.

[41] H.D. Jarass, *op.cit.*, p. 329.

[42] Case T-73/95, Estabelecimentos Isidoro M. Oliveira SA v Commission of the EC, ECR 1997, p. II-381, para. 32.

[43] Case T-73/95, Estabelecimentos Isidoro M. Oliveira SA v Commission of the EC, ECR 1997, p. II-381, para. 32.

[44] M. Szydło, *op.cit.*, p. 96.

[45] Ibidem, p. 98.

[46] Case T-395/04, Air One SpA v Commission of the EC, ECR 2006, p. II-1343, para. 61.

[47] Joined cases T-213/95 and T-18/96, SCK and FNK v Commission of the EC, ECR 1997, p. II-1739, para. 57.

[48] Case T-95/96, Gestevision Telecinco SA v Commission of the EC, ECR 1998, p. II-3407, para. 75.

[49] See Case T-81/95, Interhotel - Sociedade Internacional de Hotéis SARL v Commission of the EC, ECR 1997, p. II-1265, para. 65.

[50] Joined cases T-305/94 to T-307/94, T-313/94 to T-316/94, T-318/94, T-325/94, T-328/94, T-329/94 and T-335/94 LVM v Commission, ECR 1999, p. II-931, para. 122 and Case T-67/01, JCB Service v Commission of the EC, ECR 2004, p. II-49, para. 40.

7. THE RIGHT TO BE HEARD

The right to be heard is one of the most important procedural rights which are guaranteed to individuals in administrative procedure because it is one of the elements of the right to defence in this procedure. It was developed by the Court of Justice which claimed that the right to be heard is general principle of the EU's law in all proceedings initiated against a person which are liable to culminate in a measure adversely affecting that person and must be guaranteed even in the absence of any rules governing the proceedings in question[51]. Moreover, it "must be respected even if the proceedings in question are administrative proceedings"[52]. In that way, the Court of Justice filled the gap which occurred after codification of the right to be heard in field of competition law, antidumping and trademarks[53].

In the light of the Charter every person has the right to be heard before any individual measure which would affect him or her adversely is taken. The right to be heard requires that individual should be able to put his own case and properly make his views known on the relevant circumstances[54]. This procedural right allows affected person to take stand to truth, importance and significance of all the facts[55] which are known by administration. Unfortunately, Article 41 does not specify what an appropriate form is. Hence, it must be conceded that it is allowed to express opinion in writing form or verbally, unless the law regulates that issue differently[56]. The right to be heard implicates the ability to speak and write about all factual and law circumstances.

Before hearing individual must be informed about instituting administrative proceeding[57]. Moreover, administration should describe clearly and precisely the subject of the case[58] because if entitled person does not know about instituting proceeding and has not knowledge of case subject, individual is not able to take stand to the case. Moreover, for proper implementing of this guarantee,

---

[51] Case C-135/92, Fiskano AB v Commission of the EC, ECR 1994, p. I-2885 para. 39 or Case C-32/95 P, Commission of the EC v Lisrestal, ECR 1996, p. 5373, para. 21.

[52] Case 85/76, Hoffmann-La Roche & Co. AG v Commission of the EC, ECR 1979, p. 461, para. 9.

[53] K. Kańska, op.cit., p. 315. See K. Stoye, *Die Entwicklung des europäischen Verwaltungsrechts durch das Gericht erster Instanz*, Freiburg 2004, pp. 76 and 77.

[54] Case C-269/90, Technische Universität München v Hauptzollamt München-Mitte, ECR 1991, p. I-5469, para. 25.

[55] A. Szydło, *op.cit.*, p. 101.

[56] J. Schwarze, *Europäisches Verwaltungsrecht. Entstehung und Entwicklung im Rahmen der Europäischen Gemeinschaft*, Baden-Baden 2005, p. 1313.

[57] Ibidem, p. 1285.

[58] U.M. Gassner, *Rechtsgrundlage und Verfahrensgrundsätze des Europäischen Verwaltungsverfahrensrechts*, DVBl. 1995, p. 19.

administration must secure individuals an access to all materials collected during the proceeding**.**

When individual was heard in administrative procedure, administration must consider his/her opinion during decision-making[59]. However, if entitled person had ability to take stand to circumstances of the case but did not benefit from it, the administrative proceeding can be continued without hearing[60] and final decision can be issued.

Decision issued in proceeding, in which entitled person could not refer to circumstances of the case, constitutes a violation of the right to be heard and can be declared as invalid[61]. "However, in order for such an infringement of the right to be heard to result in annulment, it is necessary to establish that, had it not been for such an irregularity, the outcome of the procedure might have been different"[62].

8. THE RIGHT TO ACCESS TO ONE'S FILE

Effective exercising of the right to the defense in administrative proceeding is possible, when individuals have been guaranteed the right to access to file[63]. This procedural right is correlated with the right to be heard in administrative proceeding because it is not possible to speak or write in the case, if the files are unknown to the entitled person. The files may contain information concerning important circumstances which are not known to the interested but handled by administration[64]. Therefore, the Charter guarantees the right to access to his/her file.

The term *"file"* refers to all documents and materials, which were obtained during the administrative proceeding. Administration should secure access to all documents which may be relevant for defence of individual[65]. According to the principle of equality of arms the party should know materials collected in the case at the same rate as administration which decides in the case[66]. Hence, the administration cannot decide arbitrarily which documents should be available for

[59] M. Lais, *op.cit. Paragraph: Recht auf Gehör.*
[60] J. Schwarze, *op.cit.*, p. 1313.
[61] P.Sander, *op.cit.*, pp. 45.
[62] Case 301/87, French Republic v Commission of the EC, ECR 1990, p. I-307, para 31.
[63] Case C-51/92 P, Hercules Chemicals NV v Commission of the EC, ECR 1999, p. I-4235, para. 76.
[64] K. Stoye, *op.cit.*, p. 52 i 53.
[65] Joined Cases C-204/00 P, C-205/00 P, C-211/00 P, C-213/00 P, C-217/00 P and C-219/00 P, Aalborg Portland and others v Commission of the EC, ECR 2004, p. I-123, para. 68.
[66] Case T-30/91, Solvay SA v Commission of the EC, ECR 1995, p. II-1775, para. 83.

party[67] and is also obliged to disclose all acts collected during proceeding which can influence the result of proceeding[68]. Individuals should have the access to all documents which administration has obtained during the procedure, whether in one's favour or against [69].

The right to access to the file does not have absolute character because it must be ensured while respecting the legitimate interests of confidentiality and of professional and business secrecy. This means that access to some of the documents may be unavailable for participants of the procedure. The administrative body decides *ex officio* if particular documents need to be protected because of the above mentioned grounds[70]. The term *"legitimate interests of confidentiality"* refers to information transferred between the institutions, bodies and agencies of the European Union and Member States[71]. Respecting professional and business secrecy secures mainly protection individual's interests[72]. Therefore, individual may have closed access to the documents such as internal documents of the European Commission, correspondence between the Commission and the Member States, correspondence between enterprises and their lawyers and correspondence between Commission and enterprises cooperated with it[73].

9. THE OBLIGATION OF REASONED DECISION

The right to give reasons for decisions is the next component of the right to good administration. It derives from Article 296 of the TFEU according to which legal acts must be reasoned. However, this provision has a wider scope than the Charter's regulation because it obliges the institutions of the EU to motivate all legal acts, while the Charter refers to giving reasons only for decisions.

The statement of reasons has to convince the parties about the legality, rightness and fairness of the decision. It simplifies individuals to defend rights and interests because if the addressee is not satisfied with the decision or perceive it as illegal**,** he/she can appeal against it. However, in order to do it individual must know all the motives which influenced the decision[74].

---

[67] See M. Lais, *op.cit. Paragraph: Recht auf Akteneinsicht.*

[68] See K. Lenaerts, J. Vanhamme, *Procedural Rights of Private Parties in the Community Administrative Process,* Common Market Law Review, 34, 1997, p. 540.

[69] Case T-24/07, ThyssenKrupp Stainless AG v Commission of the EC, ECR 2009, p. II-2309, para. 247.

[70] P. Sander, *op.cit.*, p. 48.

[71] J. Wakefield, *The Right to Good Administration*, Alphen aan den Rijn 2007, p. 78.

[72] H.D. Jarass, *op.cit.*, p. 334. See more K. Stoye, op.cit., pp. 64-70.

[73] K. Lenaerts, J. Vanhamme, *op.cit.*, p. 545 and the case-law cited by authors.

[74] M. Szydło, *op.cit.*, p. 104.

From one hand the statement of reasons should deliver information which help individual to defend rights and interests and on the other hand it enables the EU's judicature to exercise its power of review[75]. The statement of reasons helps the Union's judges to control legality of the decision because it contain legal and factual basis. It "sets out the facts and the legal considerations having decisive importance in the context of the decision"[76]. Besides this, the statement of reasons ensures self-control of administration because by formulating of the statement of reasons administration verifies motives which are the basis for the decision[77].

An infringement of the obligation to give reasons for decision occurs not only when the decision does not have the statement of reasons but also in situation when it have been reasoned but the statement of reasons is qualitatively or quantitatively insufficient[78]. The statement of reasons is quantitatively insufficient, when it not clearly and not completely sets out the considerations of fact and of law on which the decision is based[79]. It is quality insufficient, when it does not refer to all important reasons which were grounds for decision[80]. Nevertheless, insufficient statement of reasons is equal to lack of reasons [81]and could lead to annulment of decision[82].

10. THE RIGHT TO COMPENSATION FOR DAMAGE CAUSED BY THE EU INSTITUTIONS OR ITS SERVANTS

In Article 41 paragraph 3 is predicted that "every person has the right to have the Union make good any damage caused by its institutions or by its servants in the performance of their duties, in accordance with the general principles common to the laws of the Member States". The aim of this provision is individual's protection against illegal and harmful conduct of the EU institutions and its servants[83].

---

[75] Case C-338/00 P, Volkswagen AG v Commission of the EC, ECR 2001, p. I-9189, para. 124.

[76] See Case T-44/90, La Cinq SA v Commission of the EC,ECR 1992, p. II-1, para. 41.

[77] K. Stoye, *op.cit.*, p. 103.

[78] M. Lais, *op.cit. Paragraph: Begründungspflicht.*

[79] Ibidem. See Case 2/56, Mining undertakings of the Ruhr Basin being members of the Geitling selling agency for Ruhr coal, and the Geitling selling agency for Ruhr coal v High Authority of the European Coal and Steel Community, ECR 1957, p. 3, para. B-I-2.

[80] M. Lais, *op.cit. Paragraph: Begründungspflicht.* See Case 18/57, J. Nold KG v High Authority of the European Coal and Steel Community, ECR 1959, p.41, para. E.

[81] Case 18/57, J. Nold KG v High Authority of the European Coal and Steel Community, ECR 1959, p.41, para. E.

[82] M. Lais, *op.cit. Paragraph: Begründungspflicht.*

[83] See more M.Pechstein, EU-/EG-Prozessrecht, Tübingen 2007, p. 373.

It should be mentioned that the right to compensation for damage caused by the EU institutions or its servants had functioned in primary law of the EC/EU before the fundamental rights were codified in the Charter. This right has its source in Article 340 paragraph 2 of the TFEU. Therefore, in the light of Article 52 paragraph 2 of the Charter the right to compensation shall be exercised under the conditions and within the limits defined by those Treaties.

Non–contractual liability of the EU is dependent on the coincidence of a set of conditions as regards the unlawfulness of the acts alleged against the EU institution, the fact of damage and a causal link between the conduct of the institution and the wrongful act complained of[84].

The EU is responsible for lawless actions and neglects, if there was an obligation of certain action[85]. The action is illegal, when it violates superior law (e.g. fundamental rights, duty of care and the principle of good administration), which means that it infringes provision intended to protect rights of individuals[86]. Moreover, it must be sufficiently flagrant violation of a superior law[87]. An infringement of Union's law is sufficiently serious if the EU's institution manifestly and gravely disregards the limits on its discretion[88]. "Where the institution in question has only a considerably reduced or even no discretion, the mere infringement of (…) law may be sufficient to establish the existence of a sufficiently serious breach"[89].

The European Union is liable for damages caused by its institutions or its servants in the performance of their duties. Performance of the duties constitutes every action of the institutions and servants "which, by virtue of an internal and direct relationship, are the necessary extension of the tasks entrusted to the institutions"[90].

Illegal conduct of institutions and servants must cause damage for individual. Applicant must provide the General Court with evidence to establish the fact

---

[84] Joined cases C-258/90 and C-259/90, Pesquerias De Bermeo SA and Naviera Laida SA v Commission of the European Communities, ECR 1992, p. I-2901, para. 42.

[85] J. Maliszewska-Nienartowicz, *Porządek prawny Unii Europejskiej (The Legal Order of the European Union)*, Toruń 2005, p. 238.

[86] M. Lais, *op.cit., Paragraph: Außervertragliche Haftung.*

[87] Case 5/71, Aktien-Zuckerfabrik Schöppenstedt v Council of the EC, ECR 1971, p. 975, para. 11.

[88] Joined cases C-46/93 and 48/93, Brasserie du Pêcheur SA v Bundesrepublik Deutschland and The Queen v Secretary of State for Transport, ex parte: Factortame Ltd and others, ECR 1996, p. I-1029, para. 55.

[89] Joined Cases T-198/95, T-171/96, T-230/97, T-174/98 and T-225/99, Comafrica and Dole Fresh Fruit Europe v Commission, ECR 2001, p. II-1975, para. 134.

[90] Case 9/69, Claude Sayag and S.A. Zurich v Jean-Pierre Leduc, Denise Thonnon and S.A. La Concorde, ECR 1969, p. 329, para. 7.

and the extent of the loss which he claims to have suffered[91]. The damage must be done *de facto* or must be foreseeable with sufficient certainty[92]. Besides this, it must appear causal link between the damage claimed and the conduct alleged against the institution.

It must be noticed that infringement of the right to good administration as well as particular guarantees of Article 41 may generate non–contractual liability of the UE, if the above mentioned conditions are met. In this situation an individual may claim for compensation for the damage. If the General Court decides that the individual's complaint is reasonable it holds a judgment stating compensation for the damage.

11. THE RIGHT TO CORRESPOND IN A LANGUAGE OF TREATIES

Everyone may write to the institutions of the EU in one of the languages of the Treaties and must have an answer in the same language. This is the so-called the right to correspond which was established in Article 41 paragraph 4 of the CFREU. This right was known in legal order of the EC/EU before the Charter was adopted. In 1985 the Regulation 1/1958 was issued93 which determined official languages of the EC/EU and allowed the choice of language to communicate with its institutions and bodies. Afterwards, under the Amsterdam Treaty the right to correspond was established in primary law. Currently, it is regulated in Article 24 paragraph 4 of the TFEU, according to which every citizen of EU may write to institutions and bodies of the EU in one of the languages of the Treaties and must have an answer in the same language.

The right to correspondence in one of languages of Treaties was created to respect language identity of individuals[94]. Moreover, it plays major role in the context of further guarantees of Article 41, because if an individual is not allowed to choose the language for easy communication, the procedural rights cannot be executed properly[95]. Writing and having an answer in the same language should

[91] Case T-575/93, Casper Koelman v Commission of the EC, ECR 1996, p. II-1, para. 97.

[92] See Case 44/76, Milch-, Fett- und Eier-Kontor GmbH v Council and Commission of the EC, ECR 1977, p. 393, para. 8.

[93] Regulation No.1 determining the languages to be used by the European Economic Community (OJ 1958, No. 17, p. 385-386). This Regulation was amended by Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic to the Treaties on which the European Union is founded (OJ L 2003, No. 236, p. 959). Since the 1st of January 2007 official languages of the EU have been also: Bulgarian, Irish and Romanian.

[94] K. Kańska, *op.cit.*, p. 321.

[95] H. Goerlich, *Good Governance und Gute Verwaltung*, Die Öffentliche Verwaltung, April 2006, Heft 8, p. 320.

reduce language and communication difficulties which arise during contacts between individuals and administration of the EU[96]. The aim of this Charter's provision is to simplify protection of individuals' rights and interests in relations between individuals and administration of the EU[97].

According to Article 41 paragraph 4 entitled person may come forward with question, application, opinion, request or complaint to institutions and bodies of the European Union in one of the languages of the Treaties[98]. Languages, to communicate with institutions and bodies of the European Union, are determined in Article 55 paragraph 1 of the TEU.

Article 41 paragraph 4 establishes right on individuals' side which is correlated with the duty of the administration of the EU to reply in the same language. According to this provision, the obligation to give an answer in one of the language Treaties refers *expressis verbis* to institutions of the European Union. However, in the light of Article 52 paragraph 2 of the CFREU which includes only a horizontal rule, Article 41 paragraph 4 shall be exercised under the conditions and within the limits defined in Article 24 paragraph 4 of the TFEU[99]. Consequently, the range of obliged entities is enlarged and embraces all the institutions and bodies of the European Union.

An infringement of the right to correspond occurs when the institutions and bodies of the EU do not approve question, application or request which is written in one of the languages of the Treaties[100]. The breach exists when the obliged has not answered the question or has answered in different language[101].

12. CONCLUSIONS

Codification of the right to good administration in Article 41 of the Charter and its legally binding status simplify the protection of the individuals' rights. This provision is more transparent, more legible and clearer for individuals than the general principle of good administration and particular rights, formulated by the Court of Justice of the EC/EU, even though Article 41 is the reflection of the guarantees developed in case-law and provisions of the Treaties. It is easier for the individual to find out about granted rights and invoke them in certain cases when they are gathered in one legal act.

---

[96] Ibidem.

[97] I. Kawka, *Zasada dobrej administracji w prawie wspólnotowym (The Principle of Good Administration In the European Community Law) [in:] Zasady ogólne prawa wspólnotowego (The General Principles of the European Community Law)*, C. Mik (ed.), Toruń 2007, p. 199.

[98] H.D. Jarass, *op.cit.*, p. 338.

[99] P. Sander, *op.cit.*, p. 62.

[100] H.D. Jarass, *op.cit.*, p. 339.

[101] Ibidem.

It should be noticed that Article 41 of the Charter influences better performance of the administration of the EU and protects the individuals in direct relations with the administration of the EU but it only constitutes fundamental basis. Article 41 of the CFREU guarantees particular rights to individuals that are correlated with appropriate duties of administration. An individual, invoking the rights, may expect that the EU institutions and bodies will act as it is defined in Article 41. However, if rights have been violated in the administrative proceedings which infringes these guarantees can be annulled based on Article 263 of the TFEU. Moreover, if an individual has suffered any damages caused by the conduct of the administration of the EU he/she has the right to compensation for the damage.

On the basis Article 41 of the Charter, it can be assumed that administration is good when it handles with affairs impartially, fairly and within a reasonable time, it enables the individual to be heard before any individual measure which would affect him/her adversely is taken, it gives the individual access to his/her file, it gives the reasons for its decisions, it makes good any damage caused by its actions and communicates with the individual in a language in which the individuals write to it. Good administration demands much more so it should be stated that the right to good administration is one of the element, which, however, has fundamental meaning. Development of the particular guarantees of the right to good administration is left to the case-law of the Court of Justice of EU and legal acts. Therefore, it should be concluded that Article 41 is a good ground to create legally binding standards of good administration in legal order of the European Union.

BIBLIOGRAPHY

1. Bauer R., *Das Recht auf eine gute Verwaltung im Europäischen Gemeinschaftsrecht*, Frankfurt am Main 2002.
2. Dauter-Kozłowska A., *Prawo do dobrej administracji w Karcie Praw Podstawowych Unii Europejskiej i w świetle Europejskiego Kodeksu Dobrej Administracji (The Right to Good Administration In the Charter of Fundamental Rights and In the Light of the European Code of Good Administrative Behaviour*) [in:] Mik C., Gałka K. (ed.), *Prawa Podstawowe w prawie i praktyce Unii Europejskiej (The Fundamental Rights in the EU Law and Practice)*, Toruń 2009.
3. Gassner U.M., *Rechtsgrundlage und Verfahrensgrundsätze des Europäisches Verwaltungsverfahrensrechts*, DVBl. 1995.
4. Goerlich H., *Good Governance und Gute Verwaltung*, Die Öffentliche Verwaltung, April 2006, Heft 8.
5. Grzeszick B., *Das Grundrecht auf eine gute Verwaltung – Strukturen und Perspektiven des Charta-Grundrechts auf eine gute Verwaltung*, Europarecht, Heft 2/2006.

6. Jackiewicz A., *Prawo do dobrej administracji jako standard europejski (The Right to Good Administration As European Standard)*, Toruń 2008.
7. Jackiewicz A., *Prawo do dobrej administracji w świetle Karty Praw Podstawowych*, Państwo i Prawo *(The Right to Good Administration In the Light of the Charter of Fundamental Rights)*, 7/2003.
8. Jarass H.D., *Charta der Grundrechte der Europäischen Union. Kommentar*, München 2010.
9. Jeżewski M.., *Karta Praw Podstawowych w Traktacie Reformującym Unii Europejskiej (The Charter of Fundamental Rights In the Treaty Reforming the EU)* [in:] Mik C., Gałka K. (ed.) *Prawa Podstawowe w prawie i praktyce Unii Europejskiej (The Fundamental Rights In the EU Law and Practice)*, Toruń 2009.
10. Kańska K., *Towards Administrative Human Rights in the EU. Impact of Charter of Fundamental Rights*, European Law Journal, Volume 10, No. 3, May 2004.
11. Kawka I., *Zasada dobrej administracji w prawie wspólnotowym (The Principle of Good Administration In the European Community Law)* [in:] Mik C. (ed.) *Zasady ogólne prawa wspólnotowego (The General Principles of the European Community Law)*, Toruń 2007.
12. Kowalik-Bańczyk K., Szwarc-Kuczer M*., Traktat z Lizbony - reforma czy jej pozory? (The Lisbon Treaty – Reform or Its Simulation?)*, Studia Prawnicze, 1/2008.
13. Krawiec G., *Europejskie prawo administracyjne (The European Administrative Law)*, Warszawa 2009.
14. Lais M., *Das Recht auf eine gute Verwaltung unter besonderer Berücksichtigung der Rechtsprechung des Europäischen Gerichtshofs*, Zeitschrift für Europarechtliche Studien, Heft 3/2002, available online at www.archiv.jura.unisaarland.de/projekte/Bibliothek/text.php?id=179 .
15. Lenaerts K., Vanhamme J., *Procedural Rights of Private Parties in the Community Administrative Process*, Common Market Law Review, 34, 1997.
16. Maliszewska-Nienartowicz J., *Porządek prawny Unii Europejskie (The Legal Order of the European Union)*, Toruń 2005.
17. Matsokina V., *Karta Praw Podstawowych Unii Europejskiej a Europejska Konwencja o Ochronie Praw Człowieka i Podstawowych Wolności (The Charter of Fundamental Rights of the EU and the Convention for the Protection of Human Rights and Fundamental Freedoms)* [in:] Wróbel A. (ed.) *Karta Praw Podstawowych w europejskim i krajowym porządku prawnym prawnym (The Charter of Fundamental Rights In the European and National Legal Order)*, Warszawa 2009.
18. Mendes J., *Good Administration in EU Law and the European Code of Good Administrative Behaviour*, EUI Working Papers, 09/2009.

19. Muszyński M., *Karta Praw Podstawowych po Traktacie lizbońskim. Charakter prawny i granice związania (The Charter of Fundamental Rights After the Lisbon Treaty. Legal and Binding Character)*, Przegląd Sejmowy, 1/ 2009.
20. Pechstein M., *EU-/EG-Prozessrecht*, Tübingen 2007.
21. Ponce J., *Good Administration and Administrative Procedures*, Indiana Journal of Global Legal Studies, Volume 12, Issue 2, Summer 2005.
22. Sander P., *Von der good governance zum Recht auf eine gute Verwaltung Verfahrensgrundrechte in Europa*, Krems 2005.
23. Schwarze J., *Europäisches Verwaltungsrecht. Entstehung und Entwicklung im Rahmen der Europäischen Gemeinschaft*, Baden-Baden 2005.
24. Schwarze J., *Judicial Review of European Administrative Procedure*, Law and Contemporary Problems, Vol. 68, No. 1, Winter 2004.
25. Stoye K., *Die Entwicklung des europäischen Verwaltungsrechts durch das Gericht erster Instanz*, Freiburg 2004.
26. Szydło M., *Prawo do dobrej administracji jako prawo podstawowe w unijnym porządku prawnym (The Right to Good Administration as Fundamental Right in the Union's Legal Order)*, Studia Europejskie, 1/2004.
27. Wakefield J., *The Right To Good Administration*, Alphen aan den Rijn 2007.
28. Wyrozumska A., *Karta Praw Podstawowych – polskie obiekcje (The Charter of Fundamental Rights – Polish Objections),* Sprawy Międzynarodowe, 4/2007.

REFORM OF THE UNITED NATIONS

Morana Miljanović
Graduating student
University of Zagreb
Faculty of Law
Croatia
e-mail: morana.miljanovic@gmail.com

Davorin Lapaš, Ph.D.
Associate Professor
University of Zagreb
Faculty of Law
Croatia
e-mail: dlapas@pravo.hr

Abstract

After the U.S. intervention in Iraq in 2003 on the one hand, but also having in mind the grave human suffering and atrocities in Rwanda, Somalia and Bosnia and Herzegovina, on the other hand, the question of necessity of the UN reform has appeared in academia and wider public, as well as within the UN. The organization whose primary function is the maintenance of international peace and security has been faced with severe criticism concerning its inefficiency in fulfilling this task, since it neither could prevent the unilateral use of force contrary to Article 2(4) of the Charter, nor it applied the collective measures as provided in Chapter VII of the Charter to halt such grave and massive violations of human rights.

This being so, one can be been faced with the question whether the world really needs the UN today. The continuing process of the UN reform has tried to make the world organization more effective in order to be able to face with the challenges of the new millennium. In this paper, the authors analyze the process of institutional reform of the UN, as well as the problem of the use of force in the new circumstances (e.g. international terrorism, internal conflicts and humanitarian catastrophes etc.).

Keywords: *the United Nations, reform, use of force, humanitarian intervention, responsibility to protect.*

1.Introduction

There is a broad consensus about the necessity of reform of the United Nations (UN) not only in the academia and wider public, but also in the UN. The organization whose primary function is the maintenance of international peace and security has been faced with severe criticism on account of its inefficiency in fulfilling this task. More and more frequently and loudly questions are being asked whether the world really needs the UN today, if the UN cannot regain authority, prestige and power, and whether there are alternative ways of safeguarding global peace and security.

After the U.S. intervention in Iraq, it has become increasingly implausible to assert that the UN Security Council (SC) holds even a semblance of monopoly of power at the global level. The tragic failure to prevent grave human suffering of monstrous proportions in Rwanda, Somalia and Bosnia and Herzegovina, has rendered the question of humanitarian intervention unavoidable. The opening words of the Charter of the UN, which express the basic motivation of its creators to establish the UN as a mechanism "to save succeeding generations from the scourge of war", as the most important criterion in assessing success of the UN in fulfilling its mission, point to some of the reasons for the scepticism concerning the UN today. In 1945 the "war" was perceived as a conflict between the sovereign states, a war just like the WWII, which indeed gave birth to the Charter as its historical background. Thus, the Charter was tailored in such a way to eliminate the possibility of a "Third World War". Its creators simply did not foresee that threats to the peace and security in the future would come from rogue states and localized civil wars, often followed by the genocide, ethnic cleansing and grave humanitarian disasters.[1] The nature of armed conflicts has changed significantly since the establishment of the UN, as well as the political context in which the Charter was created. Between 75 and 80% of all the armed conflicts after the WWII fall into the category of non-international conflicts and about 80% of the total casualties result from such strife.[2] Although the localized conflicts have lost their territorial focus, the implications of such conflicts are global, and their technological aspects have generated new threats of a previously unimaginable scale. Since the time of establishment of the UN the number of armed conflicts has not decreased, but on the contrary it has significantly increased. Thus, according to Glennon, the number of civil wars has increased

[1] See: Runjić, Lj., Reforma Ujedinjenih naroda, *Zbornik Pravnog Fakulteta u Zagrebu,* vol. 59, no. 4, 2009, p. 2; Verhoeven, S., The UN High-level Panel Report and the Proposed Institutional Reform of the UN, *International Law Forum*, vol. 7, 2005, p. 101; Yoo, J.C., Force Rules: UN Reform and Intervention, *Chicago Journal of International Law* , vol. 6, no. 2, 2005-2006, p. 654.

[2] See: Yoo, *op.cit.*, (note 1), p. 645.

by 400%.[3] There has been a limited success of the UN in the protection and promotion of human rights, development of international law and, to a lesser extent, in the promotion of development. Peacekeeping operations in Namibia, Cambodia, Mozambique, Haiti, Liberia, Sierra Leone and Côte d'Ivoire can be regarded as somewhat successful.[4] In the field of post conflict peace-building the institutional reforms have been introduced to the UN system. However, the UN has not proven itself to be capable of preventing conflict.

The collapse of communist regimes and of the bipolar, well-structured Cold War balance of power, gave to the UN the opportunity to perform the function for which it had been created, but on the other hand, it was followed by the recognition of a need to adapt the UN to the new circumstances. At the meeting of the SC in January 1992, Heads of States requested the UN Secretary-General Boutros Boutros-Ghali the analysis and recommendations on improving the capacities of the UN in terms of preventive diplomacy, as well as of the establishing and maintaining peace. The Secretary General (SG) prepared a report "An Agenda for Peace" and the General Assembly (GA) established a working group to elaborate further the proposals of the SG. However, the suggestions were of a limited range: starting from the viewpoint that every attempt of radical surgery in the institutional framework of the Organization would be doomed to failure, they revolved around optimization of the use of existing mechanisms and channelling the energy toward new challenges.

Another decade had passed until a critical mass was accumulated in terms of understanding the necessity of comprehensive and far-reaching reforms. This apprehension matured against the background of the Gulf War and the growing awareness of the global nature of threats arising from underdevelopment, pandemics, international terrorism and nuclear weapons, as well as the result of the evident weakness of the role of the UN on a global scale. In his speech at the 58th regular session of the GA in September 2003, the UN Secretary General Kofi Annan recognized the crisis of the existing international system of collective security and therefore the need to reform the UN. In order to halt the marginalization of the Organization and allow it to survive and gain strength in the changed circumstances in the 21st century, in November 2003 Annan appointed sixteen prominent former government officials as the members of the Panel with the task to: (a) examine the current threats to international peace and security, and (b) formulate appropriate recommendations for the reform. The High Panel for the Threats, Challenges and Change (hereinafter referred to as

[3] See: Glennon, M.J., Platonism, Adaptivism, and Illusion in UN Reform, *Chicago Journal of International Law*, vol. 6, no. 2, 2005-2006, p. 625.

[4] See: Franck, Th.M., Collective Security and UN Reform - Between the Necessary and the Possible, *Chicago Journal of International Law*, vol. 6, no. 2, 2005-2006, p. 598.

the "Panel") completed the Report on its work, entitled "A More Secure World: Our Shared Responsibility" on the 1 December 2004. A necessity of evaluating the situation and drafting of proposals was also explained as a consequence of the Millennium Declaration, adopted by all the UN member states in 2000.[5] At the meeting of the Heads of States and Governments - "World Summit 2005" - the representatives of the UN member states confirmed their commitment to strengthen the authority of the Organization and its capacity to effectively and quickly address contemporary global challenges. In March 2005 the UN Secretary-General Kofi Annan published a report, which relies heavily on the Panel's Report, and both reports received considerable attention of international stakeholders, professionals and private institutions. They were followed by the Report of the GA President Ping, which Report was judged as more conservative[6] and reflecting more closely the positions of the UN member states, relying mostly on the traditional approach. The final document, titled "World Summit Outcome," is closer to the Ping's report than to the one of the Panel. In this paper, however, we will mainly rely on the Report of the Panel as the richest in content, but bearing in mind that a totality of all the aforementioned documents reflects more credibly the true dynamics of international law[7] and therefore constitutes a more fertile ground for the seeds of future solutions to the dilemma about the future of the UN.

In January 2008 the UN Secretary-General Ban Ki-moon pointed out that threats to the environment, public health and safety knew of no national boundaries and thus by their nature required collective action of the states, civil society and the private sector. Hence, the UN is to be entrusted with the task of global coordination. It is considered as a priority to inspire the UN with a new life of a relevant, accountable and effective organization whose specific purpose is to provide people with a greater degree of health, safety, prosperity and freedom from injustice and fear. More specifically, the priorities encompass the development "pillar" of the UN, crowned with the Millennium Development Goals, increasing the capacity of peacekeeping, preventive diplomacy, mediation, peacekeeping and peace-building, countering terrorism, intensifying efforts on nuclear disarmament and non-proliferation, prevention of genocide and humanitarian disasters and the protection of civilians, especially through the expanding role of the High Commissioner for Human Rights and strengthening the Human Rights Council; greater accountability, oversight, transparency and

[5] 150 experts worked on so-called Millennium Project, with an objective to draft a plan of action towards achieving the Millennium Goals until 2015. Detailed analysis of the goals as well as of the means to achieve them can be found in the "Millenium Report".

[6] See: Hilpold, P., Reforming the United Nations: New Proposals in a Long-lasting Endeavour, *Netherlands International Law Review*, vol. LII, 2005, p. 394.

[7] *Ibid*, p. 735.

the highest ethical standards in the Organization as a whole and especially in the Secretariat and UN staff, as well as through the adoption of a more integrated holistic approach to the achievement of common goals within the larger UN "family".[8]

Before presenting the analysis of some reform proposals, we will bring some comments in the doctrine on the retrospective part of the Panel's work since 2004, as well as on the existing international system as the starting point for the UN reform. Thus, for example, Yoo points to the Panel's failure to identify the changed nature of conflicts and new sources of threats to international peace and security,[9] in the light of which a zero tolerance of the use of force is not necessarily desirable any more. Moreover, assuming that the use of force to prevent serious violations of human rights is legitimate, it is not difficult to defend the argument that the existing system is better than the model proposed by the Panel since it allows for more room for the humanitarian intervention and effective response to international terrorism. In the Report of the Panel it was furthermore asserted that there was a growing awareness of the admissibility of humanitarian intervention by the SC and greater expectations about compliance with the Charter.[10] How truthfully do they reflect the reality? Do they boil down to wishful thinking, in the absence of evidence and arguments? Does the Report rest upon the belief in tactic of rhetorical relabeling of the sensitive issues in order to overcome political quagmire? Perhaps this overly positive thinking is desirable for it indicates the direction which we want to take, especially in the light of the slow pace of progress towards achieving a global consensus in the field of world peace and security. On the other hand, one can ask whether the attempts at reform are doomed to failure, since they are based on the dogmatic assumption of the necessity of the United Nations as an organization for global coordination in an increasingly globalized world, while ignoring the possible alternatives, such as the alliance of democratic states, strengthened regional organizations and coalitions of the willing that would be less ad hoc?[11] Is it possible to measure the effectiveness of the SC or the UN in general, regardless of the possible alternatives? Would it not be more meaningful to explore the process of forming and modifying the behaviour of states, to examine the barriers to achieving consensus and possible ways to eliminate these obstacles, primarily in terms of indentifying the interests of individual states and incentives for them, which would bring them on the path of building such a system of international relations in which the goals of the United Nations and the interests of humanity would be realized to a fuller extent? And finally, how appropriate it is to compare the 60-year-old UN to Dr.

[8] See: http://www.un.org/reform/index.shtml#maincontents (26 September 2010).

[9] See: Yoo, op. cit., (note 1), p. 654.

[10] See: Glennon, *op.cit.* (note 3), p. 624.

[11] *Ibid.*, p. 626.

Johnson's dog, who is, walking on his hind legs, remarkable less for stumbling than for walking at all?[12] Would it be possible to make it stand firmly on the ground and what is the role of international law in doing so?

2. Institutional reforms

2.1. The reform of the SC

The SC is entrusted by the Charter with the primary responsibility for maintaining international peace and security. Having in mind the powers that result from this responsibility,[13] as well as considering the repeated challenges to its capability to respond to threats to international peace and security and preventing atrocities such as the genocides in Rwanda and Darfur, it came as no surprise that the central institutional reform of the UN started from the reform of the SC.

2.1.1. The composition of the SC

In Dumbarton Oaks in 1944 it was proposed that the SC was consisted of eleven members, of which five were permanent members. This proposal had been adopted in the form of the original provision of Article 23 of the UN Charter, which was amended twenty years later when the number of non-permanent members was increased to ten.[14] Nowadays, such a composition of the SC mirrors a petrified historical moment, thus being at odds with the changed geopolitical, economic and demographic constellation and dynamics in international relations, and therefore the target of a sharp opposition on account of its lack of legitimacy. The number of the UN members has drastically increased due to the process of decolonization, the disintegration of the Soviet Union and Yugoslavia, and entering of the European small states into the UN membership in the early 90-ies. The complaints on the ground of misrepresentation and non-democratic nature of the SC are most distinctly voiced by the Third World countries. As early as 1979, a group of 19 African, Asian and Latin American countries proposed increasing the number of permanent members to 16 and the total number of the SC members to 21, with a corresponding new geographical distribution. Between 1979 and 1990, the question of increasing the membership of the SC was on the SC agenda, but it was not discussed. It was not before the end of the Cold War that "democratization" was called for, at the NAM Conferences in Accra 1991 and in Jakarta 1992. This demand included the extension of permanent membership

[12] Cf. Franck, *op.cit.*, (note 4), p. 600.

[13] Decisions of the SC are binding for all the member states of the UN, pursuant to Article 25 of the UN Charter.

[14] GA Resolution 1991 A (XVIII), 17 December 1963; *UNYB* (1983), p. 87; the Amendment entered into force on 31 August 1965; *UNYB* (1965), p. 232.

on most Third World countries. In addition to quantitative changes in the membership of the UN, even more important seems to be a qualitative change in terms of leverage of the individual states on the international stage. The economic power and financial contribution to the UN budget by Japan (UN member since 1956) and Germany (UN member since 1973),[15] as well as India's and Brazil's size of population and contribution to the peacekeeping missions, exceed significantly those parameters of certain other SC permanent members, thus indicating a considerably different power relationships than those from the time when the SC was established. In that time Germany and Italy were "the enemies" (see Art. 107 of the UN Charter); Egypt, Brazil and South Africa had a much smaller impact on the international scene, India was not yet an independent state, and Nigeria did not exist in 1945. All in all, the permanent membership in the SC no longer corresponds to international relations in contemporary international community. On the other hand, some authors consider a numerical limit on the membership of the SC an essential characteristic of that body originating and inseparable from its specialized and limited powers[16] and from the need to act promptly and effectively within the scope of its mandate. Geiger believes that the imperative of existence of a real power of enforcement of the SC decisions calls for such a composition of the SC.[17] The representativeness, on the other hand, is a characteristic of the GA as a global forum with a mandate different from that of the SC. The latter was conceived as a small club capable of effectively taking care of international peace and security and taking responsibility thereof. If the SC was criticized for sluggishness of its reaction, would not an increased number of decision makers contribute to even more inertia? If the criticism of the SC boiled down to its inefficiency, would it not be merely graver should the membership further increase? Would it not slow down, at best, or block, at worst, the decision-making process in the SC? We believe that it will not, because the inertia of the SC is rooted in the interests of states, not in the number of its members, and therefore the increasing of its member states would not affect the decision-making process. It is true that the SC was not originally conceived as a democratic body, but only representative in terms of geopolitical, military and economic power, in the function of specific capacity to care about international peace and security. However, due to the changed picture of the world, as well as due to unfulfilled expectations from the SC, proposals for an extended membership of the SC seem to be reasonable indeed. Moreover, even if a small

[15] Thus, for example, the contribution of Japan in 2009 amounted to 16.624% of the UN budget. Germany contributed with 8.577% to the UN budget in 2009, which was the third largest contribution in that year.

[16] Runjić, *op.cit.*, (note 1), p. 719.

[17] Geiger, R., Article 23, in: Simma, B.(ed.), *The Charter of the United Nations – A Commentary,* München, C.H. Beck, 1994, p. 393.

number of the SC members was preferable in terms of efficiency, the crisis of legitimacy due to perceived inadequate representation of states in the SC would be of such a scale and of such graveness, that a need for reform in this direction would be hardly debatable.[18] The sustainability of the SC political legitimacy, as a prerequisite for an efficient exercise of its primary function, has become less likely without expanding the membership of the SC. Furthermore, given the changed power relations between individual states, an argument of legitimacy of the special status of the permanent members because of their greater capacity for action in terms of preserving international peace and security is no longer compelling.

Acknowledging the gap between the larger contribution of certain non-permanent members of the SC and that of certain permanent members, the Panel went exactly with the view that the key to increasing the capacity of the SC to respond to threats to international peace and security lies in a greater involvement in the decision-making process of those countries that are the biggest contributors to the UN. The criteria offered for obtaining this status include the extent of contribution to the budget of the UN, involvement in the peacekeeping operations, contribution to the voluntary activities of the UN in preserving peace and development, diplomatic activity in the direction of supporting the UN goals, and - for developed countries - reaching or coming close to the figure of 0.7% of GDP for Official Development Aid.[19] Certainly, criteria of contributions (military, financial, diplomatic) and the criterion of representativeness can come into conflict, especially if the size of a population is taken as a criterion of representativeness, and it is also possible that countries with a minor financial contribution, for instance, contribute significantly by sending troops to the UN missions or in diplomatic efforts.[20]

The Panel also held that it is necessary to include developing countries in the decision-making process and to democratize the SC (the criterion of representativeness), insofar as that would not jeopardize its effectiveness. Blum perceptively noted the Panel's intention to "mix" the criteria of accountability and efficiency, with a "healthy dose" of the criteria of representation and contribution, in order to ensure a successful reform of the SC.[21] The Report's guiding principle

---

[18] See: the response of Karel Van Kesteren in discussion at the Hague Conference 2005*, International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law, What follow-up to the High Level Panel Report,* p. 180; also see the response of Lord David Hannay, in which he deems the proposal to reduce the number of the SC members to be surely dead on arrival. *Ibid*, p. 182.

[19] Verhoeven, *op.cit.*, (note 1), p. 102.

[20] See: Blum, Y.Z., Proposals for UN Security Council Reform, *American Journal of International Law*, vol. 99, no. 3, 2005, p. 634.

[21] *Ibid.*, p. 645.

in regard to reform of the SC is strengthening of credibility, legitimacy and representativeness of the SC, through the enlargement of its membership, towards a greater efficiency in performing tasks for which it is responsible.

The first model ("Model A") includes six additional permanent members to the existing five: two permanent seats for "Africa", two for "Asia and the Pacific", one for "Europe" and one for "America"; as well as an additional three two-year non-permanent seats (to the existing ten, so that a total of seats of this category amounts to 13). New seats would be assigned in a way that each region has a total of six seats in the SC (permanent and non-permanent). Thus, "Africa" would have four non-permanent seats, "Asia and the Pacific" three non-permanent seats, "Europe" two and "America" four non-permanent seats. New permanent members would not get a veto power.

Under the second model ("Model B"), the total number of seats in the SC would also be 24, but with no new permanent members. A third category of renewable four-year seats ("semi-permanent members") was proposed. A total of eight such renewable-term seats would be distributed equally among the four regional areas, thus two seats would be allocated to each area. One new non-permanent non-renewable two-year seat would be created and the 11 non-permanent seats would be reallocated by giving four seats to "Africa", three seats to "Asia and the Pacific", three seats to "America" and one seat to "Europe". The key to the distribution would be to apportion a total of six (permanent, non-permanent and semi-permanent) seats to each region. "Europe" would therefore lose two non-permanent seats while gaining two semi-permanent ones, whereas the other regions would get two semi-permanent seats each and one additional non-permanent seat.

The two models are similar to a large extent, as they both exclude the possibility of creating new permanent members which would possess a veto power. The difference between the two models consists in the nature of the seats and their distribution within the areas. Behind the dilemma whether to create additional permanent or new semi-permanent seats there is a question of the ratio between the permanent members and the "others" (under the "Model A", 11 out of 24 seats would belong to the former, whereas under the "Model B", non-permanent and semi-permanent members would have a numerical superiority of 19 out of 24 seats). In other words, there is a fear among the permanent members of the decline of their influence in the SC. The advantage of the "Model B" is in its greater flexibility with regard to the possibility of immediate re-election of semi-permanent members and thereby giving them a *de facto* almost-a-permanent status. Also, there would be the opportunity for other countries of a given regional area to be elected as a second semi-permanent member. However, there are limits to this solution, as the practice of consecutive re-election of those states

which have been aspiring to the permanent membership (so-called "middle-powers") has demonstrated that this concession was perceived as perpetuating of their inferior status. What is more, dissatisfaction was expressed by other non-permanent member states, which pointed out that this practice disrupted the mechanism of election based on the criteria of a geographical representation. The advantage to the "Model A" consists in a better preserving of the delicate balance between the permanent and non-permanent members.[22]

Furthermore, it was proposed by the Panel that, regardless of the outcome of choosing between these models, the composition of the SC would be reviewed from the standpoint of its efficiency with regard to the collective security in 2020.

The Panel did not specify which states would obtain (semi) permanent membership. However, there is no room for doubt that the candidates are Nigeria and Egypt or South Africa (Africa), Japan and India (Asia and the Pacific), Germany (Europe) and Brazil (America). In the case of the adoption of the "Model B", in the seat intended for the European area Germany and Italy would rotate, and also most probably Spain, Poland and Turkey, whereas Argentina, Mexico and Canada would occupy in turn the second seat of the American area, the first having gone to Brazil.[23]

Among the disadvantages of the proposal the question of Indonesia, the most populated Muslim country in the world, and Pakistan, stands out, as the prospective admission of Japan and India to the (semi)permanent membership leaves the formerly mentioned two empty-handed. Blum has proposed in this respect to modify the models in terms of creating one more (25th) seat for the "Asia and the Pacific" area, in which Indonesia and Pakistan would rotate. However, assigning a permanent seat to Indonesia is likely to trigger resentment of Pakistan, whereas an additional semi-permanent seat for the Asian-Pacific area would fall short of producing a satisfactory solution for both of these countries. This problem also indicates the risks of opening the Pandora's Box, inherent to the increase of the SC membership. Countries like Argentina, Italy, Mexico and Turkey, which are denied the status of a candidate for a (semi) permanent membership, are likely to put pressure for further expansion of the SC, which could jeopardize the long-term effectiveness of the SC. Furthermore, the old disputes and rivalries of individual states could undermine the expansion of the SC membership. For example, the news agency "The New China" reported in March 2005 during the mass anti-Japanese protests that a 22.2 million of Chinese people signed a petition against the granting of a permanent seat in the

[22] See: Blum, *op.cit.*, (note 20), p. 644.
[23] *Ibid,*, p. 641.

SC to Japan.[24] China could veto the admission to the permanent membership of Japan (and India). Italy's support for the "Model B" probably stems from its opposition to the permanent membership of Germany and Mexico's "frowns" in its turn at the permanent membership of Brazil.

During the summer of 2005, Brazil, Germany, India and Japan (G4) intensified their diplomatic efforts to gain support for obtaining the permanent membership in the SC, but encountered with a strong opposition of China, the United States, African countries and other regional powers. None of the competing proposals received the necessary support so the GA was left empty-handed. In order to increase the number of the SC members the Charter must be amended and, in the case of the United States, it is also necessary to seek a prior advice and consent of the Senate. The U.S. was not willing to support any of the proposals of the Panel or the states concerned.[25] Given the veto power of the U.S. with regard to a resolution amending the Charter, it is essential to bear in mind the position of the U.S. on the increasing of the SC membership. The United States have generally opted to expand the membership of the SC, confirmed their support to Japan on its path to the permanent membership in the SC (not to Germany[26]) and put forward its own set of criteria for assessing the readiness of a certain state for the permanent membership. This set of criteria encompasses the gross national product of a state, its population, military capacity, contribution to peacekeeping missions, commitment to democratic principles and the promotion of human rights, financial contributions to the UN, the fight against terrorism and proliferation of the nuclear weapons, as well as the geographical balance.[27] The number of new permanent seats in the SC which the U.S. considers desirable is "about two" (Japan and, possibly, India).[28] Concerning the non-permanent seats, the U.S. would support two or three, open to countries based on the criteria of geographical distribution. Any further increase in the membership of the SC the U.S. deems "possibly harmful"[29] to its performance. Above all, it should be borne in mind that the expansion of the

[24] *Ibid.*, p. 646.

[25] R. Nicholas Burns, Deputy of the State Secretary for the Political Issues, in his speech before the Senate's Board for Foreign Relations in 2005, stated: "We do not think it is timely to support any proposal until broader consensus is reached." See: Crook, J.R.(ed.), Contemporary Practice of the United States relating to International Law: U.S. Views on UN Reform, Security Council Expansion, *American Journal of International Law*, vol. 99, no. 4, 2005, p. 908.

[26] Condoleezza Rice stated in 2005 that there were no compelling reasons for giving another member state of the European Union a permanent status. See: Blum, *op.cit.*, (note 20), p. 647.

[27] Crook, *op.cit.*, (note 25) , p. 908.

[28] Blum, *op.cit.*, (note 20), p. 647.

[29] *Ibid.*

membership of the SC as such is not on the list of the UN reform priorities as the U.S. sees it.[30]

2.1.2. Decision-making process in the SC - the issue of veto power

Notwithstanding the practical limits of increasing the membership of the SC, a question whether the key problem of the SC remains unanswered is often posed, and it concerns the existence of the right to veto of the permanent SC members.[31] Simma and Brunner are of the opinion that this criticism is misguided. Its object should, according to them, be a political choice of using the legal possibility of veto in particular cases, whereas the institute itself remains legitimate and useful because it performs the function of protecting the smaller states (which are *de facto* represented by the individual permanent members), and therefore it reduces the possibility of using the system of collective security in favour of certain great powers, or of the irresponsible use thereof. The fate of the League of Nations also suggests the usefulness and necessity of veto, of which the founders of the UN were aware while creating the SC.[32] *De lege ferenda*, the attempts to terminate the veto power seem like utopia given that it is not likely that the SC permanent members would give up on their privileges, as well as having in mind the provisions of Article 108 and 109 of the UN Charter. Neither the proposals of the Panel nor any subsequent proposal mentioned the abolition of the veto power of the existing permanent members of the SC, since there is a strong and widespread belief that this is too ambitious and such a proposal would be dead on arrival.[33] Admittedly, the Panel labelled the institute of veto as anachronistic and increasingly inappropriate to the times of strengthening of democracy

[30] What was on this list is the reform towards a more effective and results-based management and managing the budget of the UN, an effective mechanism for the protection of human rights, establishing of the Peace-Building Commission, economic development, establishing of the Democracy Fund, and fight against terrorism. Apart from the reforms which have been put into practice, the list remains essentially unchanged. As of 20 September 2009, reform priorities enumerated on the web page of the U.S. Department of State are "ethics, accountability, transparency, efficiency, and effectiveness". See: http://2001-2009.state.gov/p/io/c15031.htm

[31] See: Verhoeven, *op.cit.*, (note 1), p. 103.

[32] At the conference in Dumbarton Oaks no common ground was reached on questions concerning the voting procedure; only a year after, at the Yalta Conference, meeting of the 'Great Three" produced an agreement. So-called "Yalta formula" was given a form of the statement by the four governments (whom French government joined in the following month) at the conference in San Francisco in July 1945. Faced with dissatisfaction of certain small countries, the SC permanent members presented their ultimatum: the Charter would not pass without accepting the Yalta formula in its entirety (encompassing all the SC decisions except for decisions on procedural matters and all issues on which the SC is given mandate to deliberate and decide) and unchanged. They claimed that the SC decisions "on all other matters shall be made by an affirmative vote of nine members including the concurring voted of the permanent members…"

[33] See: response of Karel Van Kestern, *op.cit.*, (note 18), p. 177; also see: Verhoeven, *op.cit.*, (note 1), p. 104.

worldwide. However, this remark hardly weakened their statement that they saw "no practical way of changing the existing members' veto powers".[34]

On the other hand, proposals have been put forward in the academia that strive to neutralize the most deleterious effects of the use of veto in certain cases in a way that circumvents the question of its existence. What is on the table is narrowing of the scope of the veto power in terms of banning the use of veto in cases of aggression, genocide, crimes against humanity and war crimes.[35] In other words, a simple majority would be required for adopting decisions on issues pertaining to specific areas: investigation, activities aimed at the peaceful settlement of disputes provided for by Chapter VI, or request for a ceasefire under Chapter VII of the UN Charter. An amendment of the Charter in terms of excluding the possibility of casting a veto when making decisions under Chapter VI would not be in contradiction with the basic principles of the Charter, but it should be borne in mind that the recommendations to the parties to a dispute adopted without the support of all permanent members of the SC would carry much less political clout. Simma and Brunner have voiced a concern that the probability of creating enough political pressure on a permanent member which withheld support for the decision towards changing its attitude in terms of complying with Article 34 of the Charter does not increase significantly with the mere possibility of conducting the investigation, despite its dissent.[36]

Another possibility concerns a subsidiary role of the GA in terms of preventing the aforementioned forms of serious and massive violations of human rights in cases of a blockage (use of a veto) in the SC. This is not merely a hypothetical case for the GA sometimes was faced with a frozen SC during the Cold War period. In 1950, the GA adopted the resolution "Uniting for Peace" having provided thereby a mechanism for an emergency special session of the GA in the case of the SC failure in carrying out its duties due to a disagreement between its permanent members. The Resolution allows the adoption of decision in the GA despite the opposition of a SC permanent member.[37] The potential new

[34] United Nations, A more secure world: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change, p. 68, par. 256.

[35] As defined in this order: by the Definition of Aggression, in the Annex of the GA Resolution 3314 (XXIX); by Article 2 of the Convention for Prevention and Punishment of the Crime of Genocide of 1948 (U.N.T.S. 1021); by the court practice of the ICTY , and by the Statute of the International Criminal Court (ICC); (http://untreaty.un.org/cod/icc/statute/romefra.htm).

[36] Simma, B., Brunner, S., Article 27, in: Simma,(ed.), *op. cit.*, (note 17), p. 467.

[37] Later interventions, however, like those of the NATO forces in Kosovo, claimed legitimacy by evoking the doctrine of humanitarian intervention, and not through a GA resolution that would be based on the "Uniting for Peace" resolution. The Panel and the Secretary General do not even mention the resolution, apparently considering it a dead letter due to changed political circumstances.

permanent members of an enlarged SC would not be granted the veto power.[38] The Panel's report does not mention the number of affirmative votes required for passing a valid resolution by the 24-member SC. Blum claims that this number should be 15, a 62.5% of the SC membership, as an average value between the initially required majority and the one after the 1965.[39]

Furthermore, the Panel issued a consensual proposal to introduce so-called indicative voting on the resolutions. Under this proposal, the states would be required to publicly declare their positions on certain issues and the initial negative attitudes would have no legal force. Only the following "formal" round of voting would adhere to the existing procedural rules on voting in the SC. The intention behind this institute apparently is to embarrass a permanent member that intends to use the veto and thus dissuade it from doing it. In other words, the basic idea of that would be to increase the responsibility for veto.[40] However, the intention to cast a veto of a certain permanent member is usually well known in advance and indeed often announced at the informal meetings that precede the formal meetings of the SC. Therefore it is hard to grasp the usefulness of the institute of indicative voting.[41]

2.1.3. Amendment of the Charter

The UN Charter is one of the most rigid constitutional acts among international organizations, having its amendment procedure extremely demanding.[42] Article 108 of the Charter requires a two-thirds majority of the members of the GA (in other words, two thirds of all the UN members) for adoption of an amendment to the Charter and the same number of ratifications, including all the permanent members of the SC. Article 109 of the Charter requires the same majority as a condition for convening a reviewing conference, combined with a vote of any nine members of the SC, and affirmative votes of the two thirds of the participating countries for the adoption of the revised text of the Charter. For its entry into force, the Charter requires the ratification by two thirds of all UN member states, including again all the permanent members of the SC. It is therefore understandable that bypassing a formal amending process, the Charter has been changed by practice in its application, by interpretation of its provisions according to the needs of a given time and applying them in a manner appropriate to the evolution of the UN, international law and international relations. This

[38] In June 2005, the U.S. clearly stated their intent to oppose any effort on the side of G-4 countries to gain the veto-power. See: Blum, *op.cit.*, (note 20), p. 647.

[39] *Ibid.*, p. 640.

[40] United Nations, A more secure world: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change, p. 68, par. 257.

[41] See: Blum, *op.cit.*, (note 20), pp. 643, 644.

[42] See: Lapaš, D., *Pravo međunarodnih organizacija*, Zagreb, Narodne novine, 2008, p. 138.

process of amending the Charter and the emergence of new customary law through the practice of the Organization and its members is known as "the living Charter".[43] Simma and Brunner, however, challenge the possibility of creating new rules of customary law contrary to the rules contained in the Charter, claiming that such customary law would be contrary to Article 103, as well as to Article 108 of the Charter.[44] These authors mention a "self-contained" nature of the Charter which provides that in the event of a conflict between the Charter and any other obligation of the member states, their obligation under the Charter shall prevail (Art. 103). Thereby, the creation of such a new customary law seems unacceptable.[45] However, to interpret Article 103 as a permission to derogate any other source of international law would be to recognize an antinomy within the Charter itself, since one of the purposes of the UN as provided in Article 1(1) of the Charter is "to maintain international peace and security (…) in conformity with the principles of justice and international law (…).[46]

Some authors advocate the amendment of the Charter through "the spontaneous consent",[47] i.e. through an informal agreement between the member states. However, the question arises as whose "spontaneous consent" is required? The consent of all the member states or does the qualified majority as provided for in Article 108 for a formal amendment of the Charter suffice? However, the "spontaneous consent" is not just a theoretical possibility. It was embodied in several resolutions of the GA, for instance in those dealing with a very important issue of abstentions.[48] Recognizing the potential difficulties in the application of Article 27, the GA recommended to the SC that its members should restrain from voting unless their vital interests are at stake, legalizing thereby *ab initio* the practice of abstention from voting. Likewise, such informal amendment of the Charter might be more than welcome in the context of the use of veto, as it is conceivable that the GA might recommend the narrowing of the scope of the cases in which the use of veto would be appropriate.

On the other hand, some authors are strongly opposed to the circumvention of the formal amendment procedure laid down by the Charter. Regarding the question whether quasi-legislative powers of the SC could bring about changes

[43] The most prominent example for changing the Charter through the customary law which developed between the states is Article 27 of the Charter. Its provision which requires affirmative votes of all the permanent members of the SC for making a resolution on "non-procedural" matters has been amended so that the abstention of a certain permanent member or its absence does not prevent the SC from adopting a valid resolution.

[44] Simma, Brunner, *op.cit.*, (note 36), p. 450.

[45] *Ibid.*

[46] Lapaš, *op.cit.*, (note 42), p. 87.

[47] See: Simma, Brunner, op.cit., (note 36), pp. 450-452.

[48] GA Resolution 40/1, 13 December 1946

in the content of the obligations of the member states as regards the use of force and humanitarian intervention, Glennon denies the legitimacy to such changes and underlines the importance of respect for the constitutional limits and requirements set out for each state by its own Constitution. Be that as it may, the practice has revealed a great flexibility in the application and interpretation of the Charter, the examples of which can be the aforementioned GA resolutions, particularly the "Uniting for Peace" resolution and the resolution 40/1 of 1946. However, the dynamic interpretation of the Charter has its limits in the reality of a political situation. The institutional reform is similarly limited, for a global organization like the UN. As Simma and Brunner warned us, such a reform takes on too much risk and can be doomed to failure.[49]

2.1.4. Quasi-legislative powers of the SC

As a follow-up of the Report of the Panel, Kofi Annan has proposed the adoption of criteria for the use of force in a form of a SC resolution. In other words, he advocated the allocation of the quasi-legislative powers to the SC in the field of maintaining international peace and security. However, it remains controversial whether it is in accordance with the Charter.[50] The Charter provides that the standard-setting resolutions shall be adopted by the GA.[51] Entrusting the SC composed of 15 members - or even the expanded SC of 24 members – to set out the (binding?) rules for 192 UN member states is problematic not only in terms of legal foundation thereof, but also legitimacy. In other words, it is not clear whether the adoption of "legislative resolutions"[52] constitutes an *ultra vires* action in relation to the Charter and whether it is in accordance with fundamental principles of the law of treaties (the question of legality), but what is more, the question of political legitimacy of such resolutions is being asked as

[49] Simma, Brunner, *op.cit.*, (note 36), p. 467.

[50] See: Ronzitti, N., The Report of the High-Level Panel on Threats, Challenges and Change, the use of force and the reform of the United Nations, *Italian Yearbook of International Law*, vol. 14, 2004, pp. 18, 21.

[51] In accordance with Article 13 of the Charter, i.e. pursuing the task of progressive development and codification of international law, the GA has adopted a number of significant resolutions on the use of force, such as the Declaration on the Inadmissibility of Intervention and Interference in the Internal Affairs of States (A/36/103) of 1981; Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in accordance with the Charter of the United Nations (A/2625(XXV)) of 1970, Definition of Aggression (A/3314(XXIX)) of 1974, Declaration on the Enhancement of the Effectiveness of the Principle of Refraining from the Threat or Use of Force in International Relations (A/42/22) of 1987, etc.

[52] Thus, for example, the Resolution 1373 (2001) stipulates an obligation for a state to prevent and counter terrorist acts generally and in abstract, not related to the particular situation of post-September 11. The Resolution 1540 (2004) obliges the states to refrain from supporting any non-state subjects in their access to nuclear, chemical and biological weapons, furthermore, to pass legislation which would ban access to such weapons to the mentioned parties, to adopt and exercise certain preventive measures and to maintain the borders control.

well. Bjorn Erberling believes that the term "threat to the peace" (in Article 39 of the Charter[53]) does not include an abstract threat, and that the measures which the SC may apply under Article 41 do not include measures of abstract and general nature. He also points out to the separation of powers between the UN bodies and the lack of intent on the side of the founders of the UN to assign a role of a legislator to the SC.[54] An argument in favour of the quasi-legislative function of the SC rests upon the evolutionary interpretation of the Charter, which postulates a necessity to adapt the SC functions to a changed environment of globalized threats to the peace (especially by non-state actors that possess weapons of mass destruction) with respect to the basic duty of the SC to cater for international peace and security. Erberling rebuts this argument by disputing the existence of sufficient state practice in support of the quasi-legislative powers of the SC and proving the lack of a widespread acceptance of the legislative SC resolutions by the states, as well as by demonstrating the inadequacy of the SC for a role of a legislator due to its hegemonic and ill-representative composition. Also, the same author points out the limits of the evolutionary interpretation of the Charter which would allow the allocation of legislative powers to the SC with regard to the consensual nature of international law. Roberto Lavalle examines whether the legislative activity of the SC has reflected the general will of all member states, either expressed explicitly or implicitly in advance (through consultations between the members of the SC and other UN members), or *ex post facto* - after the adoption of a certain resolution (by fulfilling the obligations arising from the resolution). The ideal model for the international legislation is found by Lavalle in a two-step procedure analogical to the legislation procedure in contemporary democratic states: the GA would adopt by consensus a resolution that identifies the existence of an abstract threat to international peace and security, and specify the measures that states should undertake in this respect, requiring the SC to adopt a resolution which would determine the existence of the threat to the peace in the sense of Article 39 of the Charter as the grounds for taking action under Chapter VII.[55] Despite the democratic potential of this parliamentary paradigm which combines a representative body that lacks binding authority and an authoritative body that lacks representativeness, putting it in practice

[53] Article 39 reads as follows: "The Security Council shall determine the existence of any threat to the peace, breach of the peace, or act of aggression and shall make recommendations, or decide what measures shall be taken in accordance with Articles 41 and 42, to maintain or restore international peace and security."

[54] See: Remarks by Bjorn Erberling, The *ultra vires* character of Legislative Action by the Security Council, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law,* p. 49.

[55] See: Remarks by Roberto Lavalle, Constitutional Aspects of the Processes that Led to the Adoption of Resolutions 1373 and 1540 and Their Sequel, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law,* pp. 57-58.

seems highly unlikely. However, it has served to Lavalle as a starting point for the analysis and evaluation of the (non)existence of a democratic deficit with regard to adoption of legislative resolutions. Lavalle reached the same conclusion as Erberling: the case of resolutions 1373 and 1540 has demonstrated the low degree of inclusion of the member states in such a "legislative process", as well as a poor compliance with the resolution once adopted. Lavalle, however, does not share the Erberling's view that legislative resolutions as such are not in accordance with the Charter, but concomitantly dwarfs the distinction between the complaints of unconstitutionality on the one hand and practical objections (inefficiency) on the other, as both boiling down to *ex post facto* acceptance or rejection of a resolution. A related problem regarding the minimum number of states included for a resolution to be considered as binding also arises. Shirley V. Scott focuses on the political legitimacy, as opposed to the narrowly conceived legal legitimacy, pointing out the political "necessity". Scott examines the need for the SC legislative resolutions from the perspective of functionality of the SC.[56] The criterion of political legitimacy, according to Scott, is "in the eyes of the beholder" in the sense of perception of a general public. If the power of the SC "is inseparable from the power of its permanent members, similarly the legitimacy of the SC when acting as the U.S. want, is inseparable from the perception of the legitimacy of U.S. foreign policy, particularly regarding international law".[57] Understood this way, the legitimacy of a legislative resolution is dependent upon the rhetoric and behaviour of the U.S. in relation to the matters regulated by the respective resolution (for example, questions concerning the weapons of mass destruction).

From the standpoint of the constitutional law concept of separation of powers, the concentration of powers in the SC can be characterized as dangerous or at least the member states might perceive it that way. Rooted either in the fear of abuse of centralized power (which outweighs the fear of abuse of decentralized power[58]) or in the will to protect the interests of the ruling elites of certain countries,[59] the lack of political will to establish a stronger mechanism of universal standards and sanctions is a fact. In this light, the refusal of the U.S. to accept the universal jurisdiction of the International Criminal Court (ICC) and its negative attitude towards the proposal of the Secretary General in respect of a SC resolution that would codify criteria for the use of force are easily grasped as two sides of the

[56] See: Remarks by Shirley V. Scott, UN Security Council Resolution 1540 and Political Legitimacy, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law,* pp. 65-66.

[57] *Ibid.*, p. 67.

[58] See: Glennon, *op.cit.*, (note 3), p. 636.

[59] On the disappearing line between the private and public interests of key decision-makers, see: Naomi Klein, *The Shock Doctrine*, New York, Metropolitan Books, pp. 308-322.

same coin. Annan's proposal can be therefore welcomed as an attempt to engage the United States,[60] but having in mind the experience that the national interests of the U.S. outweigh the benefits of the international community, the limitations of this approach are obvious

2.2. The establishment of the Peace-Building Commission

An indispensable ingredient in the post-conflict peace-building and creating the preconditions for development of a society traumatized by conflict is the establishing of the rule of law. The analysis of transitional UN missions, such as the UNMIK, revealed a lack of a coherent strategic planning towards the strengthening of the judiciary, as well as a lack of cooperation among donors, especially in the case of overlapping and contradictory projects and the irrational use of resources due to imperfect information exchange and poor coordination. Due largely to insufficient knowledge of the local conditions, the programs were often ill-adapted to a specific situation (the so-called "cookie clutter" approach) and the work of international experts was negatively perceived in societies to which they imposed a uniform model. The Panel identified a certain vacuum in the UN system concerning the support from the international community to the states that have recently emerged from the conflict, in their transition to stable societies. Thus, its members proposed the establishment of the Peace-Building Commission, having in their minds the advantages that qualify the UN as the most appropriate institution to perform the function of helping to build peace after conflict: the organization's international legitimacy, impartiality of its staff, as well as its capability of understanding the cultural issues and the functioning of administrative systems, and the experience of organizing transitional administration.61 The role of the UN as an umbrella institution for the coordination of donors and NGOs is in this regard very natural. However, the weaknesses of the UN should not be overlooked, as they might jeopardize the effectiveness of the peace-building process - the bureaucratic clumsiness of the UN, its susceptibility to political paralysis, insufficiently developed mechanisms of internal control and accountability, and its "managerial culture". In this respect it is necessary to make further and greater efforts to increase transparency and accountability within the complex structure of the Organization. Members of the Panel also concluded that a systematic approach to identifying the best practices and choosing experts, including those from NGOs or from countries where the peace-building takes place, seems necessary. A better cooperation between the UN and the governments, donors and NGOs was recommended

[60] See: Schrijver, N., What follow-up to the High Level Panel Report, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law,* p. 175.

[61] See: Tolbert, D., Solomon, A., United Nations Reform and Supporting the Rule of Law in Post-Conflict Societies, *Harvard human rights journal*, no. 19, Spring 2006, p. 57.

to serve that purpose. In December 2005 the GA and the SC jointly established the Peace-Building Commission as their subsidiary organ (pursuant to Articles 22 and 29 of the Charter) and an intergovernmental advisory body with the task to assist post-conflict societies in peace-building, recovery, reconstruction, institution building and sustainable development. The Commission shall submit annual reports to the GA. The innovative character of the Commission results from its pooling capacity and expertise in conflict prevention, mediation, peace-keeping, human rights, rule of law, humanitarian assistance, reconstruction and long-term development planning, as well as in the possibility of coordination within a single body.

2.3. Replacing the Human Rights Commission (HRC) with the Human Rights Council

In the efforts to eliminate the possibility of reoccurring of atrocities of the WWII, the founders of the UN decided to include respect for human rights among the objectives of the UN.[62] Pursuant to general provisions of the Charter and in particular Article 68, the Economic and Social Council (ECOSOC) established in 1946 the Human Rights Commission as one of its functional commissions with the original mandate of drafting proposals and reports on all human rights issues.[63] The Commission was originally composed of 18 member states.[64] Having achieved a great initial success,[65] the Commission outgrew its institutional framework as its membership was enlarged, its composition changed, its mandate extended and the Commission became opened to NGOs. Higher standards in addressing human rights concerns were followed by significantly higher expectations, and the Commission was consequently faced with severe criticism when those expectations were not met. It also experienced an increasing polarization of individual groups of countries. In the electing of the member states of the Commission, their practice concerning the human rights was not taken into account, which resulted in a situation where those states which violated human rights the most sought membership in the Commission to avoid and neutralize criticism. Thus, a reform of the Commission started to be considered one of the key institutional changes in the reform of the UN. Annan's Panel

[62] Preamble of the Charter speaks of a determination of Nations "to reaffirm faith in fundamental human rights, in the dignity and worth of the human person..."

[63] The expansion of the mandate of the HRC started with standard-setting regarding the protection of human rights, toward their implementation: continued with establishing supervisory mechanisms and finally transforming the Commission into a political forum for discussion human rights issues. Cf. Schrijver, N. The UN Human Rights Council: A New 'Society of the Committed' or Just Old Wine in New Bottles?, *Leiden Journal of International Law*, vol. 20, 2007, pp. 811-812.

[64] The number of the HRC members increased on several occasions: in 1962 to 21, in 1967 to 32, in 1980 to 42 and in 1992 to 53.

[65] Within first two years the Commission succeeded in drafting a document which in the view of many has become the most important UN resolution ever: the Universal Declaration of Human Rights. See: Schrijver, *op.cit.*, (note 63), p. 811.

observed in its Report the problem of loss of credibility due to its compromising membership, i.e. maintaining double standards in dealing with human rights issues, as well as the problem of the lack of professionalism. Therefore the Panel proposed the introduction of a universal membership of the Commission and the establishment of an advisory committee consisting of eminent independent experts. Annan, on the other hand, proposed in his report "In Larger Freedom" the establishment of a smaller permanent council which would replace the Commission, and gain the status equal to the SC and the ECOSOC, as one of the main organs of the UN; or at least as an auxiliary organ of the GA, in order to better reflect the importance of human rights within the UN system.

Finally, in March 2006, four decades after the establishment of the Commission, the GA established the Human Rights Council as its auxiliary body66 in replacement of the Commission which thereby ceased to exist.67 47 member states of the Council are elected directly and individually by secret vote of a simple majority of the GA member states, based on the criterion of equitable geographical representation, but also taking account of the candidate's human rights records. The GA has the competence to suspend membership in the Council for the state which is found to be in fundamental breach of its human rights obligations. A state can serve no more than two consecutive terms in the Council, thus preventing *de facto* permanent membership in the Council and automatic representation of the great powers. Another improvement is increasing of duration and frequency of the Council meetings (at least three times per year, for a total duration of 10 weeks, while the Commission met for only six weeks), as well as introducing a possibility of special meetings in case of necessity. Functions and (advisory and recommendatory) competences of the Council are not essentially different from those of the Commission;68 only some new noble buzzwords were added to its goals: transparency, fairness, impartiality, non-selectivity, objectivity, universality, promoting a "genuine dialogue" and a "results-oriented" follow up.69 The GA also established a so-called universal periodical review mechanism, as a means of supervision over "the fulfilment by each State of its human rights obligations and commitments in a manner which

66 It was decided that the status of the Council was to be reconsidered in 5 years time.

67 GA Resolution 60/251

68 The general objective of the Council is to promote universal respect for the protection of human rights without discrimination and to address situations of violations of human rights, including gross and systematic violations. More specific functions include making recommendations on the promotion and protection of human rights, contributing to the further development of international human rights law, mainstreaming human rights within the UN system, and promoting an effective coordination in this respect. See: *World Summit Outcome Document*, UN Doc. A/60/1 (2005), par. 158–9.

69 Schrijver, *op.cit.*, (note 63), p. 816.

ensures universality of coverage and equal treatment with respect to all States".[70] Thus, a working group was established composed of state representatives, with the help of three Rapporteurs from different geographical areas and with the help of the High Commissioner for Human Rights. Also, the mechanism includes the intensive cooperation with the concerned states and NGOs.71 Besides, the reform includes shortening of the Rapporteurs' mandate and setting higher standards of impartiality.

During its very first year, the Council faced more polarization and confrontations than its discredited predecessor would face in hot seasons. The case of Palestine has indicated the limits to the possibilities of the Council having to deal with politically delicate and extremely complex situations. In the case of Darfur, the Council proved to be utterly helpless, when its Expert Group for Darfur, headed by Nobel laureate Jody Williams, was prevented from entering Sudan, and presentation of their report was obstructed in the Council later on.[72] The question of membership remains opened, as it is not clear whether the Council composed solely of those countries with a reputation of promoting and protecting human rights is a better solution than having a representative political body.[73]

3. Use of force: a paradigm shift?

An absolute prohibition of aggressive war was introduced into international law in the form of the Pact of Paris (Briand-Kellogg Pact) in 1928. Article 2(4) of the UN Charter[74] reiterated the ban, expanding its content, but also provided for exceptions to it in Chapter VII. The provision of Article 2(4) taken together with the provisions on the powers of the SC and the provision of Article 51 constitute a strict regulation on the (restrictive) use of force, fully acknowledging the state sovereignty.[75] Nowadays, however, even more than in the year 1970 when

[70] GA Resolution 60/251, par. 5.

[71] Modalities of functioning of this and other institutional mechanisms are set down by the HRC Resolution "*Institution-Building of the United Nations Human Rights Council*", *Human Rights Council Res. A/HCR/5/l.1* (2007). See: UN Doc. A/62/53.

[72] Sudan is a member of the African Union, Organization of the Islamic Conference and Arabic League and therefore gained protection of some of their member states whose performance regarding human rights is highly problematic.
See: http://www.unwatch.org/site/apps/nl/content2.asp?c=bdKKISNqEmG&b=1330815&ct=3698371

[73] See: Schrijver, *op.cit.*, (note 63), p. 822.

[74] The provision of Art. 2(4) reads as follows: "All Members shall refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any state, or in any other manner inconsistent with the Purposes of the United Nations."

[75] Yoo, *op.cit.*, (note 1), p. 643.

Thomas Franck declared Article 2(4) "dead"[76] (or in 1987 and 1990 when he repeatedly commented on the "deceased" provision, or, finally, in 2003, following the attack of the U.S. on Iraq, when Franck concluded that Article 2(4) died again, and, this time, perhaps for good),[77] there is a yawning chasm between the normative principles and the reality of state practice. Violations of Article 2(4) are measured by three-digits.[78] More generally, and especially with regard to an evolving technology of warfare, globalization and the expanded range of sources of threats to international peace and security, the existing system of collective security cannot adequately address the challenges of the 21st century.

3.1. Use of force in self-defence

There are two exceptions to the principle prohibiting the use of force in international law. According to the Charter, states can take military action only in the case of individual or collective self-defence in response to an armed attack (Article 51 of the Charter), or pursuant to an approval of the SC (Article 42 of the Charter). The use of force in terms of self-defence is limited in time: it ceases to be permitted as soon as "the SC has taken measures to re-establish international peace and security". The very fact that Article 51 is situated in Chapter VII also backs up the notion that a state's right to self-defence forms an integral part of the international system of collective security.[79]

3.1.1. Use of force in response to an armed attack

After the U.S. intervention in Iraq, whose theoretical foundation tried to be found in the "doctrine of pre-emptive strike", the question of a necessity of a change in the rules on the use of force was addressed by the Panel. The Panel's Report is based on the traditional interpretation of the rules on the use of force, but its interpretation of Article 51 of the Charter[80] was bashed by some authors. The Report argues that "according to long established law", a

---

[76] Cf. Franck, Th.M., Who Killed Article 2(4)? or Changing Norms Governing the Use of Force by States, *American Journal of International Law*, vol. 64, no. 4, 1970, pp. 809-837.

[77] Franck, Th.M., What Happens Now? The United Nations After Iraq, *American Journal of International Law*, vol. 97, no. 3, 2003, pp. 607, 610.

[78] According to some authors Article 2(4) was violated 200 times; by others 680 times; see: Glennon, *op.cit.,* (note 3), pp. 619, 624

[79] See: Schrijever, *op.cit.*, (note 63), p. 173.

[80] Article 51 of the UN Charter reads as follows: "Nothing in the present Charter shall impair the inherent right of individual or collective self-defence if an armed attack occurs against a Member of the United Nations, until the Security Council has taken measures necessary to maintain international peace and security. Measures taken by Members in the exercise of this right of self-defence shall be immediately reported to the Security Council and shall not in any way affect the authority and responsibility of the Security Council under the present Charter to take at any time such action as it deems necessary in order to maintain or restore international peace and security."

state may use military force only if "threatened attack is imminent";[81] whereas it previously admitted that this norm is "precious but not yet deep-rooted."[82] These contradictory statements suggest the delicate and fuzzy nature of the issue and evoke an important question of meaning of *the imminence* according to the Charter, as well as the relation between the states' practice and the Charter, on which major differences arose between scholars. Glennon sees a conflict between custom and treaties as two sources of international law:[83] Article 51 clearly and unambiguously requires an actual armed attack as a precondition for the use of defensive force,[84] whereas subsequent states' practice is not only inconsistent with that rule, but goes even further using the "self-defence" without waiting for the threat to become imminent.[85] However, repeated violations of the Charter do not amount to changing the rule. The Panel reiterated its view that the binding nature of a legal norm does not succumb to the contrary practice of states, i.e. it does not lose its peremptory nature.[86] Indeed, mere states' practice cannot override a norm of customary law, if it is not followed by *opinion iuris*.

The requirement for the existence of an imminent threat was formulated in the customary international law preceding the Charter. In the *Caroline* case it was agreed that nations should be allowed to use force in anticipation of an attack that had not yet occurred if "a necessity of self-defence was instant, overwhelming, leaving no choice of means, and no moment for deliberation."[87] The International Court of Justice expressed its view in the *Nicaragua* case noting that Article 51 of the Charter did not extinguish the right of self-defence as it existed under pre-Charter customary international law, i.e. that the *Caroline* doctrine continued to be part of the customary international law after Article 51 codified the rule on the use of force in self-defence. In other words, the use of force in face of an imminent threat would be justified.[88] The "conflict" between the Charter and

[81] United Nations, A More Secure World: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change, par. 188, p. 63.

[82] *Ibid.*, p. 32.

[83] Glennon, *op.cit.*, (note 3), p. 619.

[84] The words of Governor Harold Strassen, deputy head of the delegation at San Francisco Conference 1945, leave little room for doubt regarding the criterion that was opted for when the Charter was being drafted. See: Glennon, *op.cit.* (note 3), p. 620.

[85] See: United Nations: A more secure world: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change: "For the first 44 years of the United Nations, member states often violated these rules and used military force literally hundreds of times, with a paralyzed Security Council…"; par. 186, p. 62.

[86] See: Ronzitti, *op.cit.*, (note 50), p. 4. Gareth Evans, a member of the Panel, however, held that the use of force in self-defence before an attack occurred is justified.

[87] See: Moore, J.B., Destruction of the "Caroline", *A Digest of International Law*, vol. 2, Washington, Government Printing Office, 1906, par. 217, p. 409.

[88] Case Concerning Military and Paramilitary Activities in and Against Nicaragua (Nicaragua v. United States of America), *ICJ Reports* 1986, p. 94.

the custom disappears in the light of interpretation of the Charter as a living instrument, having in mind that "the exact interpretation of Article 51 is not cast in iron but can evolve over time."[89] Furthermore, one should not disregard the historical context in which Article 51 was born, in particular the original intent of the UN founders that the SC would have monopoly over military force and exercise it through the "UN army" composed of the contingents of the member states armed forces pursuant to their agreements with the UN under Article 43 of the Charter. Since these agreements have never been concluded, this mechanism of collective security has never come into being. The Panel presumed that Article 43 was indeed a dead letter. The Panel, as well as the UN as a whole, were divided over the issue of admissibility of the use of defensive force. Annan classified the use of force, aside from the uncontroversial self-defence (be it individual or collective) as: (a) pre-emptive use of force, in response to an imminent threat of attack, (b) preventive, in face of the "latent threat of attack" (such that it is not yet imminent, but is possible), and (c) protective, conceptualized as the use of force to prevent or halt genocide or other serious humanitarian catastrophe.[90] Thus, it seems that Annan stood for such interpretation of Article 51 which would permit pre-emptive use of force in self-defence. In this regard, the proposals of the Panel and the SG did not introduce any substantial change in the status quo. What is more, one can argue that to insist on the requirement of the existence of an imminent threat of attack in today's circumstances is to not take into account the actual threats coming from the international terrorism, weapons of mass destruction and rogue states. Such a requirement fails to recognize the fact that states come to the decision on taking a military action based on the assessment of the magnitude of the threat and the probability of an attack, rather than on the estimation of how "imminent" the threat is. Thus, as Glennon wrote: "No responsible policymaker, knowing that some rogue state or terrorist group is planning a nuclear strike, would recommend sitting tight until the attack becomes imminent."[91] Yoo introduced "an expected harm approach" which can be measured by multiplying the estimated graveness of harm and the probability that an attack would occur.[92] Whereas the criterion of imminence is a function of time, the criterion of an expected harm is a function of probability. The place of navy, cavalry and infantry from the times of the *Caroline* case has been taken by missile technology which allows launching of massively destructive attacks so

[89] Remarks by Nico Shrijver: Collective Security and the Use of Force: Reviewing the Koffi Annan Criteria, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law,* p. 172.

[90] *Ibid.* See also: United Nations, In larger freedom: Towards development, security and human rights for all, Report of the Secretary General, UN Doc A/59/2005,in: Yoo, *op.cit.* (note 1), p. 647. See also: Runjić, *op.cit.*, (note 1), p. 732.

[91] Glennon, *op.cit.*, (note 3), p. 615.

[92] Yoo, *op.cit.*, (note 1), p. 649.

quickly that there would be no real opportunity for an attacked party to use pre-emptive force to halt them. Therefore, it seems that modern warfare no longer allows for ascertaining the timing of the attack. Also the scale of potential damage to both the civilian population and the environment has dramatically increased due to this technological change. Furthermore, Yoo's probability-based approach is better suited to effectively respond to terrorism than a temporary-based one (imminence test), since terrorist attacks are by their nature extremely difficult to detect when the threat is imminent and thus require pre-emptive action. Finally, additional advantage of the expected harm approach is that it can calculate and determine proportionality. Yoo also criticized the imminence test for failing to provide the decision-maker with adequate tools of ascertaining whether the threat is imminent or only latent, since it is the member states themselves who supply the SC with the relevant evidence, which in turn can be expected to be biased. However, the same applies to Yoo's criterion.

Regarding the threat which is not imminent as well as the threat of genocide, crimes against humanity or other serious violations of human rights, the Panel and Annan were of opinion that the SC should have a monopoly over the use of force.[93] The concept of humanitarian intervention and its newer version labelled the "Responsibility to Protect" (hereinafter: "R2P") deserve particular attention. According to some authors, the principle of non-interference in internal affairs of a state as a derivative of state sovereignty has lost its absolute character with the idea that international community has a right and obligation to intervene where human rights are being gravely and massively violated. The legitimacy of the intervention can be derived from the notion of human rights as a universal good of primary importance forming an obligation *erga omnes*. Thus, fundamental human rights are no longer an internal matter of a particular state, but protected by various international mechanisms. Another justification is based on the understanding of a state sovereignty as a derivative of the sovereignty of the people.

On the other hand, the opponents of intervention consider it the new colonialism pointing out a grave danger of abuse. In absence of a global consensus on the nature, legitimacy and practical exercise of this concept, it remains floating in vagueness between a moral and legal responsibility. However, a new *opinio iuris* is believed to be growing,[94] especially after Darfur, and the states actually acted

[93] Thus, according to Art. 53 of the UN Charter, the SC has competence to decide to entrust the use of force to a regional organization or even to an *ad hoc* coalition of the willing.

[94] See: response of Robert Lavalle, in discussion at the Hague Conference 2005, *International Institutional Reform, 2005 Hague Joint Conference on Contemporary Issues of International Law, What follow-up to the High Level Panel Report,* p. 181.

in accordance with it on several occasions[95] before it was theoretically formalized, though they refused to admit they were doing so. The principle of "R2P" found its way from the report of non-governmental institutions and academic seminars to the UN itself.[96] The Panel stood for a more proactive policy of humanitarian intervention, having asserted that "today, more than ever before, threats are interrelated and a threat to one is a threat to all."[97] Glennon opposes this idea as naive, since Rwanda, Darfur and Kosovo amply demonstrate that countries do not consider these humanitarian catastrophes to be threats to their own security. Furthermore, Glennon identifies a contradiction between the Panel's embracing of the principle of zero tolerance of genocide on the one hand, and its implicit decision to tolerate it in the case if the SC is paralysed in absence of consensus on the use of force.[98] Yoo's analysis of international peace and security as (the most important) international public good, based on the theory of public choice, shows that a state will use force if the costs are lower than the benefits that it captures from the intervention, whereas the optimal point for the use of military force would in fact occur where the benefits equalled the costs for the international community as a whole, rather than for the intervening state only. From this Yoo draws a conclusion that international legal rules governing the use of force should incentivise states to use force to confront threats presented by failed states and international terrorist organizations, and to prevent humanitarian disasters.[99] Where centralized state authority has collapsed or has been taken over by local warlords, the potential of human rights disaster and the cross-border spreading of a terrorist network cease to be an internal issue, requiring an action of the international community. Theoretically, it is in the interest of the international community to use force in order to halt a regional destabilization, but Rwanda and Darfur speak volumes about insufficient motivation on the side of the states. Yoo's cost-benefit model has an in-built check of dissuading certain country to engage in an intervention for which it would not gain support of other countries nor their *ex post facto* military and financial help: countries will not hastily decide to intervene if no support can be expected from the international community. However, having in mind the dominant position of the U.S. and the experience of Iraq, an issue of legitimacy versus the likelihood of unilateral action remains

[95] E.g. Tanzania's interventions in Uganda, India' s intervention in Bangladesh, the intervention in Cambodia.

[96] See: International Commission on Intervention and State Sovereignty, *The Responsibility to Protect – The Report of the International Commission on Intervention and State Sovereignty*, Ottawa, International Development Research Centre, December, 2001, pp. XI-XIII. See also the UN document "In larger freedom: towards development, security and human rights for all" (A/59/2005).

[97] United Nations, A More Secure World: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change, p. 14.

[98] See: Glennon, *op.cit.*, (note 3), p. 615.

[99] See: Yoo, *op.cit.*, (note 1), p. 656.

on the table. In this respect, considerable differences of opinions arise. While Glennon views the lack of support from the UN to the U.S. intervention in Iraq as its inability to adapt to a "unipolar world"[100] in which the admissibility of the use of force will no longer be defined by a multilateral framework, Thomas Weiss believes that a key to the survival of the UN lies in detecting a pathway to engage the U.S., modulating its behaviour and imposing some discipline upon it.[101] Thomas Franck and Anne-Marie Slaughter stand for a greater role to be played by the UN in opposing U.S. unilateralism.[102] The Panel seems to be precautious concerning any possibility of a more lenient approach to admissibility of unilateral action, from a fear that if global peace and security were entrusted to any of the Super-Powers,[103] an international legal system would tend to develop towards a legal order essentially marked by a hegemony of a given state and so-called hegemonic law would develop. On the other hand, Glennon and Yoo challenge this uncompromising multilateralism by proposing a criterion of costs and benefits, especially in the context of humanitarian interventions.[104]

The argument put forward by the Panel in defence of the strict rule on the use of force is the fear of abuse. The Panel believed that if the criteria for the use of force were relaxed, countries would use self-defence as a pretext for illegitimate interventions and the legal norm itself would lose its binding character.[105]

In principle, the (moral) superiority of a multilateral approach to the use of force is hardly debatable. However, a question remains whether in cases of deep divisions between the SC permanent members generating the SC paralysis in face of gross and systematic violations of human rights, the use of force by individual states could be legitimate. Anyhow, it should be emphasized here that humanitarian intervention, as well as any kind of forcible intervention is illegal *per se*.[106] Therefore, the admissibility of humanitarian intervention will

---

[100] See in: *ibid.*, p. 658.

[101] *Ibid.*

[102] Cf. Franck, Th.M., The Use of Force in International Law, *Tulane Journal of International & Comparative Law*, vol. 11, Spring 2003, pp. 14-19; Slaughter, A-M., The Will to Make it Work: Accused of Irrelevance and Deeply Divided Over Iraq, the United Nations Has Never Mattered More, *Washington Post* B1 (Mar 2, 2003).

[103] Ronzitti, *op.cit.*, (note 50), p. 5.

[104] See: Glennon, *op.cit.*, (note 3), pp. 627; Yoo, *op.cit.*, (note 1), p. 655.

[105] Yoo, *op.cit.*, (note 1), p. 652.

[106] Cf. Jennings, R.Sir, Watts, A.Sir, *Oppenheim's International Law*, sv. I, London, Longman, 1995, p. 428; Franck, Th.M., Rodley, N.S., After Bangladesh: The Law of Humanitarian Intervention by Military Force, *American Journal of International Law*, vol. 67, no. 2, 1973, p. 277. The prohibition of the unilateral forcible intervention can be found in a series of international documents, e.g. Covenant of the League of Nations, Charter of the United Nations, Declaration on the Inadmissibility of Intervention and Interference in the Internal Affairs of States (A/36/103) of 1981; Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in accordance with the Charter of the United Nations (A/2625(XXV)) of

always depend on the circumstances precluding wrongfulness. In other words, humanitarian intervention as well as the later forged concept of the "R2P", could find their place only at the level of secondary norms, since they can never be understood as a mere *right* of a state. Otherwise, we would be faced with an antinomy between such a "right" and the obligation of states to refrain "from the threat or use of force against the territorial integrity or political independence of any state", as stated in Article 2(4) of the UN Charter. This being so, the advocates of humanitarian intervention in the doctrine try to formulate some conditions for the exceptional legality of such a concept. Sometimes grave and massive breaches of fundamental human rights, or at least a serious and immanent threat of it, are required. Also, some authors introduce the criterion of proportionality of the intervention, and that of impartiality of the intervening states, requiring the submission of regular and complete reports on the course of the intervention to the UN Security Council and even to the relevant regional organizations.[107] Besides, some authors require some kind of previous consultation with the UN Security Council, considering such an intervention legitimate only in the case if the Council failed to apply the collective measures provided in Chapter VII of the UN Charter.[108] Also, a claim of humanitarian intervention must be examined in light of the record of human rights of the intervening state. As Simon points out, this will limit the number of countries permitted to intervene for humanitarian purposes, but it will also prevent the absurd situation of abusive nations taking the position that they are more concerned about the condition of nationals in other countries then they are of nationals in their own country.[109] However, maybe some of the most interesting requirements were proposed by Charney. He requires that before intervening, the states that are to participate must consent both to suit in the ICJ by any directly injured state for violations of international law committed in the course of the humanitarian intervention, and to the jurisdiction of the ICC over their nationals for crimes within its

1970, Definition of Aggression (A/3314(XXIX)) of 1974, and Declaration on the Enhancement of the Effectiveness of the Principle of Refraining from the Threat or Use of Force in International Relations (A/42/22) of 1987. For the opposite see e.g.: McGoldrick, D., The principle of non-intervention: human rights, in: Lowe, V., Warbrick, C.(eds.), *The United Nations and the Principles of International Law – Essays in memory of Michael Akehurst*, London, New York, Routledge, 1997, p. 107; Tesón, F.R., *A Philosophy of International Law*, Boulder, Westview Press, 1998, p. 62.

[107] Cf. Chopra, J., Weiss, Th.G., Sovereignty Is No Longer Sacrosanct: Codifying Humanitarian Intervention, in: Ku, Ch., Diehl, P.F. (eds.), *International Law – Classic and Contemporary Readings*, Boulder, London, Lynne Rienner Publishers, 1998, pp. 382-383.

[108] Cf. Simon, S.G., The Contemporary Legality of Unilateral Humanitarian Intervention, *California Western International Law Journal*, vol. 24, no. 1, 1993, p. 151; see also: Cassese, A., Ex iniuria ius oritur: Are We Moving towards International Legitimation of Forcible Humanitarian Countermeasures in the World Community?, *European Journal of International Law*, vol. 10, no, 1, 1999, p. 27.

[109] Simon, *op. cit.*, (note 108), p. 151.

jurisdiction.[110] There is no doubt that such a requirement would not only limit the use of force for humanitarian purposes to the gravest of cases in which no alternative is available, but it would also prove the readiness of the intervening states to act in good faith.

Be that as it may, it would hardly be possible to neglect a grave danger of abuse of these concepts allowing the unilateral use of force. As Franck and Rodley observed: "History shows that when the humanitarian justification has been invoked, it has mostly been under circumstances in which there is at least a strong suspicion that the facts and usually the motive, were not as alleged."[111] This being so, the recognition of the *right* to unilateral use of force, be it in the form of humanitarian intervention, or the "R2P" could enable the powerful states to pick and choose a target-state, since, as another famous American professor Louis Henkin pointed out, the breaches of human rights could be found in many countries and such intervention could become a question of might, and political interests, rather than law.[112] After all, as some authors said, even the drafters of human rights Covenants did not intend to create human rights that could be enforced unilaterally by the military force of the stronger nations.[113]

Understood this way, even if we accept the moral reasons in preventing grave and widespread humanitarian catastrophes to justify such a unilateral use of force, we will have to be aware of the fact that the concepts like humanitarian intervention, or the "R2P" will always be at the disposal of "the stronger". The weaker states will never be able to use them against the stronger state, no matter how grave and massive the breach of fundamental human rights in its territory would occur. In this regard, it seems to us that the above mentioned concepts, at least from the theoretical point of view, hardly deserve to be understood isolated from the general legal notion of the "state of necessity".[114]

Therefore, one should not be surprised that the Panel's proposals for the reform are quite conservative. A new set of criteria has been proposed as the guidelines in the decision-making concerning the use of force in particular cases: (1) seriousness of threat, (2) proper purpose, (3) last resort, (4) proportional

---

[110] Charney, J.I., Anticipatory Humanitarian Intervention in Kosovo, *Vanderbilt Journal of Transnational Law*, vol. 32, no. 5, 1999, p. 1244.

[111] Franck, Rodley, *op. cit.*, (note 106), p. 304.

[112] See: Henkin, L., International Law: Politics, Values and Functions. General Course on Public International Law, *RCADI*, vol. 216, 1989, p. 154. See also: Lobel, J., Ratner, M., Bypassing the Security Council: Ambiguous Authorizations to Use Force, Cease-Fires and the Iraqi Inspection Regime, *American Journal of International Law*, vol. 93, no. 1, 1999, p. 136.

[113] Franck, Rodley, *op. cit.*, (note 106), p. 300.

[114] Cf. Lapaš, D., *Sankcija u međunarodnom pravu*, Zagreb, Pravni fakultet u Zagrebu, 2004, pp. 323-324.

means, and (5) balance of consequences.[115] These guidelines stem from the desire of the Panel to maximize the prospects for support from the international community for decisions of the SC and to minimize the possibility for a member state to bypass by the SC.[116] But they bring no fundamental novelty to the system of collective security recycling the old arguments and vocabulary. What is more, Glennon believes they hold a potential of producing an opposite effect.[117]

The proper purpose criterion, for example, presumes a possibility of ascertaining what the primary purpose of a given intervention is. However, it is true that "in most cases no one can know the principal reason why states behave as they do."[118] It is conceivable that an intervention might result in preventing serious violation of human rights – and, therefore, be legitimate – despite the fact that the underlying reasons for the intervention and individual or group interests behind it would not be considered legitimate by most members of the international community.

The "last resort" criterion is particularly problematic, since the comprehensive sanctions against a disobedient state are no longer imposed by the SC because of their humanitarian consequences. If the use of force was really the last legitimate measure available, imposing of comprehensive sanctions would be acceptable as well, despite its catastrophic consequences for the civilian population. One can also evoke the belated interventions of the UN as well as the changes in warfare technology as grounds for reconsidering whether the military action should always be the "last resort". Thus, the aforementioned dilemmas arising from the Panel's criteria confirm the sensitive nature thereof and cast a shadow upon the expectation of facilitating the consensus in the SC. Despite their possible potential for rendering the decision-making process in the SC more transparent,[119] the delicate nature of the matter led to leaving out the five criteria in the Draft Outcome Document. Powerful countries feared the criteria might tie their hands; small countries saw them as a guidebook for military intervention; while the others were afraid that formalizing the criteria might derail the SC discussions.[120]

---

[115] United Nations, A more secure world: Our shared responsibility, Report of the High-level Panel on Threats, Challenges and Change, pp. 57-58.

[116] Yoo, *op.cit.*, (note 1), pp. 649 and Schrijver, *op.cit.*, (note 60), pp. 177-178.

[117] Glennon, *op.cit.* (note 3), p. 618.

[118] *Ibid.*, p. 617.

[119] Schrijver, *op.cit.*, (note 60), pp. 175-177.

[120] See: response of Karel Van Kesteren, *op. cit.*, (note 18), p. 180.

3.2. Use of force with the approval of the SC

The approval for the use of force can be given by the SC to a state, a group of states or to a regional organization, pursuant to Chapters VII and VIII of the Charter.

The Report of the Panel draws a distinction between two possible grounds for obtaining the SC permission for the use of force: a threat posed by one country to another and a threat of genocide. In the latter case, Panel claims that there is a "responsibility to protect", without further specifying whether this responsibility rests with the members of the international community or with the SC. Having in mind that in practice the SC cannot oblige states to use force but only allow it, and because there is no need to call upon an emerging rule while serious violation of human rights can be qualified as a threat to international peace and security and thereby provide the SC with a legal grounds for acting under Chapter VII, it can be concluded that the aforementioned responsibility would rest with the states, while the guidelines for assessing a threat in each individual case could be the above-mentioned Annan's five criteria. However, the criterion of immediacy of the threat is not required. In other words, force can be used to counter a latent threat only if the SC will give its permission.

The original intent of the UN founders, embodied in Article 42 of the Charter, that the SC should undertake military action in order to preserve or re-establish international peace and security, remains a dead letter, while the role of the SC exhausts in giving approval for the use of force to states. [121]

4. Peace-keeping and peace-enforcement - UN peace missions

The UN peace missions encompass peace-keeping operations, characterized by the consent of the state where they take place, absence of the use of force and impartiality on the one hand, and peace-enforcement which implies the use of force, on the other hand. The Panel has not insisted on this distinction and expressed a view that a prior authorization of the SC is required not only in the case of peace-enforcement, but also for peace-keeping. This could be problematic taking into account the possibility of blockage of the SC.[122] On the other hand, the persisting problem of staff shortage for both kinds of missions, due to the fact that agreements with states provided for in Article 43 of the Charter have never been concluded, was addressed by the Panel which came up with the proposal that individual states and international organizations or entities such as the European Union should establish permanent forces available to the UN to be deployed in its peace missions.

[121] See: Ronzitti, *op.cit.*, (note 50), p. 9.
[122] *Ibid.*, pp. 8, 21.

5. Administrative reform of the UN

Inability of the UN to cope with the challenges and threats of our time is closely related to a general perception of the Organization as an outdated and rigid bureaucratic structure. The bulkiness of the institution whose bodies, committees, sub-committees, commissions, programs, funds, agencies etc. multiplied over time in response to the widening of the scope of the UN activities and responsibilities, has generated a problem of coordination, massive increase of expenses and diminishing efficiency. Additionally, the reputation of the UN has been seriously compromised through a series of scandals such as the corruption affair linked to the "Oil for Food" program[123] and sex-scandals associated with the UN staff in the field.[124] Kofi Annan initiated the reform of the administration by reducing the number of employees in the Secretariat and halting the growth of its budget. Main guidelines for the reform were enumerated in the report "Investing in the United Nations for a Stronger Organization Worldwide": computerization, rationalization, integration and modernization of the administration.[125] Ban Ki-moon has continued with the reform. His program "Stronger United Nations for a Better World" enlisted some additional goals: improving accountability and oversight; setting the highest ethical standards; providing an efficient, transparent and service-oriented Secretariat; establishing a mobile, multi-skilled and motivated staff with access to internal justice; and championing a more integrated UN family approach to achieve common goals.[126] Since these objectives coincide with the priorities for the UN reform from the standpoint of the U.S., it is hardly surprising that the reform in this area has been put in practice most successfully. Considerably lesser degree of enthusiasm for an administrative reform on the part of smaller states originates from their fear from losing influence in the UN due to the diminished participation in the administration as well as in some of the UN bodies. At any rate, numerous offices and commissions have been introduced to the UN system, such as the Office of Internal Services and the Independent Audit Advisory Committee, in order to support achieving of the aforementioned goals.

---

[123] Corruption allegations were confirmed subsequent to the investigation of Volcker's Commission, see: http://iic-offp.org/documents.htm, (8 October 2010).

[124] Thus, for example in Congo; for more details see: Kofi Annan, Our Mission Remains Vital, *Wall Street Journal* 14, 22 February 2005.

[125] See: United Nations, Investing in the United Nations For a Stronger Organization Worldwide, UN Doc. A/60/692.

[126] See: http://www.un.org/reform/mgmt_reform.shtml#1 (26 September 2010).

6. Conclusion

Finding an optimal ratio of a sober pragmatism and passionate idealism is an essential ingredient of every successful reform. The improvement of the UN action should be achieved not only through the institutional reform, but also as a consequence of changed attitudes, policies and behavioural patterns of certain member states. We agree with Glennon insofar as he embraces idealism but not that one which is blind to the fact that preferences, interests and ideals of states and other international subjects do not necessarily overlap ("unshared idealism"[127]). This being so, an adequate starting point for the UN reform is an analysis of the situation stripped of all romanticism, in order to understand which of the possible alternative solutions would be acceptable for whom and to what extent, and under which circumstances they might become acceptable. In the world where the states are not always willing to respect the international legal order and its rules on the use of force, the UN should persist in a gradual process of creating preconditions for altering their attitudes and insist on the imperative respect of international law. We are neither inclined to believe that the paradigm change on the rules regulating the use of force is feasible in the UN at this moment, nor are we convinced that, even if it were feasible, that it would be desirable. We do not fully share the view expressed by Yoo and Glennon that the Panel failed to recognize and adequately assess the contemporary threats to the international peace and security;[128] we do wholeheartedly agree that its propositions are meek and conservative – and, perhaps, rightly so.

What seems viable is strengthening accountability and transparency of the Organization. We believe that it would be useful to facilitate the access to the UN documents to a wider international public, to intensify organizing of public discussions and to establish regional offices to improve regional integrations. Better relationships should be established between the UN and the regional organizations as well.

Regarding the reform of the SC, we believe that the increase in the SC membership would significantly contribute to achieving a true multilateralism, as a bigger role in formulating the relevant questions and alternative answers to global threats would be offered to some other states as well, (e.g. Brazil, Germany, India, Japan, Nigeria), which could increase the legitimacy of the SC and strengthen the UN in general. We also believe that introducing the semi-permanent membership in the SC is desirable since the re-election of an individual state would contribute to its good reputation in the international community. Becoming a matter of prestige and vanity, it could bear some potential for

[127] See: Glennon, *op.cit.*, (note 3), p. 637.

[128] See: Part two of the Report of the High-level Panel on Threats, Challenges and Change.

larger efforts on the part of a concerned state towards greater efficiency of the SC during its mandate. The establishment of the Peace-Building Commission is probably the single most successful reform so far, as an effective prevention of threats to international peace and security could indeed "save" the UN,[129] dealing with this issue in a smarter and more economical way. A radical approach to the reform or search for the institutional alternatives which would replace the UN is undoubtedly wrong, for a huge amount of capital has been invested in the Organization and "to the extent possible, humanity should profit from its investment".[130] On the other hand, any institutional alternative, even if it were viable, would likely suffer from same diseases as the UN today, or its predecessor - the League of Nations – decades ago. Weakness in the functioning of the UN stems primarily from the power relations, rivalries and diverging interests of its (most powerful) member states, which would continue to exist within whatever institutional framework. Unfortunately, it is reasonable to expect that *ad hoc* "coalitions of the willing" will sometimes step in the place of the UN in certain situations, but at the same time efforts should be made to construct the smartest possible incentives for the member states to maximally engage in a multilateral framework in order to create an international system in which the costs of unilateral action and violation of international legal rules would outweigh the benefits. In this regard, the influence of the international public opinion should not be underestimated; its *ex post facto* judgement upon the legitimacy of certain action has a creative power of setting standards for future behaviour and defining future expectations.

The UN personified by the dog from the Introduction of this paper will succeed in putting all its legs on the ground if and when it sniffs at how to convince the states to respect its law for their own benefit. Persistence in some reforms such as the reform of the UN administration could help the UN-dog to stand firmer. The world needs the UN, albeit standing on two legs. Having it, however, with all its legs on the ground would bring much more benefit to the world, while the role of international law should be to rein in that dog.

[129] See: Verhoeven, *op.cit.*, (note 1), p. 197.
[130] Glennon, *op.cit.*, (note 3), p. 613.

Bibliography:

1. Blum, Y.Z., „Proposals for UN Security Council reform", *American Journal of International Law*. 99 (2005) 3;
2. Charney, J.I., Anticipatory Humanitarian Intervention in Kosovo, *Vanderbilt Journal of Transnational Law*, 32 (1999) 5;
3. Chopra, J., Weiss, Th.G., Sovereignty Is No Longer Sacrosanct: Codifying Humanitarian Intervention, in: Ku, Ch., Diehl, P.F. (eds.), *International Law – Classic and Contemporary Readings*, Boulder, London, Lynne Rienner Publishers, 1998;
4. Crook, J.R.(ed.), „U.S. views on UN reform, Security Council expansion", American journal of international law. 99 (Oct. 2005) 4;
5. Fijalkowski, A.(ed.), *International Institutional Reform* 2005, Hague Joint Conference on Contemporary Issues of International Law
6. Franck, Th.M., „Collective security and UN reform - between the necessary and the possible", *Chicago Journal of International Law*. 6, (2006) 2;
7. Franck, Th.M., Rodley, N.S., After Bangladesh: The Law of Humanitarian Intervention by Military Force, *American Journal of International Law*, 67, (1973) 2;
8. Giegerich, Th., "A fork in the road": constitutional challenges, chances and lacunae of UN reform, *German Yearbook of International Law.* 48 (2005);
9. Glennon, M.J., „Platonism, adaptivism, and illusion in UN reform", *Chicago Journal of International Law*, 6 (2006) 2;
10. Henkin, L., International Law: Politics, Values and Functions. General Course on Public International Law, *RCADI*, vol. 216, 1989
11. Hilpold, P., "Reforming the United Nations: New Proposals in a Long-lasting Endeavour", *Netherlands International Law Review*, vol. LII, 2005.
12. Lapaš, D., *Pravo međunarodnih organizacija,* Zagreb, Narodne novine, 2008.
13. Lapaš, D., *Sankcija u međunarodnom pravu,* Zagreb, Pravni fakultet u Zagrebu, 2004;
14. Lobel, J., Ratner, M., Bypassing the Security Council: Ambiguous Authorizations to Use Force, Cease-Fires and the Iraqi Inspection Regime, *American Journal of International Law,* 93 (1999) 1;
15. McGoldrick, D., The principle of non-intervention: human rights, in: Lowe, V., Warbrick, C.(eds.), *The United Nations and the Principles of International Law – Essays in memory of Michael Akehurst,* London, New York, Routledge, 1997;
16. Ronzitti, N., „The Report of the High-Level Panel on Threats, Challenges and Change, the use of force and the reform of the United Nations", *Italian Yearbook of International Law.* 14 (2004);
17. Runjić, Lj., „Reforma Ujedinjenih naroda", *Zbornik PFZ.* 4 (2009) 59;

18. Schrijver, N. "The UN Human Rights Council: A New 'Society of the Committed' or Just Old Wine in New Bottles?", *Leiden Journal of International Law,* 20 (2007);
19. Simma, B.(ur.), *The Charter of the United Nations – A Commentary,* München, C.H. Beck (1994);
20. Simon, S.G., The Contemporary Legality of Unilateral Humanitarian Intervention, *California Western International Law Journal,* 24 (1993) 1;
21. Tolbert, D., Solomon, A., „United Nations reform and supporting the rule of law in post-conflict societies", *Harvard Human Rights Journal.* 19 (Spring 2006);
22. Verhoeven, S., „The UN High-level Panel Report and the proposed institutional reform of the UN", *International Law Forum,* 7 (2005) 2;
23. Yoo, J.C., „Force rules: UN reform and intervention", *Chicago Journal of International Law,* 6 (2006) 2;

- The Charter of the United Nations (http://www.un.org/en/documents/charter/)

http://www.un.org/reform/index.shtml

http://www.un.org/secureworld/

THE PROBLEM OF SUNKEN ITEMS AND AUTHORISED PERSONS

Aleksandra Vasilj, Ph.D.
Assistant Professor
Josip Juraj Strossmayer University of Osijek
Faculty of Law Osijek
Croatia
e-mail: avasilj@pravos.hr

Lidija Vomš
Graduate Student
Josip Juraj Strossmayer University of Osijek
Faculty of Law Osijek
Croatia
e-mail: lidija.voms@gmail.com

Abstract

The problem of sunken items is legally regulated from the begging of the navigation. For centuries sunken items were considered as abandoned things – res nullius, and each person was allowed to extract and remove them. In the middle Ages, through the institute ius naufragii each finder could pre-empt the property affected by the maritime accident or caught on the surface of the sea, at the bottom of the sea or on the seashore.

Today every maritime country has its own laws which regulate definition, extraction, removal of the sunken items and property rights on them. Primary international legal source that regulates the problem of sunken items and authorised persons is International Convention on removal of wrecks which was adopted only in 2007.

In this paper author analyses the course of legal editing of sunken items and authorised persons in Croatia and in the world with special emphasis on International Convention on removal of wrecks and its influence and compliance of its provisions with the provisions of positive law of the Republic of Croatia.

Keywords: *sunken items, sunken ships, authorised persons, Croatian Maritime Code, International Convention on removal of wrecks, removal of sunken items, wreck, removal of wreck, navigation.*

1. INTRODUCTION

Sunken items are subject of researches, stories and legends. Each sunken item has its own story, story that brought it on the bottom of the sea and left it behind. There is a fate of the people beyond every sunken item, especially behind sunken ships. People left those ships behind along with many other things. Sunken items are monuments to sailors, soldiers, traders. People discovered new territories and expanded their skills and knowledge by using them.

Divers are key people for the problem of sunken items, but their exploits are just one link in the chain. Undersea archaeologists, oceanographers, historians, restorers, chemists, biologists, radiologists, doctors, photographers, computer experts and many other experts also participate in the detection, protection and care of the sunken items. In the end comes the law which regulates many issues – who is the owner of the certain sunken item, which person is authorized to remove it, how and when; who should keep it; is it allowed to remove it and under what circumstances; should it stay on the bottom of the sea or be removed; what is the significance of that sunken item. It is interesting that Frederic Dumas is deep diving record holder, but also a lawyer and creator of the first French special regulations on scuba diving[1].

Legal doctrine often considers institute of removing sunken items like institute of rescue, but many authors successfully highlight their specifics. Removal is carried out over the wreck things, but beached or floating ships and things are being saved. Legally, there is no immediate risk of occurrence of large losses at the removal of sunken items, while at the Institute of salvage this danger generally exists. Also, general rules of civil law are mostly used for removal, while institute of salvage uses particular, maritime law[2].

Consequently, in this paper there is analysis of specifics of sunken items and problem of their removal, which is no longer separately regulated in Croatian positive law, and the relationship between Croatia and the international conventions, especially the compliance of its legislation with the provisions of the International Convention on the Removal of Wrecks in 2007. Specifically, Croatia, as a maritime country, has a special interest to follow the unification tendencies in planning rules of maritime law. In the interest of Croatia is the adoption of new international conventions and their amendments, as well as their consistent enactment of domestic law. Goals of unification of maritime law are implemented through amendments to the Croatian Maritime Code.

---

[1] Macura, Domancic : Legal regulation of professional and amateur diving in Croatia, Split, 2003., pp.2

[2] Bravar A. : Wreck removal in Croatian law and in the Nairobi International convention on removal of wrecks, original scientific paper, Proceedings of the Faculty of Law in Zagreb, 58, (1-2), pp. 147-160 (2008), pp. 148

1.1. The beginnings of regulating the problem of sunken items and authorized persons in the world

The issue of legal fate of sunken things appeared when the beginnings of navigation. The simple reason is that the first ships or boats were unequipped and unprepared for all the hardships brought by the cruise itself and storms that often befall a ship at sea. Today, in a somewhat smaller number, vessels are carrying valuable and rare items, but in the past, ships were often full of gold and other precious things that became not only the prey of pirates on the sea, but they were sometimes thrown in the deep sea in the middle of battles or storms or sinking at the bottom. That is why for centuries there was the question of salvage, ownership right to sunken items and finally removing of sunken items.

It has long been thought that the sunken objects or items lost in the shipwreck are res nullius, acquire a permanent right to own them by the person that found them, whether the power of the currents applied them to the bank or not. Roman law is set differently - sunken things were considered lost and the finder could not acquire any ownership rights by adverse possession or occupation. So, Roman law was applied rule: *Quod ex naufragio expulsum est, usucapi non potest, quoniam non est in derelicto, sed in deperdito*[3]

In the Middle Ages introduced the notion that things have sunk, and things found at sea or on shore *res nullius* and the right prey. This is the understanding was especially accepted in northern Europe where the finders occupied and appropriated such things. In such an environment is developed so-called Institute of coastal law, *ius naufragii*, which was not only unfair, but also seriously threatened the maritime trade because it was allowed to grab someone else's property, so the sailors avoided coming to the foreign port4. With the disappearance of a feudal society, it was gone and this harmful Institute is now completely incomprehensible and rejected.

1.2. The beginnings of regulating the problem of sunken items and authorized persons in Croatia

The Adriatic Sea has always been a maritime route between various civilizations. The oldest sites of sunken things come from the time of Greek supremacy in these areas. Ancient Greeks and Romans possessed colonies on the coast of Croatia, these are : Cavtat (Epidaurus), Mljet (Meleda), Korcula (Korkira), Hvar (Pharos), Vis (Issa), Split (Aspalathos / Spalatum), Solin (Salona), Trogir (Tragurium), Rogoznica (Heracleia), anchorages in the Kornati archipelago (Zirje, Lavsa, Murter), wider area of Sibenik i Zadar (Liburnia / Jadera), Pula (Pola), Roman villas on the Brijuni islands, and many other areas that were their

[3] Horvat M. : From the history of the collision, shipwreck, rescue and assistance Zagreb, 1967.., pp. 15.

[4] Bulat Pezelj V.: Maritime disasters in the Dalmatian statutory law, Collection of the Faculty of Law in Split, No. 1 / 2006, pp. 98.

temporary residence and resting place. These are all places where in ancient times lived, traded, stopped just passing through, thus leaving traces on the sea bottom, especially a lot of amphorae, which in parts or whole is a cultural good, and is forbidden to remove them as such.

However, for many decades all these riches been the subject of legal plunder, was left completely unprotected and available to anyone who could in any way get to them. Recognizing the above-mentioned ius naufragii, each finder could pre-empt discovered asset affected by maritime accident or caught on the surface of the sea, the sea bottom or on the seashore[5].

Korcula and Zadar statute mitigate the right shipwreck. Korcula Statute from 13th century, prohibits the acquisition of sunken property from the ocean floor, but is entitled to one-fourth of all that is out of the ship or from the sea and brought ashore. Zadar Statute recognizes the finder half, in the case of finding things on the surface one-third of all. These things had to be transported to the port of Zadar, and then the ship owner could enter into various contracts with finder. Mljet statute otherwise applies to the finding of the sea. It is awarded to the finder of fact half results, a half or a quarter of Mljet monastery church of St. Pancras, depending on where they were found. Contemporary Croatian maritime tradition is based on the Dubrovnik Maritime, which was third in the world with 200 ships and 5000 sailors in the 16 century[6].

1.2.1. Law on removing sunken items in 1966.

The first modern systematic regulation on removing sunken items in Croatian law is Law on removing sunken items. The first modern systematic regulation on removing sunken items at the Croatian law is the law on removing the sunken items that was published in the Official Journal of Yugoslavia in 1966[7]. This Law includes: general provisions, rules on the right and duty removal of sunken objects, rights and duties of the contractor, selling recovered items, serviced, solutions and penalty provisions. In the special laws were contained provisions that were related to cultural monuments, objects of artistic value sank in the sea, etc.

This law stipulates that the rules on removing sunken ships and other vessels, aircraft, their equipment and cargo and other items used if they are sunk in coastal waters and inland waterways of the SFRY. This has established two criteria - must be a wreck things, and they must be placed under the sovereignty of Yugoslavia. In fact sank in high seas have also applied the provisions of this law,

[5] Bulat Pezelj V., op. cit., pp. 99.

[6] Ministry of the Sea, Tourism, Transport and Infrastructure, News, 22 November 2005.

[7] Jelinic S.: Collision, salvage and remove sunken things in the Law on removing sunken items, Proceedings of the Law Faculty in Zagreb, 1973., pp. 433.

but only if they were in public ownership, owned by the Yugoslav individuals or entities, and their extraction is carried out by organization or a Yugoslav citizen. Regarding property right, it is not lost.

If it was an item that sank during the salvage or just before the beginning of salvage, the provisions of the salvage have been applied for the extraction of such items. The reason for such a provision is that in such cases there is actually salvage that included the extraction of sunken things.

1.2.2. Law on Maritime and Inland Navigation in 1991. - comparison with foreign regulations

This law covers the expression of sunken things these terms: sunken ships, boats and other vessels, aircraft, their components and the cargo on them[8]. Thus, the law mentions boats as opposed to the Law on removing the sunken things. But there is also the expression of wrecks, or extraction and removal of wrecks which are discussed in the international conventions - the Convention on Limitation of liability of owners of seagoing ships (Brussels, 1957.)[9] and the Convention on Limitation of Liability for Maritime Claims (London, 1976.)[10],[11].

Law on Maritime and Inland Navigation did not define the term wreck, but French legislation provides a definition. Wreck (French *Epave*) is a ship that is unable to sail and abandoned. They differ in the wreck that does not float and that floats. Buoyant wreck is the same as a boat in salvage and assistance at sea.

German law gave a different solution. According to it ship is not a wreck if it doesn't have one of the important indicators temporary. Ship which is temporary sunken can be removed and repaired with the essential purpose of the ship owner. But, if stranded or sunken ship can't be removed or repaired, the ship becomes a wreck regardless of the fact whether is it or is it not erased from the register of ships. According to the German commercial Code (HGB), a ship that is unable to sail can be unable to repair (*reparaturufaehig*), or uneconomic to repair (*reparaturuwurdig*).

English law uses the term wreck for a ship which was so damaged that it no longer seaworthy. The term wreck refers to the things that were thrown with such a ship (Jetsam), so they sank (lagan), float (Flotsam), or were thrown to the shore (Derelict). These definitions are in Merchant Shipping Act (1894.) and Merchant Shipping Act (1925.).

Therefore, the conclusion is that the wreck is the rest of the vessel which has lost the possibility of sailing, but not always float, and that adrift at sea, lying on

[8] Art. 783rd Law on Maritime and Inland Navigation

[9] Hereinafter: Convention of 1957.

[10] Hereinafter: Convention of 1976.

[11] Luksic B.: Removing sunken vessels (Legal issues), the Maritime collection, no. 28, 1990. , Pp. 434.

the seabed or is stranded on the coast [12]. From this it follows that the expressions sunken, stranded or abandoned ship in the literature are often equated with the expression of a wreck.

Law on Maritime and Inland Navigation applies to sunken ships and boats, although the term removal would be much better. Convention of 1957. equated terms rising, removal and destruction of stranded, sunken or abandoned ship. Convention of 1976. added to those terms the term rendering harmless, but this convention did not make a clear distinction between the person acting in the salvage and the person extracting and removing the ship. Law on Maritime and Inland Navigation had such distinction.

According to the Law on Maritime and Inland Navigation, the domestic or foreign authorized person can take out the ship. If the person is unknown or does not intend to remove the sunken ship, or without good reason terminate or abandon already begun taking, then the authority responsible for safety of navigation could order the execution of removing to authorized Yugoslav company. Same authority could order to remove the sunken ship, stranded ship which ship represents a danger to navigation or a threat to exploit the wealth of the coastal sea and internal waters, which implies a risk of pollution of sea and shore[13].

The Law on Maritime and Inland Navigation did not limit compensation to the contractor for ordered removing the sunken items. But contractor is held accountable for the damage from their work unless he proves that the damage could not be avoided with due care. This provision also didn't exist in the Law on removing the sunken things in 1966. If the contractor took out the thing without the permission of the competent authority or contrary to the will of the authorized person, there is liability without fault on the grounds that the blame fell on the authorized and responsible person. The use of mandatory standards if the lack of port authority, or consent of an authorized person was contrary to law or morality, to the extraction rules are applied to management without a warrant, and so the contractor was entitled to reimbursement of all necessary and useful expenses, and could seek compensation for the damage and when he did not achieve the expected result. In addition, the contractor could require compensation for the effort, of course, adequate effort, which was filed for damages or taking of property.

Convention of 1976. used the term savior for a contractor without distinction between contract and tort removal or extraction and wetter those actions are being taken in the action of salvage. The contractor could perform the work under the command of the competent authority for safety of navigation and thus

[12] Ibid. pp. 435.

[13] Art. 785th and Art 786th Law on Maritime and Inland Navigation

limit its liability if he wasn't to blame for the incurred damage. Damage could limit the establishment of a fund equivalent to 1 500 tones (similar fund also mentions the Croatian Maritime Code in 2004. when talking about the rescue at sea in the article 819th). However, Convention of 1976. does not apply to cases of claims for damage by oil pollution and oil products. They were covered by the Convention on Civil Liability for pollution by oil and oil products in 1969. which established the objective responsibility of the ship owner for such damage, but not the responsibility of rescuers and the contractor so, in this field apply the Convention of 1976.

According to the Law on Maritime and Inland Navigation, the ship owner was required to set and maintain the lights and signs to mark the ship or the wreck, which constitute an obstacle on the navigate line. If he would not have done it, an organization that cares for the maintenance and waterway marking would make it for his burden[14].

The UK is already in the 19th Century set the rules in its maritime law under which relieved the ship owner from responsibility for these actions as soon as he notices the territorial authority responsible for the ship or the wreck that lies and asks him to mark it. This is because it was thought that the possession and control, and therefore the responsibility of the ship or wreck, is passed on to harbor master's office. If the transition of property, control and ultimately the responsibility of the wreck could not be proved, the ship owner was liable to a third party for damages resulting from the contact with the wreck. However, late 20th century, considered that it is not sufficient to notice the Port Authority, but that the ship owner or the owner of the wreck are released from liability only when he has taken measures to mark the wreck.

However, the transition of property and control of the wreck is not the same as abandonment of ownership, of course, in systems where there is the Institute of abandonment of ownership. In these systems, the crew is not authorized to perform abandon the ship because no one can leave the thing on which there is no right of ownership[15].

According to the Law on Maritime and Inland Navigation, loss of property on the sunken ship is solved by the ship becomes public ownership if that ship is not removed within ten years after sinking[16]. Extraction of the ship or the wreck could take an authorized person or a contractor under a contract with her. The contractor was liable for damages where the fault assumed if it was not agreed otherwise.

---

[14] Art. 12th. Law on Maritime and Inland Navigation

[15] Luksic, op. cit., pp. 438.

[16] Art. 790th Law on Maritime and Inland Navigation

Convention of 1957. offered the possibility of the ship owner to limit its liability for damage caused during the extraction, removal or destruction of sunk, stranded or abandoned ships or wrecks of any obligation arising from these actions, and the ship owner could claim the expenses incidental to the compensation in respect of the material and physical damage that occurred.

Convention of 1976. allowed the limitation of liability for bodily and property damage that incurred directly in removing, removal, destruction or making harmless sunk, stranded or abandoned ship or the wreck. The request for such damage could not ask a third person whose boat suffered damage from such ship or wreck. request could not be found even for the collision which occurred due to extraction, removal or destruction of the ship or the wreck. However, the Convention of 1976. has introduced a novelty. Specifically, it allowed third parties to act to prevent or minimize damage after the sinking of the vessel. However, the ship owner couldn't limit the liability of the person with whom he entered into a contract which is aimed at extracting, removing or destroying the ship or wreck, or a person with whom he contracted to prevent or limit damage.

Convention of 1957. required that the ship owner loses the right to limit liability if the claims for which there is his fault. This also requires Law on Maritime and Inland Navigation - the ship owner loses his right if he is the person to blame for the sinking or grounding. This applies to the case when his boat commander who was not qualified and is person to blame for the sinking or grounding, and also the case when the vessel is unable to sail because the boat has no prescribed nautical charts. However, the ship owner was personally to blame and when entrusted to a third party some stationary, portable and liabilities and therefore the transfer of damaging or sinking or stranding of the ship. However, sinking or grounding because of guilt properly qualified crew members do not entail personal liability of the ship owner for the anticipated legal claims[17].

Italian Law on maritime navigation in 1980. in such cases takes into account only *culpa lata*. Former Yugoslav law considered personal guilt and ordinary guilt within the ranks of personal guilt and blame ordinary. Common law countries use the term *negligence* which may have three meanings - state of mind that is generally contrary to the intent or generally negligent conduct or violation of duties specifically prescribed investment of attention. English law allows the use of only the first two degrees of negligence, but the English case law uses the third degree.

According to the Convention of 1957. burden of proof in proceedings for limitation of liability is the one who wants to limit their liability. On this matter

[17] Luksic, op. cit., pp. 440.

the Convention of 1976. is stricter - it requires that the burden of proof is on anyone who challenges the right of the ship owner to limit its liability.

Convention of 1976. defines intent as the subjective intent to commit harm, then completely abandons the notion of objective guilt, because subjective intent implies that the damage was caused by a personal act or omission that it occurs, or recklessly and with knowledge that it is evident that such claims arise. In this, Convention of 1976. relies on the provisions of the Warsaw Convention on carriage of goods in 1929. and the Hague - Visby rules in 1968. But, the problem is a complex understanding of the English expression recklessly. In the Croatian language, this expression is translated as *bezobzirno*, but in this convention, "it means a complete disregard for the consequences of the act or omission, and points to a particular degree of guilt, which is between the lower and higher degree of willful misconduct "18.

This question arises in cases where the ship owner refuses to remove, move or destroy a sunken or stranded ship, which presents an obstacle to navigation. Jurisprudence around the world gives different answers to that question.

Courts in the U.S. have two opposing norms regarding this issue, while the English courts considered that the ship owner can not limit its liability to pay compensation for the extraction or removal of the ship or the wreck made on the basis of orders of administrative bodies, regardless of his personal guilt in committing the sinking or stranding. English law distinguishes liability of the ship owner for damages and its liability for payment of debt incurred because of extraction or removal. If he is not personally to blame for the sinking or stranding of the ship or the wreck, the ship owner may limit this first responsibility, but others may not, regardless of his guilt. That is why the Convention of 1976. equalizes these two responsibilities, thus permitting the limitation of liability and the cost of extracting or removing a sunken ship or the wreck.

1.2.3. Croatian Maritime Code in 1994.[19]

Institute of removing sunken items had their own regulation in the Law on Maritime and Inland Navigation in 1991. The Maritime Code came into force in 1994. It locates sunken items in the ninth section, Chapter III. and devotes only 12 articles to those items.

Maritime Code are applicable to the extraction of ships, boats, other vessels, aircraft or their components and goods and other items (hereinafter: the sunken items) sunk in the internal waters and territorial sea of Croatia, and the stranded ships and boats, if it's not about their salvage [20]

[18] Luksic, op. cit., pp. 441.
[19] OG, no. 17/94
[20] Art. 801st, Maritime Code, no. 17/94

Art. 802. has determined that the extraction of things during the salvage of sunken or while it lasted danger that the ship was located just before the rescue started, the provisions of this Act relating to the rescue.

Under this Act, an authorized person for the extraction of sunken items is domestic or foreign person who owns property or has the right to dispose of this matter. Mining is permitted under license Port authority which is issued at the request of an authorized person. Approval for the extraction of the things that sunk and had military significance could be issued only with the approval of the Ministry of Defense, and the authorization for the extraction of the things that have or may be presumed to have cultural significance could be issued by the Institute for the Protection of Cultural Monuments of the Croatian Ministry of Culture and Education[21].

If the sunken item lies in such a place that represents a hazard to navigation, or the exploitation of natural resources, marine waters and territorial sea and pollutes or may pollute the marine environment, the competent territorial authority could order the authorized person to remove sunken thing within a reasonable time. Otherwise, the Authority was able to remove it at the expense and risk of an authorized person through the Croatian legal or natural person who is a business activity.

If the sunken item represented an immediate threat or impediment to navigation, the Maritime Code has been determined that the Authority may, without making the previous decision, directly order that the Croatian legal or natural person, at the expense and risk of an authorized person, take out or remove the sunken item. The decision ordering the extraction, removal or destruction of sunken items owned by the foreign person submits to the Ministry of Foreign Affairs.

If the sunken item represented an immediate disturbance or danger to navigation, and territorially competent Port Authority didn't know which person is authorized for the extraction of sunken objects or when authorized person is known but she does not intend to remove the sunken thing, or when she terminated it without just cause or leaves began quarrying, removing sunken things could take a Croatian legal or natural person who is a business activity.

The Code considered that known authorized person does not intend to take removal on sunken item when he terminated or abandoned mining if within 90 days from the day when the item sank, he didn't submit a statement that he intends to remove the sunken thing or if within 90 days of obtaining a permit office does not start a removal, or if he didn't continue to work on removing

[21] Art. 803rd, Maritime Code, no. 17/94

the sunken things that was interrupted or abandoned without reasonable grounds[22].

The owner who didn't remove his sunken item within ten years from the date when the sinking was, lost the right to property, and that thing would become owned by the Republic of Croatia. Below we will find significant shortening of this period in other provisions.

If it couldn't be determine when the thing sank, it was anticipated that a ship, other vessel, aircraft or their parts, cargo and other things in them sank the next day after getting the latest news about the ship, vessel or aircraft, and other items on the day when a place where the item was sunk has been known.

In Art. 811. The Code provides that the contractor is entitled to compensation for removing sunken items, except if the extraction has taken against the express prohibition of the authorized person. If the parties have otherwise agreed, the fee for removing sunken items may not exceed the sum of the value of items. This restriction does not apply to compensation for extraction, the removal or destruction of sunken things that was done by order of the competent authority, and for things that have or can be assumed to have the status of cultural monuments.

Contractor, unless otherwise agreed, has a lien on sunken things to ensure compensation for removing and storing things, so he can keep it until an authorized person does not settle the claim, except for items that are found and have the status of cultural monuments.

Statute of limitations for claims compensation for the extraction, removal or destruction of sunken items was three years from the date when extracting, removing or destroying sunken things were done.

In Law on Maritime and Inland Navigation in 1977. there was no possibility of making a direct lawsuit against the insurer of the injured, but the Maritime Code in 1994. determined that the injured party is entitled to a direct action in all situations where there was a cover Insured liability by the insurer, but not more than the amount the Insurer obligations[23].

1.2.4. Law on Inland Waterways in 1998[24]

This law says about removing the sunken things in Title III. and, in contrast to the Maritime Code of 1994., dedicates to this subject a lot more space. It was

[22] Art. 805th, Maritime Code, no. 17/94

[23] Book reviews, Grabovac I., Recent Croatian Maritime Law and the Maritime Code, PPP, y. 45 (2006). 160, pp. 187-191

[24] OG, no. 19/98

enacted in 1998. and was in force until the enactment of the law on Navigation and Inland Ports in 2007.

The law applied to the extraction or the destruction of ships, boats, floating structures, aircraft, parts and goods and other sunken or stranded items in Croatian inland waters, only if it is not about to rescue them. The same was determined in the Maritime Code in 1994.

According to this law to remove the sunken thing could domestic or foreign entity that owns the property or has the right to dispose of the thing, or an authorized person only with the approval of the competent authority. The authorized person had to make the request for the extraction which must contain: the name of the sunken thing, where she is, resources needed for extracting, proof of ownership and time for commencement and completion of its extraction[25]. When the authority approved by quarrying, it also determines the conditions of safety and time start and completion, and when there is a change of deadlines, an authorized person had to inform the authorities without delay. Thus in the Maritime Code of 1994.

If it is a fact that has military significance, permission for its extraction gave the Ministry of Defense, and for a sunken items of cultural significance Ministry of Culture.

As in the Regulation which will be discussed in more detail below, Law on Inland Waterways stressed that the decision of the competent authorities can order the authorized person removing the sunken things that pose a danger to navigation, or the exploitation of natural resources in the inland waters of Croatia. If the person authorized to do so, the authorities will determine the legal or natural person engaged in this activity to do it instead of the authorized person. When the sunken thing represents the source of imminent danger or interference to navigation, authorities determined extraction to a person who has to work and without solutions.

The owner who does not pull his sunken thing within five years from the date when it sank forfeit property, and wrecked the thing becomes the property of Republic of Croatia. In the Law on Inland Waterways this period has been shortened.

Law on Amendments to the Law on Inland Waterways[26] established Agency of the Inland Waterways[27] with headquarters in Zagreb. The task of the Agency's is a construction of waterways as an investor under special regulations, performance of technical maintenance and marking of waterways and aids to navigation, in

[25] Art. 188. , Law on Inland Waters, OG, no. 19/98
[26] OG, no. 151/03
[27] Hereinafter : The Agency

order to manage waterways so as to provide buoyancy, safety and navigation management[28]. Headquarters of The Agency is in Vukovar[29] since 2006.

SUNKEN ITEMS AND AUTHORISED PERSONS IN CROATIA

2.1. Croatian Maritime Code [30]

New Croatian Maritime Code[31] came into force on 29 December 2004. Croatian Maritime Code of 1994. ceased to be valid. CMC was amended 2007th and 2008. The *ratio* of occurrence of new legislative acts has given rise to many reasons, but most important is the need for harmonization of the Croatian maritime law with the international conventions adopted before and after the 1994[32].

CMC refers to the basics of navigation, provides definitions of the shipmaster, ship, marine belt of Croatian and many other determinants that are indirectly related to the sunken items and authorized persons. Part Eight, Chapter II. - Salvage refers to the extraction of sunken objects as well as the rescue of persons, ships, items from these ships and any other property that is found in distress at sea. Therefore, the institute of salvage and institute of removal on sunken items are not separately regulated any longer[33]. Specifically, CMC has been fully accepted the decision of the International Convention on Salvage in 1989., which was ratified by the Republic of Croatia. Therefore CMC deleted all provisions for removing the sunken things as mentioned Convention regulates the extraction of sunken items as a way of saving[34].

In addition to the provisions of the Maritime Code and the Regulation on the safety of navigation in ports and harbors on inland waters which will be discussed below, requires that if the owner or property from the first item does not comply with the provisions of the master, remove or salvage will be carried out at the risk and expense of the owner of the Port Authority through legal or natural persons engaged in this activity.

Against the provisions of the relevant port authorities are possible appeal within 15 days of receipt of the relevant solutions. These complaints do not stay the execution of office.

---

[28] Art. 19th Paragraph 3 b Law on Inland Waterways

[29] Art. 1st Law on Amendments to the Law on Inland Waterways, Official Gazette no. 138/06

[30] OG, no. 181/04, 76/07, 146/08

[31] Hereinafter : CMC

[32] Bolanca D., Amizic P. : The new maritime code of Republic of Croatia and question of unification of maritime law, Proceedings of the Law Faculty in Split, y. 44, 1/2007, pp. 41. -52., pp. 52.

[33] Bravar A. : Wreck removal in Croatian law and in the Nairobi International convention on removal of wrecks, original scientific paper, Proceedings of the Faculty of Law in Zagreb, 58, (1-2), pp. 147-160 (2008), pp. 148.

[34] Bulum

Art.787. talks about removing items of cultural significance. In fact, things which are on the bottom of the sea, and it is assumed that they are cultural property, must be removed, but only with the approval of the Minister of Culture.Against a decision approved by the Minister, but also against the decision to approve removing cultural property can not be appealed, but only an administrative tribunal.

From the Maritime Code is still possible to derive the definition of ship, ready to sail or boat that is not an object of this theme. The ship is seaworthy if it meets the strict conditions laid down in this law that talk about the equipment of the ship, the number and type of crew and many other criteria that are used to meet the sunken ships. Therefore, the Maritime Code says very little about the wreck things and authorized persons. But the problem exists in the fact that this law, contrary to the Croatian tradition of Croatian maritime law, led Croatia to the lack of institutes removing sunken things in their own legislation. Republic of Croatia to the justification of such regulations has to comply with the meaning of the Institute of removing sunken things in international law, primarily in the International Convention on the Elimination of wrecks from 2007.

However, other Croatian regulations talk more about the problem of sunken things and authorized persons. These are: Law on the navigation and inland waters, the Regulation on the safety of navigation in harbors and inland waters and Ordinance of the Ministry of Culture.

2.2. Law on navigation and inland ports[35]

Upon entry into force of this Act completely cease to apply the Law of navigation in inland waters.

So, today this law governs the inland waters of the Croatian Republic, the safety of inland waters, legal status, management of water transport and inland water, material and legal relations in respect of vessels, vessel registration procedures, transportation and contracting of transport, accidents of navigation, structure and operation of port authorities and monitoring and other matters relating to navigation and inland ports[36]. Maritime Code applies to matters not regulated by this Act.

"Inland waters are rivers, canals and lakes than river basin in the Adriatic part of the river which carries out shipping activities" (Article 4 paragraph 1 of the Act). Also stands in the Law on Inland Waterways.

Removing sunken goods is regulated in Chapter II. of this Act. While the Law on Inland Waterways applied to the extraction or the destruction of ships,

[35] OG, no. 109/07, 132/07

[36] Art. 1st Law on Navigation and Inland Ports

boats, floating structures, aircraft, parts and goods and other items of sunken or stranded in the inland waters of Croatian and only if it is not about their rescue, this law is applied to the "extraction or destruction (hereinafter referred to as extraction) vessels, aircraft, parts and goods and other items of sunken or stranded in the internal waters and ports of Croatian (hereinafter referred to as sunk stuff), if not their rescue (193rd article of the Act). Thus, innovation is guiding the vessel, not ships and boats.

Under this Act, sunken thing can be removed by a person who owns the item on the approval of the competent port authorities, while the Law on removing sunken items in 1966. and Law on Inland Waterways were allowing extraction of sunken items to authorized persons, or any domestic or foreign person that owns the property or has the right to dispose of the sunken item.

Sunken thing can be taken out with the approval of the competent office. The request for approval for removing sunken items must state the name of the sunken item, where it lies, way of extracting and resources needed for extracting, proof of ownership and time for the start and finish work on its extraction. Harbor Master's approval sets in nautical and technical requirements and deadline for the completion of works.

Approval for the extraction of the things that was sunk by the military uses, port authority may be granted only with prior approval of the ministry responsible for defense affairs, and the authorization for the extraction of the things that have or can be assumed to have the characteristics of cultural property provides port authorities with the consent of the ministry responsible for cultural affairs.

Owner shall, without delay, notify the harbor master's office which issued the approval in the beginning, termination, continuation or abandonment of work on removing the sunken items[37].

Art. 195. Law speaks of sunken things that constitute or may constitute a hazard to navigation, or the resources water resources, pollute, or may pollute the environment. For such things sunk local competent port authority issued a decision ordering the owner to be removed within a reasonable time. If the owner of the deaf that decision, port authority issues a decision ordering the Agency of the Inland Waterways removing sunken items at the expense and risk of the owner. Agency of the Inland Waterways was established by the Law on Inland Waterways in 1998. It has continued to work as a public institution called the Agency for waterways.

If the thing sank a direct threat or impediment to navigation, port authority and the owner of the solution without the Agency requires extracting sunken

[37] Art. 194. c. 2nd to 7th Law on Navigation and Inland Ports

things.Previous Law required the extraction to a particular legal or a natural person who engages in this activity.

If the owner of the sunken things that represent a direct threat or impediment to navigation is unknown or is found to be no intention to remove the sunken thing or when terminated without just cause or leave commenced mining, quarrying sank things also entrusts the Agency. It is believed that the owner does not intend to take the extracting sunken things, that is interrupted or abandoned mining if within 15 days from the date when the thing went down is not a declaration that it intends to remove the sunken thing or if within 15 days of obtaining the approval does not start extraction, or if you do not continue to work on removing the sunken things that broke or left without justifiable reasons.

The owner who does not pull sunken matter within two years from the date when it sank, losing the right to property, and wrecked the thing becomes the property of Croatian[38]. The previous law has determined a period of five years.

If it can't be determined when the thing sank, it is presumed that a vessel, aircraft or their parts, cargo and other things contained in them sank the next day, after receiving the latest news on the vessel or aircraft, and other items on the day a place where the item was sunk is found.

The owner provides the costs of removing the sunken things. In case the owner of the sunken things is unknown, means for extracting sunken things and costs of its further storage are provided by the state budget.

The contractor who performs the extraction of sunken items on the basis of decision of the competent port authority or under contract with the owner of the sunken fact, if this contract is not agreed otherwise, is liable for damages caused by their work if he can't prove that the damage could not have avoided even with due care. The Contractor shall be entitled to compensation for removing sunken items, except if the extraction was taken against the express prohibition of the authorized person. The fee for removing the sunken things can not be greater than the value of items taken. Contractor, unless otherwise agreed, has a lien on removed sunken things in order to ensure compensation for removing and storing things, and he can keep those things until an authorized person does not settle the claim to it, except for items that are found to have the characteristics of cultural goods. Claims for compensation for removing sunken items expire three years from the date when he done extracting on sunken things.

[38] Art. 198. Paragraph 1 Law on Navigation and Inland Ports

2.3. Regulation on the safety of navigation in ports and harbors in inland waters[39],[40]

This Regulation is made under the Law on navigation in inland waterways, but remained in effect after its decommissioning power. Therefore, it is still in force on the basis of the Law on navigation and inland waters.

This regulation stipulates conditions of safety in ports and harbors inland waters. 21st Article of the Regulation relates on the stranded, useless and sunken boats. Specifically, sank things must reside in the port only if it's approved by a legal or natural person who manages the por. Also, approval of authority is necessary.

If sunken things that are in port pose a risk of pollution or nuisance for boating, ship operator or the owner of the vessel and sank things have a duty to move the sunken vessel or thing from the port to a place designated by the authority. If these people disregarding such a request from an authority, then the authority orders to an individual or company that manages the port that the vessel, or sunken thing move from the port to the place it determines. This will be done at the expense and risk of ship operator and ship owner of the sunken thing.

If stranded, useless or sunk vessel is in port without permission, or if it's not removed from the port, legal or natural person shall be punished by a fine of HRK 2,000.00 to 10,000.00 for a violation of inland navigation.

2.4. Ordinance of the Croatian Ministry of Culture[41]

Full title of this ordinance is Ordinance on the procedure and manner of issuing permits for underwater activities in internal waters and territorial sea of Croatian protected as a cultural asset.

It is brought on the basis of the Law on the Protection and Preservation of Cultural Heritage (Official Gazette 69/99) in 2003.

Under the underwater activities are thought to dive. This regulation prohibits an individual diving in certain protected areas, except of special permission for diving. It also provides a five-year program of diving in these areas.

Therefore, the program established a protected zone on the proposal of the Board for the Protection of Cultural Heritage, and the procedure for issuing permits, the height of the minimum annual fee and special conditions and obligations of the holder of the permit. The permit may be issued by the competent Conservation Department with prior approval of the Department

[39] OG, no. 88/00
[40] Hereinafter: Regulation
[41] OG, no. 22/09

of Protection of Archaeological Heritage Management of Cultural Heritage of the Ministry of Culture. This permission is given for exceptional performance of promotional, review, memorial or educational diving activities. Diving clubs and students in the vocational education in schools can get it to view the underwater world, create sketches, explore the underwater world, plant and animal species in it, and therefore in accordance with the authorization document can be explored new sunken items.

The permit is issued pursuant to the tender invited by Ministry of Culture. Right to apply for the competition have all legal entities that are under certain assumptions engaged in underwater activities or in diving have a right to apply for the competition. The competition announces in the Official Gazette.

Tendering executes an expert committee appointed by the Minister of Culture at the proposal of the Board for the Protection of Cultural Heritage. Committee has 5 members. They are responsible for considering applications submitted to a contest, proposing to the competent department of Conservation Department for the Protection of Cultural Heritage of the Ministry of Culture and the issuance of the permit. The advantage for a permit are legal persons that sign deals with the larger amount of money for an annual fee, and its employees are local residents actively involved in protecting cultural heritage and closer to the zone for which is the required permission.

Permission is valid for a period of 5 years and contains information about the holder of the permit, requirements, time limits, the zone for which the permit is issued and information about diving and other information provided in this By-law.

The holder of the permit can't transfer rights obligations under the permit to another legal person.

Compensation for use of rights and obligations under the permit should be paid to the bank account of the Ministry of Culture, for the first year of use within 8 days of getting permission, and for each subsequent year until 15th January. Those funds are used for protection of underwater cultural heritage.

As for the wreck, the ordinance prohibits the binding of the wreck or parts of wrecks (aka wreck diving) in all protected areas. When diving on the wreck (the wreck diving) at the same time can dive more than two groups reported only by the holder of the permit (Article 9.By-law).

Ministry of Culture, the authorized officials of Port Authorities and Coast Guard surveillance diving into protected areas.

Ministry of Culture may temporarily or permanently revoke the permission if the holder of the permit or diving, acts contrary to the permit or in contravention

of the regulations on the protection and preservation of cultural property. In case of withdrawal of the permit, holder has no right to refund the annual fee.

2.5. Agreement between UNESCO and the Croatian Government on the establishment of the International Centre for Underwater Archaeology in Zadar[42]

The decision to establish the Centre was based on the fact that Croatia was among the first countries to ratify the UNESCO's Convention on the Protection of the Underwater Cultural Heritage from 2001. That was the reason for UNESCO to accept the Croatian initiative to proclaim the Centre in Zadar as a regional centre (category 2) under the auspices of UNESCO.

This Centre was opened in September 2007. as an organizational unit of the Croatian Restoration Institute, the institution that was founded by the Croatian Government. The Centre is legally autonomous and under the auspices of UNESCO since 2009.[43].

The main task of the Center is conducting training in research, restoration and preservation of underwater cultural heritage, expanding the application of the UNESCO Convention on the Removal of Wrecks, to develop methods of research, knowledge exchange in the international field, especially in the countries of Southeast Europe and the Mediterranean.

Center operates as a public institution of interest for the Republic of Croatia on the basis of the Regulation on the establishment of the International Centre for Underwater Archaeology in Zadar[44]. Founding rights and obligations achieve the Ministry of Culture on behalf of Republic of Croatia[45]. Center is managed by the Director who is appointed for a term of 4 years. The Expert Council and professional services participate in the work. UNESCO's commitment is to provide scientific and technical advice in specialized areas of the Centre and to link the Centre with programs carried out in which the participation of the Centre is considered as necessary[46]. Government has given its agreement to fully assume the costs of operation and maintenance of the Centre during the period from 2008th to 2014th, including administrative and scientific personnel required to perform his duties and shall annually examine the use of these funds, to provide funds for the employment of at least four Croatian experts, to provide annual state budget, through the Ministry of Culture, at least $ 918,000 for the Centre, of which: $ 228,000 for human resources, $ 177,000 for management and

[42] Hereinafter : Centre
[43] Promo flyer of the International centre for underwater archaeology in Zadar – 2009.
[44] OG, no. 33/08
[45] Art. 1 Regulation
[46] Art. 12th Regulation

maintenance, $ 513,000 for the programs of underwater archeology, including research, restoration and educational activities; take a share of 30% of the total cost of each international project undertaken by the Centre while the remaining part is covered by the project partners[47].

The Centre is legally separate from UNESCO. UNESCO may oversee the work of the Centre, while the Centre may emphasize its association with UNESCO.

2.6. Other regulations

On the issue of sunken things in Croatia refer to: the Law on the Protection and Preservation of Cultural Heritage (OG, no. 69/99, 151/03, 157/03 Erratum, 87/09), Law on the Restoration of endangered architectural heritage of Dubrovnik (OG, no. 21/86, 26/93, 33/89, 128/99), then the regulations of which a few are : Ordinance on the pass protection inspector of cultural property and the form and manner of keeping records of inspections carried out (OG, no. 129 / 99), Regulation on conditions for natural and legal persons to obtain permission to perform the Protection and Preservation of Cultural Heritage (OG, no. 74/03, 44/10), Rules of Procedure and manner of issuing permits for underwater activities in internal waters and territorial sea of Croatian protected as cultural property (OG, no. 22/09), Regulations on the archaeological excavations (OG, No. 102/10) and Regulations on the Register of Cultural Property Croatian (OG, no. 37/01, 4/08).

As far as international legal norms, the most important are : Law on Ratification of the Convention on the Protection of Underwater Cultural Heritage (OG, International Treaties, no. 10/04), the Convention on the Protection of Cultural Property in the Event of Armed Conflict and the Protocol relating to the prohibition of export of cultural goods from the occupied territories (OG, International Treaties, br.12/93), Council of Europe Convention on the Protection of the Architectural Heritage of Europe (OG, International Treaties, no. 6/ 94), Law on the UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects, signed in Rome on 24th June 1995 (OG, International Treaties, no. 5/00, 6/02), the Law on ratification of the European Convention for the Protection of the Archaeological Heritage (Revised) in 1992. and it was done at Valetta 16th January 1992. (OG, International Treaties, no. 4/04 and 9/04 release), the Law on Ratification of the Convention for the Safeguarding of the Intangible Cultural Heritage (OG, International Treaties no. 5/05, 5/07), UNESCO Convention on measures of Prohibiting and Preventing the Illicit Import, Export and Transfer of ownership of cultural property(OG, International Treaties, br.12/93), Regulation on publication of the Agreement

[47] Art. 13th Regulation

between the Croatian Government and the Government of the United States on the protection and preservation of certain cultural goods (OG, International Treaties, no. 9/06, 2/07), the Law on Ratification of the Framework Convention on the Value of Cultural Heritage for Society (OG, International Treaties, no. 5/07) and Regulation on publication of the Agreement between UNESCO and the Croatian Government on the establishment of the Regional Centre for Underwater Archaeology in Zadar Croatia, as a category 2 Centre under the auspices of UNESCO (OG, no. 1/09).

3. WRECK OF THE ADRIATIC SEA

As noted in the introduction, in the Adriatic Sea is about 15 000 sunken things - boats, ships, aircraft, submarines, amphorae, torpedo boats, cruisers ... Apparently, no one in the Republic of Croatia has a full list, not even the Croatian Register of Shipping, while the company "Brodospas" had such a list but it was lost. However, many unofficial lists are available to many diving centers and tourist offices across the Adriatic coast. Thanks to them, many wreck are being discovered and the more or less available to everyone. The Ministry of Culture provides them a protection by declaration of restricted areas for diving. Croatia is the fourth country in Europe for a number of underwater archaeological finds[48],[49].

3.1. Istria

Around Istria, the sea is shallow, with less clarity and visibility. But, it's full of the wreck, because this area has always been extremely busy. The reasons are the important strategic position, proximity of Pula and nearness of Italy. In this region was the intersecting route from the Mediterranean to Central Europe, and also the old Greek sea lanes to the north of Italy from ancient times. All of this has resulted with exceptionally rich sites of sunken items from the past.

Some of the wrecks in this area are : Baron Gautsch–one of the most beautiful wrecks in Adriatic sea, most promoted, used to be a passenger steamer; Coriolanus - warship of the British Royal Navy's Shakespeare class, today it's under protection of Ministry of Culture; Flamingo - torpedo boat of Austro-Hungarian navy, it was sunk in World War I; U-81 - German Navy submarine, and Hans Schmidt - cargo ship.

[48] Klisovic J., Tourists interested in an organized tour of the deep sea, Journal, 31 March 2010th, pp. 52nd-53rd

[49] Kraljic T., Adriatic Sea the richest in the world by wrecks!, Brodaricazadarmastrovic.net, 13 April 2008.

3.2. Kvarner

Band around the most northern islands in the Adriatic is rich in underwater reefs and walls, while the Cres and Losinj underwater is the most attractive because of its exceptional clarity of the sea to many divers.

In the Velebit channel best known wrecks are German and Italian warships, which acted as escorts at sea in WWII. Those are torpedo boats and corvettes damaged by British torpedo boats. The wreck is visited only by experienced divers.

The most famous shipwrecks in this area are: Lina - Italian merchant ship from the early 20 century; TA 36 (Stella Polare) - torpedo destroyer in World War II; Tihany - cargo ship of the Austro-Hungarian Navy; Vis - a British cargo ship, also from the WWII. and Peltatis - Greek cargo ship that didn't sink in the war, but in bad weather 1968th

3.3. Sibenik

Sibenik submarine is quite unexplored, because in the former Yugoslavia in this area was prohibited due to the diving because of activities of the JNA. However, here is found a few exceptional wrecks also. These are: Francesca de Rimini - quite well-preserved iron ship of the Second World War, Merano - Italian cargo ship carrying coal in the Second World War, a small unnamed steamer, sank torpedo probably lost in military exercises of Yugoslavian Army, the sunken hulk. Almost all of these wrecks can be found along the islands Velika smokvica and Mala smokvica.

3.4. Split

Ciovo, the southern coast of Solta and Brac, Hvar and Vis are the most exploited islands of the large islands of Central Dalmatia. This is also the course of many underwater photo and video-safari. Here are, among others, the following wrecks: Szent Istvan - large warship, protected as a cultural monument; Vassilios T - Greek cargo ship which sank in a storm; Ursus - tug sunk in the Second World War, Teti - cargo ship; Brioni - passenger-cargo steamer.

3.5. Dubrovnik

The area around Dubrovnik and Cavtat, Peljesac, Korcula, Lastovo and Mljet is the most southern diving area in Croatia. The sea is extremely clean there, no great depth, but very rich in fish. Mljet and Lastovo are protected zone by the Ministry of Culture, so they have a lot of unexplored seabed. From this area the most popular are the following wrecks: S-57 - German torpedo boat which sunk in World War II, Vega and Dora - the German ships who transported weapons and medical supplies in World War II.; Boka - German landing craft,

and amphorae and pithos (ancient containers, wheat) that are in the area of Cavtat, which is under the protection of the Ministry of Culture, and together form the underwater museum at a depth 25-32 meters. This is a unique place in the world in which lies even 1 600 amphorae. They come from an ancient ship that sank in the fourth century BC. With amphorae there are large ceramic pots (pouring) that were built into ships in ancient times. The vessels are at a depth of 30 feet and date from the first century BC. There is a small warship of the 18th century, with which there are found the remains of 6 guns, 3 large anchors and metal remains of marine equipment.

4. INTERNATIONAL REGULATIONS ON THE SUNKEN ITEMS AND AUTHORISED PERSONS

4.1. Comité Maritime International (CMI)

The CMI, which was formally established in 1897, is the oldest international organization in the maritime field. CMI's headquarters is in Antwerp in Belgium. It has 56 member states including the Republic of Croatia. CMI is an international non-governmental organization. The founding act of CMI, a sort of constitution of the organization, states that its objective is to contribute by all appropriate means and activities to be uniform maritime law in all its areas. Today, 56 national associations of maritime law are members of the CMI. Among them is the Croatian Society of maritime law. Under the auspices of the CMI a significant number of important maritime conventions and protocols are adopted.

The main task of the CMI is to achieve the unification of maritime law through international conventions and protocols on maritime issues. Specifically, these questions had previously been regulated by national laws which led to the passing of interpretation and different solutions, and therefore to legal uncertainty. Still, it's identified the ambiguity and ambivalence of certain provisions in conventions, so CMI loses its significance during the 60's of last century[50].

A turning point in terms of importance CMI occurred 1967th year - then the accident of Liberian tanker *Torrey Canyon* happened. After this accident, English and French courts were swamped with claims for damages due to pollution. Then there were no conventions or any other international legal rules that would edit a specific area of responsibility for pollution of the marine environment. The courts have introduced national legislation which is due to the different solutions in national laws, resulting in legal uncertainty. In addition to the different criteria

[50] Marin J.: International conventions and protocols as a source of Croatian maritime law, No. 161 (2007), pp. 91 - 111

for determining responsibility, it has appeared the other contentious issues to: the question of jurisdiction, applicable law, recognition of foreign court decisions and enforcement on the basis of such decisions, etc. It is obvious that the marine and regulation in this area is totally inadequate. This unfortunate event has shown the necessity of unification of international maritime law, particularly in the field of protection of the marine environment. Then NGOs but also the state itself began to be aware of it, particularly those that have a coastline. The general public began to show more interest in the adoption of conventions in the field of maritime law. Thus leading role in the unification of maritime law has been taken by the International Maritime Organization51.

Although they have a huge role in unification, international agreements are not the only way the unification of maritime law. Depending on the issue that is intended to edit, it might be some other suitable instrument, such as model-law, guidelines, rules, which fall under the so-called *soft law*. In practice, there are positive experiences, such as the adoption of CMI Rules on maritime lading and electronic bill of lading, York-Antwerp Rules on General Average, which is regularly upgraded. These legal instruments are not binding as a convention, but if they are carefully made taking into account the prevailing commercial practice, it can be far better means of unification of the Convention. So, it should be chosen the appropriate method for achieving the unification of the desired result for each issue52.

4.2. International Convention on removal of wrecks[53]

IMO was founded in 1948. as the International Maritime Consultative Organization. Today there are over 160 member states, among them the Republic of Croatia.

The task of the IMO is the adoption of a number of very important conventions and protocols. IMO took a leading role in terms of adoption of the conventions and protocols and the CMI has lost its relevance - CMI has consultant status in IMO.

The biggest achievement of the IMO is a convention about the problems of sunken items; the International Convention on the Removal of Wrecks convened in Nairobi, Kenya, 2007.

Data on the growing number of threatening shipwrecks are in direct connection with the fact that until the adoption of this Convention, there was

[51] Hereinafter : IMO

[52] J. Marin, op. cit., pp. 110.

[53] Rahan D.: International convention on the removal of wrecks (2007), Proceedings of the Faculty of Law in Split, vol. 45 (2009), No. 2 (1992), pp. 392.

no international convention that would systematically and comprehensively address the problem of sunken goods and their removal54.

The final draft text of the Convention on the Removal of Wrecks was approved on 92nd session of the Legal Committee of IMO in late 2006. year. At the International Conference on the Removal of Wrecks held from 14 - 18 May 2007. in Nairobi, Kenya, under the auspices of the International Maritime Organization (IMO), United Nations specialized agency responsible for safety at sea and preventing marine pollution from ships, the Government of Kenya and the United Nations Office at Nairobi (UNON), with the participation of delegations from 60 Member States of IMO adopted the International Convention on the Removal of Wrecks.

International Convention on Removal of Wrecks provides Contracting States a legal basis for the removal of ship wrecks that are potentially hazardous to people's lives, general goods, property, and marine and coastal environment.

The Convention has a number of innovative provisions. For the first time in a modern convention is mentioned as a possibility for mediation to solve disputes between member states arising from the interpretation or application of the Convention. It also introduces some innovative definition of names, so it introduces the concept of "Convention area" (area of the Convention)[55].

Unlike the European Convention contains provisions on the liability of the ship-owner, compulsory insurance and the certificate of a financial guarantee of the ship-owner.

There were adopted three resolutions with it, they are: Resolution on expressions of gratitude, the Resolution of the obligatory insurance certificates under existing maritime conventions on limitation of liability and the Resolution on the promotion of technical cooperation and assistance.

This Convention was opened for signature on 19 November 2007. to 18 November 2008. year, and will enter into force twelve months after the date on which ten states have either signed it without reservation as to ratification, acceptance, approval or accession, or have deposited instruments of ratification, acceptance, approval or accession with the Secretary-General[56].

---

[54] Bravar A.: Wreck removal in Croatian law and in the Nairobi International convention on removal of wrecks, Original scientific work, Proceedings of the Law Faculty in Zagreb, 58, (1-2), pp. 147-160 (2008), pp. 149.

[55] Bravar A., op. cit., pp. 158.

[56] Rahan, op. cit., pp. 394.

4.2.1. Application of the International Convention on Removal of Wrecks

This Convention establishes international rules and procedures that should ensure prompt and effective action to remove dangerous wreck only in areas of exclusive economic zone. If that area is not declared, then in the area that continues to the territorial sea not more then 200 nautical miles from the starting line from which the breadth of the territorial sea. Generally, the removal of wrecks located in the territorial sea is the issue of national law of the coastal State. However, the Convention introduces the possibility that Member States extend the application of the Convention to wrecks located in its territory, including territorial sea.

Convention on the Removal of Wrecks is not applying when the measures taken under the International Convention relating to Intervention on the High Seas in case of an accident which causes or might cause pollution of oil, Brussels, 1969. year, or under the Protocol relating to Intervention on the High Seas in case of pollution and other substances that are not oil, 1979. Also, this Convention shall not apply to any warship or a public vessel of which the state uses for public non-commercial activities, unless the state itself specifies otherwise, in the case where a Contracting State makes a notification[57].

4.2.2. Definition of wreck

The Convention marks a wreck as a result of maritime accidents, as follows: a sunken or stranded ship, any part of a sunken or stranded ship, including any item that is, or that was on this board, any item that was lost at sea from ship aground, sunk or swims in the sea, the ship that can reasonably be assumed that will sink or be stranded, whereby an attempt, or any action to effectively protect and save the ship or any part of the assets at risk, is not already in progress. The wrecks of warships and public non-commercial vessels are excluded from the application of the Convention[58].

4.2.3. The definition of danger

Under the concept of the dangers threatening the state maritime transport there are the threat of adverse consequences of the marine environment and coastal areas or certain related interests of one or more states. These interests are related directly to indicate the embarrassment of the coastal State by a wreck or a threat, such as coastal shipping and port activities, indicating coverage of fishing activities.

For the first time in an international compensation convention there are mentioned tourist attractions and other economic interests in that region, and the health of the coastal population and wealth management areas.

[57] Rahan D., op. cit., pp. 393.
[58] Bravar A., op. cit., pp. 153.

4.2.4. Reporting Wrecks

The provisions on reporting wrecks contain relate to the duty to report the affected country that the ship was involved in a maritime accident that resulted in a wreck, and that without delay. The concept of the affected countries is defined as one in whose territory a wreck is.

The Convention is very extensive points to the question of reporting on a wreck at the same time stating the ingredients of such reports (Article 6), then list of 15 factors that must be taken into account in determining whether a wreck is a hazard (e.g. size of the wreck, depth in the present Sea, information on tides and felt in the area, traffic density, etc.), defines a very precise way of locating, identifying and implementing measures to facilitate the removal of wrecks. Upon receipt of this information, the affected states have to assess whether a wreck is a potential hazard using the criteria laid down by the Convention.

Shipmaster and ship operator have the duty of reporting the wreck, and Member State whose flag the ship has must ensure the implementation of such reports.

Once the accident is located and after determining whether a sunken or stranded ship is being covered by the definition of "wreck", it is required from the affected states to warn mariners and other countries about the nature and location of the wreck. The next step is to determine the danger represented by the wreck of the coast affected by the state. If the affected State determines that a wreck poses a risk, it will take all reasonable measures to mark the wreck. Tagging means setting the tags in accordance with adopted international system of buoys marking used in the place where the wreck lies. In addition to such designation, the affected state is obliged to publish details of all marks, including the publication of nautical publications (Article 8).

4.2.5. Removal of wrecks

The central activity of the Convention is to control the removal of wrecks. The registered owner of the wreck is obligated to remove such a wreck. The Convention also imposes the obligation of the registered owner to the affected country, or its authorized body – he has to give proof of insurance or financial instrument to cover liability in an amount equal to the limits of liability under any applicable national or international limitation regime of responsibility.

Contracting States to this Convention are entitled to take measures specified in the provisions of the same, even when these actions may cause some danger in applying the Convention. However, these measures must be proportionate to the degree of danger posed by the wreck.

Specifically, measures taken in accordance with the powers must be within the limits of those measures that can reasonably be assumed as necessary to make certain that danger wreck is removed and should be stopped as soon as the wreck

is removed. Furthermore, these measures should not unnecessarily infringe on the rights and interests of other countries, including the country where the ship is registered, and the rights and interests of any individuals or entities that are associated taking these measures and their consequences.

Before removing the wreck starts, the affected State may impose conditions to such removal to ensure that the removal is carried out in a manner that is safe for the marine environment. The affected State shall determine to the registered owner the period in which he's obliged to implement and complete the removal of wrecks. If the registered owner, with any other person, do not remove the wreck within the period specified by the affected State, that State may itself carry out the removal of wrecks.

4.2.6. Limitation of liability of the owner

For the cost of locating, marking and removing wrecks corresponding registered owner. The Convention introduces obligatory liability insurance for the registered owner of the 300 ton ship size, which represents the input threshold obligate insurance. The certificate which confirms the insurance coverage must be issued to each ship size of 300 tons and upward. Certificate is issued by the office of the register's state.

4.2.7. Direct action

Direct action against the insurer of the registered owner is one of the most important provisions of this Convention. Insurer has the right to limit liability. It's the same right as the right that belongs to the owner of the ship. The insurer also has at its disposal and the opposition "willful misconduct", and all objections which the registered owner has, except for complaints of bankruptcy and liquidation.

4.2.8. The right to recover costs of removing wrecks

This right shall be extinguished if, within three years from the date on which the risk was determined. If after the date of casualty that resulted in the formation of a wreck passed more than six years, the complaint can not be raised.

4.3. UNESCO[59]

Convention on the Protection of Underwater Cultural Heritage is adopted under the auspices of UNESCO - UNESCO is a specialized UN agency for intellectual and ethical issues in education, science and culture. It is established in 1945. Today, it has 193 Member States and 6 Associate. Headquarters are in Paris, but around the world has more than 50 of its offices and institutes, such as the UNESCO Office in Venice which covering scientific cooperation and

[59] Croatian Ministry of Culture, UNESCO, 2010.

culture and the UNESCO European Centre for Higher Education (CEPES) in Bucharest.

UNESCO works on five program areas: education, natural sciences, social sciences and humanities, culture, communication and information.

UNESCO is the only UN specialized agency which operates through a system of National committees. That system is a major link in the dialogue of the Member States and UNESCO. It also acts as an advisory body to the Government of the Member States, and helps to implement many initiatives such as preparation of studies and expertise, enhancing and sharing knowledge, exchanging and distributing information. The role, tasks and relationships between the national committees, the Member States and UNESCO are established by the Charter of National Commissions in 1978. Members of the UNESCO committee are representatives of educational, scientific and cultural communities, parliamentarians, representatives of NGOs, academic and business communities. Important segment of each national committee is cooperation with other National Commissions of Member States.

Important part of UNESCO's work refers to the creation of international legal instruments - conventions, declarations and recommendations. Legal instruments in the field of culture are: the Convention on the Protection of Cultural Property in the Event of Armed Conflict, the Convention on the prohibition and ways to prevent illegal import, export and transfer of ownership of cultural property, the Convention on the Protection of World Cultural and Natural Heritage, Convention on the Protection of Underwater Cultural Heritage Convention Protection of intangible cultural heritage, and the Universal Declaration on Cultural Diversity.

4.4. European Convention for the Protection of Underwater Heritage

European Convention for the Protection of Underwater Heritage was adopted by the Council of Europe, the Member States and other States Parties to the European Cultural Convention of the 1969th year, and here it is presented the major features of the revised Convention of 1992. which the Republic of Croatia ratified the 2004th year[60]. The European Union is on the first place in the global shipping industry and shippers of the European Union control 40% of the world fleet.

The goals of the Convention are the conservation of archaeological heritage, its protection and insurance.

[60] Law on Ratification of the Convention on the Protection of Underwater Cultural Heritage, OG, International Treaties, no.10/04

In its preamble the European Cultural Convention, signed in Paris, 19th December 1954th, refers to the European Convention for the Protection of Archaeological Heritage, signed in Granada, 3 October 1985., the European Convention on Offences relating to Cultural Property signed at Delphi, 23 June 1985. It also refers to preserving unity among its members, the necessity of protecting the archaeological heritage of the modern lifestyle.

"Article 1: 1. The objective of this Convention is to protect the archaeological heritage as a source of European collective memory and the subject of historical and scientific research. (...)

3. The archaeological heritage includes structures, buildings, and groups of buildings, built sites, moveable objects, monuments of other kinds, as well as their context, whether situated on land or under water. "

The following text of the Convention states that parties are responsible to establish a legal system for the protection of archaeological heritage by prescribing of keeping records of archaeological heritage and the determination of protected monuments and areas, establishing a protected archaeological sites and determining the obligations of the finder of accidental discovery of the archaeological heritage to notify the authorities and submit the findings uncovered in the investigation[61].

Following this article it may be noted that Croatia made its obligation by a proclamation of zones under protection by the Ministry of Culture. That Ministry is responsible for implementation of the Convention in the Republic of Croatia.

The Convention further contains provisions on measures to protect archaeological heritage, funding of research (Article 6), the works - both physically and scientific in relation to findings and its investigation, the collection and dissemination of scientific information (Article 7 and 8), raising public awareness and educational campaigns about the archaeological findings and their availability to the public (Article 9), preventing the illicit traffic of the archaeological heritage (Articles 10 and 11), mutual technical and scientific support (Article 12) and final provisions (Art. 14th to 18th).

[61] Art 2nd Convention

5. THE CROATIAN APOXYOMENOS[62] ,[63]

5.1. The term Apoxyomenos

In ancient Greece, the athletes practiced and competed naked and oiling the body of any athlete is a key ritual of preparation for training or competition. After training or competition, and before washing, they would be stripped from the body of a layer of oil, sand and sweat by so-called strigilus.

As the dish with oil (Greek aryballos) and strigilus become symbolic accessories to athlete, so the procedure of scraping the body (Greek apoxyesis) became famous and favorite athlete representation in ancient art, and hence the name Apoxyomenos. Croatian Apoxyomenos represents an athlete who has just finished the competition (or practice) and which was shown at the time of relaxation, when it is fully dedicated to cleansing his body. It is possible that this is a winner or a view about the general personification of an athlete.

There are eight copies and versions of Apoxyomenos preserved in the world. Best known are the bronze statue of an athlete from Ephesus in Vienna, the marble statue of the Uffizi in Florence, basalt torso in Castel Gandolfo and interesting bronze head in the Kimbel Art Museum (Fort Worth, Texas). However, among all known copies, Croatian Apoxyomenos stands out as the most accurate prototype. The existence of a faithful copy of the various materials (marble, basalt, bronze), and numerous versions of reduced dimensions and variants, suggest that this is a very famous and valuable work that was often played.

5.2. The discovery and restoration of Apoxyomenos

Belgian tourist Rene Wouters found Apoxyomenos in the waters of Vele Orjule, a small island southeast of the island of Losinj in 1996. The statue was lying at a depth of 45 feet, stuck between two rocks on the sandy bottom.

1998th year, this finding has been reported to the Ministry of Culture that took the project of its submarine archaeological research, but also removing the statue and its restoration. In spring of 1999., prior to the onset of the study, Minister of Culture. Sc. Bozo Biskupic brought a decision on an emergency extraction of a statue because of a large number of illegal diving activities at the site. 27th April 1999. divers of the Ministry of Culture and the Archaeological Museum in Zadar, special police and professional divers removed the statue from the sea, and in June conducted underwater archaeological excavation of the site.

The front of the statue was completely covered with a thick layer of limestone, while the rear was very damaged and submerged in the sand. Already the sea

[62] Cupac Markovic Ira: Apoxyomenos odyssey still going on, Novi List, 10.4.2009
[63] Pejkovic I.: Apoxyomenos attracted 16 000 visitors, ezadar.hr, 23September 2010

was evident that the combination of head and neck relented and although the head was in the original position, she was separated from the body. On the left shoulder and front and rear right leg were observed cracks, on the left hand little finger is missing, and intraocular implants have not been found.

Immediately after removing the statue from the sea, it is reviewed by a team of experts. More reliable assessment of the situation derived gamagraphic's capture of the entire statue.

Croatian Conservation Institute has worked on the restoration, the preparation of construction and equipment for removing the statue, transport, desalination, and performing extensive conservation - restoration works from the beginning. The team of two restorers: restorer Italian Guiliano Tordi, a director of conservation and restoration works and Serbetic Antonio, a master restorer, the workshop leader for the metal of the Croatian Conservation Institute was selected for immediate implementation of conservation and restoration work. The work was followed by expert committee members: Academician Nenad Cambi, Academician Igor Fiskovic, PhD. Mario Jurisic, prof. Ante Rendic Miocevic, as a committee convener Prof. Miljenko Domijan who also coordinated the work as the chief conservator of the Ministry of Culture.

The statue is made of seven separate cast parts (legs, arms, torso, head and genitals) and the base. Parts of the statue were cast indirect lost wax process, as evidenced by tracks particularly well visible in the interior of the statue. Most of the research was done in the scientific laboratory of the institute Opificio delle Pietre Dure in Florence (OPD), Italy, on the Croatian side of the research performed in the laboratory of Croatian Natural History Conservation Institute, in collaboration with the Institute for Experimental Physics ''Ruder Boskovic" and with experts from the Mineralogy and Petrography Institute of Geology Department Faculty of Science, University of Zagreb.

Participating in this project, art-historical study of the statue was made by two experts: Academician Nenad Cambi from Split and prof. Vincenzo Saladino from Florence.

Academician Nenad Cambi claims that the statue comes from the time of the mid fourth century BC, and concludes that it is probably a Hellenistic statue from 2-1. century BC. Prof. Vincenzo Saladino believes that the prototype of athlete can be dated to the period of Hellenism around 300 BC and its spread through the backup began in the first century BC. The statue was probably made then and found in Vele Orjule in the Losinj Channel, famous waterway to the north of the Adriatic, Istria and Italy.

Based on previous research results, it can be assumed that the statue represented a part of a Roman cargo ship. At the site there are no trace remains of the ship.

It was probably a place where the ship tried to protect itself from strong wind and attack the northern anchor. It is possible that the breaking of rope anchors that the statue fell from a boat or was thrown overboard in order to facilitate and thus save the ship.

This extensive project that included the various stages - from discovery to final presentation, has successfully brought to an end.

5.3. Apoxyomenos today

It's been 11 years since the discovery of Apoxyomenos, but he still draws the attention of scientists, tourists, media and municipal authorities. Among 158 entries from 32 countries received a medal of the European Union's cultural heritage for second place in the category of Preservation-restoration of works of art given by the European Commission and the pan-European federation for cultural heritage, Europe Nostra 2007th. Citizens have signed petitions for the return of the statue of Losinj, but only in October 2007.year the Croatian Council for Cultural Heritage and Museum Panel decided that Apoxyomenos shall be permanently located in Mali Losinj. Zadar, Zagreb and Rijeka also fought for Apoxyomenos.

Within the project "Croatian Apoxyomenos" statue was unveiled in three cities. In Osijek, Rijeka and Split, more than 24 000 visitors saw him. The greatest interest was shown in Split, where in the Ethnographic Museum Apoxyomenos was seen by more than 15 000 visitors. In contrast, during the first introduction to the European public in Florence from 30 September 2006. to 31 January 2007., Apoxyomenos reviewed more than 80 000 visitors. Revenue at the exhibition in Florence was 344 624 euro, Apoxyomenos increased the number of visits to the Medici Riccardi Palace, and was only in January up to 425 percent and revenue increase of 545 percent over the same month a year earlier. So, in Florence, which has less than 370,000 inhabitants in the four months, the visit was several times higher than in eight months in three Croatian cities, which together count 450 000 inhabitants, in addition in Split Apoxyomenos was exposed in the heart of the tourist season. In Zadar, he was placed in a glass museum of 30th March this year - attended by around 16 000 people. From 14 October 2010 he is exhibited in Zagreb, in the exhibition "Ancient Greeks in Croatia" in Klovicevi dvori.

So Apoxyomenos still travels with no permanent address. However, he will be permanently exhibited at the Palace Kvarner in Mali Losinj since the end of the 2011. According to the preliminary design of Rijeka architects Randic Turato, Apoxyomenos will be located in the so-called. Capsule will allow visitors to get a view the statue from the frog and bird's eye view. The whole palace will be "subordinated" to Apoxyomenos. Ultimately this project will cost about 20 million Kuna's.

6. CONCLUSION

UNESCO, Council of Europe, the International Maritime Board, the National Agency for the seabed and the sea are dealing with sunken goods and authorized persons.

Problem of the sunken items and authorized persons is a complex area that involves a variety of scientific disciplines. Law, regulations of maritime nations and international conventions are governing the rules of the concept, extraction, removal, and the status of sunken items, but also the rights of owners, the finder, the contractor, and the location of sunken things.

In the last 10 years a lot of regulations have been brought in Croatia and throughout the world to protect sunken items and rights of authorized persons. Of particular importance is the International Convention on the Elimination of wrecks from 2007.year.

The Republic of Croatia legally covered sank things and authorized persons by many laws, decrees and regulations, and conventions to which Croatia is a party. The main source of Croatian maritime law is the Croatian Maritime Code which regulates problem of sunken goods and authorized persons by small number of articles. At the same time the provisions of the Maritime Code are not in accordance with the International Convention on the Elimination of wrecks from 2007. which Croatia will need to ratify. Specifically, the adoption of the Convention, will inevitably lead to reconsideration of the law in Croatia and its Maritime Code, namely the place that the institute of removing sunken things occupies in them. Therefore, the need to restore the former provisions which justly regulated this institute will come to.

However, it is much better regulated in some other acts. These are: the Law on navigation and inland waters, the Regulation on the safety of navigation in ports and harbors and inland waters, Ordinance of the Ministry of Culture, while the protection of sunken items in Croatia contributes to the Ministry of Culture through international cooperation agreements with other countries in the region, and proclaiming some wrecks monuments and limiting access to certain wrecks.

Croatia should be bound only to those international agreements which are consistent with its interests. The actual decision to bind a convention or protocol should be made after a thorough technical discussion. Finally, it must be minimized the existence of different legal regulation of the same issues at national and international level. In order to simplify the legal regulation and increase legal certainty, it is desirable that the provisions of the Croatian Maritime Code have the appropriate solutions to international maritime agreements that are acceptable for Croatia.

BIBLIOGRAPHY

1. Macura Slobodan, Domancic Jerko (2003): Legal regulation of professional and amateur diving in Croatia, Split, 2003.
< http://www.dps-zagreb.hr/macura.htm>, accessed on 30 July 2010.
2. Bulat Pezelj Vilma : Maritime disasters in the Dalmatian statutory law, Collection of the Faculty of Law in Split, No. 1/2006, original scientific article, <http://www.pravst.hr/zbornik.php?p=13&s=24>, accessed on January 15 2007
3. Wikipedia Free Encyclopedia,
<http://sh.wikipedia.org/wiki/underwater-archaeology>, accessed on July 15 2010
4. Microsoft Encarta Reference Library 2004.
5. Jelinic Srecko: Collision, salvage and remove sunken things in the Law on removing sunken items, Proceedings of the Law Faculty in Zagreb, 1973.
6. Horvat Marijan: From the history of the collision, shipwreck, rescue and assistance Zagreb, 1967
7. Luksic Branimir: Removing sunken vessels (Legal issues), the Maritime collection, no. 28, 1990.
8. Kraljic Tanja: Adriatic Sea the richest in the world by wrecks!, Brodaricazadarmastrovic.net, 13 April 2008.
<http://www.brodaricazadarmastrovic.net/index.php?option=com_content&task=view&id=158&Itemid=1>, accessed on July 19 2010.
9. Klisovic Jadranka: Tourists interested in an organized tour of the deep sea, Journal, 31 March 2010th
<http://www.min-kulture.hr/tisak/default.aspx?id=5742>, accessed on July 4 2010
10. Rules of Procedure and manner of issuing permits for underwater activities in internal waters and territorial sea of Croatian protected as a cultural asset, Official Gazette no. 22/09,
<http://narodne-novine.nn.hr/clanci/sluzbeni/2009_02_22_474.html, accessed on July 4 2010
11. Ergovic Goran: Scuba diving in Croatia, licenses, permits, forms of organization and zones under special protection, 2008.
<http://www.lotos-croatia.com/hr/hrvatska/2348/autonomno-ronjenje/>, accessed on July 4 2010
12. Promo flyer of the International centre for underwater archaeology in Zadar – 2009
<http://www.icua.hr/images/stories/publikacije/promoletak_hr.pdf>, accessed on July 4 2010
13. Croatian Ministry of Culture,
Regulation, Protection and Preservation of Cultural Property, 2010.
<http://www.min-kulture.hr/default.aspx?id=81>, accessed on November 2 2010

14. Croatian Ministry of Culture, UNESCO, 2010. <http://www.min-kulture.hr/unesco/>, accessed 4th July 2010.
15. Croatian Ministry of Culture, Selected Topics, Boris Jagacic, sleeping steel monsters wealth of the Adriatic, Privacy, 22 December 2008. <http://www.min-kulture.hr/default.aspx?id=4457>, accessed 4thJuly 2010.
16. News, online archive, 2002. <http://www.vjesnik.hr/pdf/2002/06/13/19A19.PDF>, accessed 19thJuly 2010.
17. Marin Jasenko: International conventions and protocols as a source of Croatian maritime law, No. 161 (2007), <http://www.pravo.hr/_.../MEDJUNARODNE_KONVENCIJE_I_PROTOKOLI_KAO_IZVORI_HRVATSKOG__POMORSKOG_PRAVA.doc - Similar>, accessed 19thJuly 2010.
18. Rahan Dean: International convention on the removal of wrecks (2007), Proceedings of the Faculty of Law in Split, vol. 45 (2009), No. 2 (1992) pp. 391.-406, <http://www.pravst.hr/zbornik.php?p=25&s=175>, accessed 19thJuly 2010.
19. The United Nations Convention on the Law of the Sea, Montego Bay, 1982. - MU SL SFRJ br. 1 / 86. Official Gazette - International Treaties, No. 11/95 <http://www.narodne-novine.nn.hr/clanci/medunarodni/328160.html>, accessed 19thJuly 2010.
20. Law on Ratification of the Convention on the Protection of Underwater Cultural Heritage, Official Gazette, International Treaties, br.10/04, <http://narodne-novine.nn.hr/clanci/medunarodni/327571.html>, accessed 19th January 2007.
21. Australian Government, Department of Sustainability, Environment, Water, Population and Communities, Historic shipwrecks, unknown author, 2010., <http://www.deh.gov.au/heritage/shipwrecks/>, accessed 5thOctober 2010.
22. National Underwater and Marine Agency, numa.net, Unknown author, 2007. <http://www.numa.net/about_numa.html>, Accessed 5th October 2010.
23. Cupac Markovic Ira: Apoxyomenos odyssey still going on, Novi List, 10.4.2009., <http://novine.novilist.hr/default.asp?WCI=Pretrazivac&WCU=>, accessed 5th October 2010.
24. Pejkovic Iva: Apoxyomenos attracted 16 000 visitors, ezadar.hr, 23September 2010 <http://www.ezadar.hr/clanak/apoksiomen-privukao-16-tisuca-posjetitelja>, accessed 5th October 2010.
25. Maritime Code, Official Gazette no. 181/04, 76/07, 146/08, <http://narodne-novine.nn.hr/clanci/sluzbeni/2004_12_181_3142.htm>, accessed 5th October 2010.

26. Law on Inland Waterways, Official Gazette no. 19/98, <Http://narodne-novine.nn.hr/clanci/sluzbeni/1998_02_19_2260.html>, accessed 19TH January 2007.
27. Regulation on the establishment of the International Centre for Underwater Archaeology in Zadar, Official Gazette no. 33/08, <http://narodne-novine.nn.hr/clanci/sluzbeni/338567.html>, accessed 4th July 2010.
28. Regulation of the publication of a contract between UNESCO and the Croatian Government on the establishment of the Regional Centre for Underwater Archaeology in Zadar, Croatia, as a category 2 Centre under the auspices of UNESCO, the Official Gazette. 1 / 09, <http://narodne-novine.nn.hr/clanci/medunarodni/2009_02_1_9.html>, accessed 4th July 2010.
29. Navigation Act and inland waterway, Official Gazette no. 109/07, 132/07 <http://narodne-novine.nn.hr/clanci/sluzbeni/2007_10_109_3176.html>, accessed 25th October 2010.
30. Bravar A. : Wreck removal in Croatian law and in the Nairobi International convention on removal of wrecks, original scientific paper, Proceedings of the Faculty of Law in Zagreb, 58, (1-2), pp. 147-160 (2008), Hrcak, Portal of scientific journals of Croatia <http:// http://hrcak.srce.hr/file/32053>, accessed 25th October 2010.
31. Ministry of the Sea, Tourism, Transport and Infrastructure, News, Introduced Croatian marine pre-accession strategy, Dubrovnik, 22November 2005. http://www.mmpi.hr/default.aspx?id=1248, accessed 25th October 2010.
32. Maritime Code, Official Gazette no. 17/94 <http://narodne-novine.nn.hr/clanci/sluzbeni/1994_03_17_313.html>, accessed 4th July 2010.
33. Bulum Bozena, Scientific Commons: Book Reviews: Ivo Grabovac, Modern Croatian Maritime Law and Maritime Code, PPP god.45 (2006), 160, 187-191 <file:///E:/Downloads/2006_prikaz01.pdf>, accessed 25th October 2010.
34. Bolanca Dragan, Amizic Petra: The new maritime code of Republic of Croatia and question of unification of maritime law, Proceedings of the Law Faculty in Split, y. 44, 1/2007, pp. 41. -52. <http://www.pravst.hr/dokumenti/zbornik/200784/zb200701_041-051.pdf>, accessed 25th October 2010.
35. Grabovac Ivo: International contracts as a base for harmonising maritime law –on the occasion of The amendments to the Maritime Code Act in 2008, Proceedings of the Faculty of Law in Split, vol. 46, 2 / 2009., Pp.261st-269th, <http://www.pravst.hr/zbornik.php?p=25&s=168>, accessed on 30June 2010.

INTERGENERATIONAL JUSTICE: AN ECONOMIC AND JURIDICAL ANALYSIS

Antonio D'Aloia, Ph.D.
Full Professor
University of Parma
Department of Legal Sciences
Italy
e-mail: antonio.daloia@unipr.it

Federica Roccisano
Research Assistant
Research Centre for Mediterranean Relations MEDAlics
University for Foreigners "Dante Alighieri"
Italy
e-mail: federica.roccisano@medalics.org

Abstract

Objective of the paper is to show how the idea of generational equity needs to be placed at the base of the legal reforms in order to focus the solidarity between generations, and the fiscal policy to maintain the same capital stock and opportunities for present and future generations.

The work points to create new perspective of the intergenerational justice made by the integration, not the sum, of the economic and the juridical vision. The first part is an illustration of the importance of constitutional issue of future generations: from the matters of the intergenerational aspects in the theory of rights (and duties), to the definition of welfare as a right for present and future generations.

The last chapters address some economic policies to ensure fairness between generations: the promotion of the generational accounting like a "best practice" yet recognized, and the experimentation of the generational mainstreaming.

Keywords: *Future Generation, Intergenerational Justice, constitutional law, Political Economy.*

1. RIGHT AND SOLIDARITY BETWEEN GENERATIONS

1.1 Future in the constitutional language

The constitutional right, as every sector of the legal system, show a vocation almost "natural" to the universality and the inter temporal aspects. If is true that the Constitutions, and the Constitutional rules, are an experience that developed in the time and that are affected by different kind of constraints and material element, than that experience is crossed by the time (both past and future) with all its load of stories, social and cultural conditioning, expectations, needs to be preserved and make it even solvable (Rosenfeld M., 1991).

The Constitutions born to have (and to give) stability in the time, with all their complex of principle about both the rational justification and the limit (substantive and procedural) tied to the exercise of the power and the authority, that the cohabitation rule, the structure of the social pact, starting from the right, the protection of which is a condition which move men to accept as normal and the subjection to the rules of law. In the constitutional system the right assumed a Trans generational connotation; rights are inviolable, as many Constitution enshrine explicitly and are first of all recognized and then protected by a number of institutions and mechanisms. They are, therefore, earlier, but later than the time of the policy.

Haberle, with lucid summary, says that if "the people must always be thought of in reference to future generations, why not also what they belong: the fundamental rights of men?" Is obvious and immediate reference to one of the first documents of modern constitutionalism, the Virginia Declaration of Rights of 1776, where it is written in the preamble that "these rights belong to it (i.e. the people of Virginia) and their posterity, as basis and foundation of government" (Haberle P., 2004).

In this way, the relationship between normative and constitutional future generations is the first confirmation in the same rigid constitutional rules, which cannot be changed except by special proceedings, and, in some cases are radically removed from any possibility and procedure review.

It does not seem so unfounded identify the 'constraint' a kind of constitutional relationship of reciprocity between the generations that follow. In essence, the limit that is imposed on future generations not to alter the framework of the overarching principles of a constitution may find its rationale to justify the extent that generations from time to time 'present' to impose themselves, or reasonably choose to follow, to ensure those values and the material conditions that make them viable that are required to maintain and respect the prospect of stability in time.

In other words, the 'constraint' constitution, in its complex morphology in which they are together heritage and freedom to live and interpret this in light of the needs of the future, requires that this step of the baton from one generation to another, there governments are 'exclusive', i.e. stages and moments in which the generations 'present' irretrievably compromise their principles, this transmission of values, and property-resources that make it possible to implement. His perspective is no longer that way (or madisonanian) debt of current and future generations against the previous ones, but that mutual solidarity and the relational process between successive generations remained loyal to the unavoidable presuppositions of the legislature, in which the 'commitment of successive generations to respect and maintain certain fundamental balances (especially about the inviolable rights) is' compensated' by the commitment of those past and present to keep (at least) a minimum of actual conditions of feasibility of those principles and values.

Within this reasoning, the same wording of the famous 28 of the French Constitution of 1793, that "*a toujours peuple to the droit de revoir, de reformer et de changer sa Constitution. Une génération à ses lois assujettir it peut les generations futures*" acquires a meaning consistent with the intergenerational perspective just reported. After all, the condition of freedom of each generation from the previous presupposes to some extent the idea of constitutional constraints, because this freedom needs to be drilled in a legal-material which, over successive generations, must undergo changes or reductions irreversible.

Speaking of future generations, and then try to outline a theory of rights, or responsibilities towards future generations, actually means proposing a comprehensive theory of the Constitution and constitutional law, or at least take a point of view on major categories of the phenomenon constitutional. Similarly, intergenerational responsibility is essentially a responsibility 'constitutional' or better "to the Constitution," a sort of conscious acceptance and 'active' to mean necessarily 'intertemporal' of its fundamental principles (Abrescia M., 2008).

Not only rights but also the structures of democracy, the State, political representation, work and competence of the legislature are usually projected to take into account the interests of time and humanity's future. Future generations will have a 'piece' of the general interest in reading that Jellinek has wrote many years ago, at the turn of the nineteenth and twentieth century, on the representation and political accountability (Jellinek G., 2002). And in Italy and the Holy Roman Empire, in the famous lecture of 1909 on "the modern state and its crisis," asserts that the state's ability and the right to look after the interests of future generations, "not only of present, [...] in an intimate and uninterrupted continuity of time, action, purpose, time and energy to different

", is an essential element of their strength. The State represents and works to the advantage and to the fabric of the community, but because the state is not a figure 'slow', 'temporary', but a person tends to 'permanent', its action can only point to the maintenance (through the succession of generations) the conditions of living of the community, working together for the public interest in the same continuity of its surroundings.

Yet, the gap between theory and practice of constitutional democracy and the modern representative state has been and continues to be particularly strong. Decision makers look at the short term chasing the consensus of today, even at the expense of long-time objective. The need to respect the wishes of those who vote and decide on the government produces an unavoidable bias in favor of this.

The weakness and inconsistency intergenerational politics of the matter is all here, in the 'temporary' democratic mechanisms and procedures, which never completely avoidable because democracy thrives on items that are in themselves pro tempore and temporary, such as electoral mandates , majorities, media communications, social institutions that support the concrete experience

The limit of modern democracy is this "present" absolute, in which it is difficult that can be, accommodated the interests and expectations of future generations. The challenge of democracy and constitutionalism is instead to imagine institutions, procedures, tools, rules that give substance to this principle of intergenerational solidarity.

Indeed, it begins to be something concrete. The issue is increasingly moving away from a merely theoretical and philosophical, and gradually starts to achieve outcomes of legal regulation. We are passing to if from how to protect the interests of future generations, from the theoretical reconstructions-which does not appear to be still able to dispel all doubts and difficulties that are connected to the instance of dogmatic protection of future generations-the definition of models and solutions, and their evaluation of their effectiveness.

An increasing number of fragments consisting of a "right intergenerational" are registered both in international law, both constitutional standards. In the latter case, the standard references to intergenerational responsibility, interests (or rights) of future generations, or similar concepts, are both expressed in the preamble or in specific provisions of the Constitution, which implicitly inferred from concepts, categories, normative principles that lend themselves to being interpreted in intergenerational perspective.

Belong to the first level of the constitutional language intergenerational, inter alia, the preamble to the Constitution of Estonia (1992), Azerbaijan (1995), Russia (1993), Philippines (1987), Venezuela (1999), Puerto Rico

(1993) Rwanda (1991), and a number of articles in which especially the protection of the environment and the ecosystem (and in some cases of natural resources and landscapes) becomes an opportunity to set the goal of public policy for the implementation of the constitutional protection of generations willing future and their interests: art. Albania 59 of the Constitution, Art. Argentina 41 of the Constitution, Art. Brazil 225 of the Constitution, Art. Cuba 27 of the Constitution (which introduces the reference to future generations are also talking about economic development, social development, and health and safety), Art. Ethiopia 130 of the Constitution, Art. Norway 110 of the Constitution, Art. 74 Polish Constitutions, Art. 24 South Africa of the Constitution, Art. 47 Uruguay of the Constitution (with specific reference to water resources), Art. 20 German Constitution and various constitutional provisions of the German Lander.

Other constitutions promote this approach to focus on intergenerational issues in an indirect way, with laws protecting the landscape, natural resources, heritage and cultural heritage, or use categories constitutional 'open future' (Bifulco R., 2008): I think of art. 66 of the Constitution of Portugal (speaking of sustainable development), the most recent constitutions of Slovenia and Slovakia to the Italian Constitution, where there are few constitutional provisions which, although not directly on the theme of future generations, or which contain references directed to this new figure 'subjective' or conceptual categories related to (inter-generational responsibility, sustainable development, etc.), show a marked inclination to work the same way as key input intergenerational issues in the evolution of our constitutional experience.

Without going into these profiles to not turn away from the objective article, suffice it to recall the art. 9 entrusting the Republic shall promote the development of culture, and to protect the landscape and the historical and artistic heritage of the Nation, art. 52 on the defense of the homeland - as a synthesis of the physical and cultural, tangible and intangible-of memories, art. 4, which indicates the material and spiritual progress of society, the granting to any citizen the right, and at the same time the duty to work, the art. 11 on the constitutional value of peace and the rejection of war and its destructive potential global and irreversible in its logic of conservation and ecological conditions of humanity at large, the Reference Article. 44 to the rational exploitation of land, the protection of linguistic minorities in order to maintain this over time plural identity of the nation (art. 6), the identification of the social as a limit to private economic initiative (art. 41 / 2), and it is clear that the sphere of the concept 'open', 'indeterminate, seem unrelated, adding to traditional profiles and substantial equality of social solidarity, and protection of workers, all that complex of meanings, limits, options policies that move around the notion

of sustainable development, now also consecrated in the European regulatory parameter binding for Italy and other countries that belong to it, the rules and limits on the financial indebtedness, which we tell you in greater detail below, and especially the principle of protection of fundamental human rights and the principle of reasonableness.

First of all, the art. 2, in speaking of "human rights", and attributing to them the connotation of inviolability, still insist on the mandatory duties of political solidarity, economic and social, outlines a clear framework in which values are established placed in a flow of continuity and succession of generations needed, such as identity cannot be changed on the Constitution.

As for the reasonableness of the fee, established by the Italian Constitutional Court from the principle of equality, but also in ways similar to other constitutional courts and in different contexts, it appears to be somewhat inherent intergenerational instance. In fact, the unreasonable use of the rights and resources of today that make uncertain their availability in the future. Reasonableness is 'relationship' with others, with their rights / interests / expectations. As has been sharply highlighted, constitutional rights are by definition reasonable, and as such, universal and intertemporal (Spadaro A., 2009).

This rapid review of constitutional provisions that deal expressly or contain implicit and indirect references to intergenerational issues, demonstrates the variety of subject areas where that question is more or less intensely. In the first instance, environmental protection and ecosystem, natural resources and energy, cultural heritage, the area of bio-genetics (the genetic integrity, a ban on reproductive cloning), then the sustainability of welfare and social policies and work, the stability of economic and financial systems.

It 'obvious that a constitutional provision is not enough to retain a completed and consolidated process of legalization of the intergenerational instance, because these rules are formulated mostly in terms of an open mandate to the legislature and programming (according to the German model of Staatziel) directives that are not likely to produce subjective or obligations perfect situations and actions.

But it is important that there has been this shift from narrative theory to a first-constitutional legal system of the theme of future generations. These provisions reflect a new sensibility that is forming and that is the basis for hypotheses for further investigation and more stringent regulatory and straightforward, starting from the same constitutional language.

Already at present, however, these estimates may justify the testing, legislative and administrative, some procedural rules, bodies, practices to counter the

'biased' towards the present decision-making structures of constitutional democracy.

There are many, and with different configurations, proposals that have been advanced in recent years, and not only in theoretical debate, to define a translation of the intergenerational principle: from the establishment of independent authority to the locus technique to protect the interests of future generations (as in the Maltese proposal guardian of the interests of future generations, or as "tribunes of posterity" imagined by Edith Brown Weiss in his "In fairness of future generations "), from the strengthening of the role of NGOs in cooperation policies for the benefit of developing countries, to the inclusion in the legislative processes and administrative procedures that may have a strong impact on environmental and cultural heritage and natural resources of subjects with intergenerational interests, from the prediction of class actions in which the interests of "who is not even" pass through the initiative of individuals 'replacement' (as the association of children in the case decided by the Court Opos Minors Chief of the Philippines in 1993 regarding the conservation of rainforests), to the proposal - the constitutional limits of tolerance - to graduate the ownership of voting rights based on the greater and lesser extent of the family, in the belief that those who have children is naturally led to thinking in intergenerational sense.

What seems certain is that the intergenerational right needs, from one side of a large "common moral purpose and on the other, of innovative tools based on reward mechanisms, incentives and disincentives, tax and tariff policies aimed to promote sustainable use of energy and natural resources (e.g. water) rather than simply divided into obligations and/or prohibitions to do or not do. In fact, a "new right" and not simply an update of the current mode of reasoning and decision of the legal-normative (Gore A, 2008).

1.2 The application of the theory of intergenerational rights: problems and opportunities

As mentioned above, entry of the category of future generations in constitutional law also has a major impact on the theory of rights (and duties of solidarity).

It is not easy nor discounted consequences. Speaking of fees in relation to persons who do not yet exist, or duties towards them by the present generation to imagine forms of protection of these situations today 'future', evidently through actors 'replacement', poses theoretical problems which cannot yet to give an answer and an accommodation that is definitive and satisfying. It is no coincidence that almost all the standards (international, constitutional, legislative) that relate to posterity, do it in a 'strict', with emphasis on the limits of the institutions and policy choices in the present tense rather than

asserting rights or subjective positions qualified for future generations. Are known obstacles to finding some form of legal subjectivity qualified for future generations.

First, the thesis of the unknowability and unpredictability of the needs of future generations, and-correspondingly-the will (and / or possibility) of majorities and governments of the time to meet them anyway to give them the same importance they have today. Massimo Luciani points out the paradox of being able to discover that "the sacrifices imposed on the generation # 1 were unnecessary to ensure the satisfaction of needs-say-generation # 4, either because resources were sufficient to satisfy even the needs of the # 4, or because the social structure of needs has changed (Luciani M., 2005)."

There is no doubt that this is not just a theoretical problem, and that indeed is particularly true when the paradigm is applied in the field of intergenerational rights and economic and social policies.

However, the legal reference to the instance of intergenerational interests as it were 'vital' (environment, natural resources, cultural heritage) and to attack in 'extreme' and likely to produce negative consequences not reversible, it allows you to resize this objection, and even reduce the opposition between the rights of present and (recognition of) the rights of future generations: in many cases, the adoption of offensive behavior in the interests of future generations and now is already capable of infringing the rights and essential interests of the present time. In other words, between the rights of the two segments of humanity connection but there is no conflict, sequence, and the possible rights of future generations are a projection and an argument of strengthening the rights of those who already live, as was correctly stated in this projecting future generations, we, in fact, we take care of ourselves, in a dimension where it is clear that between the generations takes place a bond of continuity.

The second objection relates to whom and how it can defend the rights / interests of future generations. In fact, this is a practical problem of legal technique. The law knows no other alternative mechanisms, in which the defense is in the name of subject positions through the use of legal fictions, to persons other than those who are the owners of the property. This solution would not be alien to the discretion of a legislature aware of new challenges related to energy and natural resources, the biogenetic, environmental protection and ecosystem, the maintenance of conditions of economic stability and sustainability of welfare.

On a different level, I think that the relationship between theory of inter-generational responsibility and fundamental rights is more profound and

complex question of the forms and techniques of protecting the interests of posterity.

The rights are also principles that hold the role of cultural orientation and consolidation of legal practices. The history of many rights since become fundamental in the dynamic development of social life, shows us that the full enforceability in court is not an original, but a culmination of processes of cultural and social roots of that right. In the meantime, you cannot say that that position is not (at least potentially) a right, or which cannot become one.

What is interesting then is the particular interplay between rights and duties characterizing the inter-instance, and that is probably the most significant contribution that this group can make to the theory of rights (D'Aloia A., 2006).

The "goods" that are relevant in the search for mechanisms of legal protection for future generations, and certainly with respect to the present generations and from time to time 'present', rights: the right environment, with a sustainable and equitable economic development, cultural heritage, a decent pension. The projection of these rights over time reveals their peculiar quality, which can be extended to other equally fundamental rights.

Rights and duties are materials that combine with each other, and duties are an integral part of the fee structure, help to re-define the content and the axiological profile. Rights that are not limited in the size of current events, but ask to take charge of the continuing existence of material conditions that they are based in practice, are rights that remain in them a perspective of responsibility to one and all against all and of all (Sirimarco M., 2000, p. 117)"; then become effectively" experiences that bind " who teach to be in solidarity with the fates, today and in the continuity of time (Occhiocupo N., 1984, p. 77).

Individualism and presentism are therefore two degeneration of this idea: in both cases, forgetting the other today and removing others that will be, the rights to expunge itself of solidarity and responsibility, thus diverging from their most genuine constitutional significance.

2. Which Welfare for future generations

2.1. Equity between generations

It's possible to check and investigate the intergenerational question considering the relations between generations and the creation of welfare systems, which, as inherently based on finding a balancing between the interests of present and guarantees of long-term sustainability of its mechanisms, are a

very reliable indicator of how a society's perception of time, and the relationship between present and future.

It 's still Haberle stated that "future generations can not be burdened beyond measure by the present living at their expense." Standard input, almost self-evident in its moral relevance, but he meets a number of difficulties when you try to transfer in terms of rules and legal constraints that Rawls has constructed as the "principle of just savings, configuring like a summary of his 'theory of justice', that is necessary to ensure that "every generation receives what it deserves from his predecessors and gives its fair contribution to those who come after, in the framework of" cooperation between the generations "in which" each of them (the generations that follow) should bear their fair share of the burden of the construction and preservation of the just society." To put it differently, to behave with future generations as we wanted that previous generations behaved with us (Thompson).

Always following the theory of equality of Rawls, the economist Robert Solow argued the importance of justice between generations and sustainability as a moral obligation to future generations (Solow, R. M. 1986): this is not fact just to respect the principle of equity between generations, but also the efficiency principle according to which the current generation are likely to be owed to the new generations, as well as the availability of this or that particular resource, the production capacity necessary to maintain a certain standard of living[1].

We must also assess the possible aggressive behavior in the case of goods cheap character 'intertemporal', such as pension rights, and economic-financial stability, social security and work.

For example, if a natural resource consumption or destroy property that belongs to the cultural heritage, the negative result (for now and for future generations) is not recoverable. Conversely, although at some point you create a state of unsustainable debt and the pension system, even in extreme momentary effects, it is conceivable that changes in the economic objective and its assumptions, strong economic growth processes, end up by determining positive reversal of the situation.

Similarly is not possible to overlook the fact that the use of unreasonable and move to the "obsession" of this, of goods' cheap', however, can produce effects of heavy (and, at least in the short to medium term, uncontrolled and therefore not reversible) condition the choice and organization of resources by

[1] "The basic question is: how much of the world's – or a country's – endowment of nonrenewable resources is it fair for the current generation to use up, and how much should be left for generation to come who have no active voice in contemporary decisions?" Solow, R. M. (1986), pp. 141-149.

the successive generations from time to time, that this area does not necessarily mean things to generations to come "in the strict sense, but simply" new. "

The final observation made shows just the other peculiarities of speech applied to the side of intergenerational economic and social policies. When we speak of intergenerational solidarity or responsibility with regard to employment policies, or pension policy, the generations 'future' are very close in time to present generations: in some cases are contextual, such as in the workplace, or simply future generations may already exist but later when considered in relation to the time of implementation to them the social protection stipulated by law, as in the case of pensions. In this sense, he's right who stresses (Boeri, 2008) that (in some contexts) "the problem of the younger generation is not only a problem of tomorrow, is already a problem of today."

This may enhance the profile of conflict that particularly the theme of intergenerational responsibility in the economic and social manifestly against the interests of present generations, and that inevitably is connected with the fact that in saving for future generations means spending less today, some say no to demands of the time, make choices that may be in the short term even 'painful'.

2.2. Well being and opportunity for future generations

The objective to preserve the productive capacity for the next generations must be linked to the objective to guarantee two important kind of equity: the same level of well-being and the same right to create well-being in the society. During the 20th Century many economist has debated on the concept of well-being relative to the intergenerational equity and the inter temporal resources allocation, creating different position and different measuring model. For the context and the target of this paper, we'll consider the position of F. Ramsey and H. Hartwick.

About the definition expressed by Frank Ramsey, the idea of well-being has to be linked to the idea of the utility related to the consumption. This utilitarian position affirms that the well-being is at its maximum rate only when the aggregated utility of all the generations is at its maximum rate too (Ramsey F. P. 1928). By this, the rate of the consumption **C** of each generation includes in itself the aggregated well-being of that particular generation.

Defining that $\boldsymbol{U(C_t)}$ is the well-being of the generation $\boldsymbol{t}$ and that an upward trend of **U.**

The function of the well-being in $\boldsymbol{t}$ will be:

$$V_t = \sum_t^{\infty} U(C_t) \qquad in\ t \geq 0$$

To identify how to maximize V_t F. Ramsey considers that the generations are always able to identify the optimal consumption's flow: "the generation 1 would consume $C_{1,}$ would invest in the better way, and would transmit the optimized capital stock to the generation 2 "(Dasgupta P. 2004). This process should be similar what was happened in the history: as well as the generation 1 has inherited from the previous generation a stated capital stock, this generation 1 should be encouraged to transmit to the next generations the optimal capital stock to guarantee to them the same life standard. But, this theory has had some strong dispute about the practice difficulty to summarize the utility of all the generations: about it, Ramsey doesn't imagined the possibility to apply a discount rate of the utility, that should be up to make the sum of utility convergent and said that such a practice "is ethically indefensible and arises merely from the weakness of the imagination" (Ramsey F. 1928: p.261) because of the different utilitarian evaluation between the currents and the next generations.

On the opportunity to apply discount rates on the utility there is a mathematical model in which the function V_t was made more sensible to the parameter of the generational distribution and equity, by the factor G (Dasgupta, P. Heal G.M. 1979):

$$V_{t=}\sum_{t}^{\infty} G\ U(C_t) \qquad in\ t\geq 0$$

A famous opposition to Ramsey's theory is that made by T. Koopmans. In according to this position, the flow consumption was not the result of a sum of each utility, as Ramsey said, but it is simply a conceptual starting point (Dasgupta, P. Heal G.M. 1979). From the T. Koopmans's point of view the discount rate must always to be positive and, by it, the well-being is the numeric representation of a regulation of all the flow consumption:

$$V_{t=}\sum_{t}^{\infty} \beta^{(\tau-1)}\ U(C_t) \qquad in\ t\geq 0$$

$$Where \quad \beta = 1/(1-\delta)$$

$$And \quad \delta > 0$$

So, **U** is the current well-being, $\beta^{(\tau-1)}$ is the current discount rate and δ the discount rate of the "pure temporal preference" (Dasgupta, P. Heal G.M. 1979).

R. Solow (Solow R.M. 1974) and other important economist, on the base of the rawlsian justice's rules (Rawls J 1971), has underlined how, for instance, to insure certain equity between generations, the pro capita consumption has to be constant. In his theory R. Solow raised as a welfare criterion the consumption standard gained by the low rich generation during the time. Hence, starting

from this egalitarian point, there is not any society that could be "justified in demanding any sacrifice, however small, from one generation in order to provide a benefit, however large, to any other generation" (Solow R.M 1986).

Anyway, also this theory has got two important limits. The first is that of the precondition required to have a capital stock so high to guarantee a certain rate of well-being, without which it could be possible only to maintain a low rate of consumption. The second limit is related to the population rate: if population has a steady rate and the technological progress is limited, this model was too much conservative to be real, because of the standardization of the consumption rate and the impossibility to increase it (Solow R.M. 1974).

another important model is that based on the "Hartwick rule" a model which affirms that a single unit of not extracted natural resource should increase in each moment as well as the rate of the current marginal product of the reproducible capital; the consequent competitive rents will be able perpetually to maintain a constant level of consumption (Hartwick, J. M. 1977). This rule, common in the environmental studies, is considered as a milestone because it shows how many of the exhaustible resources could be set aside and re-invested into reproducible capital so to control the level of consumption and prevent the disease of the non-renewable resources: it is useful to gave the most egalitarian and ethical manner to manage the capital stock for the next generations[2].

In this sense, therefore, becomes useful to identify sustainable policies that have as objective the safeguarding of public assets and the fair distribution of public goods between generations. At this point it is necessary to analyze the problem is to emphasize that equitable management of assets between generations should be the responsibility of the legislature.

2.2. . Market failure or public failure? Coase vs Pigou

As for every problem relative to the externalities, also for the intergenerational equality there is the division between ones who affirm that it is a market failure and the other ones who affirm that it is a public failure. The thesis of this paper is that only the public level should guarantee the same rights to all the generations, by introducing some rule in the law. To show this thesis will be opposed the position of Coase (pro market failure) and that of Pigou (pro public failure) about the problem of the management of the environmental risk between generations.

[2] "The image that come to mind is Ulysses lashing himself to the mast because he knows he will be tempted by the Sirens. From that point of view, Hartwick's rule is a better-than-average rule of thumb" [Solow R.M, 1986: p. 148]

A model about this kind of management shows that in the presence of an insurance market with imperfect information, the current generations aren't able to know what will be the health of the world for the future generations (Von Amsberg, J. 1995). Responsible policies choices in favour of the resources preservation could be a kind of insurable operation for the benefit of the future generations, also if this kind of operation could have, as a consequence, a consumption reduction. According to this model this particular kind of market failure is independent from the externalities. For the two generations it's impossible to reach an agreement, also assuming the possibility of trade between generations, because of the management of the public goods [3].

Considering this model, it's evident that the market failures related to the intergenerational equity are not solvable with the Coase Theorem. Indeed, if Coase affirmed that the optimal resource allocation could be restored by assigning property rights, in the case of the intergenerational equity this position is not applicable because at the moment of the bargaining the individual of the next generation, interested by the damage or the benefit, aren't yet born. So the bargaining is not possible.

On consider the entire flow of benefits and costs in the period **t**:

$$\mathbf{B(E)_t} \qquad\qquad \mathbf{C(E)_t.}$$

To summarize and compare this flow it is necessary to update the value of the flow and so it's important to fix a discount rate **r.**

The equation to calculate the net inter temporal welfare will be (F. Silvestri, 2005):

$$SB_0 = \sum_{t=0}^{\infty} \frac{B(E)_t}{(1+r)^t} - \sum_{t=0}^{\infty} \frac{C(E)_t}{(1+r)^t}$$

The inter temporal allocation of the exhaustible resources requires a trade off between present exploitation and future exploitation, related to the finiteness of the stocks. The introduction of a constrain could prevent the situation in which the decision about the exploitation cause a not sustainable flow and a reduction of the available stock for the next generations.

Mathematically, this problem is evident if we consider Qt as the exhaustible resource stock and B(Qt) the net benefit of all the generation relative to the exploitation of the resources. B(qt+1) is the disposability to pay to conserve the right to use the resource also in the future (option value). If there is no

[3] "any belief that posterity right in current resource systems, directly implies market failure" [Wright V., 2006: p. 12]

possibility to have an external coordination, every generation will be induced to consume the maximum of the available resources Q*, for so: $B(Q^*)_t=0$. Consequently the next generation will be pay an opportunity cost $B(Q+)_{t+1}$ related to the impossibility to exploit the same stock of resources of the previous generation:

$$B(Q^*)t+1/(1+r).$$

To optimize the availability of Qt between the generations, the inter temporal optimum will be:

$$\underset{Q1}{MAX}\left[B(Q1)+\frac{B(Q_T-Q1)}{1+r}\right]$$

Therefore the optimal utilize of the resource will be at the extraction level Q1 of the first generation, if the extraction level Q2 of the second generation is Q2=Qt-Q1:

$$Bm(Q1)=\frac{Bm(Q2)}{1+r}$$

By this way the exploitation of another unit of the resource by the first generation will be less than the discounted benefit of the second generation. As a result, also with the efficient inter temporal allocation the benefits of the current generation are greater of that ones of the future generations: an egalitarian allocation between the period causes a minor net benefit of the present generation and a major not discounted net benefit for the future generation (Musu I, 2003).

This consideration underlines how the impossibility to have a market in which all the generation could express their preferences and the consequent impossibility to have spontaneous transactions to guarantee the allocation (as for the Coase Theorem) generates a non optimal allocation: the current generation tries to impose an excessive discount rate **r**.

It is therefore obvious that the resolution of generational equity can not be left to market mechanisms, nor can you think that we can reach an agreement between the parties concerned.

3. PUBLIC DEBT AND INTERGENERATIONAL RESPONSABILITY

3.1. The constitutional limit on public debt

The question of the debt belongs to the history of modern constitutionalism. Just think of the debate between Jefferson and Madison on the Law of the generation component of debts to be distributed over successive generations, with the first contest in the root of financial obligation of one generation against its predecessors, while the latter emphasized the need for debt to achieve some fundamental goals of development of the nation, and therefore the reasonableness of the inter-temporal distribution of the burden, just so that future generations can benefit from the results of the costs previously incurred.

Is undoubtedly true that Madison said. Making things important, useful, capable of producing development, using more of what you have, that is, against a debt, it may be advantageous in some cases even for generations to come, because it increases the set of goods, facilities, opportunities, overall economic the "country system" that is transmitted (Fitoussi, Tremmel). We can not be sure that poverty is better than being debt-free and rich with some debt (Luciani). There are situations where you can then debt is absolutely necessary, as in the difficult economic crisis that hit the world in recent years, forcing governments to intervene heavily to maintain the conditions of social cohesion in their countries.

The point is another, and relates to the extent the amount of debt that is transmitted, and its relationship with the wealth that a country can produce.

When the debt exceeds certain levels of relationship with the wealth produced annually in a country where interest produces tens of billions of euro per year by deducting such resources policies to improve social services and education, research and technological innovation, modernizing the infrastructure, this means that the past (the many 'present' that have constituted) has eaten the future. For generations (from time to time) future than those that have produced this uncontrolled and excessive debt, the result is an unfair tax, because without representation and without any assumption of responsibility, and an obstacle to the implementation of sound policies the needs of our time.

In this regard, of particular importance is the thesis of Guido Tabellini, who in an analysis of intergenerational redistribution policies provides a dual characterization of the redistributive function of the debt: *"First of all, issue debt includes a promise of future transfers to the generations not yet born. Second, the promise is made without the consent of future generations who will be forced to bear the burden of redistribution.* (G. Tabellini, 1994: pag. 263) "An important variable in this sense, becomes the level of altruism between generations, based on the assumption that parents who take care of their children, we think the present generation to protect future generations. The figure, however, that the

level of altruism varies from family to family and it is in no way connected to economic instruments, making it less effective in its application and this model (L.J. Kotlikoff, 2001).

The outlook is not, nor can it be (for what we said about the positive effects within certain limits of the policies of deficit spending), the strict accounting and math of a balanced budget. The financial equilibrium, the stability of the accounts, must be sought and maintained on the basis of reasonableness, which means that what should be avoided is the excessive debt, uncontrolled, not tied to capital expenditure, without any mention of compatibility and consistent with the structures of a dynamic economic system.

By this standard, the question of the balance and financial sustainability of public expenditure, including social, can not be confined to a merely technical accounting, but must be regarded as a level of legitimacy of the system, and a way to ensure the rights in time and resources for equality

Appropriately, then, addresses the constitutional jurisprudence of many countries on the gradual implementation of social rights, the introduction of the Stability Pact (which share in the European context the binding nature of basic choices of the European Community) and the coordination mechanisms of finance public in the institutionally compounds (where there are local authorities), the search for the basic level of realization of fundamental rights, which implies a balance between respect for and identification of the content of these rights and the inescapable demands of sustainability over time of protection, the techniques of generational accounting that are prefigured in the theoretical debate, are pieces of an overall strategy that takes the balance sheet as instrumental value to a correct and stable realization of those values of solidarity, equality, rights protection, which is directed a modern constitutional democracy.

Everything takes place: equality achieved at the expense of the needs of economic stability in the long run produces inequality, and thus betrays itself. Furthermore, a stable budget and 'ordered' is a guarantee for today and tomorrow: avoid burdening future generations with heavy and unnecessary burden, and get used to the present time the responsible exercise of autonomy and its powers.

3.2 The Public Debt under generations

The debate around the relation between fiscal policy and redistributive aspect of the public debt has been appreciated particularly after the study about the opportunity to introduce the generational accounting in the fiscal policy. We'll deepen the functioning of the generational accounting in the next chapter, while in this chapter we'll discuss the evolution of the study about the relation between annual public debt and the trend of the intergenerational redistribution. To do that we'll utilize one of the most well-known mathematic model in which there

are two opposite generations – young and old – that lived in the period t and whose rate of growth of population is n (H. Bonin, 2001).

The evolution of the population is given by:

$$Pi,i = (1+n)Pi,i-1$$

The model includes two different situations: the first is characterized by a balanced budget, the second by a budget deficit. If we suppose to be in a situation in which the legislator decide to introduce some kind of redistributive public policies such that in each period the younger generation has to pay a z fee, whose the amount is redistributed in an aggregate manner to older generations.

TAB 1	
Generational redistribution with Periodically Balanced Budget	
Revenue	Expenditure
Period i	
Tax payment of Young Generation: $zP_{i,i}$	Transfer to Old Generation: $zP_{i,i} = z(1+n)P_{i,i-1}$
Period i+1	
Tax payment of Young Generation: $zP_{i+1,i+1}$	Transfer to Old Generation: $zP_{i+1,i+1} = z(1+n)P_{i+1,i}$

Therefore, whether the transfers to older generations are defined by the entry fee of the young people, then the budget will balance: public expenditure is equal to public revenue (see TAB. 1). Similarly, if the population of the cohort of young people is larger than the population of the cohort of the elderly to a n percent, then the revenue will be higher than the expenditure of the same n percent. To explain this model clearly it's important to analyse the changes in the life cycle of the cohorts of generations.

On maintain a constant discount rate r necessary to maintain the level of future payments in the present: the net value of the transfer payment for the younger generations born in the period i is given by:

$$zP_{i,i} - \frac{z(1+n)Pi+1,I}{1+r} = \frac{r-n}{1+r} zP_{i,i}$$

The equation shows that if the discount rate is bigger than the rate of growth of population (**r > n**) , then the transfer will result in a higher load for the generations born in the period **i** and for future generations too[4].

In the same way, if the legislature's choice will be to activate a loan amount **z** from young to old generations, the greatest burden of the intervention will fall on the shoulders of the younger generation. Indeed, the cohort of young people in the period **i** and **i+1**, will provide a loan to the older generations, while the subsequent generations will support the burden of the budget deficit resulting from the repayment of the loan from the government and for the benefit of those cohorts of generations that had supported the loan before, while they were young, and that now are old (see TAB 2).

TAB. 3	
Generational redistribution with Budget Deficits	
(a) Cash flows	
Deposit	Disbursement
Period i	
Loan of Young Generation: $zP_{i,i}$	Transfer to Old Generation: $zP_{i,i} = z(1+n)P_{i,i-1}$
Period i+1	
Loan of Young Generation: $zP_{i+1,i+1}$	Transfer to Old Generation: $zP_{i+1,i+1} = z(1+n)P_{i+1,i}$
Tax Payments of Old Generation: $(1+r) = zP_{i+1,i}$	Redemption of Loan $zP_{i,i}$
	Interest on Loan $rzP_{i,i}$
(b) Revenue and Expenditure	
Revenue	Expenditure
Period i	
Deficit $zP_{i,i}$	Transfer to Old Generation $zP_{i,i} = z(1+n)P_{i,i-1}$
Period i+1	
Tax Payments of Old Generation: $(1+r)\ zP_{i+1,i}$ Deficit $nzP_{i,i}$	Transfer to Old Generation $zP_{i+1,i+1} = z(1+n)P_{i+1,i}$ Interest on Loan $rzP_{i,i}$

[4] "The fact that the policy under investigation resources to disadvantage of future generations, however, is not indicated by conventional public deficit measures, as the government budget stays always in balance" [H. Bonin, 2001 pag. 3]

This second case is pretty similar to the functioning of a lot of security systems that risk to damage the financial capacity of the future generations. For example, the benefit pension scheme requires an intergenerational inequality because the older generations benefit from the initial contributions (bonus) borrowed from future generations. The key problem of it is about the relation between the aging and the occupation rate. The actual rate of aging is worrying because, in few years, the next generations shall have to pay the contributions to a portion of population increasingly large (Bifulco R., D'Aloia A., 2008). It's evident that changes in the demographic structure, increasing the ratio of older age groups and classes of working age, can generate generational conflicts, lead to social tensions and undermine not only the social welfare systems, but the public accounts.

For this kind of evidence it's an important must for the legislator to introduce appropriate norms in favour of the intergenerational equity. In the next chapter we'll show how the introduction of generational accounting can be a way to photograph the situation. In addition to this instrument already established we'll deepen the experimentation of Calabria Region to introduce the "generational mainstreaming" to monitor the progress of balance and positively influence the public policies.

3.2 The generational accountability

The generational accountings are a kind of instrument born to calculate the rate of economic, social and natural equilibrium in the fiscal public policies. Also in this case, as in that of sustainable development, the alarm was launched by the oil shock of the '70s. Following this event, the Western economies have decided to introduce new form of policies of deficit spending and, consequently, have experienced the consequence of a strong growth of public debt (Sartor N., 1997).

The particular instrument of the generational accountings are distinguished as an innovative and useful tool for measuring the imbalance between generations, to analyse the sustainability of the assessment of debt and to observe how fiscal policies affect the present and future generations. The generational accountings, in fact, measure the amount of tax that a representative subject of a given generation will pay during his lifecycle, with the current fiscal policy (Belloni M., Bianchi C. e Vagliasindi P.A., 1999). This instrument show the responsibility of the current generations in relation to the next once: "*unless we adults make very large sacrifices very quickly, our kids will face net tax rates that are twice those we face! On each dollar earned, our kids will be faced with taxes, net of benefits they receive, that are nearly twice what we currently pay* (Kotlikoff L. J., Burns S., 2004: p. 21)*"*.

The functioning of the Generational Accounting is explained by the Kotlikoff model (Kotlikoff L. J., Burns S., 2004). On consider a simple budget constraint of a family. For this family the value of the earning (**E**) net of payments and transfers of taxes, is equivalent to the sum of expenditure (**S**) and of the current debt (**M**). In this equation it's particularly important to think about the temporal perspective of its variables: **E** includes not only the present earnings but also the future earnings, while **S** and **M** measure the future expenditures and debts but related to the present value.

$$\mathbf{E = S + M}$$

The equation makes possible to maintain the equilibrium of the familiar budget constraint. Another kind of equilibrium is that given by a second equation that considers the public aspect and the intertemporal public budget constraint:

$$\mathbf{A + B = C + D}$$

In this equation A and B are respectively the debt rate, calculates at the present value, burden to future generations, and the present value of the richness of the present generations net of taxes. C and D are the present value of the public expenditure and the public debt net. The key of this equation is that there is no free lunch: every public choice, both of expenditure than of debt, strongly influences the equilibrium and the tax rate that the future generation shall have to pay in their lifecycle.

The specific formula to calculate the Generational Accounting, considering the geographic differences (like North and South of Country) and considering different period is (Belloni M., Bianchi C. e Vagliasindi P.A., 1999):

$$\mathbf{GA_{t,k} = \sum_g (N_{t,k,g} / P_{t,k,g}) = \sum_j \sum_g (T_{j,k,g} P_{j,k,g} / P_{t,k,g} (1+r)^{j-t})}$$

Where:

- $\mathbf{GA_{t,k}}$ indicates the actual value (in time **t**)of the net taxes expected from an individual of the generation **k**;
- $\mathbf{N_{t,k,g}}$ indicates the actual value of the future net taxes of the individual of the generation **k** and of the group **g** in the base time **t.**
- $\mathbf{T_{j,k,g}}$ indicates the present value of all the net taxes of the individual of generation **k** of the group **g** reported to the time **j** (relevant period for the generation)
- $\mathbf{P_{t,k,g}}$ is the indicator of the numerosity of the individual in the generation **k** reported to the group **g** in time **t**
- $\mathbf{P_{j,k,g}}$ is the indicator of the numerosity of the individual in the generation **k** reported to the group **g** in time **j**
- **r** is the discount rate

The calculation of the Generational Accounting is a complex proceeding that simultaneously considers three aspects and their interactions: i) the demographic structure and its evolution; ii) the set of rules governing the revenue and the expenditures of the public budget; iii) the level and the long-term sustainability of public debt (Sartor N., 1997).

Compared to the classical aspects of the budget, Generational Accounting are complicated by the fact that must evaluate the financial resources absorbed or supplied by each of the public programs (such as taxes on labour income, indirect taxes, health care spending, spending on pensions etc..) and the estimate of the average per capita income of these programs, distinguishing the beneficiary by age and gender. The result of this estimate of per capita income has to be such that the sum of the unit entitlements of each of the citizens "type" that has broken down the entire population is equal to the total amount that is reported in the "Income Statement of Public Administration".

Generational Accounting are now institutionalized in at least 22 Country and lot of supranational Institution like the IFM and the OECD, where the legislators have decide to call attention to the amount of fiscal debt that each generation leaves to the next generation and how this debt will be paid by future generations in the form of fees for access to the health service, rather than doctors or service, or simply in the form of opportunities denied.

The admonition to recognize the "right for future" of the new generations launched by lawyers and constitutionalists, has necessarily to become a key step that may influence the choices of the legislature applying generational accounting tool for evaluating tax policies. According to this it's born the idea to introduce a Generational Mainstreaming in the Public Administration. To show the validity of this instrument is one of the principal aims of the writer, who is also involved in the team that is working at this experimentation.

The first Public Administration interested in applying Generational Mainstreaming is Calabria Region that decides to introduce, by law, the instrument (L.R.: 15/2008, art. 12 (see Appendix 1)). Inspired by the idea of gender budgeting, it is in fact designed to create a "dedicated" budget to replace the need for equal opportunities between genders, with that of equality between generations.

But also the Region Calabria, one year later, had vote a law on the intergenerational equity (l.r. 9 2010). Among the key objectives of this law, which begins with the recognition of the principle of equity between the generations present and future generations, there has been preventing and combating all forms of unfair distribution of economic resources between generations, and support and promoting the rights and needs of younger generations in the

policies and measures to increase the sustainability of the urban environment and choices related to planning and design of space and time in the city.

The idea to start this experimentation, is born analyzing the particular scenario of Calabria, which shows serious problems for the younger generations: the aging population, the continued mobility of young people toward the North, and a too high unemployment rate (SVIMEZ 2009). The methodology applied is twofold: first of all, the generational accounts, similarly to the state budgets, they will allow the legislature to identify the fiscal imbalance between the present generations and future generations, on the other side there will be a matrix created ad hoc on the model of that of gender budgeting, where there will be reported the action taken that will be enjoyed by present and future generations or to be incurred by the tax point of view, from two generations.

As for the gender budgeting, the aim of the legislator to apply the Generational Mainstreaming is to identify the demand and the supply service of the two generations, and how the supply is related to the future generations, e.g. if the legislator has included some future targeted planning or if he has to do that (see FIG 1). The context analysis is useful to comprehend the demographic trend and the needs of the various generational cohorts relatively to the macro-survey (family and person, economic development, staff and governance). The supply analysis considers the services, direct grants and investments targeted to the enhancing of human capital. Through this analysis the legislator could have as a first result, a classification of the regional budget and in the second time, after the balance sheet, he could decide to modify some policies into the next budget, in function of the right of the new generations.

To identify the equity rates we will use the Generational Accounting and appropriated indicators that analyse the ratio of spending on programming and planning, as well as the context, the supply and the demand. The figure of those indicators, produced at the end of each phase, summarizes the results of the various phases of analysis and directed towards the final result that the legislator want to achieve (see TAB 4).

TAB 4 Matrix of Generational Mainstreaming						
Cohorts	Direct grants		Indirect grants		Human capital and environmental investments	Tot Expenditures
	Services	Structures	Services	Funding		
K (≤ 15)						
j (16 – 25)						
a (26 – 40)						
m (41 – 55)						
o (56 – 70)						
v (≥ 71)						

To analyze the sustainability rate between generations we need two kind of data: the direct grants, that are directed to the beneficiary, and the indirect grants that are paid to a public administration or a private entity to guarantee a service or a functioning of a targeted structure (kindergartens or hospices): for example if we would to analyse the relation between the expenditure targeted to the very young generation (cohort k) and the expenditure for the oldest generation (cohort v) the indicator of the Generational Efficiency (**GE**) for a given period **t** will be:

$$\mathbf{GE_C = \Sigma_t\ (S_{k,}/P_k)/\ (S_{v,}/P_v)}$$

As long as the ratio is below 1, the choice of fiscal policy may not be efficient since the per capita expenditure for the generation with less life expectancy is higher than that allocated to cohorts whose life expectancy is higher. So under budget policy choices may vary[5]. According to this if the indirect grants targeted to the creation of care facilities for the elderly or the support of voluntary associations specializing in the care of the elderly exceeds the user's needs on the ground, the legislator could divert some funds for the establishment of nurseries or schools. Similarly, an expenditure evaluation of the investments aim at the enhancing of human capital or aimed at the protection of environment are useful to identify the sensibility level of the policy maker for the sustainable policies and for the guarantee of the generational rights.

The methodology is pretty similar to that of Bonin, proposed in the preceding pages, but in this case the legislator has the possibility to correct the intergenerational unequal policies in the short period considering the

[5] Maybe the legislator could decide to don't modify the policies in relation to electoral reason: the individual of the oldest cohort votes, while the kids don't vote. So the legislator may decide to encourage the will of its potential voters and to not asses the data about the Generational Efficiency.

elaborations made in response to budget sheet, before to prepare the new budget. Particularly this instrument could be very useful for the Ex Objective 1 Region (now Convergences Regions), like Calabria's, because it could help the legislators from these Regions to identify the most efficient policies to achieve the objectives of the Lisboan Strategy and so to operate for a economic development of quality that takes care of the social inclusion, the protection of the environment and the generational equity.

3.3 The pension problem: is there an equilibrium?

Pensions are a 'symbol' of this reading of intergenerational social policies. The technique is built on a pension play relationships between generations: those who work pay the pensions of those who worked before, and expects employees to do the same next to him.

it is clear that the balance of the system affected by a number of factors and conditions. The number of employees, the number of pensioners, the birth rate of a country, young / elderly, the degree of integration of women working, the flows of migrant workers. The weight of these components is not immutable and given once and for all, especially the various factors are not exclusively positive or exclusively negative: it depends on other elements.

If we consider the aging population, you can highlight the many good things: better quality of life and nutrition, health services more efficient, reducing the work exhausting and arduous, but the effects of rising life expectancy, welfare systems, and in particular pension systems, are very worrying. Many more pensions, and for much longer.

Similarly, the decline in birth rates, which features mainly the most developed societies in economic terms, while avoiding the acceleration of energy and natural resources, a very negative impact on the balance of pension systems, because it reduces in perspective the number of employees 'taxpayers' than that of ex-retired, and thus alter the viability of the generation mechanism. Nor can we continue to think that for much of the increase in migration flows to compensate for this phenomenon is only one way to push the problem over time, because in the medium to long term, the stabilization of many migrant workers may exacerbate the problem, Further weighing on the side of pension expenditure.

Pension reform has thus become the 'heart' of any process of reform of welfare systems, and, within it, the issue is the intergenerational 'password' that is affirmed, with varying degrees of awareness on the floor solutions actually adopted. It could not be otherwise, since the ratio is genetically a pension contract between generations, as incomplete and asymmetric in the decision

and signed by one party only. The young (and future) generations in fact, have no power of decision or contract, other than to challenge the results ex post realization of the framework adopted (Vagliasindi, 2008).

The fact is that the change in the demographic assumptions of many modern pension systems today has created a situation that is of great inequality among pensioners (old and newer), and between workers and future retirees, and financial unsustainability of the model.

A system that needed to run stable for many workers to pay contributions to a certain proportion of retirees, found himself crowded out from a situation where workers are less and less, and have fewer guarantees of stability (and therefore ability to pay), and many retirees are living longer and longer. That is why the exchange between the generations is broken, causing the first models to obsolescence breakdown, and then the failure of these systems contributions introduced in many European countries over the past 15-20 years, unless you imagine actually increases unworkable 's impact of contributions on earnings, which is a drastic (and equally unacceptable) reduction in pension benefits. Add to this the effects within 30/40 years of falling birth rates of the processes in place, and the increase in pension expenditure for the millions of immigrant workers entering the labor market over the past 10-15 years, it is understandable why the picture is very worrying, and governments have been forced to intervene several times a few years on pension systems, in order to correct and put in balance (at least in intention) trends.

What to do? Definitely should be an integrated, organic. The issues are connected, and in some cases an instrument may have ambivalent effects. Raising the retirement age, for example, is a passage that can not be avoided, however, and may make it harder to enter the world of work by young people, and the ability of these to begin to form their own retirement packages

We must think of the state social security of workers 'flexible', temporary, 'discontinuous', which will be the typical figure of the work as to prevent the repeated 'gaps in social security contributions' may fall into overly simplistic terms on the pension rights of these workers .

Policies for the integration of working women may also be important in the perspective of maintaining the conditions of equilibrium of the pension system. Women who (rightly) work tend to sacrifice the desire of birth, because there are no rules, institutions, instruments (working hours, times of cities, childcare facilities, telecommuting) to enable a real and effective reconciliation of professional needs and function of the family. Finally, it is crucial to the development of supplementary pension, which certainly can not replace the public welfare, but may represent a complementary instrument capable of

compensating for the drop 'quantity' of the pension protection 'traditional'. On the other hand, the idea of a supplementary pension, 'private', is anything but foreign to the constitutional evolution of the welfare system, which sees a growing importance of the concepts of individual responsibility, subsidiarity, autonomy. To draw a parallel with the Italian Constitution, just art. 38, dedicated to the care and welfare institutions, it contains an 'important statement in closing argument that "private care is free." In other words, the social security system protecting the public interest (the individual as a component of the community) and private interests, individual, and this justifies the protection of pension is in two spheres, integrated with each other, the public and complementary.

Rather, the problem is serious about promoting the model of the supplementary pension system, and to this end may not be sufficient in the current configuration meaning that private-voluntary in most countries in the supplementary pension fund.

Beyond these initiatives, which are certainly positive, and indeed in some respects essentially required, we must ask whether the adoption of an intergenerational perspective on pensions should not lead to other consequences.

The impact of the reforms taken so far was, as we have said, grossly unequal. The definition-however unavoidable-of timelines for the transition from one system to another has led and will involve considerable differences, both in the level of pension benefits, both in deteriorating conditions for entitlement to social security protection.

Under these conditions, can be considered reasonable and fair that there are treatments considered unchangeable (vested rights) and others, partly because of the requirements and the level of the first, should suffer alone the negative fallout of the reforms required? And that, in a period of time substantially 'contextual' there are subjects which, while beginning with the same career path, end up having a very different state pension?

This is a clear consequence of this decision, we also identified initially as a defect in the relationship between democracy and constitutional principle generations. The logic of rights is just one reflection of who decides who has the privilege to those who in future will be affected by its decision.

Basically, if it grows, as is happening and will probably continue to be life-expectancy of persons, the board may be a corresponding and proportional reduction, partly offsetting the negative effect that the aging population and rising the period of board imposes new and future generations of pensioners to those already covered by the warranty. This is also a way to contribute to the cost of those reforms already retired.

Every choice of public policy, whether national or supranational, has consequences not only on the present generation, with increases or reductions in disparities between the people, but also on the future generations, affecting their growth prospects and the quality of their lives.

The principle of protection of future generations is not a liberal principle, or a device argument of the ruling elites and the economically powerful classes to reduce social benefits and redistribution. Worrying about future generations deal also means the weak today, which are economically and socially disadvantaged individuals within the community government, and peoples on the international scene.

The main principles of the Constitution, such as equality, solidarity, not just in-time (and intertemporal), but universal, or are not credible. The survival of mankind is based on a combination of necessary ecological question, understood in the broadest sense, economic issue, Democratic issue, one vital for each other.

Poverty and underdevelopment of many peoples and countries, as part of an increasingly unequal and asymmetrical, likely to be a factor in the retreat of the principle of ecological sustainability and natural, for the simple fact that the poorest countries, to encountered problems with 'extreme' survival (hunger, debt, ...) on the one hand have a different perception of the scale of priorities of the policies to be implemented, on the other are often forced to make hard (or take advantage of better leave, the other countries and multinational corporations), with serious risks and irreversibility of the resources available to them. It 's the same mobility of people, as a result of poverty and misery, which can weaken their ties with their countries of origin and their commitment to preserving the environment.

On the other hand, the huge and intolerable distance of opportunities, resources, development conditions between the different 'worlds' of this planet, is no less untenable and dangerous for the cohesion and stability of the human community, environmental degradation, and irreversible consumption of energy and natural resources.

Many constitutions, including the Italian, they speak of 'justice between nations'. What seems lacking is the awareness that justice among nations is a precondition of peace, solidarity, responsibility and respect for public goods such as environment, nature, cultural heritage.

Ultimately, responsibility towards future generations is not possible without a political strategy and institutional framework of equality in favor of individuals and peoples, that the States and the international community must assume as a duty, in the same manner as it thinks it is a duty to intervene to prevent crimes

and gross violations of human rights. There is no future for countries whose external debt exceeds their ability to produce wealth, which is missing or totally inadequate basic services for health and education, in which millions of people the primary concern of off hunger or have access to water.

The protection of public assets across generations, or instrument like the Generational Accounting or the Generational Mainstreaming, are necessary to facilitate a targeted use of anti-cyclical public spending that does not affect the balance of natural, social and economic in the medium term. A major consideration for interventions aimed at the support of income of the weakest, can only stem from structural reforms of the Welfare System, a reform designed to balance the expenditures by the adult generations towards the younger bands.

A truly inclusive system of Welfare for the younger generations as well for the future generations, which also looks at the future demographic previsions, certainly can not be financed by an expansion of public debt, which would be reflected necessarily on the same future generations, much less to economic and productive systems that do not involve any consideration of the distribution of natural resources, but from deep and courageous reforms based on a careful assessment of generational accounting, starting, for example, to the pension system (Roccisano F. 2009). Only one legislator who acts in this way can be said to have worked to give his children and future generations, his own opportunities.

BIBLIOGRAFHY

ABRESCIA M., 2008, Analisi Economica del diritto pubblico, Il Mulino

BIFULCO R., 2008, Diritto e generazioni future. Problemi giuridici della responsabilità intergenerazionale, Franco Angeli

BONIN H., 2001 - "*Generational Accounting, Theory and application"*, Springer, Bonn,

BURNS S., KOTLIKOFF L.J., 2004 - *The Coming Generational Storm, what you need to know about America's Economic Future*, MIT Press,

D'ALOIA A., 2006, Divieto di discriminazione e giurisprudenza costituzionale, Quaderni di diritto della rivista costituzionale

DASGUPTA P AND HEAL G.M. 1979: Economic Theory and Exhaustible Resources Cambridge, UK: Cambridge University Press.

DASGUPTA P. 2004: Human wellbeing and the natural environment, Oxford University Press

GORE A., 2008, Una scomoda verità. La crisi del riscaldamento globale, Rizzoli

GRUNBERG I., I. KAUL, e M.A. STERN, Global Public Goods; International Cooperation in the 21st Century, New York, Oxford University Press, 1999.

HABERLE P., 2004 "L'Etat Constitutionnel", Paris

HARTWICK J. M., 1977, Intergenerational Equity and the Investing of Rents from Exhaustible Resources, *American Economic Review* Vol. 67 (5), pp. 972-974

KANGAS O., PALME J. (edited by), "*Social Policy and Economic Development in the Nordic Countries"*, Palgrave Macmillan, New York

KOTLIKOFF L.J., 2001 - "*Essay on saving, bequests, altruism and Life-Cycle Planning",* MIT Press,

JELLINEK G., 2002, La dichiarazione dei diritti dell'uomo e del cittadino, collana Biblioteca Universale Laterza, traduzione di G. Bongiovanni, Laterza, Bari, 2002.

LUCIANI M., 2005, Art. 75 Referendum, Zanichelli

OCCHIOCUPO N., 1984, La Corte costituzionale tra norma giuridica e realtà sociale. Bilancio di vent'anni di attività, Bologna

PIGOU A. C. 1932 The Economics of Welfare, Macmillan, London.

RAMSEY F. P. 1928: "A Mathematical Theory of Saving", Economic Journal, Vol. 38, December, 543-559.

RAWLS J. 1971, "A Theory of Justice", Cambridge, Harvad University Press

REPETTO R. 1985: The Global Possible: Resources, Development, and the New Century, A World Resources Institute Book. New Haven, CT: Yale University Press.

ROCCISANO F., 2010, *Cosa lasceremo alle generazioni future? L'equità generazionale per la creazione di un futuro sostenibile,* L'Officina delle Idee, Cosenza,

ROCCISANO F., 2010, *Sostenibilità ed equità tra generazioni:la sperimentazione del bilancio generazionale della Regione Calabria,* n° 4/2010 Rivista Economica del Mezzogiorno della SVIMEZ, Il Mulino, Bologna

ROSENFELD M., 1991, A Philosophical and Constitutional Inquiry, CT: Yale University Press

SARTOR N., in AUERBACH A.J., KOTLIKOFF L.J., LEIBRITZ W., 1999, "Generational Accounting around the world", The University of Chicago Press

SILVESTRI F., 2005, Lezioni di economia dell'ambiente ed ecologica. II Edizione, CLUEB, Bologna,

SIRIMARCO M., 2000, Il dubbio della sopravvivenza, in E. Baglioni, (a cura di) Ospiti del futuro, Giappichelli, Torino, 2000;

SOLOW R.M. (may 1974), "The Economic of Resources or the Resources of Economics", in American Economic Review n.2

SOLOW R.M. (Symposium 1974), "Intergenerational equity and exhaustible resources", Review of Economic Studies

SPADARO A., 2009, Lineamenti di giustizia costituzionale, Giappichelli

VAGLIASINDI P. "Problemi intergenerazionali nell'economia pubblica. in: R. Bifulco, *A. D'Aloia (eds) UN DIRITTO PER IL FUTURO*. Teorie e modelli dello sviluppo sostenibile e della responsabilità intergenerazionale. p. 443-470, 2008, Jovene Editore, NAPOLI.

WITTEMAN A. D. 2003, Economic Analysis of the Law: selected readings, Blackwell Publishers, Oxford

WRIGHT V., 2006, "Intergenerational equity as a market failure", Practical Change Research, Department of Primary Industries, Victoria

SOVEREIGN DEBT RESTRUCTURING: THE LEGAL ASPECTS INVOLVED

Zeenat Munir Masoodi, LL.M.
Advocate
Delhi High Court, New Delhi
India
E-mail: zeenatmasoodi@gmail.com

Abstract

The history of sovereign debt lending and borrowing goes back to ancient times. Sovereigns borrow money for reasons similar to individuals. The vital difference between the two however, is one of recovery. Unlike individuals, a sovereign's assets may not be seized and liquidated for recovery of debts. In the absence of an international consensus on how to restructure debt, several techniques and methods have been created and suggested by diverse groups. Many Important changes have ensued and a trend of litigation has also evolved in the past couple of decades.

While sovereign debt restructuring has almost always stirred a debate in the realm of economics, certain important legal issues and aspects also deserve to be highlighted.

Keywords: *Sovereign Debt Restructuring, Paris Club, Bondholders, SDRM, Collective Action Clause, Sovereign Immunity, Vulture Funds.*

1. INTRODUCTION

Historical evidence shows that sovereign debt borrowing and lending was in practice since time immemorial. Sovereign debt lending increased immensely in the past few hundred years and is a popular practice today. And with the coming of each sovereign debt crisis comes to the forefront the concern over the lack of a universally binding legal mechanism for resolving the crisis. While an overwhelming majority of the literature available on sovereign debt restructuring is based on the economic aspects of the subject, the legal aspects involved in sovereign debt restructuring are equally important. Sovereigns have been borrowing through a significant part of the past century and will continue to do so. In this process myriad legal aspects related to sovereign debt restructuring crop up. This paper, therefore, chooses to focus on them.

2. HISTORICAL BACKGROUND

Borrowing of international loans has been in practice since time immemorial. The earliest recorded instance of such sovereign borrowing and default in repayment of the debt can be traced back to the fourth century B.C., when ten out of thirteen Greek municipalities in the Attic Maritime Association defaulted on loans from the Delos Temple.[1] In the middle ages, the emergence of Italy as a major banking centre in Europe fuelled international borrowing within the continent and banks remained the main source of credit during the period. The European kings of the era were rarely out of debt[2]. A more or less sustained trend of international borrowing and lending may be traced to the 14th century AD when the Italian banks of Bardi and Peruzzi were ruined because the English King Edward III defaulted on the repayment of his loans to finance the Hundred Years' War.[3] The history of sovereign borrowing, fifteenth century onwards[4] is quite well documented with France, Portugal and Spain defaulting in debt payments in the mid-sixteenth century[5]. In the following centuries several other nations also defaulted in the repayment of debts incurred by them.

There has been a veritable explosion in the number of sovereign borrowings and defaults since the nineteenth century.[6] The key change which ensued in the nineteenth century was the growth of international capital markets and the consequent shift in the source of credit from commercial banks to international bondholders. The London Stock Exchange emerged as the preferred market for floating sovereign bonds.[7]

The first sovereign debt default of the era was by Germany on bonds floated on the London Stock Exchange.[8] The post Napoleonic war era witnessed a sudden rise in borrowing of sovereign debts.[9] Around the same time a number of newly independent South American nations such as Colombia, Chile, Peru, etc also began borrowing heavily on the London Stock Exchange and later defaulted on

---

[1] Winkler (1933) quoted in Federico Sturzenegger, Jeromin Zettelmeyer, Debt defaults and lessons from a decade of crises (Massachusetts : Massachusetts Institute of Technology Press, 2006), 3

[2] James Macdonald, A free nation deep in debt, The financial roots of democracy (New Jersey: Princeton University Press, 2006), 105

[3] Philip R Wood, Principles of international insolvency (London: Sweet & Maxwell, 2007), 757

[4] Barry Eichengreen, "Historical Research on International Lending and Debt," Journal of Economic Perspectives 5(1991): 150

[5] Federico Sturzenegger and Jeromin Zettelmeyer, Debt defaults and lessons from a decade of crises, 3

[6] See note 5 above.

[7] Oesterreichische National bank, "The London Stock Exchange in the 19th Century: Ownership Structures, Growth and Performance", Working Paper 115, Larry Neal, http://www.oenb.at/en/img/wp115__tcm16-38822.pdf

[8] Wood, Principles of international insolvency, 757.

[9] Ibid., 758

repayment.[10] In 1841 and 1842, eight American states and the territory of Florida defaulted on their debts.[11] The decade of 1870's again brought in its wake defaults by, in addition to many countries which had defaulted earlier, Turkey and Egypt.[12]

Around this time, creditor nations began taking direct control of the debtors' finances by establishing customs receiverships. The Ottoman Public Debt Administration was formed to recover loans from Turkey after it began defaulting on its payments to European creditors.[13] The Decree of Mouharrem in 1881 empowered the Council to seize turkey's revenues.[14] Soon after in 1882, Britain and France took control of Egypt's internal revenues for the latter's failure to service its debt.[15] In many cases creditors also resorted to direct military action to secure repayments of their loans. Military action was initiated against Venezuela by Germany, Italy and UK in 1902 and against Haiti by the USA in 1915.[16]

In the twentieth century, the incidence of sovereign borrowing and defaults was even higher. It may be attributed to the rapid increase in international interaction as well as international flow of capital. The 1920's witnessed a drastic increase in cross border lending with the rise of America as an economic superpower and New York as London's rival financial centre. It was followed by a major period of defaults in the 1930's attributed to the great depression.[17] Almost all European nations defaulted on their debts which they had borrowed from the USA. Again a majority of the Latin American nations defaulted in repayment.

By the time the Second World War ended, the world economy was severely damaged by the depression and the unprecedented scale of the war. This breakdown in international monetary cooperation led the International Monetary Fund's (IMF) founders to plan an institution charged with overseeing the international monetary system—the system of exchange rates and international payments that enables countries and their citizens to buy goods and services from each other.[18] Efforts were made towards improving the global financial system and

---

[10] Ibid.

[11] National Bureau Economic Research, "Sovereign debt and repudiation: the emerging-market debt crisis in the US. states, 1839-1843" , John Joseph Wallis, Richard E. Sylla and Arthur Grinath III ,NBER Working Paper no 10753 http://www.nber.org/papers/w10753

[12] Eichengreen, "Historical Research on International Lending and Debt," 150

[13] Jeffry A. Frieden, "International investment and colonial control: A New Interpretation," International Organization, 48(1994):587.

[14] James R. Silkenat and Charles D. Schmerler, The Law of International Insolvencies and Debt Restructurings, (USA: Oceania Publications, 2006): 435.

[15] Holger Schier, Towards a reorganisation system for sovereign debt: an international law perspective, (The Netherlands: Martinus Nijhoff publishers, 2007), 5.

[16] See note 15 above.

[17] Ibid.

[18] International Monetary Fund, History, "Cooperation and reconstruction (1944–71)," http://www.imf.org/external/about/histcoop.htm

bring a semblance of order. The nascent United Nations convened a conference at Bretton Woods, New Hampshire, in the USA in 1944 which resulted in agreements leading to the creation of the IMF and the International Bank for Reconstruction and Development (IBRD).

Two landmark debt restructuring agreements made around that time deserve a special mention. The first was the Anglo American Financial Agreement of 1946 between the USA and Great Britain. It rescheduled the debt which Britain had to pay to the USA by settling the amounts used in the two World Wars and stipulating a period of fifty years for repayment. [19] The second was the Multilateral London Conference on German External Debt of 1953 and was meant to reduce to a large extent German debt after the wide scale devastation it suffered in the war.[20] The London Debt Agreement wrote down the German debt between the first and second World Wars by approximately 50% and lengthened the period for repayment.[21] It was exemplary because it was based on the premise of the debtor nation's capacity to pay rather than on account of what it actually owed to its creditors.[22]

The 1960's and 1970's again saw an increase in sovereign defaults. The debt problem began to build up in the 1970's when many developing countries began incurring vast amounts of external debt.[23] But it was during the 1980's that the maximum number of countries in history became insolvent.[24] In this era it was mainly the large commercial banks which served as the source of credit and the world faced a threat of a banking system meltdown.[25] Beginning with Mexico's default in August of 1982, the crisis soon spread to other Latin American nations. The banks rescheduled the payment of the principal amount but insisted on receiving the interest on time. Further bank loans had to be furnished to the defaulting nations to enable them to pay the interest. In October 1985, the then U.S. Treasury Secretary James Baker proposed that additional loans be given to the fifteen highly indebted nations by commercial banks and international financial organizations for a period of three years. The plan failed to work as expected and banks began withdrawing from the sovereign debt market.

---

[19] John H. Ferguson, "The Anglo-American Financial Agreement and Our Foreign Economic Policy," The Yale Law Journal 55 (1946):1151.

[20] H. J. Dernburg, "Germany's External Economic Position," The American Economic Review 44(1954):530-558.

[21] Economic growth center, Yale university, "Center discussion paper no. 880, financial vergangenheitsbewältigung: the 1953 London debt agreement," Timothy W. Guinnane, http://www.econ.yale.edu/growth_pdf/cdp880.pdf

[22] Wood, Principles of international insolvency, 759.

[23] Detlev Dicke, Ed., Foreign debts in the present and new international economic order, (Fribourg: Fribourg University Press, 1986), 164.

[24] See note 22 above

[25] Wood, Principles of international insolvency., 761

A new successful attempt at rescheduling sovereign debt was made in 1989 by the then US treasury secretary Nicholas Brady. The Brady plan, as the proposal came to be know, contemplated the securitization of the bad debts and rescheduled as thirty year bullet bonds i.e. bonds on which payment of principal is made in a single installment. The bonds were offered publicly and the proceeds were used to pay off the bank debt. To pay for the interest on the bonds, US zero coupon treasury bonds were bought by the sovereign debtors with the help of loans by international financial organizations. This restructuring technique was hugely successful and the debtor nations quickly rescheduled their debts. It also led to a return to bonds as a source of credit as had been the practice before 1930's. But the return to bonds brought in its wake a new era of litigation which stripped sovereign debtors of the traditional immunity enjoyed by them under international law. Bondholder renegotiation has proved to be the most cumbersome and shall be discussed in detail subsequently.

The last decade of the twentieth century also had its share of defaults with the Russian debt crisis after disintegration of the former Soviet Union and the Southeast Asian crisis in the late 1990's being the most prominent ones.[26]

With so many events of sovereign debt defaults, there have been countless attempts and instances of sovereign debt restructuring. Right from the proposed scheme of delegating responsibility for solving the debt crisis to the Bank for International Settlements(BIS) in the 1930's [27] to the very recent Sovereign Debt Restructuring Mechanism (SDRM)[28] proposed by the International Monetary Fund (IMF) in 2002, attempts have been made to resolve debt crises and introduce a universally acceptable procedure for restructuring debt. In between many other plans were suggested – the Kindersley-Norman Plan which proposed the establishment of an international corporation for the purpose of disbursing loans to countries which otherwise were unable to obtain them[29], the Beyen and Crena de Jongh Plan which proposed to convert the credits into loans repayable in installments over a period of few years,[30] the proposals of creation of an international credit bank by Turkey and a normalization fund by the Great Britain,[31] and the 1974 call for a New International Economic Order at the United Nations, following the OPEC oil crisis where proposals to deal with sovereign debt negotiations were discussed. Unfortunately, for a variety of reasons, none of these could ever be successfully implemented.

---

[26] Ibid., 762

[27] Eichengreen, "Historical Research on International Lending and Debt,"165

[28] Anne O. Krueger, A New Approach To Sovereign Debt Restructuring (Washington. D.C: International Monetary Fund, 2002)

[29] See note 27 above.

[30] Ibid.

[31] Ibid.

In view of the historical discussion of sovereign debt borrowing and restructuring, there arises a major point for consideration – the nature of the creditor. The type of credit source has influenced the way in which debt is borrowed and later in the event of a default, restructured. In the early twentieth century, issuance of sovereign bonds was the favorable source of credit. After the great depression of the 1930's, inter governmental loans became the favoured source. This was followed by the preference for commercial bank loans in the 1970's and 1980's. The 1990's saw a return to bondholders as the major creditors and the threat of litigation as a major hurdle in rescheduling of debt.

3. SOVEREIGN DEBT AND ITS RESTRUCTURING – CONCEPTUAL OVERVIEW

Sovereign debt has been defined by the IMF as, "a debt instrument issued by a sovereign government".[32] However, the analysis of the complex procedure of sovereign debt restructuring and the legal aspects involved must begin with a simple question – Why do countries borrow money? Nations borrow pretty much for the same reasons as people or corporate entities do – to meet their financial needs. The key difference lies in the mechanism by which the loan is sought to be repaid. [33] Unlike corporations and private individuals, sovereign governments theoretically cannot become "insolvent".[34] Therefore a considerable debate has been generated on why debtor governments choose or refuse to service their debts. A large volume of economic literature has been generated on various issues of sovereign debt and the concept has been the subject of a protracted debate among economists. While a detailed discussion of the economic perspectives is beyond the scope of this research, a brief summation of the key ideas is warranted.

Economic theory tells us that governments generally borrow for three purposes – short-term transaction smoothing which usually involves borrowing for up to a period of ninety days, medium-term expenditure smoothing which involves borrowing in periods such as economic recessions and investment in longer-term projects such as development of infrastructure.[35]

The economic literature is mostly focused on questions such as why sovereigns borrow debt, why or not it is repaid and why a market for sovereign debt exists at all. The economic theories posit various views but two seminal papers have been the most influential and laid the foundation of the present economic discourse

---

[32] Glossary of Selected Financial Terms, Terms and Definitions, http://www.imf.org/external/np/exr/glossary/showTerm.asp#110

[33] Federico Sturzenegger and Jeromin Zettelmeyer, Debt defaults and lessons from a decade of crises, 659

[34] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 431

[35] Barry Herman, "The Players and the Game of Sovereign Debt," Ethics & International Affairs, 21(2007): 5-32.

on sovereign debt. The first paper by Eaton and Gersowitz [36] published in 1981 argues that sovereigns service their debts because of the threat of *permanent* (emphasis supplied) exclusion from the credit market in the future. The approach is further based on the assumption that the borrowing is the only way out for a sovereign to meet its financial requirements. It was quickly criticized on the grounds that the threat would do more harm to both the lender and creditor than in a situation where lending would later continue.[37] Later Bulow and Rogoff [38] in their 1989 paper asserted that if the assumption of international borrowing as the only available option was dropped, the threat of future exclusion would not be enough to make governments pay.[39] They argued instead that it was the threat of direct punishments such as interference with the country's trade and payment through seizure outside the country's border,[40] which prompted governments to repay.

In addition to these, there have been several other approaches to the matter over a period of nearly three decades. However, the existence of a sovereign debt market and the various issues allied with it, still remain debatable and there seems no consensus among the economists.[41]

Traditionally the doctrine of sovereign immunity protected the sovereign in the event of a default. The position initially was that in the absence of a law on the matter, there did not arise any legal obligations on part of the sovereign to repay the debt. The obligation, if any, was only one of honour.[42] With the passage of time however, the obligation crystallized into a legal one.[43]

Recovering sovereign debt, however, is a very complex and time consuming exercise. While the assets of a corporate entity may be liquidated to pay the debt, it is generally not possible to attach and liquidate the assets of a sovereign state in order to secure repayment owing to the doctrine of sovereign immunity. This acts as a major hurdle for creditors to get their money back. In order to be recovered, debt usually is restructured by various means. There have been various instances

---

[36] Jonathan Eaton and Mark Gersovitz, "Debt with Potential Repudiation: Theoretical and Empirical Analysis," Review of Economic Studies, 48 (1981): 289- 309.

[37] Ugo Panizza, Federico Sturzenegger, and Jeromin Zettelmeyer, "The Economics and Law of Sovereign Debt Default," Journal of economic literature 47(2) (2009): 660.

[38] Jeremy Bulow and Kenneth. S. Rogoff, "Sovereign Debt: Is to Forgive to Forget?" American Economic Review 79 (1989): 43-50.

[39] R. Gaston Gelos, Ratna Sahay and Guido Sandleris , "Sovereign Borrowing by Developing Countries: What Determines Market Access?" IMF Working Paper No. 04/221, (2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=879046

[40] Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default," 661

[41] Ibid., 693

[42] Schier, Towards a reorganisation system for sovereign debt, 6

[43] Ibid.

of creditors not amenable to the rescheduling process and having resorted to litigation.[44]

Sovereign debt is sought to be restructured when countries are burdened by their unsustainable debt and fail to come up with feasible macroeconomic policies to resolve the crisis.[45] Debt officially becomes "unsustainable" when the debt-to-Gross Domestic Product (GDP) ratio rises incessantly. [46]

The trend of sovereign debt restructuring has caught up in the 1980's beginning with the Mexican default of 1982.[47] Restructuring has been correctly attributed to the change in the source of credit. Bondholders began replacing commercial banks as the chief source of credit. However the absence of a uniform legally binding mechanism for resolving debt crises have hindered the timely and smooth restructuring of sovereign debt. With the majority of credit coming from bondholders, the problem increases manifold – bondholders are not homogenous in nature, are scattered, and not represented by a single person/body. In addition to this, dissident bondholders often threaten the sovereign debtor with litigation. Foreign creditors may feel they would be discriminated against the domestic creditors of the sovereign. Alongside the debtor nation may itself have an entirely different set of notions.[48]

Generally speaking, restructuring agreements involve a number of common legal issues. The accurate issues may differ according to the nature of the restructuring mechanism but the typical ones include the governing law, exchange control, sovereign immunity and interdependence of the restructuring agreement and IMF programmes of assistance. [49]

3.1. Sources of sovereign debt

Sovereign debt may be sourced from foreign governments, international financial institutions, commercial banks and the issuance of government bonds in foreign jurisdictions.

Governments often turn to foreign governments for securing loans. The OECD defines Bilateral Debt as, "Loans extended by a bilateral creditor."[50]

---

[44] See infra 6. SOVEREIGN IMMUNITY AND SOVEREIGN DEBT LITIGATION.

[45] Shalendra D. Sharma, "Resolving Sovereign Debt," Journal of World Trade 38 (2004): 627.

[46] Richard Euliss, "The Feasibility of the IMF's Sovereign Debt Restructuring Mechanism: An Alternative Statutory Approach to Mollify American Reservations," American University International Law Review 19 (2003):108 - 151

[47] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 433

[48] Ibid., 434

[49] Dicke, Foreign debts in the present and new international economic order, 274.

[50] Glossary of Statistical Terms, Bilateral Debt, http://stats.oecd.org/glossary/detail.asp?ID=5887

These bilateral debts form a part of the official debt owed by a sovereign to another sovereign.

Historically, commercial banks have been the most important source of credit in Europe. Through a major period of the twentieth century too, commercial banks have acted as the major lenders of credit to sovereigns. Syndicated bank loans are made through sophisticated institutions.[51] International financial institutions such as the IMF and the World Bank and regional development banks such as the Asian Development Bank, African Development Bank, Islamic Development Bank also lend large loans to nations.

Sovereign bonds have emerged as the preferred source of debt in the past few decades. Sovereigns issue bonds in other jurisdictions to raise finances. Bond issues are loans made typically by sophisticated investors such as insurance companies, banks and large corporate pension and investment funds and are evidenced by transferable debt securities issued by the borrower (issuer) to the initial lenders (subscribers).[52] Investment bankers arrange for the issue by entering into a subscription agreement with the issuer (in this case the sovereign) and agree to procure subscribers for the securities for a fee.[53]

International issues are issues of debt securities to investors in different countries.[54] International securities are usually denominated in a foreign currency, especially the US dollar, the Euro or Japanese yen.[55] Sovereign bonds are issued to sophisticated investors and not to the public.[56] Offering circulars for bond issues are also often exempt from disclosure and prospectus registration requirements if sent to defined classes of sophisticated investors.[57] The loan documentation for bondholders involves a subscription agreement, a trust deed (if there is a trustee) and a fiscal agency or paying agency agreements.[58] The issue used to be evidenced by bonds which were security printed (because they are bearer securities), but are now evidence by a typed global bond held by a custodian in trust for the settlement systems.[59] Sovereign bonds for the purpose of borrowing foreign debt are international bonds i.e., those issued by a government in an international financial center (for example, New York, London, or Tokyo) under

[51] Philip R. Wood, International loans, Bonds, Guarantees, Legal opinions (London: Sweet & Maxwell, 2007), 194.
[52] Ibid.,193
[53] Ibid.
[54] Ibid.
[55] Ibid.
[56] Ibid., 194.
[57] Wood, International loans, Bonds, Guarantees, Legal opinions, 195
[58] Ibid.
[59] Ibid.

foreign law.[60] "Eurobonds" refers to a specific category of international bonds, namely bonds that are issued in countries other than the one in whose currency the bond is denominated. Eurobonds often U.S. dollar denominated bonds issued in a European jurisdiction (e.g., England, Germany, or Luxembourg), hence the name. [61] New York law and English law are by far the most popular governing laws for the issue of international bonds, though Luxembourg law (for Brady bonds), German law and more recently Japanese law and Italian law (for Argentine debt) have also played a role.[62]

Bonds are usually issued out in a single advance.[63] Sovereign bonds often contain a large number of important clauses which are instrumental at the time of restructuring. Bond documents contain covenants such as negative pledge, the *pari passu* clause and remedies for breach. The *pari passu* clause has played a key role in successful sovereign debt litigation by bondholders in the past several years.[64]

3.2. Hierarchy of creditors

A sovereign may borrow from many creditors – bilateral debts, commercial banks, international financial organizations such as IMF, World Bank and the regional development banks such as Asian development bank, Andean bank, Islamic development bank and bondholders. All these debts are not rescheduled and there are different informal mechanisms for rescheduling them. As mentioned before, there exists no legally binding, universally acceptable mechanism for sovereign debt restructuring.

Unlike corporate debt, the repayment of sovereign debt does not have a fixed hierarchy of creditors. But it is an issue of major importance for sovereign debtors as it helps with burden sharing.[65] It is established by negotiation, consensus and market practice.[66] The rescheduled creditors stipulate that preferred creditors shall not be rescheduled and may be paid when due.[67] Each class of rescheduled creditors requires an undertaking from the debtor state that it will not pay creditors of the class concerned , who are eligible for rescheduling but who do not agree to reschedule and will obtain comparable treatment from other classes

---

[60] Federico Sturzenegger, "Has the Legal Threat to Sovereign Debt Restructuring Become Real?" http://www.utdt.edu/download.php?fname=_115331294204239500.pdf

[61] Ibid.

[62] Ibid.

[63] Ibid.

[64] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 452.

[65] Wood, Principles of international insolvency, 757

[66] Ibid., 777

[67] Ibid.

of creditors who are required to be rescheduled on equivalent or worse terms.[68] It means that the sovereign debtor assures each class of the rescheduled creditors that dissident creditors and creditors of each class shall not be paid on better terms. The sovereign has to ensure inter-creditor equity.

3.2.1. First priority

Debt to certain multilateral public entities such as the IMF and the World Bank has been treated as exempt from restructuring. It has to be repaid by the sovereign debtor.

3.2.2. Second priority.[69]

These are bilateral debts owed to other governments, debts owed to commercial banks and bondholders. These are debts which are rescheduled. The types of creditors being different various mechanisms have emerged which are used for rescheduling debt owed to different entities. However, the mechanisms are not always uniform. Rescheduling bondholders has proven to be the toughest among creditor restructuring.

3.2.3. Third priority

This covers dissident creditors. They are excluded from rescheduling by virtue of the comparable treatment clause which agrees not to pay them.

3.3. The role of the IMF and the creditor clubs

The IMF plays a central role in the sovereign debt restructuring process.

The judgment of the IMF about the scale of the financing it is willing to provide in the absence of a debt restructuring and the design of an economic program supported by the IMF both help determine the timing of a sovereign payment suspension.[70] Before a member decides to seek a comprehensive debt restructuring, it typically approaches the IMF for financing (either in the context of an existing or future arrangement) with the aim of avoiding such a restructuring and the associated economic, social, and political disruption.[71]

Once the member country suspends payments to creditors, it usually works on getting an appropriate IMF programme which often is a prerequisite for debt negotiations under the creditor clubs. [72]

In the absence of an internationally binding mechanism for restructuring of sovereign debt, various countries have formulated flexible informal procedures

[68] Ibid.
[69] Ibid., 779
[70] Krueger, A New Approach to Sovereign Debt Restructuring, 21
[71] Ibid., 22
[72] Ibid.

to do so. Two main creditor clubs – the Paris Club and the London Club – have emerged for restructuring official debt and private bank debt respectively. They represent a set of procedures currently used for negotiating arrangements to delay payment obligations on credits.[73] The IMF deeply influences both the creditor clubs. Both the Paris and the London Clubs stipulate the assistance of an IMF programme as pre requisites for their debt rescheduling.

3.3.1. Paris Club

Intergovernmental loans between nations and debt from international financial organizations and regional development banks are official debt. The term official creditors refers to a) official bilateral creditors (governments or their appropriate institutions), including Paris Club members; b) multilateral creditors (international institutions such as the IMF, the World Bank or regional development banks). [74] As afore mentioned, the debt owed to IFIs is preferred debt and may not be rescheduled. The Paris Club however offers debt relief to countries which are willing to use its services. The term 'debt relief' broadly encompasses any kind of modification in a country's debt obligations for the purpose of avoiding or getting out of a default situation, including debt forgiveness, reduction and rescheduling.[75] The Club[76] is an informal group of 19 permanent official creditors and a few other associated member countries.[77] It was formed in 1956 has since reached 415 agreements with 87 debtor countries.[78]

Debt restructuring under the Paris Club is based on five main principles which developed over the years as a result of the club's practices. These are[79] debt treatment on a case-by-case, consensus among all the participating creditor countries, condition that the country must have a current program supported by an appropriate arrangement with the IMF,[80] creditor solidarity for implementing the agreed terms and the comparability clause.[81] While the large number of agreements

[73] Lex Rieffel quoted in Eva Riesenhuber, The International Monetary Fund under Constraint, Legitimacy of its Crisis Management,(The Netherlands : Kluwer Law International, 2001),60.

[74] Glossary, ODA credits, http://www.clubdeparis.org/sections/services/glossaire/?letter=o

[75] Lex Rieffel, Restructuring Sovereign Debt: The Case for Ad hoc Machinery (Washington D.C: The Brookings Institution, 2003), 20.

[76] Amita Batra, "Sovereign Debt Restructuring," Ocassional Policy Paper, October 2002, Indian Council for Research on International Economic Relations, http://www.icrier.org/pdf/OP02SovDebt.pdf

[77] The Paris Club, "Permanent Members" http://www.clubdeparis.org/sections/composition/membres-permanents-et/membres-permanents

[78] Data as on 28th April 2010.See http://www.clubdeparis.org/sections/donnees-chiffrees/chiffres-cles

[79] The Paris Club, "The five key principles," http://www.clubdeparis.org/sections/composition/principes/cinq-grands-principes

[80] E.g., Stand-By, Extended Fund Facility, Poverty Reduction and Growth Facility

[81] The comparability of treatment means that a debtor country agrees not to accept from its non-Paris Club creditors terms of treatment of its debt less favorable than those agreed with the Paris Club.

reached under the Paris Club is ample evidence of its success in smooth restructuring of official debt, the club has also come under criticism for what according to a few analysts is the undermining of economic self determination of nations.[82]

3.3.2. London Club

In the 1970's and 80's, commercial banks were the most preferred source of credit.[83] The early 1980's there were a series defaults in repayment of sovereign debt by many countries. [84] By that time however, a debt restructuring procedure was commercial bank debt was already established. It had developed organically in the mid-seventies as a result of commercial bank negotiations with Peru and Zaire in 1976, and later with Turkey, Sudan and Poland.[85] Since these early meetings for renegotiating debt took place in London, the ad hoc forum came to be known as the London club. Also most of the agreements were governed by English law as Euro-currency loans formed the bulk of the rescheduled amounts. Additionally, the interest rates were based on the London Inter bank Offered Rate (LIBOR).[86] While later meeting were not necessarily held at London, the name London Club remained

The Club is an informal group of Banks and has no secretariat or formal procedures but follows common practices[87] which have evolved over the years. Unlike the Paris Club, the London Club does not have a fixed group of members[88] owing to the fact that the creditor banks involved in the negotiations vary from debtor to debtor. Also, the London Club negotiations tend to be much more protracted than Paris Club, because of the larger number of creditors involved.[89]

The London Club rests on the premise that all similarly situated commercial creditors must be treated equally, both in terms of the rescheduling of their

---

[82] Noel G. Villaroman, "The Loss of Sovereignty: How International Debt Relief Mechanisms Undermine Economic Self-Determination," Journal of Politics and Law 2 (2009): 3 - 16

[83] See note 37 above.

[84] Wood, Principles of international insolvency, 760

[85] Dusan Zivkovic, "Debt Renegotiation Framework," UNCTAD Paper prepared for the expert group meeting on Debt Sustainability and Development Strategies, October 2005, 12

[86] LIBOR is a benchmark giving an indication of the average rate a leading bank, for a given currency, can obtain unsecured funding for a given period in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market http://www.bbalibor.com/bba/jsp/polopoly.jsp?d=1627

[87] Hal. S. Scott, "A bankruptcy procedure for sovereign debtors," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=384220

[88] Oluwole Akanle, "Rescheduling of the External Debt: London Club", Online Resource Centre, UNITAR, http://www2.unitar.org/dfm/Resource_Center/Document_Series/Document1/C_Akanle.htm

[89] Richard P.C. Brown and Timothy J. Bulman, "The evolving roles of the clubs in the management of international debt," International Journal of Social Economics 33(2006):12.

existing exposure and their participation in any new credit facilities. The procedure requires that all participants to the rescheduling agreement must be unanimous in respect of any amendment or waiver and especially as regards loan commitment of all creditors, interest payable, amortization dates and amount of repayment.[90] It is common practice for the more recent London Club of private lenders to insist on an IMF stand-by arrangement before private debts can be renegotiated.[91]

The creditor banks form a committee known as the Bank Advisory Committee (BAC) or steering committee which usually consists of the representatives of 15 – 20 banks and deals directly with the sovereign borrower.[92] The BAC represents the interest of all commercial bank creditors by acting as communication link between the debtor country and all the creditor banks by undertaking the negotiation and documentation of the rescheduling agreements on behalf of all banks.[93]

4. LEGAL ASPECTS COMMON TO LENDING OF SOVEREIGN DEBT

While there are various different sources of obtaining credit by sovereign nations, there are a few legal aspects which are common to all modes of sovereign borrowing.

4.1. The Loan Agreement

Borrowing takes place through a loan agreement. The borrower obtains funds from the lender immediately and the lender understandably insists on the borrower signing a legally binding document that defines his obligations for repayment.[94] Generally the following five standard elements are present in all international loan agreements: [95]

- Loan Mechanics. This sets forth the amount of the loan, the procedures for drawdown, interest charges and repayment mechanism.

---

[90] Ousmène Jacques Mandeng, "Intercreditor Distribution in Sovereign Debt Restructuring", IMF Working Paper, WP/04/183, http://www.imf.org/external/pubs/ft/wp/2004/wp04183.pdf

[91] Stephen T. Easton and Duane W. Rockerbie, "Does IMF Conditionality Benefit Lenders?" Review of World Economics,135(1999): 347

[92] Current Legal Issues Affecting Central Banks, Vol 5, ed. Robert C. Effros, (Washington D.C: International Monetary Fund, 1998), 322.

[93] See note 88 above

[94] Thomas M. Klein, External Debt Management: An Introduction, World Bank Technical Paper No. 245, (Washington D.C: The World Bank 1994), http://books.google.co.in/books?id=Af1QFUYXKDcC&printsec=frontcover&lr=#v=onepage&q&f=false

[95] Ibid., 37

- Protection clauses. These spell out what is to be done in the event of default and also include warranties and covenants
- Change in circumstances. For loans based on variable interest rates, the agreement must explain what adjustments in the payment arrangements are required as the cost conditions change in money markets.
- Relationship between banks. Financial credits often involve the lending of money pooled by several banks. The loan agreements must set forth clearly what are the responsibilities of the lending banks to each other.
- Dispute resolution clauses. These include agreement on which courts have jurisdiction and what laws apply. If a sovereign state is the borrower, there may be a waiver of immunity.

4.2. Governing law[96]

In international lending and borrowing, different legal jurisdictions are involved and the laws of more than one could apply to the loan.[97] Therefore, it is customary to choose the jurisdiction of the country which the parties agree upon.[98] While sovereign borrowers usually wish to put their own law as the governing one, lenders generally insist that the law of another jurisdiction be applicable.[99] This is because if lender faces the risk of loss in case the borrowing sovereign amends its laws in order to frustrate attempts of recovery in case of a default. Foreign lenders also want to know that a foreign judgment obtained against the borrower with respect to non performance would be enforced in local courts without a re examination of the merits of the judgment and that the borrower would not be entitled to sovereign immunity. [100]

4.3. Forum

The choice of forum for settlement of any dispute is also of significance and is settled beforehand. The reason for specifying the forum is to confer jurisdiction on courts which might otherwise not have authority to adjudicate upon disputes.[101]

4.4. Sovereign immunity waiver [102]

While the notions of sovereign immunity were previously absolute, they have now changed and are restricted in view of the sovereign's role as a private

[96] Ibid.
[97] Ibid.
[98] Ibid., at 38
[99] Ibid., at 37
[100] Klein, External Debt Management: An Introduction, World Bank Technical Paper No. 245,38
[101] Ibid., at 39
[102] Ibid., at 40

person when it comes to borrowing money. Therefore now most sovereign loan agreements include a sovereign immunity waiver clause. Lenders will usually seek waivers for both pre judgment and post judgment attachment of assets.[103] Both the USA and the UK have laws which deal with sovereign immunity waiver.

5. BONDHOLDER RESCHEDULINGS

Bondholders form the largest part of sovereign debt owed to private entities.[104] Bondholder restructurings have proven to be the most cumbersome and controversial with a large number of them ending in litigation. Bondholders made a comeback in the sovereign debt market in the 1990's after the Latin American debt owed to commercial banks was securitized in the form of bonds known as Brady Bonds, named after the US Treasury Secretary Nicholas Brady who had put forth the proposal.

Several attempts, albeit unsuccessfully, have been made at reaching an agreement for creation of a universally binding mechanism for sovereign debt restructuring. The restructuring of sovereign debts have been getting difficult, due to the transition of component of sovereign debts from bank loans to bonded debts.[105] Restructuring bonds involves myriad issues as the bondholders are scattered and not homogenous in nature. Bondholders, on the other hand, are naturally a more diverse, amorphous group with eclectic interests.[106] Broadly speaking, there are two main reasons for the difficulties encountered in restructuring sovereign bonds. The first factor is the mobility of bonds which makes the timely identification of creditors difficult owing to the active trading of the bonds in the secondary market. [107] The second is the difficulty of coordination and consensus of creditors' opinions since they are dispersed and diversified.[108] Bondholders also tend to fear a loss of their money and therefore many of them often are not amenable to rescheduling the debt and threaten litigating against the sovereign. Further, bondholders are also less likely than banks to agree to any accommodations in order to maintain a commercial relationship with the state.[109]

The broadened investor base in bond financing raises problems of coordination and collective action in the event of a sovereign borrower's default

[103] Ibid., at 40

[104] Wood, Principles of international insolvency, 789

[105] Kentaro Tamura, "The problem of sovereign debt restructuring: How can we deal with Holdout problem legally?" http://www.law.harvard.edu/programs/about/pifs/education/sp45.pdf

[106] Euliss, "The Feasibility of the IMF's Sovereign Debt Restructuring Mechanism", 108.

[107] See note 105 above

[108] Ibid.

[109] Steven L Schwarcz , ' "Idiot's Guide" to sovereign debt restructuring,' Emory law journal, 53(2004):1193

and restructuring.[110] The complex relationships among the borrowers, creditors, and the global taxpayer have made restructuring obligations a costly and time-consuming exercise, especially with the possibility of "holdouts."[111] Both the sovereign borrower and its creditors have an incentive to avoid a restructuring in the hope of financial assistance from the IFIs – sovereign governments may not undertake the politically painful steps involved in beginning a restructuring when there is always the hope that official assistance will be forthcoming and similarly the creditors may not accept a reduction in the value of their claims, also in hoping for official assistance to the debtor.[112] The costs of sovereign debt restructuring are also high for both the debtor nation and the creditors

Two main proposals for Debt restructuring were put forth in the recent years – the contractual versus the statutory approach. An extended debate ensued between the proponents of both the proposals for a long period of time. The first proposal was known as the Sovereign Debt Restructuring Mechanism (SDRM) was put forth by the IMF. The second proposal was in favour of inclusion of Collective Action Clauses (CACs) in the sovereign bonds. Both these proposals form the bedrock for the analysis of the bondholder restructuring process and are discussed in detail. While the IMF's SDRM failed to take off, CACs have gained substantial acceptance.

5.1. Sovereign Debt Restructuring Mechanism (SDRM)

In 2002, the managing director of the IMF, Anne O. Krueger, presented a new proposal for restructuring sovereign debt. [113] Addressing the relevant issues, the elaborate paper advocated the establishment of a Sovereign Debt Restructuring Mechanism (SDRM) to facilitate the orderly, predictable, and rapid restructuring of unsustainable sovereign debt, while protecting asset values and creditors' rights.[114]

The ideas for the establishment of an SDRM draw an important analogy with Chapter 11 of the U.S. Bankruptcy Code.[115] The main features of the proposed SDRM were to include majority restructuring to enable the majority of creditors to bind a dissenting minority to the terms of a restructuring agreement[116], stay on creditor enforcement to deal with the minority holdout issue[117], protecting

[110] Randall S. Kroszner, "Sovereign Debt Restructuring," The American Economic Review, 93(2003): 75-79

[111] Ibid.

[112] Ibid.

[113] Krueger, A New Approach To Sovereign Debt Restructuring.

[114] Ibid., 4

[115] Patrick Bolton, "Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice around the World," IMF Staff Papers, Vol. 50, http://www.imf.org/external/pubs/ft/staffp/2002/00-00/pdf/bolton.pdf

[116] Krueger, A New Approach To Sovereign Debt Restructuring, 14.

[117] Ibid.

creditor interests during the period of the stay[118], priority financing to supply new money from private creditors during the period of the stay[119] and creation of a dispute resolution forum[120] to settle claims of the negotiating parties. The SDRM proposal had envisaged an extensive role of the IMF in the mechanism with three main functions[121] – endorsement on activation of a stay on creditor action on request by the sovereign debtor, extension of the stay with IMF approval of a restructuring agreement and IMF approval of a restructuring agreement.

5.2. Collective Action Clauses

Private creditor groups and the U.S. Treasury, principally in the person of John Taylor, the Undersecretary for International Affairs, called for a contractual mechanism, use of collective action clauses (CACs) in sovereign bonds, to facilitate sovereign debt restructuring. [122] The USA though initially in favour of the IMF's proposal of SDRM[123], later opposed it and insisted that the mechanism was unnecessary.[124]

Collective Action Clauses approach advocated the use of certain contractual provisions in sovereign debt contracts to improve the sovereign debt restructuring process.[125] Collective representation clauses provide for the establishment of a representative forum-a bondholders' meeting-where the creditors may exchange views and information.[126] CAC's would be placed in individual bond issues and would bind all bondholders to accept debt reduction and restructurings where a specified supermajority of holders consented to it.[127]

The treasury proposal also called for sovereign borrowers and creditors, to insert a package of new "contingency clauses" into future bond contracts designed to set forth the modalities of a sovereign debt workout and in particular describe the process to be followed if restructuring proved necessary. [128] Two new clauses, the engagement clause and the initiation clause were also proposed to

---

[118] Ibid., 16.

[119] Ibid., 17.

[120] Sharma, "Resolving Sovereign Debt,"629.

[121] Krueger, A New Approach To Sovereign Debt Restructuring, 23

[122] See note 87 above.

[123] Sharma, "Resolving Sovereign Debt,"630.

[124] Jonathan Sedlak, "Sovereign Debt Restructuring: Statutory Reform Or Contractual Solution?" University of Pennsylvania Law Review, 152 (2004): 1483

[125] Sharma, "Resolving Sovereign Debt,"631.

[126] Barry Eichengreen, "Restructuring Sovereign Debt" The Journal of Economic Perspectives,17 (2003): 83

[127] Anne O. Krueger, "Sovereign Debt Restructuring: Messy or Messier?" The American Economic Review, 93(2003):72.

[128] See note 125 above.

be put in the bonds. [129] The engagement clause would describe the procedure for the coordination between the debtors and the creditors in the event of a restructuring.[130] The initiation clause would serve as a "cooling off" period between the announcement of restructuring and the appointment of a creditor representative and act as bar to litigation during such period.[131]

Following a meeting at the Institute for International Economics at Washington DC in April 2002,[132] where both groups proposing the SDRM and the inclusion of CACs in bonds were asked to present their arguments, the IMF reviewed its proposal of the SDRM and included in it the collective action clauses by which debt restructurings would be facilitated. [133]

CACs were already present in government bonds issued on the London market, but not in those issued in New York.[134] Therefore the proposal for inclusion of CACs in sovereign bonds issued under New York Law had its limitations as they did not have the provision of collective action and represented the largest percentage of sovereign debt issued in the emerging markets. [135] However since March 2003, bonds issued under the New York law typically include CACs.[136] In addition, bonds governed by English law typically specify procedures for selecting a bondholders' representative and enumerating that party's responsibilities.[137] That representative, generally the trustee, is empowered to communicate the bondholders' negotiating terms to the debtor.[138] Bonds governed by U.S. law instead typically provide for a "fiscal agent," who has a variety of administrative responsibilities, but lacks the power to speak for the bondholders in negotiations.[139] The fiscal agent is an agent of the issuer rather than of the bondholders, mainly responsible for keeping track of interest and amortization payments and distributing these to the holders of the debt securities.[140]

CACs also appear in sovereign bonds issued under Japanese law but not under German law.[141] Restructurings bonds which do not contain CACs becomes very

---

[129] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 460

[130] Ibid.

[131] Ibid. 461.

[132] See note 123 above.

[133] Ibid. 631.

[134] See note 46 above

[135] International Monetary Fund, "Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework", http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf

[136] Ibid.

[137] Ibid.

[138] Ibid.

[139] Ibid.

[140] Ibid.

[141] Joy Dey, "Collective Action Clauses Sovereign Bondholders Cornered?" Law and Business Review of the Americas, 15 (2009): 504.

difficult because debtor countries have to gather unanimous vote to amend the payment terms in order to restructure bonds.[142] In the absence of CACs, debtor nations use the so called "exchange offer" to restructure debt by issuing new bonds which restructure the debt and exchange it with the existing "old bonds".[143] This increases the chances of creditor litigation by "hold out" creditors. This also brings in another aspect of free riders who refuse to take part in the restructuring in the hope of getting a better bargain later.

By 2003, it appears that CACs began to be accepted as part of bonds. The European Union officially recommended inclusion of CACs in the sovereign bonds issued [144] and so did the IMF in its guidelines on public debt in 2003.[145]

CACs bind only bondholders in a single bond issue. They fail to address concerns in complex restructurings where multiple instruments are issued.[146] CACs provide for a bondholder assembly and qualified majority voting, debt instrument by debt instrument, on whether to accept a restructuring offer, but they do not specify a way of aggregating the preferences of creditors holding different issues.[147] Given the multitude of instruments that exist when a sovereign wishes to engage in a comprehensive restructuring, many of which are held by creditors with diverse interests, this limitation is a serious one.[148] For the purpose of voting for restructuring debt, the clause provides the terms on basis of which creditors holding different kinds of instruments can aggregate their claims.[149]

A significant controversial confrontation began between the two approaches put forth for resolving sovereign debt crises. The IMF's SDRM was pitted against the US treasury proposal of including CACs in sovereign debt instruments. While initially, a number of countries were receptive of the SDRM, the USA firmly opposed it and the SDRM was never implemented. First, it would have been no real change in debt management.[150] The IMF would continue to take the important decisions as it had done so far. Lenders have opposed the introduction of SDRM on the basis that it would erode their rights as creditors, make defaults easier and more frequent therefore drying up the emerging-markets bond

---

142 See note 105 above

143 Ibid.

144 Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 461

145 Ibid.

146 Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 463

147 Barry Eichengreen and Ashoka Mody, "Is Aggregation a Problem for Sovereign Debt Restructuring?" The American Economic Review, 93(2003):80 -84.

148 International Monetary Fund, "the design and effectiveness of Collective Action Clauses." http://www.imf.org/external/np/psi/2002/eng/060602.pdf

149 Ibid.

150 Kunibert Raffer, "The Present State of the Discussion on Restructuring Sovereign Debts: Which Specific Sovereign Insolvency Procedure?" http://r0.unctad.org/dmfas/pdfs/raffer.pdf

market.[151] There were also concerns about the strong institutional self-interest behind the SDRM.[152] The SDRM caused graven concern of the IMF's influence over restructurings in future.[153] Some of the governments of IMF member states opposed the idea altogether because it would presuppose a (*de facto*) enhanced role for the IMF, a reduction in its bailouts, a conflict of interests, etc.[154]

Even more surprising has been the opposition to SDRM by borrowers on the basis that it would raise the cost of borrowing for them.[155] They believe that such a mechanism would be perceived by creditors as magnifying a moral hazard problem, according to which sovereigns would feel freer to take excessive risks and this, incorporated in the creditors' valuation of the financial instruments, would lead them to expect higher rates of return.

5.3. Exit Clauses

Another interesting development in the bonds is the insertion of exit clauses amidst concerns over the threat of litigation by holdout creditors. Exit consents were originally used in the 2000 Ecuador restructuring and are designed to decrease the value of old, rescheduled bonds and thus make them less attractive to the creditors who refuse to exchange them.[156]

The exit consents technique is borrowed from the U.S. corporate bond restructuring context and is used in an exchange offer where bondholders agree before the exchange to amend the non-payment terms of the bonds from which they are exiting.[157] This technique takes advantage of the fact that bonds governed by New York law contain clauses allowing for majority amendment of nonpayment terms, even though there is no majority restructuring provision with respect to amendment of payment terms.[158] The amendment agreed through the exit consent impairs the bonds left in the hands of holdouts and is intended to induce higher participation in the exchange; otherwise a holdout faces the risk of holding an impaired instrument.[159] The purpose of exit consents is to encourage the full participation in the exchange and to discourage creditors from retaining their old bonds by allowing the exiting bondholders to amend their terms in favour of the sovereign.[160]

---

[151] Andrea Orzan, "Sovereign Debt Restructuring Mechanism: Who opposes it and Why?" http://www.cilae.org/publicaciones/SDRM.pdf

[152] See note 150 above.

[153] Ibid.

[154] See note 151 above.

[155] Ibid.

[156] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 462

[157] See note 135 above.

[158] Ibid.

[159] Ibid.

[160] Ibid.

The use of exit consents has raised some legal questions and concerns – those of inter-creditor equity and secondly, the concern that some amendments achieved through exit consents circumvent the contractual provisions requiring that payment terms can only be amended by unanimous consent.[161] Exit consents have also come under criticism as they involve an obvious element of coercion.[162]

Exit consents in sovereign bonds serve to minimize the number of hold out creditors as it required no change to existing laws or standard bond documentation. The exit consents also ensured that neither they nor the sovereign are exploited by a dissident minority of creditors

6. SOVEREIGN IMMUNITY AND SOVEREIGN DEBT LITIGATION

Sovereignty denotes independence.[163] It is a cardinal principle of international law that all sovereign nations are equal in status. Sovereign immunity is the recognition of sovereignty and bars legal action against a sovereign in the municipal courts of another sovereign nation. The notion of equality of status of all states, whether large or small, strong or weak, led to the conclusion that no state should have jurisdiction over another.[164] Sovereign immunity refers to the legal rules and principles determining the conditions under which a foreign state may claim freedom from the jurisdiction of another state.[165]

This customary principle of international law finds its roots in the notion that states ought to treat each other with dignity. The notion of sovereign immunity did not develop overnight. Courts in many jurisdictions have played an active role in strengthening it. The traditional view regarding sovereign immunity has been succinctly put by the Queen's Bench in the case of ***De Haber v. The Queen of Portugal*** [166] as, " to cite a foreign potentate in a municipal court … is contrary to the law of nations and an insult which he is entitled to resent."[167]

An important aspect of sovereign immunity is that it may be waived if a nation so wishes. Such waiver may be express or implied.

---

[161] Ibid.

[162] Lee C. Bucchiet and G. Mitu Gulati, "Exit Consents in Sovereign Bond Exchanges", UCLA Law Review 48(2000), 59.

[163] Ernest K Bankas, The State Immunity Controversy in International Law, Private Suits Against Sovereign Suits in Domestic Courts(Berlin: Springer,2005),33

[164] Ian Brownlie, Public International Law, (London: Oxford University Press:1998), 289

[165] Akehurst's Modern Introduction to International Law, ed. Peter Malanczuk (London: Routledge, 1997), 118.

[166] (1851) 17QB 171,207

[167] Philip R. Wood, Conflict Of Laws And International Finance (London: Sweet & Maxwell,2007), 557

6.1. The dilution of sovereign immunity

While the nature of the sovereign changed from that of an individual to modern day government, the notion of sovereign immunity was retained and afforded to nations instead.[168] Prior to the twentieth century the principle of sovereign immunity was considered inviolable and the sovereign was absolutely immune from other jurisdictions regardless of any circumstances.[169] Changes in international financial relations have led to a more restrictive interpretation of the principle of sovereign immunity especially in commercial matters[170].Therefore now national courts are often presented with two issues associated with sovereign immunity. [171] The first one is sovereign immunity of a state in municipal courts of another jurisdiction in claims of contract or tort and the second deals with exemption of a foreign state's property in enforcement measures pursuant to the decree of municipal court. [172] The dependence of sovereigns on private bodies and individuals for securing credit has led to this change of approach as immunity from repayment of debt results in injustice to the creditors.[173]

The USA was the first country to begin limiting its own sovereign immunity vis-à-vis its own citizens. The first step in this progress occurred very early in 1797 with the enactment of an Act by virtue of which the federal government was, in any suit against a citizen, subjected to all counterclaims which that citizen might have, up to the extent of the Government's claims.[174] The statute was also construed very liberally by the American Supreme Court in ***United States v. Wilkins***[175]. This trend continued to grow with the US Government incorporating wholly-owned corporations for carrying on some of its businesses during World War I which widely fell under governmental functions but were incorporated as ordinary business corporations and could sue and be sued, as any private corporations.[176] However, as regards the sovereign immunity of foreign nations, the USA initially maintained the international practice of absolute sovereign immunity to the foreign states.[177]

As international trade increased and governments expanded into what had previously been private spheres, courts in many countries began to modify

---

[168] See note 163 above.

[169] Malcolm N Shaw, International Law (London: Cambridge University Press, 2003), 625

[170] See. e.g., Dralle v Republic of Czechoslovakia 17 ILR, 155

[171] Akehurst's Modern Introduction to International Law ,18

[172] Ibid.

[173] Wood, Conflict Of Laws And International Finance, 557

[174] William Harvey Reeves, "Leviathan Bound. Sovereign Immunity in a Modern World," Virginia Law Review, 43(1957): 544

[175] (19 U.S. (6 Wheat.) 135)

[176] Ibid.

[177] See Schooner Exchange v. McFaddon 11 U.S. (7 Cranch) 116 (1812).

the absolute doctrine of sovereign immunity.[178] With a change in the nature of sovereign activities a restrictive theory arose under which the sovereign was immune for his public acts *(jure imperii)* but not for his private or commercial acts *(jure gestionis).*[179] Sovereigns thus were prevented from claiming immunity in commercial acts.

An important question which arises here is the distinction between the public acts and commercial acts of a sovereign. The characterization of governmental activity is controversial and blurred, although a consensus has begun emerging recently. [180] Whether the purpose of the transaction or the nature of the activity is to be considered were questions faced by the national courts.[181] Different jurisdictions gave divergent decisions regarding a particular transaction. The international consensus is that borrowings are commercial and therefore deimmunised, even if the proceeds are to be used for a government purpose.[182] Contracts for purchase of goods or commercial services by government instrumentalities have been held as commercial activities in many jurisdictions.[183] Again, an important point for consideration arises – whether a default under a commercial transaction for political reasons can make an act immune even though the original transaction was commercial.[184] The prevalent view, it seems, is that such an act would not be immune if the transaction was originally for commercial purposes. [185]

This important shift in the concept of sovereign immunity, i.e. restrictive immunity, has been codified by many countries. The USA introduced the Foreign Sovereign Immunities Act in 1976. Section 1605(a) (1) FSIA permits litigation against Foreign Sovereigns in American Courts if the matter pertains to a commercial activity.[186] It reads, *"(a) A foreign state shall not be immune from the jurisdiction of courts of the United States in any case- (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States."* This was followed with similar legislations

[178] Nathan J. Shmalo, "Is the Restrictive Theory of Sovereign Immunity Workable?" Stanford Law Review, 17(1965): 501-507

[179] Ibid.,

[180] Wood, Conflict Of Laws And International Finance, 560

[181] Ibid.

[182] Ibid., at 561

[183] Ibid.

[184] Ibid., at 562

[185] Ibid.

[186] Ibid.

in the UK and in many other jurisdictions. There is a general approval if this approach in most of the world's commercially important jurisdictions. [187]

The fact that sovereign immunity may be waived by a sovereign has led to the inclusion of sovereign immunity waiver clauses in most bank loans and sovereign bond issues. The waiver applies to the action itself, the pre judgment actions to preserve the assets and also to enforcement. [188] In case where such a clause does not exist, most jurisdictions consider commercial activities by sovereigns as deimmunised. [189] The usual practice in contracting debt is the inclusion of an elaborate sovereign immunity waiver clause in financial agreements whereby the borrower waives immunity from jurisdiction in relation to the agreement, from prejudgment proceedings, Mareva injunctions, other prejudgment injunctions enforcement, execution, relief and attachment of its assets as regards any judgment in relation to the agreement, and appoints an agent for services of process within the jurisdiction to avoid the slow-moving procedures for diplomatic process under relevant immunity legislation and to confer relatively automatic jurisdiction.[190]

However, the degree to which immunity is waived may vary with the jurisdiction concerned.[191] Also states often exclude external property of diplomatic missions, military property, assets located within their territory and dedicated to a public or government use and heritage property.[192]

6.2. Sovereign debt litigation

Sovereign debt litigation differs from corporate debt litigation for obvious reasons. Corporates cannot evade paying their debts because their assets are liable to be attached and liquidated by virtue of Court orders. Such a mechanism is very restricted in the context of sovereign debt because of the various restrictions placed under international law. Even when a sovereign is successfully sued in another sovereign's court, the enforcement of the judgment is nothing short of a Herculean task. This is owing to two reasons. Firstly, few foreign assets (including future income streams) are located in foreign jurisdictions and a sovereign cannot credibly commit to hand over assets within its borders in the event of a default.[193] Secondly, there are legal principles that protect sovereign assets even when they are located in foreign jurisdictions. [194]

---

[187] Ibid., at 557

[188] Wood, International loans, Bonds, Guarantees, Legal opinions 141
Wood, *Conflict Of Laws And International Finance*, 557

[189] Ibid.

[190] Ibid., at 573

[191] Ibid., at 557

[192] Ibid., at 573

[193] Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default,"653

[194] Ibid.

The re introduction of bondholders as the source of credit for sovereign debt brought along with it the threat of litigation. This was because unlike the banks which had a familiarity with the nature of the debt relationships with sovereigns, bondholders feared an absolute loss of their money. There have been instances of litigation by "hold out" or "rouge" creditors, i.e. those creditors who refuse the terms of restructuring agreements because they feel they are unfavourable to them. These creditors hold out from the restructuring process in the hope of gaining a full repayment of their credit. If a large number of creditors hold out, it could delay the restructuring process by a long period of time. [195]

As aforementioned, the change in the nature of acts of the sovereign nations has brought about this shift in the traditional notions of sovereign immunity. The defence of sovereign immunity has largely diluted and in certain jurisdictions completely vanished. Therefore, in addition to seeking refuge under the Sovereign Immunity principle, the Act of State doctrine and the principle of international comity of nations have also been invoked by sovereign debtors to preclude lawsuits.[196]

The Act of State doctrine permits a court to refuse to hear a case that would require it to pass upon the validity of a foreign state's sovereign act.[197] It cannot be contractually waived. Comity rests upon entirely different policy considerations than does the Act of State doctrine.[198] Under the doctrine of comity, a US court may decline to rule in deference to the laws and policies of a foreign sovereign.[199] The US courts initially invoked this doctrine as a basis for denying the efforts of creditors to enforce their contractual rights against sovereign states. [200]

However, later such claims of public international law principles were without much success and sovereign default in payment of debt as an Act of State has been dismissed as invalid objection in the case of ***Allied Bank International v. Banco Credito Agricola de Cartago.***[201] The facts of the case were that in 1981, Costa Rica suspended debt payments to a thirty-nine member bank syndicate. The country was able to reach a restructuring agreement with all the creditors except for one – Fidelity Union Trust of New Jersey which sued Costa Rica in

[195] Sturzenegger and Zettelmeyer, Debt defaults and lessons from a decade of crises,64

[196] Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default," 654.

[197] David A. Brittenham, "Foreign Sovereign Immunity and Commercial Activity: A Conflicts Approach," Columbia Law Review 83 (1983):1145

[198] Stephen Bainbridge, "Comity and Sovereign debt litigation : a bankruptcy analogy," Maryland journal of international law and trade, 10(1984):21

[199] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 447

[200] Ibid.,

[201] 733F. 2d23, 27, Second Circuit 1984

US courts. [202] A lower court held that Costa Rica's actions were protected by the *Act of State* doctrine. On further appeal, in 1984 the Second Circuit Court overturned the decision and held that failure to service external debt could not be protected under the *Act of State* doctrine. However it agreed with the lower court's decision on the principle of international comity. The case was reheard by the same court in 1985 and it reversed its earlier decision on the point of international comity. The US government urged Fidelity Union to accept the package agreed to by the other members of the syndicate.[203] While Fidelity Union was unable to strike a better deal with Costa Rica, it proved to be a landmark decision as it allowed a holdout creditor to make a successful claim in court and also showed the uselessness of seeking refuge under the principles of Act of State and international comity. [204]

This shift was further developed in ***First National City Bank v Banco Nacional de Cuba***,[205] where the US Supreme Court supported by an amicus brief by the US Government expressly representing that the application of the act of state doctrine would not advance the interest of American foreign policy, refused to apply the doctrine as a bar to a counterclaim. [206]

Since the 1992, American Supreme Court decision of ***Republic of Argentina v. Weltover, Inc***[207] the American Courts have began summarily rejecting any of the sovereign defenses claimed by sovereign defaulters on the issue of debt liability. [208] In this case, the Court held that any borrowing by a sovereign constituted a commercial activity under the Foreign Sovereign Immunities Act, 1976 and sovereigns therefore were not immune from suits by American lenders. Following the Weltover Court's expansive interpretation of the FSIA, various other American Courts also began broadly interpreting the FSIA. The shift in judicial interpretation became very prominent henceforth.

An allied issue and another highly interesting development in the area is the increased inclination towards the enforcement of the judgment thus obtained in sovereign debt litigations.[209] With the dilution of the notion of sovereign

---

[202] Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default," 655

[203] Greenwood and mercer quoted in Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default," 660.

[204] Panizza, Sturzenegger, and Zettelmeyer, "The Economics and Law of Sovereign Debt Default," 655

[205] 406 U.S. 759, 92 S. Ct. 1808 (1972).

[206] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 445

[207] 504 U.S. 607 (1992).

[208] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings,448

[209] Ibid., 449

immunity, the focus has shifted from litigation to enforcement.[210] In ***Lightwater Corp. Ltd. V. Republic of Argentina***,[211] the court rejected Argentina's request for a stay while it negotiated with its creditors and granted summary judgment in favour of the plaintiffs.

However enforcement of the judgment is not an easy task due to the following main reasons[212]:

- Even if the debt agreement provides for a waiver of immunity with respect to attachment, the laws of the sovereign will in all probability prohibit the attachment of assets located within the sovereign's jurisdiction.
- Even if the creditors look for assets outside the debtor's jurisdiction, many such assets are immune from attachment. The laws of several states are rather restrictive when it comes to seizing the property of other sovereigns, and therefore few assets would qualify for attachment (normally, only assets used for commercial purposes or for the transaction in question would qualify for attachment)
- National laws usually offer protection to assets of an agency or instrumentality of another sovereign, and therefore such assets do not qualify for attachment.
- Usually the assets of a sovereign's central bank- which could potentially be an attractive target for enforcement- are granted immunity from attachment by most jurisdictions.

While enforcement is usually permitted in cases where the sovereign state has waived immunity,[213] where the defendant is a state entity[214]or where the assets of the sovereign are purely commercial in nature and not public assets e.g. land or a ship[215] used for trading purposes, states often exclude external property owned by diplomatic missions[216], military property public assets[217] and heritage property[218].

It has been observed that the increase in sovereign debt litigation and enforcement has garnered support from the presence of the *pari passu* clauses in

---

[210] Pavlos Maris, "Sovereign Debt Restructurings: Legal and Economic Analysis of a Multi-Faceted and Conveniently Forgotten Topic," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1461404

[211] 2003 WL 1878420 (S.D.N.Y May 14, 2003).

[212] See note 210 above

[213] Wood, Conflict Of Laws And International Finance, 566

[214] Ibid.,

[215] See, e.g., Article 1 of the Brussels Convention for the Unification of certain rules concerning the Immunity of State Owned ships, 1926.

[216] Wood, Conflict Of Laws And International Finance ,573

[217] Ibid., 574

[218] Ibid., 574

bonds. These have appeared in sovereign bonds for well over a century.[219] The conventional explanation of the *pari passu* covenant is that this provision prevents the borrower from incurring obligations to other creditors that rank legally senior to the debt instrument containing the clause. [220] The presence of this clause in sovereign bonds was successfully used for its benefit in ***Elliott Assocs. v. Republic of Peru***,[221] which has become a landmark case in this area. The facts of the case were that in June 2000, Elliott Associates, L.P., a New York-based hedge fund, obtained a federal court judgment against the Republic of Peru and a Peruvian public sector bank.[222] The underlying claim arose pursuant to a 1983 New York law-governed letter agreement and guarantee of Peru containing a *pari passu* clause.[223] Elliott, a "vulture fund" specializing in obligations of distressed firms and countries, had purchased $20.7 million face amount of Peru's 1983 debt at the discounted price of $11.4 from two international banks at the time the restructuring negotiations were ongoing.[224] Vulture funds buy up sovereign debt issued by poor countries at a fraction of its face value, and then sue the countries in courts — usually in London, New York or Paris — for their full face value plus interest.[225]

Elliott brought an action to enforce the debt at face value in the Southern District of New York [226] and got a judgment in its favour. It then relied on the 1983 debt contract's *pari passu* clause, which provided, "The obligations of the Guarantor hereunder do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon."[227] Elliott took the clause to Brussels, the home Euroclear, a clearing house through which funds from abroad enter the European banking system and through which Peru was about to dispatch a large payment on its Brady bonds to European holders.[228]

Elliott filed an ex parte motion with the President of the Commercial Court in Brussels seeking to enjoin Morgan Guaranty Trust Company, as the operator of the Euroclear System, from processing any payments received from Peru in

---

[219] Silkenat and Schmerler, The Law of International Insolvencies and Debt Restructurings, 452

[220] Lee C. Buchheit and Jeremiah S. Pam, "The Pari Passu Clause In Sovereign Debt Instruments," Emory Law Journal,53(2004):869

[221] 12 F. Supp. 2d 328 (S.D.N.Y. 1998)

[222] Ibid.

[223] Ibid.

[224] William W. Bratton, "Pari Passu And A Distressed Sovereign's Rational Choices," Emory Law Journal,53(2004):823

[225] Ashley Seager and James Lewis, "How 'vulture funds' prey on poor nations," The Hindu, October 19, 2007, Opinion section.

[226] See note 224 above

[227] Ibid.

[228] Ibid.

respect of its Brady Bonds.[229] When the Commercial Court denied the motion, Elliott appealed to the Court of Appeals of Brussels, also on an ex parte basis.[230] The Belgian Court of Appeals reversed the lower court's decision and blocked the payment of the Brady bonds by Peru. The Court held, "It also appears from the basic agreement that governs the repayment of the foreign debt of Peru that the various creditors benefit from a *pari passu* clause that in effect provides that the debt must be repaid pro rata among all creditors. This seems to lead to the conclusion that, upon an interest payment, no creditor can be deprived of its proportionate share." Faced with an approaching payments deadline that would have brought the whole stock of Brady debt into default, Peru decided to settle with Elliott for a reported sum of US$56.3 million rather than continue the legal fight.[231] Therefore it paid Elliot the full amount it had claimed.

Holdout creditors have normally caused disruptions in the orderly restructuring of sovereign debts.[232] Elliot was a cause for concern as it gave rise to the possibility of an increase in holdouts and other creditors resorting to similar tactics. It also raised questions of interpretation of the *pari passu* clause based on the right to receive a proportional share of payments which contradicts the conventional interpretation of clause i.e. the claim in question does not have a lower priority than other unsecured claims. [233] While certain other vulture funds have attempted to follow Elliot's tactics, only very few of them have been successful because of the high legal costs involved.[234]

Several authors have noticed that the dilution of state immunity may also result in a damaging effect to the sovereign.[235] As has been mentioned before, there exists no international insolvency law which would protect the sovereign by placing a restriction on proceedings. It therefore renders the assets of a sovereign vulnerable. Therefore sovereign immunity may significantly be understood as a protection afforded to the sovereign from its creditors.[236] The key challenge however lies in balancing the interests of both the debtor state as well as the creditors. [237]

---

[229] See note 220 above.

[230] Ibid.

[231] See note 60 above.

[232] Hal Scott and Howell Jackson, "Sovereign Debt Restructuring: Should We Be Worried About Elliott?", International Finance Seminar, Harvard Law School, http://www.law.harvard.edu/programs/about/pifs/education/sp44.pdf

[233] Sturzenegger and Zettelmeyer, Debt defaults and lessons from a decade of crises, 70.

[234] Ibid., 71

[235] Wood, Conflict Of Laws And International Finance, 557

[236] Ibid.

[237] Ibid.

7. CONCLUSION

The discourse on sovereign debt and its restructuring is lengthy and complex. The broadened investor base had led to an increase in the already present complexities in the process of sovereign debt restructuring.

The Economic literature suggests that notwithstanding the extensive research in this field, it remains difficult to assess why a market exists for sovereign debt in spite of all the defaults which have occurred over the past few decades. The legal literature focuses on the lack of a universal mechanism which would effectively solve the matter.

Recovering sovereign debt however, is a very complicated and time consuming exercise. The role of the creditors clubs has come under scrutiny for their lopsided role in the debt restructuring process. The rejection of the IMF's proposal of Debt restructuring and the acceptance of the US treasury proposal of inclusion of CACs seems to have improved the state of the restructuring process. However, CACs may not always prove to be the most effective way of restructuring when multiple instruments are issued. Sovereign bonds have thus proven to be the most difficult to restructure. Along with them came the issue of holdout creditors and the dilution of sovereign immunity. A connected issue is one of vulture funds which was briefly discussed and how these funds prey on debt defaulted by poor nations.

While there have been at least three main proposals which were advocated, the CACs being the most widely accepted, there certainly remains a gap in the various techniques used for restructuring. It is agreed that it would be unfair to ask creditors to forgive the debt owed to them by the sovereigns. Yet the absence of a comprehensive legally enforceable mechanism makes restructuring an unequal bargain. This may clearly be ascertained from the Paris Club procedures which exclude the debtors while framing the agreement for debt servicing.

One of the most suitable approaches, as suggested by Kunibert Raffer, would possibly be the constitution of an independent panel for arbitration between the debtors and the creditors. It appears that a middle path should be chosen by incorporating the best provisions from each of the proposals which have at various times been suggested. However, gaining the consent of all nations is a Herculean task and such proposals if at all sought to be implemented would take many years in the future.

BIBLIOGRAPHY

Akanle, Oluwole.1991. "Rescheduling of the External Debt: London Club." Online Resource Centre, UNITAR, http://www2.unitar.org/dfm/Resource_Center/ Document _Series/ Document1/C_Akanle.htm (accessed June 15th 2010).

Bainbridge, Stephen. "Comity and Sovereign debt litigation: a bankruptcy analogy." Maryland journal of international law and trade, 10(1984):1-54.

Bankas, Ernest K. The State Immunity Controversy in International Law. Berlin: Springer, 2005.

Batra, Amita. 2002. "Sovereign Debt Restructuring," Indian Council for Research on International Economic Relations Occasional Policy Paper, October 2002, http://www.icrier.org/pdf/OP02SovDebt.pdf (accessed May 19th 2010)

Bolton, Patrick. 2002. "Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice around the World." IMF Staff Papers, Vol. 50

Bratton, William W. "Pari Passu and a Distressed Sovereign's Rational Choices." 53 Emory Law Journal (2004): 823- 868.

Brittenham, David A. "Foreign Sovereign Immunity and Commercial Activity: A Conflicts Approach." Columbia Law Review 83 (1983):1440 – 1512.

Brown, Richard P.C. and Timothy J. Bulman. "The evolving roles of the clubs in the management of international debt." International Journal of Social Economics 33(2006):11-32.

Brownlie, Ian. Public International Law. London: Oxford University Press: 1998.

Buchheit, Lee C. and G. Mitu Gulati, "Exit Consents in Sovereign Bond Exchanges," in Social Science Research Network eLibrary, http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=231511 (accessed April 21st 2010).

Bulow, Jeremy and Kenneth. S. Rogoff. "Sovereign Debt: Is to Forgive to Forget?" American Economic Review 79 (1989): 43-50.

Dernburg, H. J. "Germany's External Economic Position." The American Economic Review 44(1954):530-558.

Dey, Joy. "Collective Action Clauses Sovereign Bondholders Cornered?" Law and Business Review of the Americas, 15 (2009): 485 – 449.

Dicke, Detlev. Ed. Foreign Debts in the Present and New International Economic Order. Fribourg: Fribourg University Press, 1986.

Easton, Stephen T. and Duane W. Rockerbie. "Does IMF Conditionality Benefit Lenders?" Review of World Economics, 135(1999): 347-357.

Eaton, Jonathan and Mark Gersovitz. "Debt with Potential Repudiation: Theoretical and Empirical Analysis." Review of Economic Studies, 48 (1981): 289- 309.

Effros, Robert C. Current Legal Issues Affecting Central Banks. Washington D.C: International Monetary Fund, 1998.

Eichengreen, Barry. "Historical Research on International Lending and Debt." Journal of Economic Perspectives 5(1991): 149-169

Eichengreen, Barry. "Restructuring Sovereign Debt." The Journal of Economic Perspectives, 17(2003): 75-98.

Eichengreen, Barry and Ashoka Mody. "Is Aggregation a Problem for Sovereign Debt Restructuring?" The American Economic Review, 93(2003):80 -84.

Euliss, Richard. "The Feasibility of the IMF's Sovereign Debt Restructuring Mechanism: An Alternative Statutory Approach to Mollify American Reservations." American University International Law Review 19 (2003):108 – 151.

Ferguson, John H. "The Anglo-American Financial Agreement and Our Foreign Economic Policy." The Yale Law Journal 55 (1946):1140-1157.

Frieden, Jeffry A. "International investment and colonial control: A New Interpretation." International Organization, 48(1994): 559-593.

Guinnane, Timothy W. 2004. "Financial vergangenheitsbewältigung: the 1953 London debt agreement." Economic Growth Center discussion paper no. 880, Yale University.

Organisation for Economic Co-operation and Development (OECD). Glossary of Statistical Terms, Bilateral Debt, http://stats.oecd.org/glossary/ detail.asp?ID=5887 (accessed May 15th 2010).

International Monetary Fund. Glossary of Selected Financial Terms, Terms and Definitions, http://www.imf.org/external/np/exr/glossary/showTerm.asp#110 (accessed May 12th 2010).

Herman, Barry. "The Players and the Game of Sovereign Debt." Ethics & International Affairs, 21(2007): 5-32.

International Monetary Fund. 2003. "Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework." http://www.imf.org/ external/np/ pdr/sdrm/2003/080103.pdf (accessed May 5th 2010).

International Monetary Fund. 2002 "The design and effectiveness of Collective Action Clauses." http://www.imf.org/external/np/psi/2002/eng/060602.pdf (accessed May 18th 2010).

International Monetary Fund, History. "Cooperation and reconstruction (1944–71)."International Monetary Fund. http://www.imf.org/external/ about/ histcoop.htm (accessed May 20th 2010).

Klein, Thomas M. "External Debt Management: An Introduction, World Bank." Technical Paper No. 245, Washington D.C: The World Bank, 1994.

Kroszner, Randall S. "Sovereign Debt Restructuring." The American Economic Review, 93(2003): 75-79.

Krueger, Anne O. A New Approach to Sovereign Debt Restructuring. Washington. D.C: International Monetary Fund, 2002.

Krueger, Anne.O. "Sovereign Debt Restructuring: Messy or Messier?" The American Economic Review, 93(2003):70 -74.

Macdonald, James. A free nation deep in debt, The Financial Roots of Democracy. New Jersey: Princeton University Press, 2006.

Malanczuk, Peter, ed. Akehurst's Modern Introduction to International Law. London: Routledge, 1997.

Mandeng, Ousmène Jacques. 2004. "Intercreditor Distribution in Sovereign Debt Restructuring", IMF Working Paper 04/183.

Maris, Pavlos. "Sovereign Debt Restructurings: Legal and Economic Analysis of a Multi-Faceted and Conveniently Forgotten Topic," in the Social Science Research Network http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1461404 (accessed March 23rd 2010)

Neal, Larry. 2005. "The London Stock Exchange in the 19th Century: Ownership Structures, Growth and Performance", Oesterreichische National bank, Working Paper 115.

Orzan, Andrea. "Sovereign Debt Restructuring Mechanism: Who opposes it and Why?" http://www.cilae.org/publicaciones/SDRM.pdf (accessed March 28th 2010).

Panizza, Ugo., Federico Sturzenegger and Jeromin Zettelmeyer. "The Economics and Law of Sovereign Debt Default." Journal of economic literature 47(2009): 651-698.

Paris Club. Glossary, ODA credits, http://www.clubdeparis.org/sections /services/glossaire/?letter=o (accessed May 20th 2010).

Paris Club. "Permanent Members."http://www.clubdeparis.org/sections /composition/membres- permanents-et/membres-permanents (accessed May 20th 2010).

R. Gaston Gelos, Ratna Sahay and Guido Sandleris. 2004. "Sovereign Borrowing by Developing Countries: What Determines Market Access?" IMF Working Paper No. 04/221.

Raffer, Kunibert "The Present State of the Discussion on Restructuring Sovereign Debts: Which Specific Sovereign Insolvency Procedure?" http://r0.unctad.org/dmfas/ pdfs/raffer.pdf (accessed May 7th 2010).

Reeves, William Harvey. "Leviathan Bound. Sovereign Immunity in a Modern World." Virginia Law Review, 43(1957): 529-557.

Rieffel, Lex .Restructuring Sovereign Debt: The Case for Ad hoc Machinery. Washington D.C: The Brookings Institution, 2003.

Riesenhuber, Eva. The International Monetary Fund under Constraint, Legitimacy of its Crisis Management. Den Haag: Kluwer Law International, 2001.

Schier, Holger. Towards a Reorganisation System for Sovereign Debt: An International Law Perspective. The Netherlands: Martinus Nijhoff publishers, 2007.

Schwarcz, Steven L. '"Idiot's Guide" to Sovereign Debt Restructuring.' Emory law journal 53(2004):1189 – 1218.

Scott, Hal. S. "A bankruptcy procedure for sovereign debtors," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=384220 (accessed May 13th 2010).

Scott, Hal.S. and Howell Jackson. "Sovereign Debt Restructuring: Should We Be Worried About Elliott?" http://www.law.harvard.edu/programs /about/pifs/education/sp44.pdf (accessed May 12th 2010).

Seager, Ashley and James Lewis. "How 'vulture funds' prey on poor nations."

The Hindu, October 19, 2007, Opinion section.

Sedlak, Jonathan. "Sovereign Debt Restructuring: Statutory Reform or Contractual Solution?" University of Pennsylvania Law Review, 152 (2004): 1483 – 1510.

Sharma, Shalendra D. "Resolving Sovereign Debt." Journal of World Trade 38 (2004): 627-646.

Shaw, Malcolm N. International Law. London: Cambridge University Press, 2003.

Shmalo, Nathan J. "Is the Restrictive Theory of Sovereign Immunity Workable?" Stanford Law Review, 17(1965): 501-507.

Silkenat, James R. and Charles D. Schmerler. The Law of International Insolvencies and Debt Restructurings. USA: Oceania Publications, 2006.

Sturzenegger, Federico. 2005. "Has the Legal Threat to Sovereign Debt Restructuring Become Real?" http://www.utdt.edu/download.php?fname=_ 115331294204239500. pdf (accessed May 12th 2010).

Sturzenegger, Federico, and Jeromin Zettelmeyer. Debt Defaults and Lessons from a Decade of Crises. Massachusetts: Massachusetts Institute of Technology Press, 2006.

Tamura, Kentaro. 2004. "The problem of sovereign debt restructuring: How can we deal with Holdout problem legally?" http://www.law.harvard.edu/programs/about / pifs/education/sp45.pdf (accessed may 12th 2010).

Villaroman, Noel G. "The Loss of Sovereignty: How International Debt Relief Mechanisms Undermine Economic Self-Determination." Journal of Politics and Law 2 (2009):3 -16

Wallis, John Joseph., Richard E. Sylla and Arthur Grinath III. "Sovereign debt and repudiation: the emerging-market debt crisis in the US. States, 1839-1843."National Bureau Economic Research Working Paper no 10753.

Wood, Philip R. Conflict of Law and International Finance. London: Sweet & Maxwell, 2007.

Wood, Philip R. International loans, Bonds, Guarantees, Legal opinions. London: Sweet & Maxwell, 2007.

Wood, Philip R. Principles of International Insolvency. London: Sweet & Maxwell, 2007.

Zivkovic, Dusan. "Debt Renegotiation Framework," UNCTAD Paper prepared for the expert group meeting on Debt Sustainability and Development Strategies, October 2005 http://vi.unctad.org/debt/debt/m3/documents/zivkovic.PDF (accessed May 18th 2010).

GLOBALIZATION AND INFORMATION-COMMUNICATION TECHNOLOGY DEVELOPMENT IMPACT ON THE NEW WORLD ORDER

Ivana Barković Bojanić, Ph.D.
Full Professor
Josip Juraj Strossmayer University of Osijek
Faculty of Law in Osijek
Croatia
e-mail: barkovic@pravos.hr

Marina Budimir
Ph.D. Candidate
Josip Juraj Strossmayer University of Osijek
Faculty of Economics in Osijek
Croatia
e-mail: marina.budimir@sb.t-com.hr

Abstract

Global economic trends have consolidated national and local markets in the world erasing national borders. The same inevitable market trends and competitive pressures have imposed the new game, new rules of conduct and operations sweeping cultural and social diversities. This is supported by the facts about the high criteria of business, quality and efficiency, inevitable exhausting of human and natural resources, striving for higher profits, inefficiency and system inertia, the spread of underground economy, environmental disasters, questionable moral values and non-ethics per se. Globalization is considered to be a normal and natural chapter in the social development in general, however the effects of market rules, the interweaving of international policies and economic interdependence among national governments by the world order discreetly imposing new market trends and new rules, violate national borders under the pressure of global connectedness, of information-communication technology development impact, unified culture and individual state uniformity. Therefore, enormous financial losses caused by a series of negative market trends have left mark on national and local market economic order changing in an unpredictable and undesired direction. Has the new world order benefited in the course of the past decades or has it been stuck deep in the consequences of greed and idealized connectedness of the world as a unified place?

Keywords: *globalization, global future, information-communication connectedness, neo-economy.*

I. Introduction

Economic changes effected by globalization and the impact of information-communication technologies progress are reflected in global economy on daily basis. Past decades with eras of booming and declining economy as well as changes in global sphere caused by progress and impact of information-communication technologies, inevitably led the seemingly unlinked market flows into different and often unpredictable directions. Fundamental postulates of free market marred by turbulent turmoil and impact of information-communication technologies have introduced changes into macroeconomic and other spheres leaving a direct mark on a new global system. Consequently we should not wonder about the aftermath such as economic disasters of certain governments, market instability and a stock-exchange index decline, frequent uprisings in various countries and ravages of war, ecological disasters, booming of underground economy, Sisyphus striving for neo-information, clashes of economic powers, deep depression, wars, famine, poverty, a visible disproportion between the rich and the poor, survival struggle and surviving on the market, struggle for power and progress, financial, stockholding, market, oil and other speculative games. Power on one side unmercifully means poverty on the other. Power of injustice over justice, huge differences per se in national governments, currencies, trends, markets have inevitably caused visible differences on a global scene. Thus new differences emerge based on globalization whereas globalize is blind to asynchronism and progress differences accepting them simply as transitional forms.

Bearing this in mind, many questions arise. Has inevitable and rapid spreading of information-communication technologies led to world deceleration and burn-out in general? Has growth of global industrial production enriched national treasury or has it impoverished national human potentials and natural resources resulting in economic, ecological and other disasters? Has the network of world economy and a level of integration in economic life led globally to the feeling of loneliness of an individual and retreating to virtual e-world? Has interaction of economic activities led globally to inevitable national and local knowledge and wealth exploitation? Has an information age caused deceleration or expansion of society towards progress and at the same time confining it and closely controlling it locally, nationally and globally? Along the lines of these ideas, many questions need to be answered.

II. A review of world trends

Globalization has proven to be a very complex phenomenon which is differently viewed in the scholarly and the policy community (Higgot and Simon, 1998). This complexity has resulted in fruitful academic discussions regarding various

aspects and impacts of globalization on all spheres of life. For example, Mann (1997) discussed the impact of the globalization of the rise and (potential) fall of the nation-state; Lieber and Weisberg (2002) conferred about the culture serving as a primary carrier of globalization; Scholte (2005) contributed to the multidisciplinary understanding of globalization, its causation and consequences. Still, a common denominator to various aspects of globalization process and its multifold impact on economy and society is the recognition that globalization may offer many opportunities but its dangers are equally challenging.

Greed for profit and enormous striving for establishing a new unified world system have brought many rapid changes of global proportions, an untearable interaction between the underdeveloped and the developed, unsurpassed wearing out and exploitation of the underdeveloped at the expense of profit, global growth and corporative progress that only the strongest and fittest have had the benefit of. In the same context J. Rubin points out: ''Being an economist, I have been taught not to worry about resource limitation – the question is not; is there enough of something – but how much will it cost to dig it out from the soil" (Rubin, 2010: 15). On the other hand J. Gray points out that ''economic stabilization – global spreading of industrial production and new technologies encouraging unbridled capital mobility and unlimited trade liberty – really endangers the stability of a unified global market…" (Gray, 2002: 26).

Progress is vital both for human race and an individual. However, is it vital to such an extent that it may destroy national uniformity or each individual uniformity? Global economic trends have imposed new codes of conduct inevitably creating a disproportion between national and local societies and international powers erasing state borders and controlling unsafe growth and progress. In reference to it M. Chossudovsky points out: '' A driving force of this crisis is a huge scramble and haste around the world to strike it rich with a help of "financial manipulations. It is a source of economic turmoil and social hardships" (Chossudovsky, 2008: 349). Thus it is no wonder that economic, political and alike interests of the most powerful countries in the world tread other national and local economic borders underfoot destroying dignity, integrality, simplicity, traditionalism and culture at the expense of profit and growth disguised beneath globalization, progress and development of information-communication technologies and a new world order. Instead of social nationalization and integrality, there emerged the world of economic uniformity ''in which non-national geo-economic powers set conditions to national and economic policies. In internationalization, national governments lose many traditional instruments of economic control" (Thurow, 1997: 127). Joining of world markets has surely led to changes in national economies as to creating interdependence among markets on a global level.

It would be needless to mention deculturalization of national and local wealth, devaluation of traditional values at the expense of global ones, crushing the closed communities or societies as such, a global communication at the expense of local and national identity. It is a paradox but the answer to it has been given by J. Gray as following: ''The collapse of today's global economic regime could easily emerge from contemporary policies. Those who consider the big political mistakes cannot be repeated in the course of history, have not learnt its main lesson – nothing has been taught to last a while. Nowadays we are in the middle of an experiment of Utopian social engineering the result of which we can anticipate" (Gray, 2002: 36).

III. Aftermath of globalization and information-communication technologies development

The global idea of creating a unique world image has imposed a struggle for profit, growth and development per se by pushing human dignity and an individual into the background over growth and organization development and daily competitive struggles on markets. Such an advantage has been gained by exploiting human potential as capital, work, knowledge and innovation making it an organization capital as such. ''Global market of today does not allow the world nations to live in harmony side by side. It forces them to become rivals in struggle for resources setting no methods for their preservation" (Gray, 2002: 209). The collapse of national economies, increase of unemployment, the aftermath of rapid information-communication technological and scientific progress make a globalization of poverty, misery and other devastations. In reference to that, M. Chossudovsky points out: ''Human lives have been destroyed by playing with prices, wages and interest rates; the whole national economy has been destabilized" (Chossudovsky, 2008: 17). The new world order thrives on human misery and environmental destruction, it causes social disintegration, provokes racism and stirs up ethnic strife, it violates women's, children's and pensioners' rights, etc. The integration of various world economies into a unique global free market has caused social disturbances, political and economic instabilities of huge proportions, omnipresent corruption, inequality of income and wealth, let alone living conditions.

Globalization goals such as profit, finding and conquering of new markets, cheaper resources, decreasing of business risk, removing or confining the competition and domination of world trade from leading developed countries have left their mark. As J. Rubin points out: ''In global economy no one thinks about distance in kilometers but in dollars" (Rubin, 2010: 9). For that very reason it would be incorrect to believe that globalization favors long-term prosperity in favor of sustainable development, elimination of misery and unrest, poverty,

unemployment, inequality on the basis of sexual, age or other affiliation. ''All features of economic globalization nowadays – velocity, volume, interdependence between commodity movement and information worldwide – have inevitably grown bigger than they have ever been before." (Gray, 2002: 79). Furthermore, globalization tends to weakening of the countries. Powerful states sustain social stability and resistance to changes to some extent whereas some others show weaknesses, collapse, failure, loss of control, vulnerability.

Thus negative trends become inevitable. Free organizational and unethical conduct in relation to environmental and natural resources issues has contributed to instability of natural balances and environment pollution. ''To organize world economy as a universal free market means in fact jeopardizing the planet's fate and assuming those huge dangers will disappear as an unintentional aftermath of unlimited run for profit. Gambling of more ruthless kind is hard to imagine" (Gray, 2002: 211). Unfortunately, not everybody thinks in that direction. A. Giddens considers globalization development as an undirectional process by rejecting natural disasters and inclining to a sphere of economic global development: ''Ecological dangers are said to be exaggerated or even not to exist – it is a fabrication of alarmists. Instead, there is evidence that we are entering a progress age that will be larger and more universal than ever." (Giddens, 1999: 22). Impacts of globalization and rapid development have still been underestimated regardless of environmental risks. ''If we want to build a world which unites stability, equality and progress, we cannot yield such problems to an unpredictable vortex of global markets and relatively helpless international bodies" (Giddens, 1999: 147). The reaction of the environment to pollution and enormous changes in ecological spheres, abrupt climate shifts will eventually cause larger disturbances in future. ''In the end, we will face a hard choice between adjusting to the reality of new, lesser world and sticking to artifacts of the old one that we no longer possess. On the one hand a series of expensive and risky investments awaits us; on the other hand a defeat confession, as well" (Rubin, 2010: 205).Not only does the impact of globalization and information-communication technologies progress determine the new world order but it also guides it. ''The impact of science and technology on our way of living can be considerably set in motion by economic factors but this goes beyond the economic field. Science and technology affect both political and cultural issues and *vice versa*" (Žager et al., 2008: 44)

IV. Neo-technologies of information-communication age

Global interaction based on information-communication technologies and interdependence between the developed and underdeveloped countries have left an indelible imprint on individual within national borders creating turmoil on local, national and global levels with constant changes and targeting. ''A hotbed

of high technology development shows rapid growth at the expense of traditional industries which emerged and progressed in the developed countries throughout the history since the beginnings of industrial revolution" (Chossudovsky, 2008: 103). Impact of information-communication technologies has had in this context a stimulating but also contractual role which enables various organizations to be in contact with any part of the world any time. In conditions of growing competition, the goal to ensure a leading position on global market is supported by information-communication technology. J. Gray points out: '' Expanding of new technologies worldwide has not improved human freedom. Instead, it has brought to light the liberation of market forces from any social and political control. By giving such liberty to global markets, we make it possible for this globalization age to be remembered as just another circle in the history of slavery" (Gray, 2002: 220).

In the course of past decades organizations attach even more importance to investments in application of modern information-communication technologies in everyday business activities. Apart from contributing surely to work and organization business activities it represents considerable expenses for investments in information-communication systems, models and lines burdening financially the organization business and at the same time creating inevitably opportunistic expense of investment into other considerable organizational functions. Furthermore, considerable investments in information-communication technologies are impalpable and often immeasurable by basic financial indicators such as productivity, profitability and other indicators and there is no expected refund of such investments in relation to other visible investments by financial refund rates. The huge problem is that immeasurable and impalpable assets represent a considerable part of business value and current financial reports frequently cannot show the numerical value. The information-communication technologies and information systems should be adjusted to organization and business activities, management, employees, a way of running business and importance in the organization ought to be assessed in accordance to other systems and adjusted to working practice and everyday business activities.

Economic processes, modern information-communication technologies, rapid growth and development have inevitably caused faster economic movements, a new way of living and working, unique market, cultural and conduct standards, attitudes and values by devaluating norms and rules, leaving behind unemployment, poverty, excessive exploitation of natural resources, system imbalance. Facing globalization by the countries that lag behind developed ones along with out-of-date technology, low productivity, uncompetitiveness on global market have caused profound disturbances resulting in unemployment, social insurance and subsidized prices (Puljiz, 1998). Speed of information flow forces organizations, individuals, societies and national governments to change whereas

unreadiness to adjust to them, the disorientation in new situations, the pressure of new technology progress destroy the systems making them uncompetitive, weak and out-of-date.

Neo-technologies of information-communication age have considerably brought progress such as running a business, networking, rapid information spread, however it has also brought many negative connotations by which the strongest make profit at the expense of the weaker economies, governments, resources and eventually individuals. Development of new information-communication technologies exploits available resources only in favor of competitive advantage, profit and growth prevalence over stagnation, progress and development prevalence over natural resources preservation, exploiting working and other potentials, human dignity and mind. ''New technologies make the policies of the full employment of traditional kind completely inapplicable. The aftermath of information technologies sets a social division of labor into a constant change" (Gray, 2002: 39).

Globalization with constant and long present trends …. changes everyday life, especially in the developed countries and at the same time it creates new supernational systems and powers" (Giddens, 1999: 40). Individuals meet the cost of new technologies and unlimited free trade. In reference to it, J. Rubin points out: ''Distance is costly. This will be a new chant of the new local economy" (Rubin, 2010: 113). The return to old Keynesian neoliberal school of visible and first of all national hands that will prevail on global market by creating a new economy order, is inevitable. ''The neoliberal answer, even larger capital market freedom, means even larger disturbances than there have been before. An assumption that the restraining of free capital movement diminishes effectiveness does not take into consideration social and economic costs of currency speculation crises" (Giddens, 1999: 144).

V. Globalization in communication vs. communication in globalization

There would be no globalization without communication. But communication without globalization makes no sense, either. The spreading of neo-communication-information trends has unsurpassably left its mark on a global level. On the other hand global trends have been imposed with a help of neo-communication-information technologies. Both positive and negative changes are visible on a global level, national and local markets and they impose new ways of thinking on a market scene. ''Technological innovations that were introduced in the western developed countries, have been quickly copied everywhere. Without free market policy, the controlled post-war economies could not survive – the technological progress would make them unsustainable." (Gray, 2002: 39). Thus, technological changes, guided by development of information-communication technologies

and global network, have enabled acceleration of economic activities among states aside from spatial distance. Protectionism has been pushed into the background by separating organizational activities and locating them anywhere in the world and making agreements in distant countries. ''Globalization is a historical fate for the mankind at the end of modern era. Its fundamental mechanism is a swift and inevitable emergence of new technologies worldwide. This technology-carried modernization of the world economic life will progress regardless of free world market fate." (Gray, 2002: 42)

Information-communication technology development has never to such extent forced the local and national institutions, organizations, governments to adjust to global changes, global way of thinking and new game rules. '' In the 19th century you could take for granted that every large industry would generate a special technology and the technologies from different industries would never meet." (Drucker, 2006:66). However, the thing that will inevitably happen in future economic trends is the development of neo-technologies and information-communication way of thinking that will force the world to think globally, uniformly, codirectionally. ''Changes that are happening nowadays in the world, make different cultures and societies much more interdependent than they have ever been before. While the changes are getting swifter, something happening in one part of the world can directly affect other parts" (Žager et al., 2008: 45). J. Rubin contemplates in the same direction by pointing out: ''If you believe in the market, you may be surprised by future. There are neither personal spaceships nor shiny mega-cities; this is day dreaming of cheap energy era. The future will be very much alike the past" (Rubin, 2010: 172).

VI. Neo-economic reality

Nowadays there are big changes going on in the world in the spheres of social, economic, technological, political and information life. Economy globalization and information revolution are transitional conditions that the nations will live through and survive in the sphere of economic, fiscal and monetary policies, foreign policy, control of international business activities…But finding a way to pull the most out of what is at our disposal, will be the adjustment key to a smaller world and it refers more than anything to investments such as infrastructure and a skilled labor force" (Rubin, 2010: 192).After the settling of aftermath storm caused by a double-bottomed deep depression that has been shaking financial, commodity-, capital, banking, oil and other markets, it would inevitably be followed by the same fundamental economic postulate of supply and demand imbalance that national, local and world economies have already encountered decades and centuries ago and eventually lead to the beginning of market activities and the search for new principles of work, production, thinking. Neo-Keynesian economics has therefore gained importance again after a century. ''As

huge increase in transportation costs caused by energy source prices swings the economic pendulum from global economy to a local one, all of sudden we have to become generalizers. We have to focus again on smaller, more local markets that may not be big enough to support specialization which used to be secured by wider global markets" (Rubin, 2010: 177).

Global trends are impossible to evade. In reference to it: ''We cannot reverse history. Still I do not want to lose faith that the world, that is a reasonably peaceful coat of various paints, of which each part develops its own special cultural identity and is tolerant to others, is not a Utopian dream" (Gray, 2002: 207). Safranski contemplates in the same direction by pointing out: '' The desire for a society as a large community ends with freedom abolition. The society should stop being something external, it should become a single interior" (Safranski, 2008:87). Increase of world social relations and interdependence affect an individual activity and the world problems have an impact on everyday life. Nowadays globalization affects people's lives in all countries, the poor and the rich, and it does not only change the global systems but also our daily life. This bond of political, economic, cultural and social factors has sped up connections and activities among the people in the whole world especially by a stimulating progress and influence of information-communication technologies.

VII. Global future

Globalization as a process that causes inevitable changes on world scene is impossible to avoid. Global market sets high criteria of quality, efficiency, technological progress, striving for open markets, deep international integration, knowledge and labor economy. Globally, production factors, natural resources, capital, technology, human resources, neo-information, goods and services move around the world creating at the same time the new market and similar flows and interdependence between international economies and world economy. However, the main goal of global, common world market imposes different rules of conduct to world economy. The globalization process and impact of information-communication technology on economic life in a society indirectly leaves marks on a global scale to a greater or lesser extent. On the other hand, a part of society economy shall always remain intact, almost protected from world market regardless of the impact of globalization. In this context, neither positive and negative impacts nor consequences can be avoided.

Globalization and impact of information-communication technology are natural and necessary processes of new world order formation with new market rules, international economic policies, a new way of market and competitive thinking and game rules. Globalization is a transitional period out of which states, governments and eventually world economy should make only their

best. Negative trends need to be surpassed so as to continue the normal flow of economic movements based on simple economic postulates of supply and demand resulting in clear permanent bonds among nations, states, world integrality in general. The struggle in solving daily economic and similar issues is a long-term process that needs to be surpassed, lived through so as to enable normal economic trends. Nevertheless, integrality of states, permanent bonds in struggle for surpassing negative connotations and making use of positive ones make globalization just one step further in setting new trends, values and rules of conduct in the world in order to create better conditions for world economy in the world of the Sisyphus competition struggle lead solely by a unique and simple ancient rules of supply and demand.

References

1. Chossudovsky, M. (2008): *Globalizacija bijede i novi svjetski poredak* (eng. *The Globalization of Powery and the New World Order*), Prometej, Zagreb.
2. Drucker, P. (2006): *Upravljanje u budućem društvu* (eng. *Management in the Next Society*), M.E.P. Consult, Zagreb.
3. Giddens, A. (1999): *Treći put - Obnova soijaldemokracije* (eng. *The Third Way: The Renewal of Social Democracy*), Politička kultura, Zagreb.
4. Gray, J. (2002): *Lažna zora- Iluzije globalnog kapitalizma* (eng. *False Dawn: The Delusion of Global Capitalisation*), Masmedia, Zagreb.
5. Higgott, R., and Reich, S. (1998): Globalization and Sites of Conflict: Towards Definition and Taxonomy (March 1998). *CSGR Working Paper* No. 01/98. Available at SSRN: http://ssrn.com/abstract=146972 or doi:10.2139/ssrn.146972)
6. Lieber, J.R., Weisberg, R.E. (2002): Globalization, Culture, and Identities in Crisis, *International Journal of Politics, Culture and Society*, Volume 6, Number 2: pp. 273 -296
7. Mann; M. (1997): Has globalization ended the rise and life of the nation-state? *Review of International Political Economy*, 4(3): pp. 472-496.
8. Puljiz, V. (1998): Globalizacija i socijalna država, *Revija za socijalnu politiku,* Zagreb, str. 11-25.
9. Rubin, J. (2010): *Zašto će se vaš svijet jako smanjiti* (eng. *Why Your World Is About To Get a Whole Lot Smaller*), Škorpion, Zagreb.
10. Safranski, R. (2008): *Koliko globalizacije čovjek može podnijeti* (eng. *How Much Globalisation Can We Bear*), Naklada Ljevak, Zagreb.
11. Sholte, J.A. (2005): *Globalization*: *A Critical Introduction*, Macmillan, London.
12. Thurow, L. (1997): *Budućnost kapitalizma* (eng. The Future of Capitalism), Mate, Zagreb.
13. Žager, K., Mamić Sačer, I., Sever, S., Žager, L. (2008): *Analiza financijskih izvještaja*, Masmedia, Zagreb.

VALUATION AND RESERVING TEHNIQUE IN THE GENERAL INSURANCE

Benţe Corneliu, Ph. D.
Lecturer
University of Oradea
The Faculty of Economics
România
e-mail: corneliubente@yahoo.com

Alb(Benţe)Florina Maria
Student
University of Oradea
The Faculty of Economics
România
e-mail: florinaalb@yahoo.com

Abstract

Technical reserves that are held by a general insurance company are the amounts set aside to meet its insurance liabilities. They are established to enable the company to meet and administer its contractual obligations to policyholders. Specific reserves are required to meet indemnity or other compensatory payments to policyholders together with the associated administrative costs. Also, contingent reserves might be held in order to provide a further buffer against adverse developments of claims and to smooth the emergence of profit. It is important to note here, that the reserves of general insurance companies are usually not discounted providing a further safety margin. However, some regulatory regimes insist that reserves must be calculated on a discounted basis.

Keywords *incurred but not reported reserve, chain-ladder method,development factors, reported but not settled.*

1. INTRODUCTION

Chain ladder reserving methods have been discussed in the actuarial literature for many years. Taylor (1986) dates the original methodology back to Harnek (1966). Taylor, describes chain ladder models for reserving as those that chain a sequence of ratios together „into a ladder of factors ... which enable one to

climb from experience recorded to date to its predicted ultimate value"[1]. Taylor provides a detailed overview of traditional chain ladder reserving methods, as does Booth, Chadburn, Cooper, Haberman, and James[2] .

In recent years, a number of authors have considered Bayesian methods for claims reserving. While not an exhaustive list, notable contributions on the topic are made by Verrall[3] , Ntzoufras and Dellaportas, de Alba , England and Verrall[4] ,and Lamps[5] . Verrall describes some ways in which the traditional chain ladder method can be analyzed using the theory of Bayesian linear models. These are inspired by work of Kremer[6], who shows how to transform the multiplicativechain ladder model into the form of the linear model associated with the two-way analysis of variance by taking logarithms. Assuming positive and lognormally distributed incremental claim amounts, Verrall demonstrates how this model can be analyzed using either an empirical Bayesian or a parametric fully Bayesian approach in the context of hierarchical linear modeling. Verrall emphasizes a Kalman filter (state space) approach in the Bayesian analysis.

Ntzoufras and Dellaportas[7] consider the Bayesian analysis of four models for claim amounts using Markov chain Monte Carlo (MCMC) methods. Their models begin with an assumption of lognormally distributed incremental claim amounts in an analysis of variance setting. They go on to explore the use of state space modeling and the inclusion of additional information in the form of inflation factors, measures of exposure (such as portfolio size), and associated claim counts. In his discussion of Ntzoufras and Dellaportas , Scollnik[8] shows how the models of Ntzoufras and Dellaportas can be implemented using WinBUGS (specialized software for MCMC).

---

[1] Taylor, G.C., "Loss Reserving: An Actuarial Perspective", Kluwer Academic Publishers, 2000, Norwell, p.26

[2] Booth, P., R. Chadburn, D. Cooper, S. Haberman, and D. James, "Modern Actuarial Theory and Practice", Chapman & Hall/CRC Press LLC, New York, 1999, p.153

[3] see Verrall, R.J., "Bayes and Empirical Bayes Estimation for the Chain Ladder Model," ASTIN Bulletin 20, 1990, pp. 217-243, and Verrall, R.J., "A State Space Representation of the Chain Ladder Linear Model," Journal of the Institute of Actuaries 116, 1989, pp. 589-609.

[4] England, P., and R.J. Verrall., "Stochastic Claims Reserving in General Insurance," Sessional Meeting Paper Presented to the Institute of Actuaries on January 28, 2002. Online at www.actuaries.org.uk

[5] Lamps, D., "Bayesian Analysis of Claim Lag Data Using WinBUGS Software." Presented at the Annual Meeting of the Society of Actuaries, Boston, Massachusetts, October 27-30, 2002.

[6] Kremer, E.., "IBNR-Claims and the Two-Way Model of ANOVA," Scandinavian Actuarial Journal 1: 1982, pp. 47-55.

[7] Ntzoufras, I., and P. Dellaportas.. "Bayesian Modeling of Outstanding Liabilities Incorporating Claim Count Uncertainty," North American Actuarial Journal 6, 2002, pp. 113-128.

[8] Scollnik, D.P.M., "Actuarial Modeling with MCMC and BUGS," North American Actuarial Journal 5 (2): 2001, pp. 96-124.

The paper by de Alba[9] considers several model specifications that are essentially the same as two of those appearing in Ntzoufras and Dellaportas . Note that de Alba states that Ntzoufras and Dellaportas require the number of claims per year of origin be known and fixed in order for their MCMC procedure to be implemented.

In fact, Ntzoufras and Dellaportas permit this value to be a stochastic variable and describe how to modify the MCMC procedure in this case. It turns out that the principle diference between de Alba and Ntzoufras and Dellaportas is in the method of implementation. Whereas Ntzoufras and Dellaportas emphasize the use of a MCMC simulation method, de Alba describes how direct Monte Carlo can be used instead. The former approach may be more accessible to the average practitioner, especially if he or she wishes to introduce changes to the basic models. The paper by de Alba is valuable for its summary of Bayesian reserving methods that have appeared to date.

England and Verrall gift us with a detailed treatise on the state of current claim reserving methodologies. The methodologies they describe are primarily non-Bayesian, but they also discuss the Bayesian analysis of an over-dispersed Poisson chain ladder model. These authors also describe a variety of generalized linear models appropriate for loss reserving; in principle, any of these models could be implemented using a Bayesian method.

Numerous authors, including Cairns[10], Rosenberg and Young[11], Scollnik, Ntzoufras and Dellaportas , and de Alba , along with many others referenced in these cited works, have described the advantages of Bayesian over traditional non-Bayesian methods of analysis and given reasons for the popularity of Bayesian models in recent years. Included among the commonly stated advantages of the Bayesian method of analysis are these:

- it requires that the statistical model be completely specified;
- it allows one to incorporate relevant and significant prior information in the analysis when it is available;
- it allows parameter and model uncertainty to be explicitly modeled and accounted for in
- the analysis and in the resulting predictive forecasts;

[9] De Alba, E., "Bayesian Estimation of Outstanding Claim Reserves," North American Actuarial Journal 6 (4), 2002, pp. 1-20.

[10] Cairns, A.J.G., "A Discussion of Parameter and Model Uncertainty in Insurance," Insurance: Mathematics and Economics 27 (3), 2000, pp. 313-330.

[11] Rosenberg, M.A., and V.R. Young., "A Bayesian Approach to Understanding Time Series Data," North American Actuarial Journal 3 (2), 1999, pp.130-143.

- it yields complete posterior distributions for quantities of interest, and posterior predictive distributions for unobserved future observations, not just point estimates or confidence intervals.

In addition, Rosenberg andYoung note that the output of their particular 'Bayesian method is easier for actuaries to understand than output from non-Bayesian methods because actuaries are used to thinking in terms of probability.

2. CATEGORIES OF THE RESERVES

Insurance management implies, among other things, the control of expenses, an appropriate investment policy and the provision of reserves sufficient to meet any liabilities which remain outstanding at that point in time. Reserves must not only be adequate but must also be seen to be adequate under all circumstances.

The reserves that a general insurance company holds are broken down into various categories. However, it is important to mention that the reserves names are not prescribed and it is possible that some companies may not hold some of these reserves explicitly.

According to the legislation in our country (The Order of the President of the Commission for supervising Insurers no. 3.109/2003 with the latter modifications and completions), the insurers held the following categories of reserves:

a) premium reserve;
b) claims reserve;
c) unauthorized claims reserve;
d) catastrophe reserve;
e) unexpired risk reserve;
f) equalization reserve.

With the introduction of Solvency II (in 2012) and IFRS 4 Phase II (in 2013), insurers face major challenges. The measurement of future cash flows and their uncertainty becomes more important and also gives rise to the question of whether current techniques can be improved.

3. THE BASIC CHAIN-LADDER MODEL

Current techniques can be applied to so-called run-off triangles containing either paid losses or incurred losses (for example, the sum of paid losses and case reserves). In a run-off triangle, observable variables are summarised by arrival (or origin) year and development year combination. An arrival year is the year in which the claim occurred, while the development year refers to the delay in payment relative to the arrival year.

The most popular approach is the "chain ladder" approach, largely because of its practicality. However, the use of aggregate data in combination with (stochastic variants of) the chain ladder approach (or similar techniques) gives rise to several issues. A whole canon of literature has evolved to solve these issues, which are (in random order):

1. Different results between projections based on paid losses or incurred losses, addressed by Quarg and Mack (2008)
2. Lack of robustness and the treatment of outliers, see Verdonck et al (2009)
3. The existence of the chain ladder bias, see Halliwell (2007) and Taylor (2003)
4. Instability in ultimate claims for recent arrival years, see Bornhuetter and Ferguson (1972)
5. Modelling negative or zero cells in a stochastic setting, see Kunkler (2004)
6. The inclusion of calendar year effects, see Verbeek (1972) and Zehnwirth (1994)
7. The different treatment of small and large claims, see Alai and Wüthrich (2009)
8. The need for a tail factor, see, for example, Mack (1999)
9. Over parameterisation of the chain ladder method, see Wright (1990) and Renshaw (1994).
10. Separate assessment of 'incurred but not reported' (IBNR) and 'reported but not settled' (RBNS) claims, see Schieper (1991) and Liu and Verrall (2009).
11. The realism of the Poisson distribution underlying the chain ladder method
12. Not using lots of useful information about the individual claims data, as noted by England and Verrall (2002) and Taylor and Campbell (2002).

Most references above represent useful additions to the chain ladder method, but these cannot all be applied simultaneously. More importantly, the existence of these issues and the substantial literature about it indicates that the use of aggregate data in combination with (stochastic variants of) the chain ladder approach (or similar techniques) is not fully adequate for capturing the complexities of stochastic reserving for general insurance.

For liability to the insured, determined by the prejudice which occurred and the insurer was informed about, insurance companies form their RBNS – reported but not settled. There are although prejudice from insurance contracts generated by the occurring of the insured risk which happened, weren't reported

to the insurance because of various reasons and may be made known to the insurance in the future.

In order to cover this liability from not reported prejudice, the insurer must constitute the

incurred but not reported reserve – IBNR. Determining this reserve is done using one of the following methods: the "rate of prejudice" method (there are no triangles used), basis chain-ladder, chain-ladder method to which is applied the inflation correction and the method of average cost per prejudice. According to the legislation in our country (The Order of the President of the Commission for supervising Insurers no. 3.109/2003 with the latter modifications

and completions), the incurred but not reported reserve is created and is adjusted at least at the end of financial activity, if internal regulations of the insurer do not foresee otherwise, based on its estimations, statistical data or actuarial calculus for incurred but not reported.

Due to the importance the incurred but not reported reserve has for insurance companies, within this article we aim at highlighting a way of estimating it substantiated on the basis chain-ladder method.

The chain-ladder method was the first of the run-off techniques to be developed. It is the simplest of all the models that can be used and it is based on the assumption that there is a consistent delay pattern in the payment of claims.

The deterministic model underlying the basic chain-ladder method can be expressed as:

$$C_{ij} = S_i R_j + E_{ij} \quad (1)$$

where,

C_{ij} represents the claims (numbers or amounts) for year of origin i and development

period j ;

S_i represents the ultimate level of claims for year of origin i ;

R_j is the proportion of the ultimate that has emerged by the end of the j th development period;

E_{ij} is an error term.

In the basic chain ladder, the R_j are derived using weighted averages of the ratios of cumulative values of claims in successive development periods. The methodology can also be applied to incremental values, but this is not usually the case since the amounts tend to reduce as a period of origin matures and the ratio in successive years becomes unstable.

The method assumes that the cumulative position at development period *j* is the most appropriate basis to estimate the accumulated position at development period *j*+ 1 and, by deduction, the incremental movement from period *j* to period *j*+ 1.

Consider the following example in order to illustrate the method[12].

Table 1. Incremental Paid Claims - thousands of euro-

Year of origin	Development period				
	0	1	2	3	4
2005	12 104,34	10 301,15	5 019,29	2 456,11	2 124,00
2006	13 775,24	10 245,16	4 976,40	1 490,00	
2007	15 851,38	13 115,20	5 885,00		
2008	35 910,41	11 040,00			
2009	61 753,18				

Source: UNIQUA Insurance company

The first stage is to turn the incremental data into cumulative data. The cumulative paid claims are shown below in Table 5.2.

Table 2. Cumulative Paid Claims

Year of origin	Development period				
	0	1	2	3	4
2005	12 104,34	22 405,49	27 424,78	29 880,89	32 004,89
2006	13 775,24	24 020,40	28 996,80	30 486,80	C 09,1
2007	15 851,38	28 966,58	34 851,58	C 07,3	C 07,4
2008	35 910,41	46 950,41	C 08,2	C 08,3	C 08,4
2009	61 753,18	C 09,1	C 09,1	C 09,1	C 09,1

Source: UNIQUA Insurance company

It is also useful to calculate the development ratios between successive cumulative payments, within the year of origin.

The development ratio is obtained by dividing one years' figure by the previous years' figure. The results are shown below:

$$r_{0,1}=\frac{22405,49+24020,40+28966,58+46950,41}{12104,34+13775,24+15851,38+35910,41}=\frac{122342,88}{77641,37}=1,57574345=1,5757$$

$$r_{1,2}=\frac{27424,78+28996,80+34851,58}{22405,49+24020,40+28966,58}=\frac{91273,38}{75392,47}=1,21064318=1,2106$$

$$r_{2,3}=\frac{29880,89+30486,80}{27424,78+28996,80}=\frac{60367,69}{56421,58}=1,06993973=1,0699$$

[12] The data is taken from the company of insurance UNIQUA

$$r_{3,4}=\frac{32004,89}{29880,89}=1,07108222=1,0710$$

The value of the prejudice which are going to be reported in the future (C'0x,y) is computed by multiplying the last accumulated value for the prejudice occurred in the year of origin x with the development factor corresponding to the y year of delay:

For year 2009

C09,1=61753,18*r0,1=61753,18*1,5757 =97304,4857

C09,2=61753,18*r0,1*r1,2=61753,18*1,5757 *1,2106=117796,81

C09,3=61753,18*r0,1*r1,2*r2,3=61753,18*1,5757
*1,2106*1,0699=126030,807

C09,4=61753,18*r0,1*r1,2*r2,3*r3,4=61753,18*1,5757*1,2106*1,0699*1,0710=
=134978,994

For year 2008

C08,2=46950,41*r1,2=46950,41*1,2106=56838,1663

C08,3=46950,41*r1,2*r2,3=46950,41*1,2106*1,0699=60811,1541

C08,4=46950,41*r1,2*r2,3*r3,4=46950,41*1,2106*1,0699*1,0710=65128,746

For year 2007

C07,3=34851,58*r2,3=34851,58*1,0699=37287,7054

C07,4=34851,58*r2,3*r3,4=34851,58*1,0699*1,0710=39935,1325

For year 2006

C06,4=30486,80*r3,4=30486,80*1,0710=32651,3628

This simple analysis provides initial insights into trends within the data that might be outside the scope of the model. It further provides a crude indication of the stability with which the ultimate claims would have been estimated in the past, and, hence, the reserving error that could be inherent in using this method.

Table 3. Incremental Paid Claims

Year of origin	Development period				
	0	1	2	3	4
2005	12 104,34	22 405,49	27 424,78	29 880,89	32 004,89
2006	13 775,24	24 020,40	28 996,80	30 486,80	32651,36
2007	15 851,38	28 966,58	34 851,58	37287,70	39935,13
2008	35 910,41	46 950,41	56838,16	60811,15	65128,74
2009	61 753,18	97304,48	117796,81	126030,80	134978,99

Source: UNIQUA Insurance company

The value of the incurred but not reported reserve at the end of 2008 is computed through deducting the last known values for the last years of origin from the cumulated value of the reserve at the date of the calculation. Concretely, the value of IBNR computed on 31st of December 2009 is:

IBNR 2009=(134978,99-61753,18)+(65128,74 -46950,41)+ (39935,13-34851,58)+(32651,36-30486,80) =73225,81+18178,33+5083,55+2164,56= =98652,25

4. Conclusion

The basic chain-ladder is usually used to estimate the numbers of claims incurred or to be finalised, for use in payment per claim analyses and projections. It can also be used with claim payments and incurred costs. However, extreme care is required in the interpretation of the results of the analysis, in the case where there have been large payments or large changes in estimates. Nevertheless, the method is useful as a check on other, more sophisticated methods, because it has fewer estimated parameters and is therefore less subject to estimation error. For small and highly variable portfolios, the problems of parameter estimation may make most other methods unusable.

There are many variations on the basic chain-ladder method but all have the same objective: to extract from the loss development triangle a pattern for the claims runoff that can, possibly with some additional manual adjustment, be used to extrapolate the less mature years of account.

BIBLIOGRAPHY

1. Taylor, G.C., "Loss Reserving: An Actuarial Perspective", Kluwer Academic Publishers, 2000, Norwell, p.26
2. Armeanu, D.. *Risc şi incertitudine în asigurări,* Editura CISON, Bucureşti, 2005
3. Booth, P., R. Chadburn, D. Cooper, S. Haberman, and D. James, "Modern Actuarial Theory and Practice", Chapman & Hall/CRC Press LLC, New York, 1999
4. Bowers, N.L., jr., Gerber, H.U., Hickman, J.C., Jones, D.A., Nesbitt, C.J. (2000). *Actuarial Mathematics*, The Society of Actuaries, Schaumburg, Illinois
5. Cairns, A.J.G., "*A Discussion of Parameter and Model Uncertainty in Insurance*," Insurance: Mathematics and Economics 27 (3), 2000, pp. 313-330.
6. De Alba, E., "*Bayesian Estimation of Outstanding Claim Reserves*," North American Actuarial Journal 6 (4), 2002, pp. 1-20.
7. England, P., and R.J. Verrall., "Stochastic Claims Reserving in General Insurance," Sessional Meeting Paper Presented to the Institute of Actuaries on January 28, 2002.
8. Kremer, E.., "*IBNR-Claims and the Two-Way Model of ANOVA*," Scandinavian Actuarial Journal 1: 1982, pp. 47-55.
9. Lamps, D., "*Bayesian Analysis of Claim Lag Data Using WinBUGS Software*." Presented at the Annual Meeting of the Society of Actuaries, Boston, Massachusetts, October 27-30, 2002.
10. Ntzoufras, I., and P. Dellaportas.. "*Bayesian Modeling of Outstanding Liabilities Incorporating Claim Count Uncertainty*," North American Actuarial Journal 6, 2002, pp. 113-128.
11. Rosenberg, M.A., and V.R. Young., "*A Bayesian Approach to Understanding Time Series Data,*" North American Actuarial Journal 3 (2), 1999, pp.130-143.
12. Scollnik, D.P.M., "*Actuarial Modeling with MCMC and BUGS*," North American Actuarial Journal 5 (2): 2001, pp. 96-124.
13. Verrall, R.J., "*A State Space Representation of the Chain Ladder Linear Model*," Journal of the Institute of Actuaries 116, 1989, pp. 589-609.
14. Verrall, R.J., "*Bayes and Empirical Bayes Estimation for the Chain Ladder Model*," ASTIN Bulletin 20, 1990, pp. 217-243
15. ***Ordinul preşedintelui Comisiei de Supraveghere a Asigurărilor nr. 3.109/2003, publicat în Monitorul Oficial al României, Partea I, nr. 770 din 3 noiembrie 2003, cu modificările şi completările ulterioare
16. ***Ordin nr. 7/2008 pentru modificarea şi completarea Normelor privind metodologia de calcul şi evidenţă a rezervelor tehnice minimale pentru activitatea de asigurări generale, puse în aplicare prin Ordinul preşedintelui Comisiei de Supraveghere a Asigurărilor nr. 3.109/2003, publicat în Monitorul Oficial, Partea I nr. 465 din 23 iunie 2008

BUSINESS REGISTER FOR PAKISTAN – ECONOMIC ADVANTAGES, INSTITUTIONALISATION AND LEGAL ASPECTS

Dr. Christian Lorenz
Gesellschaft fuer Technische Zusammenarbeit GmbH (GTZ)
German Technical Cooperation
Pakistan
e-mail: christian.lorenz@gtz.de

Abstract

A business register (BR) can be defined as a comprehensive database containing all significantly active business entities in the country together with their contact and classification information. It allows for transparency of the types of business activities and actors in the country. Such a BR includes not only information on regional coordinates, the legal status, the ownership, but also on the size and kind of economic activity. This information is imperative for governmental and administrative purposes such as assessing taxes and social contributions, auditing corporations, supervising environment-friendly ways of production and fair competition, subsidizing efficiently, performing reliable and comprehensive statistics, steering structural reforms and the like.

In addition to this, a BR can also increase the accuracy of resource allocation of private investors. A BR is a tool for the preparation and co-ordination of surveys in order to fulfill its main purpose to supply sample data necessary for conducting surveys.

Keywords: *Business register, sample design, statistic burden, nonresponse, industry survey, investment climate*

1. Introduction

In order to increase transparency on the establishments, enterprises and their interconnections it is useful to have a register of these businesses. Such a business register (BR) includes not only information on regional coordinates, the legal status, the ownership, but also on the size and kind of economic activity. This information is imperative for governmental and administrative purposes such as assessing taxes and social contributions, auditing corporations, supervising environment-friendly ways of production and fair competition, subsidizing efficiently, performing reliable and comprehensive statistics, steering structural reforms and the like. But for the optimal allocation of their resources and their

investment, private entrepreneurs also need transparency about the institutional economic setup they are part of.

In Pakistan as in many other countries transparency is limited since the informal sector is relevant. Nevertheless, those economic actors who are playing the tune in business and in commerce should be known well to the ministries, to the other relevant government agencies and to semi-government institutions like chambers and associations. They should be listed or otherwise be captured as comprehensive and up-to-date as possible.[1]

In order to apply advanced survey methodologies, survey frames with the following requirements are essential to provide the basis for data collection and integration. These frames need to be up to date and modified regularly to avoid including establishments which aren't running their business anymore. The frame has to ensure a comprehensive coverage of the universe under consideration; viz. that all business entities which are still running a business are included. If the frame is combined out of several existing data sets it has to ensure that the entries are mutually exclusive and non-duplicative in the listings.

Since 2010 in Pakistan the Federal Bureau of Statistics in collaboration with GTZ has started the task of developing a Business Register (BR). Presently, establishment survey frames are constructed from Economic Census 2005 and directories developed by federal & provincial Governments, Chambers of Commerce & Industries or Business Associations. These directories are overlapping, are usually outdated, do not include new units and don't bother about units dying out, do not cover employment or other such information for every unit to enable stratified sampling[2], have different classifications needing adjustments. Hence, these frames may not be reliable in coverage of surveys and quality results.

A BR can be defined as a comprehensive database containing all significantly active business entities (establishments as well as enterprises) in the country together with their contact and classification information. A BR is a tool for the preparation and co-ordination of surveys in order to fulfill its main purpose to supply sample data necessary for conducting surveys. A business register can provide a directory from which mailing lists can be assembled for the dispatch of questionnaires in statistical surveys. It can provide a population of businesses for which efficient sampling schemes can be designed and panels monitored. A BR can provide the basis for grossing-up results from sample surveys to produce business population estimates. It can help to prevent duplications and omissions in the collection of information on businesses and also improve congruence

[1] See Struck, Business Register in Pakistan, 2008, 1.

[2] Stratification applies prior knowledge about the structure of sampling units and utilizes different sample ratios for the different strata of the population. Usually in economic surveys the big units are fully covered relatively few units of the small units are selected by random.

between the results of different surveys. A BR can control survey overlap by effective co-ordination of samples, thus reducing both costs and response burden and it can help to improve coverage or reveal inaccuracies in statistical data collection (EC, 2003, 17). A BR is to be developed in such a way that it covers all relevant private and public entities, classifies the business entities by legal status and form of organization, etc., covers their geographic location, economic activity and size in terms of employment, sales, or investment, etc., is updated regularly and is accessible to official statistics users (Rana, 2010, 4). A BR should support updates of survey frames, viz. to timely implement start-ups and keep track of current business names. A BR should enable stratification for improved results and coincidently reduce response burden (Lorenz, 2009, 15). It should classify units (enterprises and establishments) in a uniform way enabling aggregation of results of different surveys. BR can improve the coverage and the timeliness of surveys and provide useful information even without any survey. The development of such a BR covers data collection, classification, sorting, matching, storing and regular updating activities.

2. Institutionalisation

In Pakistan at present the Provincial Departments of Labour are responsible for the registration of establishments according to the Factories Act 1934. These and other directories contain information which is outdated, partly overlapping and incomplete. Therefore, in 2006 the Prime Minister of Pakistan approved the constitution of a committee for developing Business Register in Pakistan. The 29-member committee consisted of representatives of different ministries and departments of federal & provincial governments as well as GTZ advisors. Three sub-committees were further set up for detailed discussions on 1) technical and statistical aspects of BR, 2) legal aspects of BR and 3) workflow and data processing.

According to their recommendations BR section has been set up in FBS in October 2008 with one Director and one Chief Statistical Officer and started developing BR in close collaboration with GTZ advisors; in addition BR has been supported with study visits to BR experts in Germany.

Initially the committee decided that the scope of register would be limited to large scale manufacturing industries, based on Census of Manufacturing Industries (CMI) & Karachi Stock Exchange (KSE) data. Data from other sources (like SECP, FBR & WAPDA) would be added subsequently. It was planned that the scope will be extended to other parts of the economy later on. In this scope the threshold could be kept simple and flexible to use; the threshold could differ between sectors, e.g. for large scale manufacturing industries, multiple thresholds

have been recommended by the committee are (10 and above workers, 5 million PKR sales/turnover or 40 KW and above electricity consumption).

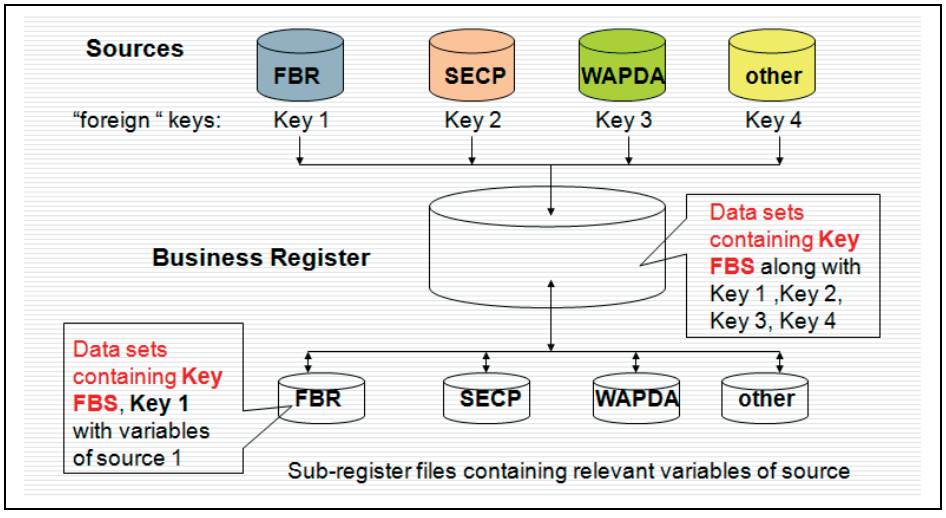
Since the BR has not been included in the statistical law, the ownership of the data delivered as well as the right to publish parts of it is not clear; the same holds for the legal mandate to collect and analyze the data in a BR in general. One of the crucial points is the provision of addresses by governmental and semi-governmental authorities and by associations. Another crucial point is to create by law or legislation the duty for all relevant enterprises and establishments to get registered in time and to provide information of updates.

3. Current situation

Since 2010 BR section continues not only its methodological work, but also started initialising BR practically with additional staff from FBS and GTZ on IT and data processing. External sources of data are Security Exchange Commission of Pakistan (SECP), Federal Board of Revenue (FBR), Karachi/Lahore/Islamabad Stock Exchanges, electricity providers like WAPDA, KESC, SNGPL, SSGC and Directorates of Provincial Labour & Industries Departments. The source agencies will be required to supply soft copies of data files on predetermined dates on annual basis. Another important secondary data source is the Census of Manufacturing Industries (CMI), which is a large scale manufacturing census containing detailed business data.

The database is constructed according to the following idea of applying identifiers for each data source:

Figure 1: *Data sources and identifiers*



Source: Struck, Business Register, 2007, 17.

Business data are delivered by different sources and is has to be assured that each establishment can be identified in each of the sources data since it is available in more than one source. In a first step the original data sets are transformed into cleaned data sets by 'matching'. Matching means to harmonise company names and compare addresses in different sources or find alternative office addresses and identify whether it is the same establishment. The box in the centre shows the master data, which contains the different keys to allow for identification and which can connect to the cleaned source data sets to have access to the variables given in each original source. Some variables are stored in this centre part of BR. The variables also included in the data sets are:

- Name
- Address
- Kind of activity
- Legal Status
- Type of ownership
- Employment size
- Sales / Turnover
- Electricity Consumption

Additional items like "product range" for manufacturing industries and "suitable balance sheet items" for banking and insurance sector will also be added as per requirement. In the cleaned data after some years time series will be available, which can also be applied for plausibility checks. For the whole procedure data of Census of Manufacturing Industries 2005-06 is being used as base information.

In addition to the data sets containing information from each source the BR has access to separate data sets containing information on the classification, the ownership and the regional distribution.

For the business activities the Pakistan Standard Industrial Classification (PSIC 2010) is applied for industries, which up to the 4 digit level is the same as the ISIC4. The PSIC coding should be limited to the 5 digit level, since further information on the products produced is available in separated datasets.[3] Commodities are classified according to the Central Product Classification[4] (CPC2) which has been completed in 2008 by United Nations. These classifications are collected in data sets for several digit levels of the classifications and are connected to the BR product data set.[5] Further attached data sets contain information on enterprises and enterprise groups which include several establishments. Besides that, two

[3] See Struck, PPI, PSIC, CPC and BR, 2010, 3.
[4] See http://unstats.un.org/unsd/cr/registry/cpc-2.asp for details.
[5] See Ashraf, Initial documentation of BR software, 2010, 3.

datasets describe the details of the location of the establishments by listing district and Tehsil codes, which can be identified with the available addresses.

Regarding the IT structure and due to non availability of proper software, required man power and proper lab , the BR section in FBS developing a database in Ms Access which will be replaced by a reliable database expected to be developed in MS.SQL Server and Visual Basic. Net.

Batch processing has been run between different data sources on the variables 'name' and address' to identify already listed establishments. As result about 3500 establishments could be identified and their data merged (mainly CMI to FBR and CMI to SECP). For mass operations the batch processing is more suitable for this type of applications. In addition cross-checks and case decisions are carried out manually on real time basis through LAN system. This holds for the matching of variables like 'name' and 'address' as well as for the business activity and the classification to be applied.

Based on the described data sources the current data situation is the following. A questionnaire has been developed to extract information from audited reports of companies listed with various stock exchanges of Pakistan for updating and correcting the base information in the Business Register. The list of big establishments (B3 and B4 categories) consuming electricity for manufacturing obtained from WAPDA[6] is also being corrected/utilized to update the BR. Another list of establishments involved in economic activities has been downloaded from FBR[7] website for inclusion. For engineering industries an engineering BR has been developed by the Engineering Development Board (EDB), which currently covers more than 2,000 establishments from this sector. This figure will increase, since the e-BR is relatively new.[8] Another potential data source is the yellow pages including addresses and the provincial Departments of Industries might be an additional source as well. The rough number of covered establishments in the starting phase is given in the following table.

Table 1: Number of establishments covered

Data source	Number of establishments
FBR	500,000
SECP	60,000
WAPDA, KESC, GAS	160,000
CMI	10,000
Engineering BR (EDB)	>2,000 (growing)
TOTAL	730,000

Source: BR section FBS.

[6] Water Resources and Power Development Authority Pakistan, http://www.wapda.gov.pk/.

[7] Federal Board of Revenue, Pakistan's tax authority, http://www.fbr.gov.pk/.

[8] See http://www.engineeringpakistan.com/EngPak1/newpd.htm.

Those establishments which cannot be matched with existing data sources have to be saved in a second stage BR and have to be validated from the internet or the DOI. The first stage BR only contains matched establishments.

After the matching phase, where establishments are searched from different sources, each establishment is provided with a key (br_id) in the initial phase. The activity phase distributes industry and products keys to the primary and the two major secondary activities of each establishment, which are connected to the br_id. The validation phase checks the given addresses and harmonises them from the different sources. After that, the regional codes are distributed and connected to each establishment; here also enterprises and groups of enterprises are identified and their codes connected.[9]

BR aims in finalising the large scale manufacturing BR until end of the fiscal year 2010-11; this would allow the next Census of Manufacturing Industries, which starts in July 20111 to be based on the new frame.

4. Conclusion

Until December 2011 GTZ is supporting FBS besides others in the development of BR. According to PC1 FBS comes up with own staff to be trained during these months to assure sustainability of the capacity developments undertaken.

The BR data dissemination strategy foresees that non-confidential information would be freely available on the FBS website and to be back upped regularly and updated after every three months. The update of such a register is cumbersome due to the volatile changing of the enterprises' set-up and due to the increasing habit of outsourcing entrepreneurial functions in form of segregating or creating different legal entities of their own for these functions. Therefore the outdated data are kept in graveyard data sets to be able to review the development of a business.

As soon as a working BR exists, industry statistics can be produced on the basis of surveys instead of more costly censuses. But also in this case official statistic of Pakistan has to ensure, that these establishments which are part of the sample frame, do respond to the questionnaires and start sanctioning nonresponse (Lorenz, forthcoming).

[9] See Ashraf, Initial documentation of BR software, 2010, 5.

Literature

Ashraf, Ali (2010), Initial documentation of Business Register software, GTZ project report Support to Federal Bureau of Statistics.

European Commission (EC) (2003), Business register – Recommendations manual, http://ec.europa.eu/eurostat/ramon/statmanuals/files/KS-BG-03-001-__-N-EN.pdf.

Lorenz, Christian (forthcoming), Nonresponse in developing countries – Adjustment techniques for Pakistan's Census of Manufacturing Industries.

Lorenz, Christian (2009), Unit non-response in statistical surveys - the need for a business register in Pakistan, in: Business & Finance Review, Vol. 4.5, 15.

Rana, Ishaq (2010), Business Register, presentation on first meeting of BR team Pakistan, Federal Bureau of Statistics, Islamabad.

Struck, Bernd (2010), PPI, PSIC, CPC and BR: Some thoughts, GTZ project report Support to Federal Bureau of Statistics.

Struck, Bernd (2008), Business Register in Pakistan, GTZ project paper for Engineering Development Board.

Struck, Bernd (2007), Business Register - Presentation to the Committee for Establishment of a Business Register, Wiesbaden.

THE EFFECTS OF FISCAL POLICY AND HUMAN CAPITAL INVESTMENT IN NIGERIA (1980-2009)

Oseni Isiaq Olasunkanmi
Research Student in Economics
Obafemi Awolowo University
Nigeria
e-mail: ollyrayimpact@yahoo.com

Abstract

By using ECM technique, this paper examines the effects of govermnent expenditures and fourdifferent types of tax policy innovations on human capital investment in Nigeria for the periods 1980-2009. Our results show that two out of four different types of tax policy innovations have a negative significant effects on human capital investment (measured by total students' enrolment); that is, income taxes and indirect taxes while social security taxes is negaive signed but insignificant and corporate taxes has positive sign and statistically significant.

Keywords: *Error Correction mechanism, Fiscal Policy and Human Capital.*

1. Introduction

Education holds a central place in the development of mankind and of the modern contemporary society. Human capital is considered to be one of the most important assets of the society and higher education has a major contribution for human resources development.

Based on the pioneering work of Lucas (1988), the important role of human capital accumulation in economic growth has been broadly studied and recognized. In addition, it is suggested that the most paramount element of national wealth is human capital (Trostel, 1993) Thus, the effects of government policies on human capital accumulation have become one of the major concerns of policymakers and one of the topical issues investigated by economic researchers.

However, many previous studies on the effects of government policies on human capital investment issue have been theoretical, conducting analyses based on mathematical models and/or their calibrated parameters (Trostel, 1993; Heckman, Lochner and Taber, 1998; Ortigueira, 1998; Capolupo, 2000; Lin,

2001 and Jacobs, 2003). Taber (2002) is the only study we are aware of that uses micro data in obtaining model estimates. Also, in the context of studies in Nigeria, Adebiyi (2002) examined the effect of public expenditure on human capital based on macro level using autoregressive model estimates. There is, therefore, an imminent need for policymakers and economists to have a good empirical understanding of how fiscal policy actions would affect the human capital accumulation process at the macro level in a broad sense. This is the neglected area where the present paper attempts to contribute, by empirically investigating the effects of four different tax groups and government expenditures on the human capital accumulation process, using a macro time series data set in Nigeria. Similar study was conducted in OECD countries using dynamic model by Arin, P.K and Li, X (2005).

The results presented in this paper also empirically provide evidence on the nagging question that has been subjected to often theoretical inquiries: in what ways does taxation affect investment in human capital? For instance, the existing argument in the literature as regards the effects of income taxes on human capital varies across studies: positive (e.g., Heckman, 1976); no or minimal (e.g., Boskin, 1977); and negative (e.g., King and Rebelo, 1990; and Lucas, 1990). Heckman et.al. (1998), emphasise a progressive labour income tax discourages education, since the taxes saved while in school are then more than offset in present value by the future taxes due on the resulting extra earnings. Moreover, any tax on the return to savings lowers the individual's discount rate leading to an increase in education. Therefore the effects of the personal income tax need to be explored on human capital investment. Such conflicting theoretical views of the effect of taxes on human capital, or the combined impact of these separate effects, can only be resolved by empirical research.

The empirical evidence of the effects of taxation on economic growth is also scant and mixed. Kneller et. al (1999), by using average tax rates from a panel of OECD countries establish that income taxes and social security taxes (i.e. labour taxes), as well as corporate taxes are growth-detective. Conversely, Lee and Gordon (2005), by using cross country top marginal tax rate data claim that top corporate marginal tax rate is distortionary for long-run economic growth.

Therefore, this paper examines the effects of government expenditures and three different types of tax policy innovations (fiscal policy variables) on the human capital accumulation process in Nigeria for the period 1980 to 2009 using time-series data estimation techniques.

The remaining part of the paper is organized as follows. Section 2 discusses the theoretical framework underpinning the study. Section 3 presents the data and methodology employed. Section 4 presents and discusses the empirical results and section 5 entails the concluding aspects of the study.

2. Theoretical Framework

The theoretical framework is presented with the aim of identifying the suitable variables in an econometric model that would be estimated based on econometric techniques, thus, the signs of model parameters are subjected to test.

Based on the pioneering work of Solow and Swam (1956) and borrowing the idea of Kocherlakota and Yi (1997) and Hercowitz and Sampson (1991) among others about the physical capital accumulation, the study assumes that human capital H accumulates according to the process:

$$H_{t+1} = AH^{1-r} I_{t+1}^{r} \qquad 0 < r < 1 \qquad 1$$

In the equation 1 above, I_{t+1} represents investment in human capital which does not translate into new human capital in unit elastic term, but instead has decreasing returns. This specification may be interpreted as allowing for both the depreciation of human capital and adjustment costs.

Following Lin (2001), we assume that investment "goods" of human capital are produced in period t but to be used in period t+1. Their production uses the technology as described in Glomm and Ravikumar (1992) and Capolupo (2000):

$$I_{t+1} = RG_t^{a} (Z_t H_t)^{1-a} \qquad 0 < a < 1 \qquad 2$$

Where G_t stands for government expenditures, and Z_t is the fraction of time devoted by individuals to learning (or human capital production). Putting (2) in (1) for I_{t+1} and transform to log-linear, we have:

$$InH_t = (InA + r\ InR) + (1 - r\,a)InH_{t-1} + r\,a\ InG_t + r\,(1-a)InZ_t \qquad 3$$

Taking the differences of equation 3, we have

$$\Delta InH_t = (1 - r\,a)\Delta InH_{t-1} + r\,a\,\Delta InG_t + r\,(1-a)\Delta InZ_t \qquad 4$$

Jacobs (2000) examines theoretically the effects of taxation on learning time Z, and discusses three cases. However, this paper focused on the case of taxes being flat and arrived at the following equation for the change in time spent on learning:

$$dInZ = A_1 dInW + A_2 T + A_3 IR \qquad 5$$

where W represents the real wage rate, T stands for change in the tax rate of wage income, IR represents the change in the real interest rate, and A_1, A_2 *and* A_3 are parameter estimates. Jacobs's work shows that $A_1 > 0$, $A_2 \leq 0$ and $A_3 < 0$. Thus, the learning time depends on real wages positively, taxes negatively and real interest rates negatively. But if direct costs in learning are fully tax-deductible, $A_2 = 0$ meaning that taxes do not affect human capital decision.

Hence, equation (5) is the theoretical model, and considers the effect of wage income taxation only. In order to obtain the estimated model econometrically to achieve the purpose of this study, we modify the equation in several ways to suite the purpose. At first, we linearised the theoretical relation between time spent on learning and real wage rates, tax rates and real interest rates. Second, to allow for the possible different effects both quantitatively and qualitatively on human capital decisions, we consider different tax groups instead of wage income taxes. Thus, taking differences of each variable in the model, we have these modifications:

$$\Delta InZ_t = \sigma_1 \Delta InW_t + \sum_{i=1}^{k} \sigma_{2i} \Delta T_{it} + \sigma_3 \Delta ir_t \qquad 6$$

Combing equations (6) and (4), we obtain:

$$\Delta InH_t = \beta_0 + \beta_1 \Delta InH_{t-1} + \beta_2 \Delta InG_t + \beta_3 \Delta InW_t + \sum_{i=1}^{k} \beta_{4i} \Delta T_{it} + \beta_5 \Delta ir_t + \varepsilon_{t+1} \qquad 7$$

Equation (7) is the estimated equation, and in estimation it, we use three tax groups (i.e., k = 3) depending on data availability. These are: labour taxes (income and social security taxes) corporate taxes and indirect taxes. Jacobs (2000) claims that income taxes should have a negative effect on human capital, as for the direction of the effect of the other two tax groups, no theoretical justification seem to exist. Thus, the signs of β_{4i} are subject to empirical tests. Theoretically, the a priori expectations for other parameters are $\beta_1>0$, $\beta_2>0$, $\beta_3>0$ and $\beta_5<0$, all these are still test to see whether they are supported by data.

3. Data and Methodology

Secondary data are used for this study. Time-series data on Human Capital proxied by student's enrolment on primary, secondary and tertiary education; in order to identify the tax policy changes, two different measures are used: average tax rates (following Kneller et.al., 1999), the top marginal tax rates (as suggested by Lee and Gordon, 2002). For indirect taxes, we should also note that, the average rate is equal to top marginal tax rate (consumption) taxes, because of the non-existence of income brackets.

During recession, the decrease in tax revenues and the increase in government expenditures automatically increase the government deficit. Similarly, during an economic boom, when more taxes are collected and transfer payments fall, budget deficits fall. Evidently, this stabilizing property is stronger when the tax system is more progressive (van den Noord, 2000). For this reason, the size of the actual deficit is not a reliable measure of the current fiscal policy. (de Leeuw and Holloway (1982, 1983), Holloway (1984, 1986) and Eisner (1986)). In a similar manner, individual fiscal variables not isolated from the effects

of cyclical movements do not reflect the true magnitude of the fiscal policy applied by policymakers. The cyclically adjusted budget (structural budget) is what the government budget stance would be after the automatic responses of receipts and expenditures to economic fluctuations are removed (de Leeuw and Holloway (1982, 1983), Holloway (1984, 1986), Eisner (1986) and van den Noord (2000)). Therefore, while calculating average tax rates, cyclically adjusted variables are used, following Alesina et.al. (2002).

Data on cyclically adjusted fiscal variables, wages and interest rates are obtained from World Development Indicator Database, 2010. For the government expenditure variable, we use aggregate government expenditure obtained from Central Bank Statistical Bulletin, 2009. We deduct inflation rate from nominal interest rate obtained from CBN, Statistical Bulletin to measure real interest rates. The data for top marginal income tax rate and top marginal corporate tax rate is obtained from the World Development Indicator Database, 2010.

We estimated the econometrical model specified in equation (7) above using Error Correction Mechanism. Since most of the time-series data are not stationary at level, we first conducted unit root test based on Augmented Dickey Fuller (ADF) and Phillip Perron (PP). To measure the stability of the tax policy variables as well as whether restrictions are linear in the coefficients, we employed Ramsey Reset test and Wald test respectively. Also, to correct for this biasness of the lag variable, we employ an estimation technique proposed in Arellano and Bond (1991), where an optimal instrument set is used. Arellano and Bond (1991) derived a Generalized Method of Moments (GMM) estimator using the lagged dependent variable, the predetermined variables and the differences of the strictly exogenous variables. The GMM estimator enables us to estimate equation (7) with error correction mechanism. A one-step robust estimator of the model is used in this paper. We should also note that the presence of first-order autocorrelation in the differenced residuals does not imply that the estimates are inconsistent, but the presence of second-order autocorrelation does.

4. Empirical Results and Interpretations

To determine whether the variables are stationary or non-stationary, the augmented Dickey Fuller (ADF) test was employed along with the Phillip-Perron Z-test (PP). The result of the ADF and PP test for the period 1980 to 2009 are presented in table 1 below. The results show that all the variables are not stationary at their levels except interest rate; that is they become stationary after differencing them once.

Table1: Unit Root Test

Variables	ADF	PP	Integration	Variables	ADF	PP	Integration
G	-0.1787	0.2949	I(1)	ΔG	-3.4228	-3.9945	I(0)
IR	-4.0239	-4.1749	I(0)				
TL	-1.8100	-1.7028	I(1)	ΔTL	-4.2883	-4.5207	I(0)
TC	-1.4358	2.6984	I(1)	ΔTC	-5.3931	-3.5956	I(0)
TD	-0.7459	0.6281	I(1)	ΔTD	-3.6207	4.0971	I(0)
W	-1.9328	1.5569	I(1)	ΔW	-5.5125	-4.5489	I(0)
H	-0.6444	0.3598	I(1)	ΔH	-3.4228	-3.9945	I(0)

Notes: PP=Phillip-Perron, z-test = Central value: 5% = -2.9626; 1% = 3.6661

ADF = Augmented Dickey Fuller test central values: 5% = -3.0290; 1% = 3.8300

The results of our regression analysis is presented in table 2 below

Table 2: Estimates of the Human Capital Equation

Explanatory Variables		Regression Coefficients		t-value
Conventional variables				
Ecm			-0.7377	-3.5374**
H_{t-1}			1.5335	9.7512**
Wages			-0.0007	-2.8201*
Government Expenditure		0.0060		1.1098
Policy-related variables				
Income Tax (% of GDP)	-0.2435			-3.4256**
Social Security Tax (% of GDP)	-0.0043			-1.6170
Corporate Tax (% of GDP)		0.0092		4.9220**
Indirect Tax (% of GDP)	-0.0234			-3.5445**
Other variables				
Interest Rates			0.0002	1.0313
Adjusted $R^2 = 0.9523$ F-Statistic = 108.581**			Durbin-h = 1.97.	
Wald Statistic				6.3048*
Ramsey Reset Test				5.7107*
Arellano-Bond Test Ho: No autocorrelation in residual of order 1				-2.32*
Arellano-Bond Test Ho: No autocorrelation in residual of order 2				-0.87

**Significant at 1%. *Significant at 5%.

In the estimated regression results in table 2, the Adjusted R2 is 0.95. This implies that the variables in the model explain 95 percent of the variation in the human capital investment. The Durbin-h statistic is significant, implying that serial autocorrelation is not a problem. The Ramsey reset test is significant indicating that the policy variables are stable and the significant of the Wald test implies that restrictions are linear in the coefficients.

The coefficient of error correction variable is correctly signed and statistically significant, implying that the method is suitable to measure the effect of fiscal policy variables on human capital investment in Nigeria.

The coefficient of the lagged dependent variable is positive and significant. The wage rate has a negative and significant effect on human capital. The government expenditure variable is positively signed but insignificant, indicating that a percent increase in government expenditure in Nigeria may not likely lead to a unit percent increase human capital.

The interesting finding from table 2 is that income taxes, corporate taxes and indirect taxes, all distort the human capital decision, whereas the social security taxes is neutral, judged from the statistical significance/insignificance of the four tax groups' coefficients. This result is robust. As this finding is important, it needs to be elaborated further. The income taxes include physical capital return, wages and interest income; and as taxation reduces the net return on physical capital which may encourage a shift of investment from physical to human capital, an increase in taxes on wage income would cause individuals to expect future net wage rates and, hence, future hours worked to fall. This means that the future utilization of human capital and couple with returns to current human capital investment are expected to decline. Based on this expectation, individuals would reduce current human capital investment. Also, increase in tax on interest income amounts to a fall in interest rate with taxes held constant, there would be a reduction in human capital investment. Therefore, the empirical result indicates that the four tax group has a noticeable influence on the growth of human capital in Nigeria.

5. Conclusions

This paper provides empirical evidence on the impacts of some fiscal variables on human capital investment using macroeconomic time-series data in Nigeria for the periods 1980 to 2009. Our results clarify to a certain degree the ambiguity in terms of the effect of taxation on human capital which exists in theoretical studies by suggesting that the composition of the fiscal policy and the choice of fiscal instruments are crucial for long-term economic performance. It is quite clear that different taxes affect human capital differently at different stages, and using time-series data is crucial for unveiling the effects of fiscal policy on human capital investment process.

Reference:

Adebiyi, M.A. (2002). Public Expenditure and Human Capital in Nigeria: An Autoregressive Model, Department of Economics, University of Lagos, Akoka- ..... Yaba, Nigeria.

Alesina A., Ardagna, S., Perotti, R. and Schiantarelli, F. (2002). "Fiscal Policy, Profits and Investment" American Economic Review, 92(3), 571-589.

Arellano, M and Bond, S. (1991) "Generalized Method of Moments (GMM) estimator using the lagged dependent variable: Monte Carlo Evidence and an Application to Employment Equations", Review of Economic Studies, 58(2), 277-297.

Arin, P. K. and Li X. (2005) 'Effects of Fiscal Policy on Human Capital Accumulation: Evidence from OECD Countries' Jel Classification 023, H20, H40, 128.

Boskin, M. J. (1977), "Notes on the Tax Treatment of Human Capital", In Conference on Tax Research 1975. Washington: Department of Treasury. Capolupo, R. (2000), Output Taxation, Human Capital and Growth", The Manchester School,. 68(2,) 166-183.

de Leeuw, F. and Holloway, T.(1982), "The High-Employment Budget: Revised Estimates and Automatic Inflation Effects", Survey of Current Business, 62 (4), 21- 33.

de Leeuw, F. and Holloway, T.M. (1983), "Cyclical Adjustment of the Federal Budget and Federal Debt", Survey of Current Business, 63(12), 25-40.

Eisner, R. (1986), How Real is the Federal Deficit? The Free Press, New York. Heckman, J. J. (1976), "A Life-Cycle Model of Earnings, Learning, and Consumption", Journal of Political Economy, 84(4), 11-44.

Heckman, J. J., Lochner, L. and Taber, C. (1998) "Tax Policy and Human Capital Formation", American Economic Review, 88 (2), 293-297.

Hercowitz, Z. and Sampson, M. (1991), "Output Growth, the Real Wage, and Employment Fluctuations", American Economic Review, 81 (5), 1215-1237. Holloway, T.M., (1984), "The Economy and the Federal Budget: Guides to the Automatic Effects", Survey of Current Business, 64(7),102-105.

Holloway, T.M, (1986), "The Cyclically Adjusted Federal Debt: Revised and Updated Estimates", Survey of Current Business, 66,11-17.

Jacobs, B.(2000), "A Note on taxation and Human capital Accumulation", unpublished manuscript.

Jacobs, B.(2003), "Optimal Income Taxation with Endogenous Human Capital", forthcoming Journal of Public Economic Theory.

King, E. G. and Rebelo, S. (1990), "Public Policy and Economic Growth: Developing Neoclassical Implications", Journal of Political Economy, 98(5), 126-150. Kneller, R., Bleaney, M.F., Gemmell, N.(1999), "Fiscal Policy and Economic Growth: Evidence from OECD Countries.", Journal of Public Economics, 74, 171-190. Kocherlakota, N.R and Yi (1997), K. "Is There Endogenous Long-Run Growth? Evidence from the

United States and the United Kingdom" Journal of Money, Credit and Banking, 29(2), 235-267.

Lee, Y. and Gordon, R.H., (2005), "Tax Structure and Economic Growth", Journal of Public Economics, 89, 1027-1043.

Lin, S. (2001), "Taxation, Human Capital Accumulation and Economic Growth", The Japanese Economic Review, 52(2), 185-197.

Lucas, R. E., (1988), "On the Mechanics of Economic Development", Journal of Monetary Economics, 22, 3-42.

Lucas, R. E., (1990), "Supply-Side Economics: An Analytical Review", Oxford Economic Papers, Vol. 42, 293-316.

Ortigueira, S.(1998), "Fiscal Policy in an Endogenous growth model with Human Capital Accumulation", Journal of Monetary Economics, 42 (2), 323-355.

Solow, R.M. and Swan (1956), "A Contribution to the Theory of Economic Growth", Quarterly Journal of Economics, vol. 70, pp. 65-94.

Taber, C. (2002), "Tax reform and human capital accumulation: Evidence from an empirical general equilibrium model of skill formation", Advances in Economic Analysis & Policy, 2(1).

Trostel, P. A. (1993), "The Effect of Taxation on Human Capital", Journal of Political Economy, 101(2), 327-348.

van den Noord, P, (2000), " The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond" , OECD Economics Department Working Papers No 230.

DILEMMAS OF STRUCTURED PRODUCTS VALUATION

Izabela Pruchnicka-Grabias, Ph.D.
Assistant Professor
Warsaw School of Economics
Poland
e-mail: izabela.pruchnicka@sgh.waw.pl

Abstract

Structured products are a broad range of instruments and their construction depends both on the market situation and on investor's aim. The literature presents many of their definitions, one of the most useful ones seems to be the one given by S. Das who says that any structured product can be treated as a combination of a fixed income instrument and a derivative and emphasizes that the derivatives in question are mostly forwards and options written on certain underlying instruments.

The market of structured products started to develop 20 – 25 years ago. It has developed gradually however at present one can observe a slowdown in this market. It is probably due to the problems with their valuation which must take into consideration as many market factors that the final effect is difficult to predict.

The paper concentrates on the problems with structured products valuation which are in author's opinion the main reason for the limited development of the market of these products. Besides, the process of a structured product creation is shown. As the most popular structured product is a bond linked with an option, valuation of it is discussed in detail. The author describes market factors influencing the value of a structure product, paying special attention to the most complex and most often used derivatives such as options. The author also emphasizes the need of volatility stabilization on the option market when investing in products that are combinations of options.

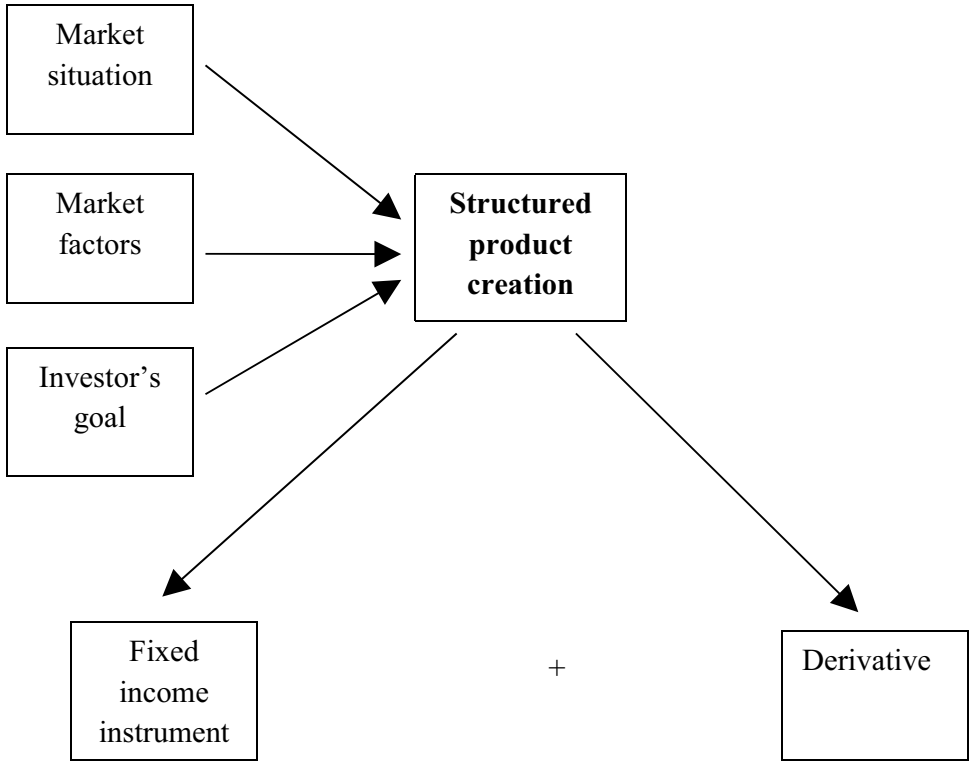
Keywords: *structured products, option valuation, volatility stabilisation.*

1. Definition and the main idea of structured products

Structured products started to develop about 20 – 25 years ago. It has developed gradually however at present one can observe a slowdown in this market. It is probably due to the problems with their valuation which must take into consideration as many market factors that the final effect is difficult to predict. That is why the author decided to devote this paper to the issue of structured products valuation.

S. Das defines a structured product as a combination of a fixed income instrument and a derivative and emphasizes that the derivatives in question are mostly forwards and options written on certain underlying instruments.[1] Any kind of product can be also defined by its characteristic features. If one analyses them, it can be concluded that the distinctive of a structured product is its profit function combined of two elements. One of them is the profit from the principal investment and the second is a possible profit from the derivative which derives from fluctuations of the underlying asset price.[2] Generally speaking, structured products are a broad range of instruments and their construction depends both on the market situation and on investor's aim (see figure 1). Thus a structured product is simply a product that is structured.

Figure 1. The process of the structured product creation.



Source: Author's own study.

As it is shown in figure 1, the process of the structured product creation requires taking into consideration such matters as: the market situation, the

[1] S. Das, Structured Products and Hybrid Securities, John Wiley&Sons, Singapur 2001, p. 1 – 2.

[2] See: J.C. Braddock, Derivatives Demystified – Using Structured Financial Products, John Wiley & Sons, Chichester 1997, p. 11.

market factors and the investor's goal. As far as the market situation is concerned, the following variants are possible:

- Bull market
- Bear market
- Horizontal trend.

Market factors should be understood as most of all:

- Volatility level (low, medium or high)
- Interest rates level and their volatility
- The underlying asset value.

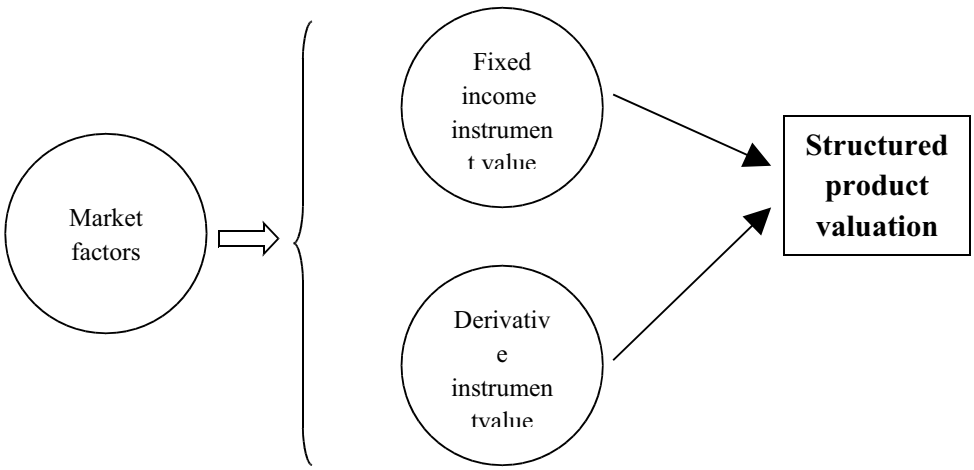
As for investor's goals these can be :

- Capital protection
- Portfolio diversification
- Fixed income at a low risk level
- High income at a high risk level.

2. Basics of the valuation process

The structured product construction influences its valuation that should take into consideration both the value of the fixed income instrument and a derivative.

Figure 2. ***Parameters influencing the structured product valuation.***



Source: Author's own study.

As it is depicted in figure 2, the value of any structured product is influenced by a fixed income instrument value (mostly bonds or notes) and a derivative

value. Whereas the value of the fixed income part is rather easy to calculate, the most difficult part of the structured product valuation is to assess properly the value of the derivative, especially if it is a complex one like an option. As the most common example of the structured product is the combination of a zero coupon bond and an option, the majority of the paper will be devoted to its valuation.

Thus to value the bond one can sum up its revenues received during its life by applying the time value formula:

$$P = \sum_{t=1}^{n} [C_t \,/\, (1+YTM)^t$$

Where:

YTM – *Yield To Maturity*

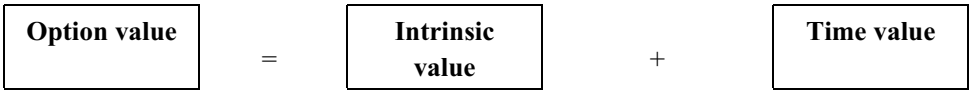
t – the number of years to maturity

C_t - the income on the bond received in t time

P – the bond price

In order to value any structure with an option it is necessary to assess the option part properly. The option price generally consists of two elements that is of the intrinsic value and the time value. (see figure 3). The intrinsic value is the amount that would have to be paid by the option seller if the time of its exercise was at that moment. It also applies to European options although their exercising is only possible during the last day of their life. The time value results from the time which is left until option maturity. The longer the time is the higher the time value because there is a greater chance that the underlying asset value changes in the right direction and the option intrinsic value increases.

Figure 3. ***Elements of the option value.***

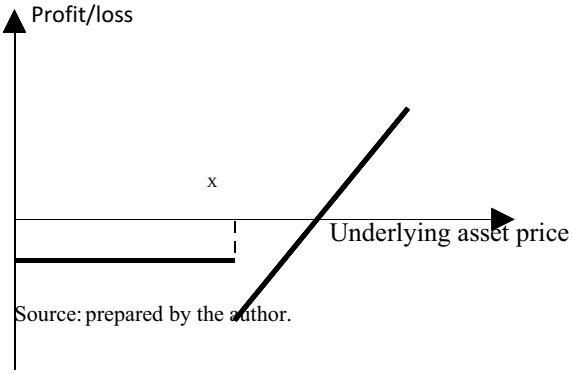


Source: author's own study.

The intrinsic value is influenced by the underlying asset price and the option exercise price. The time value is mostly influenced by such factors as time to maturity, interest rate and volatility of the underlying asset prices.

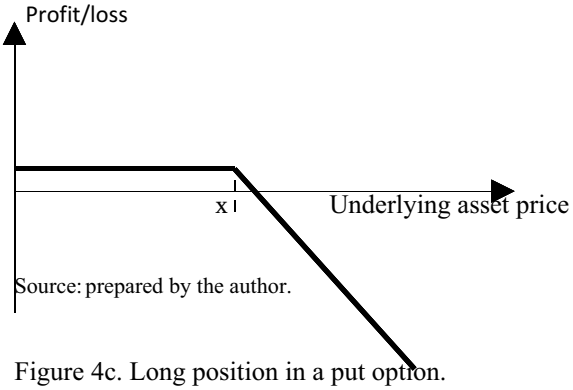
Options payoff profiles from the point of view of both parties of the option contract are depicted in figures 4a-d.

Figure 4a. Long position in a call option.



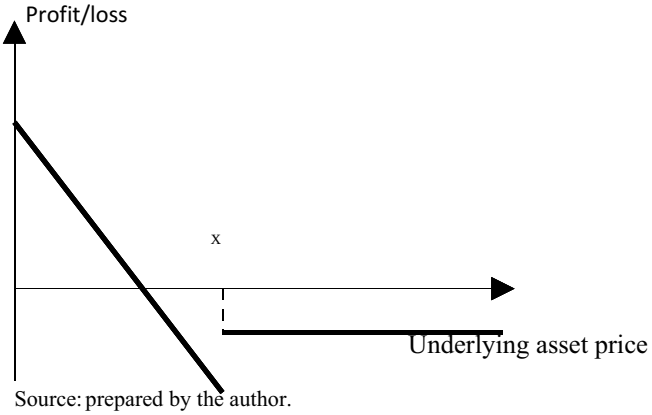
Source: prepared by the author.

Figure 4b. Short position in a call option.



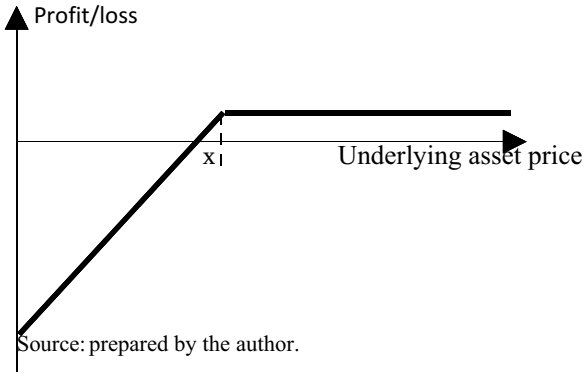
Source: prepared by the author.

Figure 4c. Long position in a put option.



Source: prepared by the author.

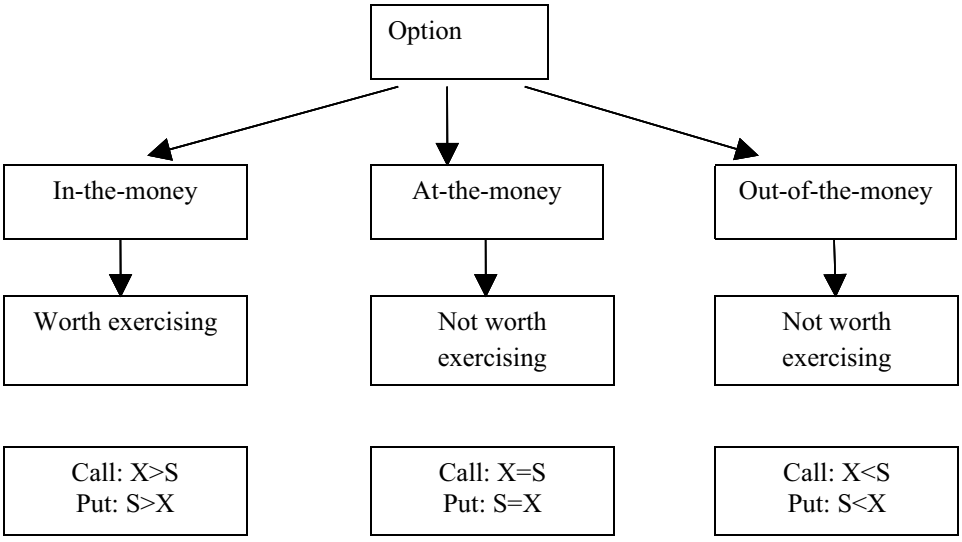
Figure 4d. Short position in a put option.



Source: prepared by the author.

Any option can be exercised when it is in-the-money, which for a call option means that its exercise price is higher than the underlying asset price, whereas for a put option it means that the exercise price is lower than the underlying asset price (see figure 5).

Figure 5. ***Option degree of moneyness.***



Where:
S – underlying asset price
X – option exercise price
Source: prepared by the author.

Basic types of options on the grounds of the underlying asset price are:

- Stock options
- Index options
- Interest rate options
- Commodity options
- Currency options.

The most popular options on the international foreign exchange market are currency options, however for structured products these are stock options that are used most often.

Amongst the most important factors influencing the option price there are:

- Volatility
- Spot price
- Strike price
- Interest rate
- Time to maturity
- Dividend expected in the time of option's life; however it is important for stock options only.

The above mentioned factors influence the option price in different ways. In theoretical studies this impact is assumed as in table 1.

Table 1. Factors influencing a standard option price.

Parameters	Option contract type	
	Call	Put
Underlying asset value	↑	↓
Option strike price	↓	↑
Risk-free domestic interest rate	↑	↓
Volatility	↑	↑
Time to maturity	↑	↑

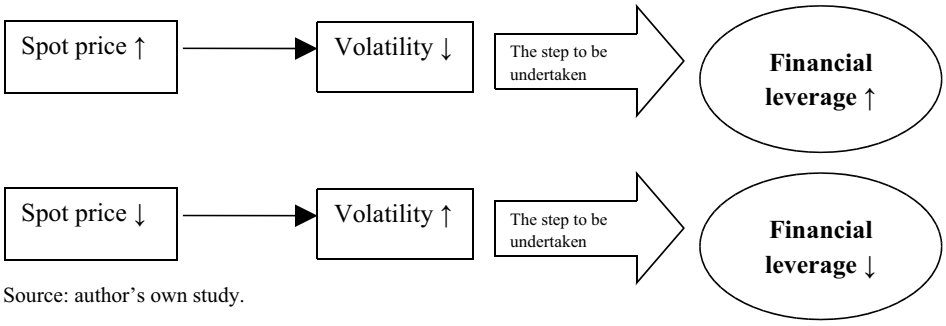
Source: prepared by the author.

However, after having analyzed some practical cases of options it can be seen that some factors in certain circumstances go in different directions than the theory says. For example, generally the higher the volatility, the higher the option price, both for a call and a put option.[3] However, my market experience shows that for extremely high volatilities, the option price is not effected by volatility. Furthermore, in theoretical models it is assumed that when the interest rate rises,

[3] See also for example: R.L. McDonald, Derivatives Markets, Pearson Education, Inc., Boston 2003, p. 372 – 378.

the call option price increases, whereas the put option price decreases. [4] In reality, the influence of interest rates on option price can be different from assumptions because of many variables that are influenced by interest rates. For instance, in countries having relatively high interest rates, the interest rate is positively correlated with the option price, while in countries having relatively low interest rates, the interest rate is negatively correlated with the option price. Besides, the influence of the interest rate on the option price is also affected by the type of an underlying asset. As far as time to maturity is concerned, for American options the longer time to maturity, the higher the option price. For European options the relationship between time to maturity and option price is ambiguous. It can also influence the European option price positively and negatively, especially when the option time to maturity is relatively long. In such a case it may turn out that a 25 year European option will have a lower value than a 23 year European option. As for the strike price, its rise results in the call option price decrease and the put option price increase. Last but not least, the spot price influences the call option price positively and the put option price negatively. Moreover, it must be emphasized that in practice the sensitivity of the option price to the analyzed factors fluctuates continuously. It is also worth stressing that there is a negative correlation between the spot price and volatility. Thus, when the spot price increases, the volatility decreases. This is the case when the investor can increase the financial leverage. In contrast, when the spot price decreases, the volatility increases, which means that the investor should decrease the financial leverage (see figure 6). This procedure is called a volatility stabilization and can be summarized as adjusting financial leverage to volatility levels. If applied properly, it lets reduce potential losses.

Figure 6. ***Volatility stabilization on the option market.***



Source: author's own study.

[4] See for example: J.C. Hull, Options, futures and other derivatives, fourth edition, Prentice-Hall International, Inc., Upper Saddle River 2000, p. 245 – 250.

It is also necessary to point out here that volatility fluctuations affect investment results measured by the Sharpe ratio which is defined as:[5]

$$S_i = \frac{\overline{r_i} - R}{s_i}$$

where:

$\overline{r_i}$ – the average rate of return generated on the i-portfolio

s_i – standard deviation of rates of return generated on the i-portfolio

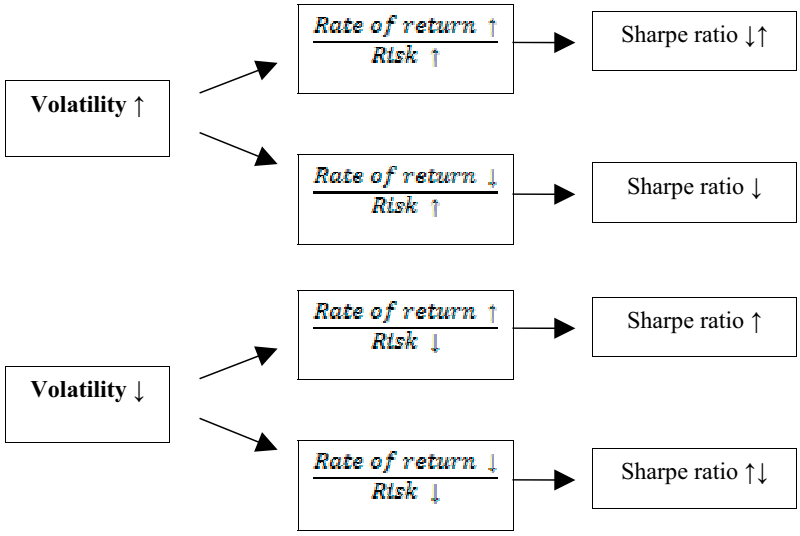
R – risk-free interest rate

Provided that the risk-free interest rate is constant and for the purpose of this paper the Sharpe ratio will be presented in a simpler form as:

$$\text{Sharpe ratio} = \frac{Rate\ of\ return}{Risk}$$

If the volatility stabilization is not used, when the spot price decreases and thus volatility increases, if both the rate of income and risk increase, the Sharpe ratio does not go up as fast as if the rate of income goes down together with the risk increase when the Sharpe ratio goes down quickly (see figure 7).

Figure 7. ***The influence of volatility on the Sharpe ratio.***



[5] For more details see: W.F. Sharpe, Mutual Fund Performance, Journal of Business, Supplement on Security Prices, January 1966, p. 119 – 138.

When the volatility rises, two cases are possible. The first is when the rate of return increases, which makes the Sharpe ratio go up or down depending on which effect is stronger. The second is when the rate of return decreases which pushes the Sharpe ratio down. When the volatility falls down, two variants are also possible. The former is the rising rate of return which causes that the Sharpe ratio becomes smaller. The latter is the diminishing rate of return which may both increase and decrease the Sharpe ratio. Thus, when the volatility rises, the increasing rate of return does not increase the Sharpe ratio as fast as when the volatility decreases. That is why when the volatility goes up, the financial leverage should be decreased. Besides the decreasing rate of return causes a faster decrease of the Sharpe ratio than in the case of the decreasing volatility.

3. Option most popular valuation models and their assumptions

Moving on to the models of option valuation, the author decided to present in short the most common models like the Black-Scholes and the binomial model. The binomial model is often called the Cox-Ross-Rubinstein model from the names of its creators. It was developed in 1978 and it assumes that two scenarios of the underlying asset are possible: either a rise or a decrease.[6] The binomial process is characterized by the following features:[7]

- There is a specified discrete number of trials
- There are only two possible variants of events (0 or 1, heads or tails)
- The probability of any variant is constant
- Events are independent, which means that the result of one event does not influence another event.

As far as the Black-Scholes model is concerned, the theoretical value for a European call or put stock option for companies that do not pay dividends can be computed as:[8]

$$C = SN(d_1) - X e^{-rT} N(d_2)$$

$$P = Xe^{-rT} N(-d_2) - SN(-d_1)$$

where:

[6] J.C. Cox, S. Ross, M. Rubinstein, Options Pricing: A Simplified Approach, Journal of Financial Economics, September 1979, p. 229-263.

[7] See for more information on the binomial trees also f.ex.: Z. Bodie, A. Kane, A.J. Marcus, Investments, McGraw-Hill, New York 2002, p. 703 – 708.

[8] F. Black, M. Scholes, The pricing of options and corporate liabilities, Journal of Political Economy nr 81, maj/czerwiec, 1973, p. 637-659.

$$d_1 = \frac{\ln(\frac{S}{X}) + (r + \frac{\sigma^2}{2})T}{\sigma\sqrt{T}}$$

$$d_2 = \frac{\ln(\frac{S}{X}) + (r - \frac{\sigma^2}{2})T}{\sigma\sqrt{T}} = d_1 - \sigma\sqrt{T}$$

where:

c – value of a call option
p – value of a put option
S – strike price
σ - volatility of the underlying instrument
X - exercise price
r - risk free interest rate
T - time to expiration given in years
ln – natural logarithm function
e - the base of the natural log function = 2, 71
N (d) – the probability that a random draw from a standard normal distribution will be lower than d

$$C = Se^{-\delta(T-t)}N(d_1) - Xe^{-r(T-t)}N(d_2)$$

$$P = -Se^{-\delta(T-t)}N(-d_1) + Xe^{-r(T-t)}N(-d_2)$$

where:

$$d_1 = \frac{\ln(\frac{S}{X}) + (r - \delta + \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}} = d_2 + \sigma\sqrt{T-t}$$

$$d_2 = \frac{\ln(\frac{S}{X}) + (r - \delta - \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}}$$

δ – dividend yield

The above presented formula can be slightly modified in order to value other kinds of options. Thus, for currency put and call European options the formula will be the following:

$$C = Se^{-r_f(T-t)}N(d_1) - Xe^{-r(T-t)}N(d_2)$$

$$P = -Se^{-r_f(T-t)}N(-d_1) + Xe^{-r(T-t)}N(-d_2)$$

where:

$$d_1 = \frac{\ln(\frac{S}{X}) + (r - r_f + \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}} = d_2 + \sigma\sqrt{T-t}$$

$$d_2 = \frac{\ln(\frac{S}{X}) + (r - r_f - \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}}$$

r_f – foreign interest rate

For commodity put and call European options the formula will be:

$$C = Se^{-u(T-t)}N(d_1) - Xe^{-r(T-t)}N(d_2)$$
$$P = -Se^{-u(T-t)}N(-d_1) + Xe^{-r(T-t)}N(-d_2)$$

where:

$$d_1 = \frac{\ln(\frac{S}{X}) + (r - u + \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}} = d_2 + \sigma\sqrt{T-t}$$

$$d_2 = \frac{\ln(\frac{S}{X}) + (r - u - \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{(T-t)}}$$

u – convenience yield

Some of the important assumptions underlying the Black Scholes formula are:

- both the interest rate and variance (volatility) rate of the stock are constant (or in slightly more general versions of the formula, both are known functions of time – any changes are perfectly predictable),
- the arbitrage on the market is not possible,
- the distribution of stock prices return is lognormal,
- the trade on the market is continuous and the stock price is described by the continuous diffusion process,

- short term interest rates are constant during option life. Besides market participants can make investments at the same interest rate,
- stocks can be divided endlessly,
- transaction costs and taxes are not taken into consideration,
- short sale is possible,
- stock prices are continuous, meaning that sudden extreme jumps such as those in the aftermath of an announcement of a takeover attempt are ruled out.

The starting formula for options price was the thermal conduction equation:

$$\frac{\partial C(S_t,t)}{\partial t} = rC(S_t,t) - rS_t\frac{\partial C(S_t,t)}{\partial S} - \frac{1}{2}\sigma^2 S_t^2\frac{\partial^2 C(S_t,t)}{\partial S^2}$$

With the following marginal condition:

$C_T = C(S_T,T) = (S_T - X)^+ = \max(S_T - X, 0)$

The Black Scholes model allowed to both finish and begin option valuation problems. It can be said that it lets value an option, however from another point of view there started to appear many of its modifications which tried to make it function better by elimintaing some of its assumptions. However, so far no one has created a better model than the Black Scholes one. It is easily understandable, easy to use and in spite of some simplifying assumptions it gives quite accurate option prices. Although sometimes it may give too high prices (especially for high levels of volatility), taking into consideration both the level of complexity and the level of precision, it has been the best model ever made.

Final remarks

As it was shown, the most difficult part of the structured product to value is the derivative, especially if it is an option. This is why structured products are rather difficult to value, which in turn makes their development more difficult. In order to trade an instrument, it is necessary to value it properly. If some instrument is difficult to value, it is difficult to use, which makes its market hard to develop. Thus, although structured products have developed for 20 – 25 years, they still encounter problems due to many different factors influencing their prices, and which results from it, difficulties with proper valuation. It means that institutions selling structured products should pay more attention to the development of valuation models and to the increase of their precision. It can be done by investments not only in advanced software, but in science as well as.

Bibliography:

1. Black F., M. Scholes, The pricing of options and corporate liabilities, Journal of Political Economy nr 81, maj/czerwiec, 1973.
2. Bodie Z., A. Kane, A.J. Marcus, Investments, McGraw-Hill, New York 2002.
3. Braddock J.C., Derivatives Demystified – Using Structured Financial Products, John Wiley & Sons, Chichester 1997.
4. Cox J.C., S. Ross, M. Rubinstein, Options Pricing: A Simplified Approach, Journal of Financial Economics, September 1979.
5. Das S., Structured Products and Hybrid Securities, John Wiley&Sons, Singapur 2001.
6. Hull J.C., Options, futures and other derivatives, fourth edition, Prentice-Hall International, Inc., Upper Saddle River 2000.
7. McDonald R.L., Derivatives Markets, Pearson Education, Inc., Boston 2003.
8. Sharpe W.F., Mutual Fund Performance, Journal of Business, Supplement on Security Prices, January 1966.

CONTEMPORARY ECONOMIC RESEARCH OF CORRUPTION

Marko Danon
Ph.D. Student
University of Nice Sophia Antipolis
France
e-mail: marko.danon@gmail.com, danon@unice.fr

Abstract

In this paper, we focus on the economic research of corruption. In the first part, we define corruption, types of corruption, its factors and ways to measure it. This section brings together various definitions by notable authors of this domain, such as Begovic, Tanzi, Mauro or Lambsdorff. Before moving to the second section, we are presenting definitions, typologies and factors already researched by acclaimed authors. In the second part, we focus on the channels by which corruption transmits its effects through the economy. This section consists of two major sub-parts, the first one in which we take part in a vivid scientific discussion with the ''apologists" of corruption, i.e. with those economists who underline positive roles of corruption. In the second sub-part of the second section, as a logic continuation of the previous sub-part, we are listing three important consequences of rampant corruption in one economy: consequences to economic growth, foreign direct investments and economic efficiency. Major contribution of this paper is compilation of significant scientific discoveries in the area, as well as bringing new arguments in the discussion on the economic consequences of corruption. The paper uses traditional approach of the New institutional economics (NIE), by underlining the importance of governance, transaction costs and rent seeking.

Keywords: *corruption, institutional capacities, new institutional economics, transaction costs, FDI.*

1. INTRODUCTION

Corruption has become one of the major economic issues of our time, up to the point where we consider this phenomenon as one of the most important obstacles to the development. However, the economic research of corruption is relatively new. It is only in the Susan Rose Ackerman's article ''Economics of corruption" that corruption has become a subject of one serious economic work. Ackerman's work cannot be fully comprehended out of the scientific framework set up by the school of public choice and Gary Becker. This economist has shed light on the problem in his famous 1968 article ''Crime and Punishment". He has

focused a special economic interest on one form of crime, i.e., on corruption; by modeling the costs of the crime and costs of the penal system for one society.

Corruption itself does not belong only to the economic domain. This problem can also be approached from the aspects of law, criminology, sociology, and other sciences. However, we research corruption on the grounds of the economic methodology. As an economic problem, corruption can be researched on two levels: macroeconomic (for instance what is the role of corruption within one economy) and microeconomic (for example, what are the incentives for one economic agent to take part in one corruptive activity). Our methodology has mostly a macroeconomic optic of this problem, because we want to see the concrete consequences of corruption for one economy.

For these reasons, we will ask the following questions: what is corruption? Can we approach this problem by using strictly the economic methodology? Which agents take part in a corruptive activity? What is the role of the state? Why and how is corruption embedded in one economic system? Which are the economic consequences of corruption?

In order to give an adequate answer to these questions, we are going to present a paper divided on two sections, which will be divided on several sub-sections further on. In the first section, we will present the definitions, factors, typology and different measures of corruption. In this part we wish to describe *what* corruption is *per se*, which factors contribute to its development, what kinds of corruption there are, and how are we able to measure this problem. In contrast with the first chapter, in the second section we try to answer *how* does corruption affect one economy, how does it transmit its effects, and does it have only negative, or maybe some positive aspects too? We believe that these two sections are deeply complementary, whereas the first one tries to describe corruption, and the second tries to situate it inside an economic context. In the both sections, we will heavily rely on the contemporary literature and econometric findings.

2. DEFINITIONS, FACTORS, TYPOLOGY AND MEASUREMENT OF CORRUPTION

2.1 Definition of corruption

What is corruption? Is it a cultural phenomenon or not? Can corruption be understood by every human being the same way? As Rose Ackerman (2004) puts it, corruption is a term whose meaning shifts with the speaker. So how can we use the economic methodology in a domain where not all of the economic agents are ready to cooperate, because of the fact that their activities are condemnable by the society?

Historically, it was considered that corruption is a phenomenon of *the corrosion of the social material.* This means that it was a question of morality. As moral is

too vague of a concept, we have to search for another, more stable definition. For example, Begović (2007, p. 51) offers a very elegant solution. According to Begović, corruption can be defined as a behavior that spreads away from a certain norm; whereas the norm is defined as a set of legislative, public interest or public opinion criteria. This elegant solution has at least two major problems. First, there is an institutional problem: there are different judicial interpretations of corruption, which treats the notion of corruption the different way. A problem linked with this one is that the law system is a human – built, social system. This means that it is prone to promulgation of certain laws that are not favorable in diminishing corruption, but on the contrary, they aggravate it. Secondly, corruption can not be approached only from the judicial point of view. There has to be more sociological and economical explications.

A more comprehensive definition is proposed by Tanzi (1998). Corruption, according to Tanzi (1998, pp. 6-7), exists if *there is an intentional violation of the principle of impartiality in the process of the decision making in order to appropriate a benefice.* Tanzi also adds that corruption is an *abuse of the public power for private benefits.* We shall underline five important implications drawn from these definitions:

1. Principle of impartiality – interpersonal relations should not have any importance in the decision making process. Any other behavior raises doubts of corruptive activities.
2. Differentiation of corruption from other forms of abuse – corruption is not extortion or fraud, *stricto sensu*. There has to be two sides in consent for a corruptive activity to take place.
3. Corruption is not only a public sector phenomenon – it exists also in private organizations
4. Not every corruptive activity is connected to bribe – the benefit does not always have to be material. Bribe is only a specific form of a corruptive ``tax``
5. Corruption is a transaction – between the *corruptor* and the *corrupted*

2.2 Factors of corruption

As for the definition, there is a number of typologies of corruption. We are going in this section to present some of the most important.

Begović (2007, pp. 135) proposes the following factors:

1. Rents
2. Size of the state
3. Incitation to the public functionaries
4. Pressure from the civic society

5. Extent of democracy
6. Culture and tradition
7. Economic (in) equality

Johan Graf Lambsdorff (2005a, p.14) proposes a similar typology:

1. Size of the state and decentralization
2. Institutional quality
3. Competition
4. Liberty of the medias
5. Extent of democracy
6. Culture and tradition
7. Other variables
   7.1 Colonialism effect
   7.2 Natural resources effect
   7.3 Corruption in the neighboring countries
   7.4 Percentage of the women in the public institutions

Jean Cartier Bresson (2008, p. 63) proposes this typology:

1. Economic causes
   1.1 Information asymmetry
   1.2 Extent of discretionary power
   1.3 Rent seeking
2. Political causes
   2.1 Transparency of the funding of the political parties
   2.2 Low paid politicians
   2.3 Clientelism
   2.4 Neo-corporatism
   2.5 Extent of the democracy
   2.6 Extent of centralization
3. Administrative causes
   3.1 Bureaucratic market
   3.2 Poverty and inequality
   3.3 Public approval of corruption

Mauro (1997) focuses on the size of the state and those government politics that provoke rent seeking activities. For example, according to Mauro, if the regulations are omnipresent and if the functionaries have a large set of discretionary powers in hands, the economic agents will be incited to offer them bribes so they

might obtain certain rents. If the regulations are too complicated, the absence of transparence and the rents coming out of government politics, represent a trigger factor of corruption. When it comes to the rent seeking, Mauro shows the origins of this phenomenon. The first origin is the commercial barriers. For instance, these barriers might take the form of the quantitative restrictions of the imports, under pretext of protection of domestic businesses. In his article (1997) Mauro shows a statistically significant relation between the level of openness and corruption. Some other sources of rents might be subventions, price control systems, even fixed exchange rates in some extremely corruption ridden economies. Mauro also stipulates that certain economies might suffer from corruption if they are rich in natural resources and poor in terms of institutional quality. Finally, Mauro underlines the importance of the sociological factors, such as the ethnic or linguistic fragmentation of a country. This might be an important source of clientelism, particularly in those countries that have weak democratic and regulatory institutions.

Finally, Tanzi proposes this typology:

1. Regulations
2. Taxation
3. Public expenditures
4. Public procurement at prices different from market ones
5. Political parties financing (transparence and regulation)
6. Indirect factors
    6.1 Quality of bureaucracy
    6.2 Salary level
    6.3 Penal system
    6.4 Institutional controls
    6.5 Transparence
    6.6 Positive example from the leaders

Our idea is that major factors of corruption are: level of economic openness, size of rents and level of complicatedness of regulations. The first factor, level of economic openness, is often approximated by share of the sum of exports and imports in the nation's GDP. It reflects the economic willingness to trade with the exterior, and it is normally correlated with importance of the trade barriers. Economies with high barriers (import or export ones) are often affected by high corruption, because of difficulties to enter such a market. In these situations, exporters might have to pay to obtain ''exporting subventions" (even the exchange rate might be altered by discretionary decisions for some companies), and importers might have to pay very high prices due to importing

restrictions provoked very often by lobbying of domestic producers (who tend to be monopolists themselves). Therefore, the level of economic openness is in the same time an indicator and a factor of corruption.

As mentioned by various authors, rents have an important role in causing corruption. It is because of the possibility of certain economic agents to attribute parts of the social wealth through a discretionary decision. Finally, complicated regulations sometimes seem to be meant to increase the costs of the legal operating within an economic system, as we are presenting on the figure 1.

2.3 Typology of corruption

As for the typology, we will present the typologies proposed by the following authors. Begović (2007, p. 75) proposes the following types of corruption:

1. *Corruption without collusion* – where there is no collusion (agreement) between the corruptor and the corrupted agent. This type of corruption exists mostly in the public institutions, where the employees ask certain material or immaterial benefits from the beneficiaries, in order to procure them with certain resources.
2. *Corruption with collusion* – where there is an agreement between the corruptive parties. Whilst the first type of corruption is effectively extortion, corruption with collusion represents a voluntary pact.
3. *Centralized vs. decentralized corruption* – where the difference between the two represents the hierarchical level of a corruptive person or a group. For example, a highly centralized corruption is where the president and clique, make ask for ``voluntary contributions`` from the economic agents of some particular country. The decentralized corruption is the most common one – for instance the one that appears in various government, health or education institutions.
4. *Administrative corruption vs. the state capture* – difference between the two is situated at the level of institutional regulations. According to Begović (2007, p. 99), the administrative corruption is linked to the execution of certain rules. Put simply – whilst the rules of the game rest intact, their application is altered. The state capture is where the rules of the game are changed in order to be more convenient for one or various economic agents that have influenced this particular change. Needless to say; the latter type is difficult to detect and to determine its particular scope, because it tends to embed into the economic and political system.

Tanzi (2000) proposes the following typology:

1. Bureaucratic (administrative) vs. the political (state capture)

2. Materialized thru the cost reduction vs. materialized by the increase of benefits
3. Initiated by the corruptor or the corrupted
4. Centralized vs. decentralized
5. Financial vs. non financial bribing

Lambsdorff (2005a) proposes the following typology:

1. *Market corruption* – This is essentially a competitive corruption, with the rules of the corruptive game known to the general public.
2. *Parochial corruption* – As opposed to the previous type, a corruption with a smaller degree of transparency, where the rules of the game are known to a limited number of economic agents.

2.4 Measuring corruption

The importance of measuring corruption is vast: what is not measurable is not understandable and thus solvable. But, by its nature, corruption is hardly quantifiable. The best known indices that we have at disposal are the World Governance Indicators, compiled by the World Bank, and the Corruption Perception Index, which is made by the Transparency International (TI). Some less known – and less direct – are the Opacity Index, made by the PricewaterhouseCoopers, Nations in Transit by Freedom House, Bribe Payers Index (TI), World Values Surveys, etc. The TI`s Corruption Perception Index is up today the most comprehensive and the most direct measurement of corruption available. The World Governance Indicators is an index on governance, which gives notes of most countries in the world in 6 different sectors, of which one is corruption. It is important to notice that these indicators are actually perceptions of economic agents working and/or living in selected countries. This is a serious limitation to the quality of these indices, which than raises doubts on its aptness to measure thoroughly corruption. There are generally four limitations of these two major indices:

1. Perceptions – whose perception, and of what? Did the economic agent that states a certain perception really encounter corruption? Is it engaged in corruption? The indices do not differ political from administrative (petty) corruption, which too blurs the precision of these instruments.
2. Standardization – whereas we use the indices to measure corruption in one country, we also use them to compare countries. But, as the business culture differs from country to country, so does the perception of corruption. This leads to the reduced precision of the indices.

3. Number of base indicators – most of these indicators is composite, which means that they are being compiled out of a number of certain base indicators, such as the World Values Surveys or the Opacity Index. However, most of the countries are not noted on the yearly basis, which alters the quality of the overall indices on the year – to – year basis.
4. Transparency – whilst the composite indices are compiled the transparent way, this is not always the case of the base indicators.

3. INEFFICIENCE OF THE INSTITUTIONS AND CORRUPTION. INFLUENCE OF CORRUPTION ON THE ECONOMY

3.1 Is corruption tonic or toxic?

Many authors like Cazurra (2008) claim that corruption may be positive for the economy. In the academic circles, especially in the 80's, some economists have been comparing corruption to a lubricant that makes the ''economic wheels" turning around. In this paper we will present the main arguments of the apologists of corruption, and afterwards we will try to refute them.

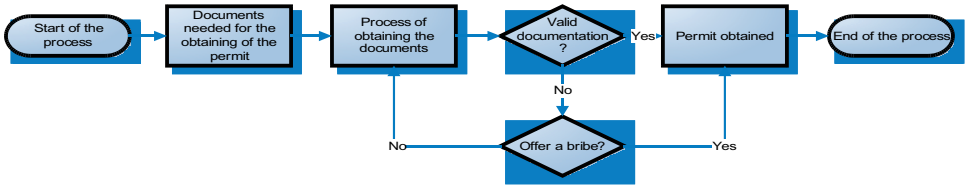
The first apologist argument (A): if the regulations aren't optimal or are inefficient, corruption helps to escape from its application. In the post-socialist economies, corruption had the deregulation role. In this way, the barriers for market entry were neutralized, which allowed stronger competition. Nevertheless, we think that this argument does not hold, because of three reasons: 1) costs, 2) integrity of public policies, 3) incitation to the bureaucrats to complicate the regulations further on.

As for the costs, we make difference between two types of imposed costs. First of all, by *bribing* the bureaucrats, the economic agents are paying for obtaining a service for which these bureaucrats were already paid by their salary. This is why we think that the ''institution" of bribe is an irreparable economic loss of resources that could have been used in productive activities. Second type of cost that we refer to is the *transaction costs*. Escaping to respect the inefficient regulations can boost the economic efficiency in the short term. In the long term, it makes the regulation disappear, by creating a situation in which the economic agents are forced to ''muddle" through a non regulated institutional system. In this kind of situation, the transaction costs tend to elevate, which leads to a smaller number of transactions on the market, with further repercussions on the level of specialization and finally on the economic efficiency. So, basically, even if it looks as if corruption may be positive for efficiency in the short term, it is negative in the long run.

The integrity of the public policies is harmed when they are executed selectively. By the integrity of the public policies we think of: arbitrariness of the regulation application (where the integrity represents the application of all the regulations) and the quality of the state interventionism. As for the first point, the corruptive activities make the arbitrariness more important because a lower transparence, where the decision makers can choose freely which regulations to apply. As for the interventionism policies, the same reason, lack of transparence, makes public projects less reliable. The first cause is that the projects (especially in infrastructure) are more prone to higher costs and a less significant quality in presence of high corruption.

The third remark, cited by Habib and Zurawicki (2001, p. 4), stipulates that if one institutional system is ''sclerotic", it will generate corruption, because the economic agents will be incited to escape to apply the regulations. However, the response from the system will not be a simplification of the rules of the game; but on the contrary, it will complicate the regulations further on. It will do so to make possible to elevate the potential bribes. So, corruption generates corruption. We can illustrate our point by the following algorithm.

Figure 1: Algorithm of process of obtaining a permit



If the necessary documentation for obtaining a permit is valid, this permit will be issued. If the costs for obtaining the documentation are superior to potential bribes, the economic agents will be incited to offer them, and the bureaucrats will be incited to accept them. So, the only solution might be the simplification of the regulations, so that the process of obtaining the documentation becomes less expensive than the potential bribe. Habib and Zurawicki stipulate that the system will seldom simplify the regulations, because only through its complication it can always make the regular obtaining of the documentation more expensive than to bribe the bureaucrats.

The second apologist argument (B) is that corruption incites the bureaucrats to work on their tasks more efficiently. Highly qualified staff is attracted to work in the public administration because of the possibility to ask for the bribes. As the bureaucrats are already paid for their work efforts, the economic agents who are bribing them are forced to offer some sort of a ''voluntary tax". The main problem with this tax is that it raises the transaction costs, because the size and

frequency of the tax are not normally known. The only type of corruption that allows the ''voluntary tax" and low transaction costs in the same time is the centralized corruption. This type of corruption centralizes the discretionary powers in the hands of a relatively small group. According to Blackburn and Forgues – Puccio (2007), in South Korea, for instance, corruption has proven to be somewhat beneficial for the development, because the ruling class obviously had the intention to centralize all the resources under the single command, and thus to channel the development into the promising industries (by using the ''voluntary taxes" as a macroeconomic tool). However, this is more of an exception than a rule. Except for the case of the ''enlightened absolutisms", the voluntary tax does not end in the public funds, which not only raises the transaction costs, but also lowers the quality of public services and infrastructure. In case of decentralized corruption, the position of a corruptive agent is substantially worse – if an economic agent decides to offer a bribe to a bribe solicitor (the bureaucrat for instance), it may end in being blackmailed by the same bribe solicitor, which raises the transaction costs over the acceptable level for most agents.

Another problem of this argument is that the bureaucrats may work more efficiently – but only for those agents who are ready to bribe them. It should not go unobserved that, even if the bureaucratic system is able to cut the waiting lines – and thus improve the resource allocation – the public resources are delivered not to those who merit, but to those who are specialized in corruptive activities (in terms of financial situation and the social capital).

Finally, the last good known argument (D) is that the superior levels of governance and low levels of corruption can be reached only in developed countries. Au contraire, according to Kaufman (2005, p. 86), the good governance and the low corruption are not a luxury, but a necessity for the development. There are many countries that still haven't reached the high development, but they have already substantially lowered their levels of corruption. The best known cases are Botswana in Southern Africa, Chili in Latin America and Slovenia in Central Europe. The example of these three countries is flagrant, as they are, in terms of governance as measured by the WGI, far in advance comparing to their respective regions.

Corruption can substantially increase the efficiency, especially in terms of better resource allocation and cutting down the waiting lines. However, in the long term, the effect of a devastation of the rules of the game leads to a permanent dissolving of the system, which in turn increases the transaction costs.

3.2 The economic effects of corruption

In this section, we will show three economic domains, normally affected by corruption. These are: the efficiency, the growth and the foreign direct investments.

3.2.1 The efficiency and corruption

The efficiency drops as a consequence of four reasons: drop in specialization, barriers to competition, incapacity to protect the lender and the indirect costs.

As for the first reason, our argumentation is based upon a double presumption: that every exchange needs a contract, and that the decrease in level of exchange leads to a decrease in specialization. We stipulate that corruption reduces the quality of the judicial institutions (which is why the contracts are not solid anymore), which raises the business uncertainty, consequently the transaction costs lift, which makes the economic agents to abstain from all but only necessary market exchanges. In turn, the level of specialization drops, leading to a lesser efficiency.

The second reason is a rise in competition barriers. Corruption affects competition in two ways. The first way is that the institutional fragility makes the transaction costs higher. In corruption free countries, the economic agents, because of low transaction costs, have the ability to change partners very often. Contrary to this, in corruption ridden economies, the rational agents should be incited to form partnerships, in order to protect themselves from high transaction costs. As a consequence, these partnerships are difficult to join for the outsiders, and difficult to quit for the insiders. This results in the fact that the membership in these partnerships is often rewarded in a cut in a certain monopoly, but paid by long-standing loyalty to the alliance, and a prime paid to every transaction committed with a partner. From the outsider point of view, the fact that it is difficult to join a partnership, leads to the fact that the outsider enterprises, especially the foreign ones, have high un-institutionalized entry barriers to the market. It should not be forgotten that even to form a partnership it takes year of investing in seeking a right partner, which also constitutes a considerable economic loss of resources, otherwise usable in productive activities.

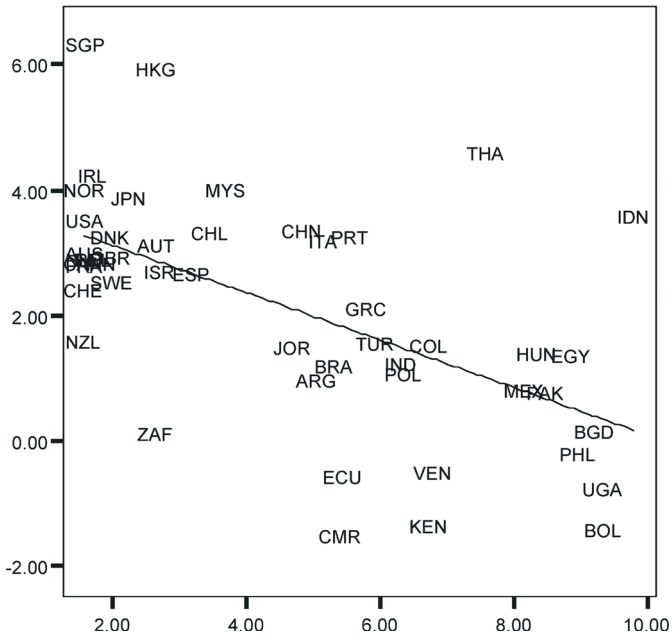
As for the third reason, it is not possible to keep the credit system, because the law and economic system is incapable of protecting a lender. In this kind of system, these are the borrowers who are protected, because they are not forced to return the resources they have borrowed, because the judicial system is unstable. This incites the creditors to raise the cost of the credit, which in turn raises the business risk, makes business ventures more expensive, raises the costs of investments, raises the general price level, and all in all, lessens the efficiency.

There are three indirect costs that affect the efficiency. The first are the costs of the corruptive transaction. As corruption is normally illegal, the partners in this activity are not protected by the court of justice. This is why they have to protect their ''contractual" interests themselves. In other words, they have to find a partner for their activity and to negotiate with him. As normally there is no ''beaten track" in finding a partner, nor in negotiation, this activity provokes a considerable loss in resources. Second type of indirect costs is the opportunity costs, the costs spent at rent seeking, that could have been used in productive activities. Third type of indirect costs, according to Begović (2007, p. 303), are the costs of property rights protection. In a country with a frail judiciary system, the economic agents are forced to protect their property themselves, which augments their costs (for instance, they have to hire the physical protection)

3.2.2 The growth and corruption

The second consequence is the growth. There are many authors who underline the significant connection between the economic growth and corruption. For instance, Pellegrini and Gerlagh (2004, p.7) show the significance of corruption on the growth. The regression they have obtained is the following:

Figure 2: Corruption and growth



It seems that the rise in corruption leads to a drop in the growth rate levels. Begović (2007, p. 303) differs two factors of growth – the one that is the consequence of the growth of the engaged resources (population, investments)

and the second which makes the factor productivity higher (institutional factors, investments in the human capital, etc). This author also makes difference between three channels by which corruption affects directly the level of corruption: the investments, the investments in the human capital and the political stability. Lambsdorff (2005b) shows the link between corruption and the productivity. He stipulates that corruption diminishes the factor productivity. Pellegrini and Gerlagh (2004) show the significance of the following factors for the growth: investments, education, commercial openness, political instability and corruption. We stipulate that corruption affects the growth on both direct and indirect way: apart from rending the institutional system instable, corruption lessens the quality of the other factors – education, investments in public infrastructure, political stability, commercial openness, etc. It is a veritable vicious circle –corruption lessens the government institutions quality, by which it widens the social gaps. These two affect the political stability, which creates more corruption. This is affirmed in the paper of Pellegrini and Gerlagh (2004), who quantify these relations. According to these authors, among several variables to affect the growth, corruption is not the most important: it is the investments (32%), followed by the commercial openness (28%), corruption (19%), political instability (16%) and education (5%). Although corruption is not the most directly influential, it most certainly affects the other variables. The quality of investments in public infrastructure is lower – the projects are more expensive and worse maintained than they could have been in absence of corruption[1]. The commercial openness is lower in corruption ridden countries than in corruption free countries for two reasons. Where there is significant corruption, the local producers might be interested in pushing for higher commercial barriers, in order to protect themselves from the international competition. Second, international competitors are reluctant to enter a corruption ridden economy, because they are not familiar with the local rules of the game, they have low social capital. Thus the transaction costs for them are too high to enter.

3.2.3 Foreign direct investments (FDI) and corruption

The FDI are especially vulnerable to corruption, but in the same time, they are invaluable for the development. If we apply the question of the usefulness of corruption on the FDI, we confirm that it has a slightly positive role in the short term and a negative role in the long term. Corruption, in the long term, provokes the arbitrariness that abolishes the regulations, and thus increases the transaction costs. Tanzi (1998, p. 586) says that the level of uncertainty is directly and negatively linked with the FDI. The uncertainty functions like a

[1] According to Tanzi and Davoodi (1997) show that corruption elevates the investment expenditure, but it lessens the investment quality and that these investments do not have substantial effect on growth.

''voluntary tax". The foreign companies know neither the size nor the frequency of the imposed ''supplementary" taxation.

Habib and Zurawicki (2001) distinguish two types of direct investments: the local (LDI) and the foreign direct investments (FDI). Their opinion is that, because of the fact that the local investors are better informed, the impact of corruption on their business will be less important. The two authors made a list of factors who contribute to the level of both kinds of investments, wishing to see if corruption is 1) important for investments, and if yes 2) does it hurt the LDI and the FDI the same way. The list constitutes the following factors: size of the economy (approximated by the GDP), GDP per capita, GDP growth, orientation towards exports (approximated by the percentage of exports in the GDP), political instability, the inflation rate and fiscal position of the country. Their paper confirms the two presumptions: it is true that corruption is negatively linked with both types of investments, and it is also confirmed that the FDI are more affected by the LDI.

Not only that corruption lowers the general level of the FDI, but its structure is less favorable for the development. Begović (2007, p. 332) stipulates that in a country where corruption is rampant, the international investors will look for the local partners, because they are better informed; for it is in this joint venture with the local partners that the international investors are seeking to lower the transaction costs. However, this solution may not be a durable one, because the foreign investors will not be incited to transfer their technology to the local partners. Because of this, if corruption is high, the FDI will arrive under form of the investments in production of low technology goods and services. This has been proven by the research of Smarzynska and Wei (2000). Effectively, these authors have shown that high corruption may raise the level of the joint ventures, but also that the investors disposing with high technology will avoid the country.

There is another important question linked with the FDI: which type of corruption affects the FDI more – the small (administrative) or grand (political) corruption? Lambsdorff (2005b) stipulates that the investors are particularly vulnerable to the impact of the small corruption, because this corruption provokes higher uncertainty. For instance, Lambsdorff gives empirical evidence that the impossibility to obtain some public services, such as the electricity, water or gas[2], have a strong negative impact on the investors. It is for that reason that Lambsdorff stipulates that the eradication of corruption in infrastructural companies will significantly ameliorate the business climate for the foreign investors. Finally, Lambsdorff remarks that the 1) high level of corruption lowers

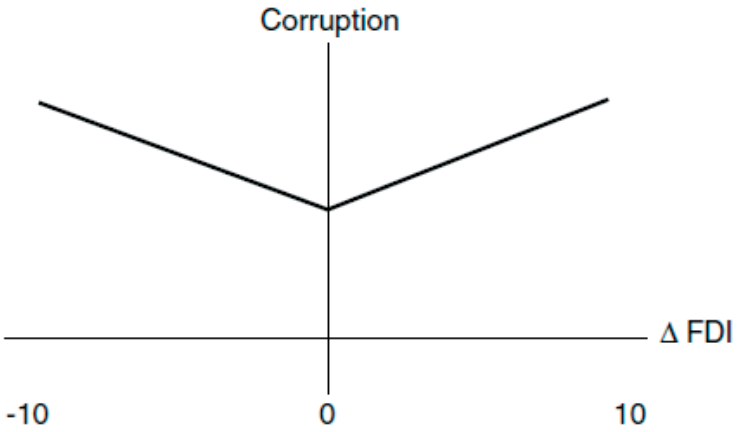
[2] These services, however, are being delivered by lower rank bureaucrats, and thus we believe that it is an example of how the small (petty, administrative) corruption scares off the foreign investors

the FDI, and that 2) for a fixed level of corruption, the augmentation of the grand corruption compared to the small one, raises the general level of the FDI. One interpretation of this find might be that the grand corruption practically transfers the discretionary powers to the high rank bureaucrats, who can then personally step into a political trade with the foreign investors.

Al Sadig (2009) tries to explain the role of corruption in attracting the FDI. At the sample of 117 countries, he is trying to observe the different roles of corruption in different institutional systems. His conclusion is that the decline in corruption for 1% makes the FDI per capita increase for about 20%, in all the countries. However, in a model where Al Sadig includes the governance variable, corruption effect diminishes, which can be interpreted as the fact that the foreign investors prefer the institutional stability to corruption.

Finally, Robertson and Watson (2004) show the link between the FDI and corruption inversely. They are not looking to explain the influence of corruption on the FDI, but on the contrary, what kind of effect do the FDI have on corruption. The authors stipulate that the rapid afflux of the FDI might raise corruption, but that this effect might take place even if there comes to a drop in the FDI.

Figure 3 : Corruption and the FDI, source : Pellegrini and Gerlagh (2004)



For instance, the massive FDI in Ecuador in 2000 have been followed by growth of corruption of 13%. Au contraire, countries such as Estonia, who had a gradual increase in the FDI, also had a gradual drop in corruption. Our interpretation is the following. If the FDI grow without forming an institutional system[3] in order to welcome these investments, the local bureaucrats and politicians might have a possibility to deviate an important part of this afflux to their personal accounts.

[3] Which means a system of regulations and controls

For instance, a country like Nigeria, rich in natural resources generally attracts the FDI, but those FDI rarely contribute to growth of development.

4. CONCLUDING REMARKS

We have tried in this paper to focus the attention to the problems of corruption in modern economies. In the first part of this paper, our intention was to show *what* is corruption, how does it appear, what aggravates it, how can one measure it. In the second part, our intention was to show *how* corruption transmits its effects through an economy. The focal point is the transaction costs, whereas the rise in corruption makes those costs more important, and thus lowers the overall efficiency of one economy. The body of literature presented in the paper confirms our ideas. In spite of the growing body of corruption literature, there is still a live discussion on the question whether corruption is tonic or toxic for the economy, whereas we choose the latter answer.

BIBLIOGRAPHY

Ackermann R. S. (2004) «The Challenge of Poor Governance and Corruption» *Copenhagen Consensus Challenge Paper*, p. 62.

Al Sadig A. (2009), «The Effects of Corruption on FDI Inflows», *Cato Journal,* vol. Spring – Summer 2009, p. 1 – 29

Begović B. (2007), *Ekonomska analiza korupcije,* Centar za liberalno-demokratske studije, 536 p.

Bresson J. C. (2008), *Economique politique de la corruption et de la gouvernance,* L'Harmattan, 242 p.

Cuervo – Cazurra (2008), «Better the devil you don't know», *Journal of International Management,* p. 23

Habib, M, Zurawicki, L. (2001): «Country Level Investments and the Effect of Corruption – Some Empirical Evidence», *International Business Review*, Vol. 10, pp. 687 – 700

Kaufmann D. (2005), «Myths and Realities of Governance and Corruption», *Global Competitiveness Report,* pp. 81-98

Lambsdorff J. G. (2005a), «Consequences and Causes of Corruption – What do We Know from a Cross-Section of Countries? » *Diskussionsbeitrag* n° Vol. 34-05.

Lambsdorff, J.G. (2005b), «Between Two Evils, Investors Prefer Grand Corruption», *Diskussionsbreitrag,* n° Vol. 31-05

Mauro P. (1997), «The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross Country Analysis», *Corruption and the Global Economy,* Institute for International Economics

Pellegrini L, Gerlagh R. (2004), «Corruption's Effect on Growth and its Transmissions Chanels», *Kyklos*, Vol. 57, pp. 429 – 456

Robertson C, Watson A, (2004), «Corruption and Change: The Impact of Foreign Direct Investment», *Strategic Management Journal,* n°25, pp. 385 – 396

Smarzynska, B.K, Wei, S.J. (2000), «Corruption and the Composition of Foreign Direct Investments», *Policy Research Working Paper Series 2360*, pp. 25

Tanzi, V, Davoodi, H.R. (2000), «Corruption, Growth, and Public Finances», *IMF Working Paper,* WP/00/182, p. 24

Tanzi V. (1998), «Corruption around the world», *IMF Staff Papers,* vol. 45, n°4, p. 559 – 594

THE MULTIPLE FACES OF CORRUPTION: TYPOLOGY, FORMS AND LEVELS

José G. Vargas-Hernández, M.B.A, Ph.D.
Profesor Investigador miembro del Sistema Nacional de Investigadores
Departamento de Mercadotecnia y Negocios Internacionales
Centro Universitario de Ciencias Económico Administrativas
Universidad de Guadalajara
México
e-mail: josevargas@cucea.udg.mx

Abstract

This paper is aimed to analyze the multiple forms and faces of corruption, its typology and levels. The analysis begins reviewing a tipology categorizing political corruption, economic corruption and public administration corruption and showing some examples of tipologies, stablishing the levels of corruption and indicating where can be encountered. Corruption takes many forms. Because there is no universally accepted definition of corruption, there is no universally valid typology of corruption. Researchers on corruption have elaborated multiple classifications.

Corruption takes many forms. Because there is no universally accepted definition of corruption, there is no universally valid typology of corruption. Researchers on corruption have elaborated multiple classifications.Corruption is present on both the low and high levels of the bureaucracy and also both types of corruption are linked by corruption on the intermediate levels of the bureaucracy. Levels of corruption indicate where corruption can be encountered. Levels of corruption are associated with economic and political factors although it is hard to establish a robust causal link between levels of corruption and levels of economic performance. The same is truth for a relationship between levels of corruption and levels of political development.

It is concluded that corruption is just as multifaceted concept as there are societies and economic and political systems, embracing from the broad concept of corruption to the narrow legal concept of bribery. However, it is difficult to assess the overall levels of corruption phenomena based on empirical or perceived data which do not reflects the realities of corruption world.

Keywords: *Corruption, forms of corruption, levels of corruption.*

Introduction

Corruption is a social disease that entails social injustice that plagues many developing countries today. Corruption is just as multifaceted concept as there are societies and economic and political systems that embraces from the broad concept of corruption to the narrow legal concept of bribery.

Corruption is the abuse of public office for private gain and the abuse of public power for private benefit. A well known definition of corruption is the one of the World Bank which considers it is the abuse of public office for personal gain. Transparency international also defines corruption as the abuse of entrusted power for private gain. "Corruption, while being tied particularly to bribery, is a general term covering misuse of authority as a result of considerations of personal gain, which need not be monetary" (Bayley, 1966; Alemann 1989, p. 858). Corruption has been broadly defined as the misuse of public office for private gain and the abuse of entrusted power. Corruption is a behavior which deviates from the formal duties of a public role.

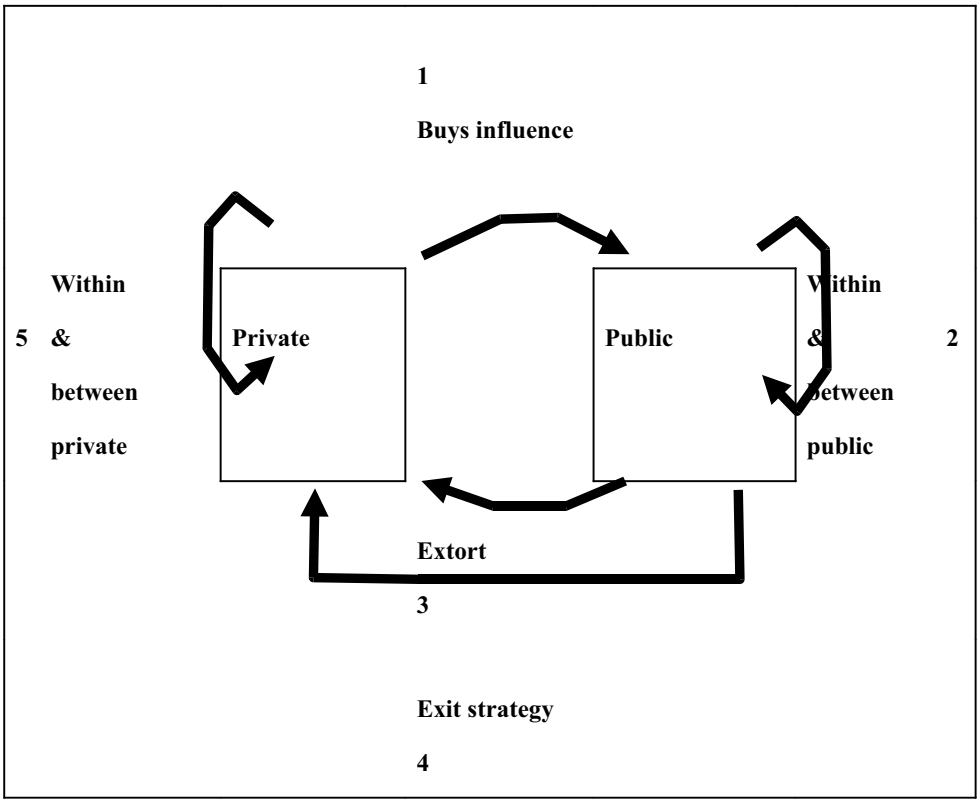
In defining corruption it should be addresses if all forms of corruption are the same regardless of the levels and if the differences in form and consequences of grand corruption and petty corruption can be treated in the same manner. All forms of corruption are based on the potential conflict between the individual's professional and personal interests and values but to find out the causes of different forms of corruption proves to be a difficult task.

Pedersen and Johannsen (2008) have developed a model to analyze the different forms of corruption (Figure 1).

1. Typology of corruption

Corruption takes many forms. Because there is no universally accepted definition of corruption, there is no universally valid typology of corruption. Researchers on corruption have elaborated multiple classifications. Weber (1964) developed a typology of corruption on the basis of subjective intentions that have or expect the individuals such as gaining power and influence, economic and business success, self-enrichment, social motives, opportunism, etc. Weber (1964) assumes that corruption is a State centered phenomenon reflecting the malfunctioning of a rationalized bureaucracy acting according to rules and in the public interest of society reflected in a democratic political system.

Figure 1: Forms of corruption – a simple view



Source: Pedersen and Johannsen (2008)

Corruption can be active or passive taking into consideration who is the person that has the power of decision making or to whom is requested. Corruption also can be private among particular individuals and public corruption that takes place in the public sphere of politics and government administration. A basic categorization considers political corruption, economic corruption and public administration corruption.

Political corruption

Political corruption results in gaining political power. There is political corruption when the behaviors deviate from the principles that guied politics and policies, adapting decisions with abuse of power, which means that the private interests displace the public and common interests. Power is used to service the private interest.

Economic corruption

Economic corruption can be defined as the sacrifice of the principal's interest for the agent's interest. Economic corruption results in making profits. Economic corruption has implications of determining the loss of income, how and how much for the principal, the agent, the state, the consumer, the economy, etc.

Public administration corruption

In the administrative corruption the behaviors of public agentes neglect the principles of efficiency, truthfullness and rightfulness. Public administration corruption results in transfer of public benefits to private benefits taking advantage of the entrusted power, as for example, in the form of nepotism that results in the transfer of benefits from society to family members.

Taking into consideration the magnitude of corruption, the type of corruption can be grand corruption and petty corruption. According to the depth, corruption can be individual and systemic. Other typology of corruption also considers commercial scale illegal logging, and legal logging but contributions paid to gain access to concessions of resources.

Some examples of forms of corruption are bribery, collusion, embezzlement of public funds and theft, fraud, extortion, abuse of discretion, favoritism, clientelism, nepotism, the sale of government property by public officials, patronage, etc.

Bribery is the most widespread form of corruption driven by lucrative profits and the giving of some form of benefit to unduly influence some action or decision on the part of the recipient or beneficiary. Bribery provides incentives for over-regulation and over-bureaucratisation of procedures. Bribery is likely representing the transfer of a portion of rent to government officials. Bribery is committed when a public servant is offered, promised, or granted an in return for an action already carried out or is to be expected. Bribery can be initiated by the person soliciting the bribe or the person offering the bribe. The benefits may vary from money or other valuables to less tangible ones such as inside information or employment. Bribery as illegal action of corrupt relationships is conducted between the involved expending time and resources to keep their secret out of risk and instability that harms reputations when a word ultimately leaks.

Jurists have developed a typology of bribery. Bribery as a form of corruption can be active or passive, in public office or in business relationships. The different types of bribes have different impact depending of the level that can be from tempting of individual politicians to political landscape conservation of factions and parties, from an extraordinarily high one time payments for a specific purpose to impact donations to influence future decisions.

There are some circumstances that are conducive to bribery, including the amount of discretion that civil servants are able to exercise, a legal system that fails to punish bribery, and private companies that are willing to pay the costs of doing business (Al-Jurf, 1999) Bribery also can be a characteristic of the vacuum of political power. Bribery becomes a part of the normal course of business after a firm makes some payments because bureaucrats worldwide expected similar treatment. Bribes may be paid on a case-by-case basis or as part of an ongoing relationship. Consequently, the bribery estimate between firms and the public sector does not cover every form of corruption, such as embezzlement. The estimate of worldwide bribery does not include the extent of other forms of corruption such as embezzlement of public funds from central and local budgets, or from theft or misuse of public assets.

Collusion. Some behaviors of corrupt collusions lead to the subversion of the flow of information within an economic, societal or political unit. Contractual collusion between two parties A and B, to convert a non tradeable contractual condition such as safety conditions into a tradeable, earns them a rent over and above normal profits. Corruption can be collusive in nature where individuals escape official regulations or sanctions by paying bribes to officials. Because of a contractual collusion, consumer C suffers an externality through an unperceived drop in safety.

Embezzlement and theft are forms of corruption characterized by the taking or conversion of money, property or other valuables for personal benefit. Embezzlement often happens by colluding with the subcontractors who are employed for performing some services such as the maintenance work. Officials can have a source of revenue if they embezzle money from the budget for financing the maintenance work, for example. Embezzlement and theft involve the taking of property by someone to whom it has been entrusted. In the aggregate, this represents embezzlement of state revenues of the first order.

Embezzlement, fraud, enrichment in office, favoritism, clientelism, nepotism, simony etc., are forms of corruption and misdemeanor in office. The misuse of authority and power for personal benefits can be embezzlement, enrichment in office, fraud, favoritism and nepotism. Although it is a very serious form of corruption, there are no worldwide estimates of embezzled funds, because it is difficult to have an estimate for the worldwide extent of embezzlement in the public sector from central and local budgets.

Fraud consists of the use of misleading information to induce someone to turn over the property voluntarily, such as the case of misrepresenting the amount of people in need of a particular service. Also other typical fraudulent practice is the sales-buy relationships between public and private sectors. It is well known the form of corruption based on fraudulent sales of second hand or

surplus equipment, but when the buyer is the public sector there is no attempt to include the extent of fraud within the private sector.

Extortion involves coercive incentives such as the use of threat of violence or the exposure or damaging information in order to induce cooperation. The typical extortion is a small scale bribery such to pay to pass security check points or the soliciting of money by low level official where the office holders can be either the instigators or the victims of extortion. Under the form of extortion clients and consumers of government or public services have to pay bribes in addition to the official price, license, permits, access to facilities, etc. As a form of political corruption prevalent in many settings, politicians and public officials make extortions to smaller and weaker firms.

Abuse of discretion is concerning abuses and corrupt government agency practices for private gain without external inducement or extortion. The administrative structure system functioning from high national levels through to the local levels is established by corrupt governments premised on enabling state agents to comprehensively abuse citizen rights for their own personal benefits and in complicity that of their partners and extended network. Some politicians and public officials abuse their political power to capture natural resource rents in such sectors as the mining sector, for example.

In some societies, the combination of acceptance in the face of entrenched systems of abuse has become the norm. Human rights abuses are associated with economic exploitation taking place in areas under the control of the armed opposition and their foreign backers. The history of colonial societies during the last centuries has provided ample examples of how the unprincipled exploitation of natural resources can give rise to human rights abuses also and it has demonstrated how corruption or the mismanagement of natural resources can undermine a country's development and hence the social and economic rights of their citizens. Government officials who are the perpetrators of human rights abuses shielded on the impunity of the rule of law, address the endemic problems of corruption and resource and financial mismanagement to gain benefits exploited as effectively as possible to the tangible benefit of the population as a whole.

At the global and international levels, the comprehensive and systematic abuse of power and authority on global and international laws, standards and norms for all aspects of national level are stricking. Patterns of such abuses are usually associated with bureaucracies in which broad individual discretion is created and few oversights or accountability structures are present. Also these abuses of office´s discretion are related to complex decision-making rules which are capable to neutralise the effectiveness of such structures.

Abuses of natural public resources, asset confiscation and forfeiture by governments, law enforcement agencies and political appointees are so egregious that the assets are sold in fake actions to relatives and friends of prominent politicians, party hacks, etc. at bargain prices. The ruling political parties are potentially more likely to have members who are in positions where they would be able to abuse public resources. Common types of abuses in privatization of state owned enterprises are bankruoting them and assigning a lower value than the real estimate.

Favoritism, gift-giving, nepotism, clientelism and financing networks of cronyism and patronage as forms of corruption involve abuse of discretion, although the act is governed not by the direct self-interest of the corrupt individual, but by some less tangible affiliation, such as advancing the interest of family or nepotism, a political party, or of an ethnic, religious or other grouping. The incidence of corruption practices such as gift-giving and nepotism increased "not as much the result of the deviance of behavior from accepted norms as it is the deviance of norms from the established patterns of behavior" (Huntington 1968, p.60). Citizens follow informal institutions and rules and corrupt practices such as bribery and nepotism to obtain public benefits, goods and services, where they are signaled by mistrust in the transparency and efficaciousness of state institutions.

There are some countries where public sector institutions are historically based on patronage and nepotism rather than merit, and the consecuences may be different. Nepotism increases public employment as a substitute for defficient public works (Bayley, 1966) Per capita higher income of individuals relieves family obligations and lowers the incidence of nepotism. Nepotism subvert laws promoting equity in the workforce and usually increasing the gender inequality.

Other form of corruption is clientelism wher are exchanged votes for managerial decisions related to individual and collective goods, mainly for infrastructure o equipment such as roads, schools, etc. Ethnic based patron-clientelism and prebendalism, gives officeholders and bureaucrats the opportunity to make official decisions as vehicles for rewarding political support and contribute to personal or clan enrichment (Joseph, 1987). Well established networks of clientelism always as the result of inequality and in-group trust, have to be cotrolled more intensively.

Improper political contributions are payments made in an attempt to unduly influence present or future activities by a party or its members when they are in office. To distinguish this from legitimate political contributions is very difficult. The political economy literature explains distortions due to the influence of special political interest groups (Coate and Morris, 1995). Some forms of corruption and venal behaviors can be categorized as improper politica contributions such as

acceleration or facilitation fees for the provision of goods, services or the divulging of information; information altering fees to subvert the flow of truth and complete information and the selling of permits; income supplement of the provider without affecting the real world; relocation fees are benefits paid to affect the allocation of economic resources, material wealth and the rights such as concessions, licences, permits, tenders awarded, assets privatized, etc., etc.

The perception of corruption influences the political and economic behavior of citizens in actions such as voting or investment decisions (Treisman, 2000, p. 400). The term "the grabbing hand" (Shleifer and Vishny, 1998) describes rent-seeking governments which are constrained only by the political and economic institutions in their countries. Ades and Di Tella (1999:987) found that political rights consistently had no significant effect on corruption. An empirical study conducted by Persson, Tabellini, and Trebbi (2003) examine the direct relationship between political institutions and corruption and found that proportional electoral systems are likely to have higher corruption levels.

2. Examples of some typologies of corruption

Corruption typology of Roebuck and Barker (1974)

Roebuck and Barker (1974) postulates an empirical typology of police corruption derived from a content analysis of the literature published between 1960-1972 and the police work experience. Police corruption is analyzed as a form of organizational deviance hinging primarily on informal police peer group norms. The types of police corruption delineated are:

Corruption of authority
Kickbacks
Opportunistic theft
Shakedowns
Protection of illegal activities
The fix
Direct criminal cctivities, and
Internal payoffs.

These types are analyzed along the dimensions of acts and actors, norm violations, support from peer group, (organizational degree of deviant practices, and police department's reactions. Contradictions among formal norms, informal norms, and situational rules are indicated.

Corruption typology of Heidenheimer (1989)

Heidenheimer (1989:149 ff.) distinguishes three different evaluations of corruption in society:

White corruption: Corrupt behavior ist coded tolerantly. This is typically the case in traditional familiy based system as well as in patron-client based systems.

Grey corruption: Corruption is regarded with some opprobrium. Corruption is reprehensible in public moral standards, but the affected persons are widely missing a consciousness of doing wrong. This is typical for modern constitutional states and states in transition towards democratic political culture.

Black corruption: Corruption is generally regarded as severe violation of community moral and legal norms. This is characteristic for modern democratic media societies.

Corruption typology of Alemann (1995)

Corruption in societies is inevitable, being a part of informal politics or shadow politics is ranging from a grey area of completely normal informal agreements and regulations to the black area of illegal and unlawful corruption and organized crime. Corruption is the extreme black side of a scale of informal politics, or, as Alemann (1995) suggests, shadow politics. At what point grey behavior of informal politics turns to black corruption, is extremely difficult to fix, such as for example, a smile is not a bribe.

Alemann (1995) proposed the following types of corruption in his typology:

- low level corruption
- top level corruption or
- petty corruption
- routine corruption
- aggravated corruption

Corruption defined as a breach of contract with externalities, constituting at least a three agent game which can derive in the typology of contracts private, public, and political (Alemann, 1995). Corruption is always a process of exchange between two persons groups: The corrupter (A), who has economic resources at his disposal, and the corruptible person (corruptee B), who has power resources at his disposal.

Corruption can be conceptualized as a model of a cycle of at least seven steps. The exchange logic of corruption is formed by the following 7 components of corruption.

1. The **buyer** (the person offering the bribe: the corrupter) wants
2. a **rare good** (an order, licence, or position) which
3. the **seller** (the person to be bribed: the corruptee) can assign. The latter receives

4. an **additional incentive** (money or payment in kind) for the assignment above the normal price. The corruptee thereby
5. **violates** generally acepted **moral standards** and
6. **damages the interests** of a third party or competitor and/or the public interest.
7. Therefore **corruption is hidden** and concealed.

3 Way Corruption typology of Punch (2000)

Punch (2000) defines corruption as doing something against the officer's duty in exchange for money or gifts from an external corruptor. The 3 way typology of corruption, misconduct and crime modeled by Punch (2000) distinguishes between 3 categories of police deviance:

– *corruption* is the conventional understanding of taking something (such as a bribe), against your duty, to do or not to do something, as an exchange from an external corruptor.
– *misconduct* involves police breaking their own internal rules and procedures.
– *police crime* describes behaviour such as using excessive violence, drug dealing, theft and burglary, sexual harassment, and violating a person's rights.

Punch (2000) provides more detail on the nature of those incidents and who is involved. The typology describes the purposes defining what we are looking at and provide a useful framework for further exploring other causal factors such as personality, background, social dynamics, as well as tailoring prevention efforts.

i.

i.i.

i.i.i. ***Typology of corruption in privatization of state owned companies Tserendondov (2001)***

iv.

v. Analysing the case of corruption in privatization of state owned enterprises in Mongolia, Tserendondov (2001) develops a typology of corruption which provides a framework of reference for dealing with individual corruption in different contexts of privatization:

- Taking state assets without competition and misusing public funds for their own benefit.
- State individuals, groups, or firms using their current position and authority to influence the formation of privatization laws and other government policies.

- Bankrupting state owned enterprises and assigning a lower value than the real estimate have become common types of abuses in privatization.
- The law was breached by privatizing property into the ownership of unfairly authorized people or by privatizing it based on a low appraisal of property value.

Holmes (2006) is optimistic about the possibility of building a comprehensive hierarchical typology of corruption which is a challenging task for methodological and empirical reasons.

Corruption typology of Miller (2003)

Miller (2001, 2003) sustains that officers are vulnerable to bribes when they feel let down by their job and develop a dual typology of corruption:

– *Individual* vs Organized, internally *networked*

Corruption typology of Skogan and Meares (2004)

– *Proactive vs reactive*

– *Personal gain vs organizational gain* ('noble-cause' corruption)

Rasma (2005) presented her typology of corruption and how the combination of systemic inadequacies and a culture of impunity have created an environment in which corruption can flourish unchecked.

Corruption typology of Pedersen and Johannsen (2008)

Pedersen and Johannsen (2008) have developed a typology of corruption based on actor categories

Table 1: A typology of corruption based on actor categories

		The purchaser	The provider
Petty corruption	Day-to-day corruption	Individual citizens	Individual providers of public services – health personnel, police
	Administrative malpractice	Individual economic actors – firms etc.	Public control and licensing agencies
Grand corruption	Political state capture	Collective economic actors – interest organizations Individual economic actors	Politicians – individuals and political parties

Source: Pedersen and Johannsen (2008)

A typology of corruption can be developed as an analytical tool based on different levels of severity of state capture, administrative corruption and other determinants associated with the institutional capacity of the state.

Corruption typology of Baker.

Ray Baker´s typology of corruption considers the following forms of corruption based on the actors: Traditional government corruption, criminal corruption, entrepreneurial governmental corruption.

Political influence, state capture and administrative corruption are phenomena at the interface between the public sphere in which political actors, public administrators and civil servants operate and relate to actors of the private sphere, persons, firms, nongovernmental organizations, civil society, etc.

Administrative corruption

Administrative corruption as a form of corruption refers the implementation of existing laws, regulations, and decrees. The role that political and upper level administrative corruption have come to play in contributing to the profound and enduring malaise for societies, States and firms alike. Administrative corruption for example, spreads if corrupt officials have to pay an entry fee and have to resort to other citizens to finance the entry fee, allowing to additional groups of voters to have a stake in corruption.

Combating administrative corruption has been approached by reforming public administration and public finance management.

Political influence

A new type of corruption, referred as uninstitionalized political influence (Scott, 1972) was directly generated from the rise of new groups of wealth and power during modernization (Huntington, 1968) and their efforts to make themselves effective in politics in a political system that was slow to provide legitimate channels. The modernization theory on corruption derived in the hypothesis to sustain that the more rapidly a country modernizes, the higher the level of corruption. The process of modernization in developing countries contributed to generate high levels of corruption through the expansion of governmental activities, the rise of a new rich social class seeking political influence and change of social values and norms (Huntington, 1968 and Scott, 1972).

Political influence allows private individuals to help shape public law and depends on the size of the firm and interactions with state officials, rather than direct payments (Al-Jurf, 1999:193, 198). The judiciary, legislative and executive systems may be weak to political influence. Political influences can buy the decisions of the legislative, executive and judiciary actors even in a

party system. Victims of a corrupted legislative, judiciary or executive systems lacking of political influence make illicit offerings to gain access to public goods, government jobs and resources. Political influence of the higher-rank officials can be modeled as a function of their revenues from collecting relatives. There are some models to capture large political influences such as the lobbying models and the probabilistic voting models which analyses contributions of small group voters.

State capture

State capture is defined by the Worls Bank as "The actions of individuals, groups, or firms, both in the public and private sectors, to influence the formation of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials" (Helman, 2000). State capture as a form of corruption surrounds the formation of laws, regulations, and policies. One form of state capture is decision altering which encompasses bribes and promises of bribes to alter or affect decisions, affect policy formulation and formation of laws, regulations, or decrees in order to benefit the bribing person or entity.

State capture is also a phenomenon of undue influence and capture of the State by powerful firms. The extent, level and degree of State capture and monopolistic vested interests vary significantly across countries. Firms engaged in illicit influence experienced higher growth rates than firms that did not engage in this form of corruption (Kaufmann& Kraay, 2002; Helman, 2000). Where state capture is a major constraint for multinational and domestic firms as a whole, they suffer by growing more slowly while the firms that are purchasing laws and regulations obtain higher benefits and growth faster and higher.

Generally, state capture cannot be abolished by democratic institutions. State capture has been associated with corruption and lobbying literature with campaign expenditures which are linked to policy outcomes (Grossman and Helpman 2001).

State capture and administrative corruption are identified as significant issues to be confronted by transitional economies. The character of corruption matters with respect to the functioning of the political, economic and administrative system. Corruption in different forms and areas, state capture and distrust are mutually reinforcing and may be prevalent to differing degrees depending on the specific State. Countries in economic transition with high levels of both forms of corruption, administrative and state capture are associated with output decline, poverty, inequality, and even organized criminal activity (The World Bank, 2000). This report recognizes that the state capture poses formidable challenges, status quo often benefits powerful interests and the political economy

of anticorruption initiatives has proven complex and difficult. The institutional vacuum in countries with transitional economies provided ideal opportunities for state capture.

Typology of Cahn and Gambino (2008)

Cahn and Gambino (2008) have developed a corruption typology based on natural resources, commodity dependence, and good governance in different contexts identifying four broad categories of countries in Sub-Saharan Africa. This typology is intended to emphasize the importance of poor governance to underdevelopment and clarifies the need for different strategies for countries in four different categories.

Category 0 denotes the near-absence of both effective governance and significant levels of foreign investment. Higher levels of corruption.

Category One denotes countries highly dependent on a single-source of export revenue and economic dependence that creates opportunities for corruption and can have anti-democratic consequences.

Category 2 includes countries that have a broader range of export commodities characterized by substantial levels of external investment and governments that are more interested in decreasing corruption and improving the business environment.

Category 3 includes nations where country governance is much improved and vastly better than other countries, economies are diversified, with strong agricultural sectors, and levels of foreign investment are reasonably high. Lower levels of corruption.

Corruption typology of Merat and Roth Deubel (2008)

Merat and Roth Deubel (2008) use the typology of both formal and informal institutions proposed by Gretchen and Levitsky (2006), who distinguishes informal institutions according to the complementary, substitutive, accommodative and competitive types. Merat and Roth Deubel (2008) analyze on the basis of North's neoinstitutionalist framework violence and corruption corresponding with the presence of informal institutions and powerful armed groups who compete with the formal institutions and pursue divergent goals, drawing from the case of the municipality of Tumaco, Colombia. In tis case, the local institutional level, where the balance of power is in favor of informal institutions, is the most affected.

Corruption typology of Pedersen and Johannsen (2008)

The typology used by Pedersen and Johannsen (2008) for measuring corruption distinguishes:

Day-to-day corruption that takes place at the lower levels of the administrative hierarchy related to ways of behavior that are necessary and appropriate to get things done and administrative malpractice.

Grand corruption at the middle and higher level of public administration and directly in the political sphere, that circumvents legitimate democratic decisions and decision making. This type of corruption is related to the specific context of transforming and redefining private-public relations in society.

Pedersen and Johannsen (2008) illustrate how this typology may be applied in terms of concrete position in the political and administrative sphere, in the following table.

Table 2. Identification of the 'provider' of corruption

Grand corruption	Parliament
Grand corruption/Administrative malpractice	Ministers
Administrative malpractice	Top level officials
	Intermediate level officials
'day-to-day' corruption	Lower level officials

Pedersen and Johannsen (2008)

Corruption typology of Transparency International (TI) UK

Based on economic and political defense analysis, the Transparency International UK has developed a typology of corruption as a framework for defense. In one of the main categories of the typology of defense corruption, political context and control, corruption in the defense establishment under democratic political authority encompasses, over-elaborate and non-agreed defense policy, hidden defense budgets, underestimated or off-budget defense spending, cronyism and dishonest leadership level, secret power networks, organized crime links, misuse and control of intelligence for corrupt purposes, misuse of investigatory powers, misuse of power to influence legislation and parliamentary investigations, corruption of the judicial process, involvement in elections and politics, and ultimately state capture, de facto illicit takeover of defense by officials, (TI UK, 2009).

Table 3: Corruption – framework for defense

POLITICAL CONTEXT AND CONTROL	DEFENSE PROCESSES	DEFENSE PERSONNEL
Defense policy	Procurement, bribery, diversion of funds	Values, standards, rules, weak, ignored.
Defense budgets, not transparent, debated or audited	Salaries, diversion of funds	
Leadership and accountability, dishonest, unclear or split	Property and sales	Small bribes
Organized crime links	Personal control of secret budgets	Money for security
Control of intelligence	Private businesses	
State capture	Reward, promotion, disciplinary, failures, inequities	Job preferences

Source: TI UK (2009)

One set of problems with the literature on corruption typology is that it offers a very narrow definition of corruption, whereas there is a need to proffer one comprehensive framework for analyzing a wider typology of corruption phenomena.

3. Levels of corruption

Corruption is present on both the low and high levels of the bureaucracy and also both types of corruption are linked by corruption on the intermediate levels of the bureaucracy. Levels of corruption indicate where corruption can be encountered.

Alemann (1995) has proposed the following leves of corruption:

Vertical levels of corruption

- local politics (micro level)
- middle level, regions (meso level)
- nation-state level (macro level)
- international level (mega level)

Horizontal areas of corruption

- administration of housing and construction
- agencies of economic development
- procurement administration
- licenses, approvals
- military procurement
- secret services

A well know characterization of levels of corruption considers individual, business and political corruption.

Individual corruption takes place primarily in relations between individual citizens and public officials and authorities.

Business corruption takes place primarily in relations between enterprises/ companies and public officials and authorities.

Political corruption takes place in the higher echelons of public administration and on a political level.

Levels of corruption are associated with economic and political factors although it is hard to establish a robust causal link between levels of corruption and levels of economic performance. The same is truth for a relationship between levels of corruption and levels of political development.

According to the modernization hypothesis, the modernization process brings corruption (Huntington, 1968; Scott, 1972). Countries with faster developing economies tend to have higher levels of corruption.Therefore, Countries that modernize faster tend to have higher levels of corruption that could be perceived as the result of "the law of inertia" by which parts of the society pioneer in modernization while other parts were reluctant to change. However, some developing countries challenge systemic corruption and have lower levels of corruption than some wealthy countries.

Functionalists (Leff, 1964; Ney, 1967; Huntington, 1968) emphasize the positive effects of corruption on development arguing that corruption is likely to increase the efficiency of government, overcome bureaucratic obstacles and divisions in a ruling elite that might otherwise result in destructive conflict. These arguments are rejected by empirical research. Rose-Ackerman, 1999; Montinola and Jackman, 2002) show that high levels of corruption are associated with lower levels of investment and economic growth.

Some economists agree that there are significant correlations between high levels of corruption and economic consequences such as the inefficiencies in the operation of markets, distorting the composition of public expenditure by focusing spending on activities likely to yield large bribes and reducing the level of direct foreign investment by adding costs and creating uncertainty. Montinola and Jackman (2002) and Xin and Rudel (2004) found that large government spending is associated with lower levels of corruption. Fisman and Gatti (2000) have demonstrated that more decentralized countries have lower levels of corruption.

Countries that have relatively low levels of corruption may attract significantly more investment than those perceived to be more prone to corrupt or illicit activity

(Campos and Pradhan, 1997). Higher levels of corruption are associated with greater government intervention in economy. The public choice theory asserted that large government sectors are associated with higher levels of corruption. Firms can contribute to have higher levels of corruption by seeking rent compete for government contracts and licenses not through price mechanisms but through bribes to public officials.

States with high levels of corruption are not incompatible with high levels of economic growth although if those states had been able to reduce their levels of corruption, they would have experienced even higher rates of economic growth. In a large robust dynamic economy, the economic costs of low levels of corruption are minimal, while in a fragile, unbalanced, stagnant economy, the economic costs of high levels of corruption are insupportable. Countries that tolerate relatively high levels of corruption are unlikely to perform high rates of economic growth although may enjoy still decent rates. High levels of corruption may tend to increase imports of goods and services.

In developing economies there seems to be significant correlation between high levels of corruption and lower levels of investment and growth. Mauro (1995), based on cross-country perceived corruption studies finds a direct link between high levels of corruption and low levels of foreign direct investment and that corruption is strongly negatively associated with the investment rate. Tanzi and Davoodi (2000) found that corrupt procurement practices reduce growth by reducing the productivity of public investment, increasing public investment that is not adequately supported by nonwage expenditure on operation and maintenance, reducing the quality of the existing infrastructure and by decreasing the government revenue needed to finance productive spending.

In developing countries, Boerner and Hainz (2004) observe high levels of corruption even if they have democratic political systems. One of the reasons is that functioning financial institutions reduce the incentives of some groups of voters to support high levels of corruption. Lower levels of corruption are associated with more democratic countries under the assumption that democracy may have some attributes to reduce corruption, a lthough some emerging democracies have exhibited higher levels of corruption than authoritarian regimes.

An institutional factor that matters for corruption is the fairness of the legal system, not the efficiency of the legal system. In policy strangling regulation leads to higher levels of corruption. The relationship between corruption and trust in informal institutions makes the most effective means to obtain goods and services, which in turn increases the levels of corruption. Mistrust creates an inefficient public sector that in turn raises levels of corruption and undermine popular trust in the state. Thus, corruption and the lack of institutional trust feed each other, producing a vicious circle.

Social groups may contribute to higher levels of corruption by seizing the opportunity to exploit the power vacuum and expanding the groups' interests at the expense of the society. Countries with higher levels of human development have lower perceived levels of corruption, as measured by the control of corruption index. Higher levels of corruption are correlated with lower school enrolment and higher dropout and illiteracy rates, blocking key routes out of poverty. Countries with high levels of corruption also have higher levels of poverty. Inequality leads to low out-group trust, which in turn leads to high level of corruption. Land reform and the initial adoption of industrial policy produced different levels of inequality, and thereby different levels of corruption and social trust. Countries with low levels of corruption tend to have fewer conflicts and can exacerbate the impact of natural disasters.

Chakrabarti (2001) demonstrates that societies have locally stable equilibrium levels of corruption that depend upon a small number of socio-economic factors and shows that under certain conditions it is possible for corruption to go on an ever-increasing trajectory till it stifles all economic activity.

It is difficult to assess the overall levels of corruption phenomena based on empirical or perceived data which do not reflects the realities of corruption world. Kaufmann, Kraay and Zoido-Lobaton (1999) assume that each source is a noisy indicator for an unobservable component. The Corruption Perceptions Index (CPI) is a composite index that assesses and compares perceived levels of corruption among public officials and politicians in a wide range of countries around the world reflecting the views of business people and country analysts from around the world.

References

Ades, A., and R. Di Tella. (1999). "Rents, Competition, and Corruption." *American Economic Review* 89: 982-93.

Alemann, Ulrich von (1995) Corruption in Germany. *The debate in politics and political science.* Paper prepared for the IX Jornadas de Filosofía Práctica organized by the Facultat de Dret Universitat Pompeu Fabra Barcelona May 25 and 26, 1995 at Tossa de Mar.

Alemann, Ulrich von (1989) "Bureaucratic and Political Corruption Controls. Reassessing the German Record". Heidenheimer, Arnold J., Johnston, Michael, Le Vine, Victor T. (eds.) *Political Corruption. A Handbook*. New Brunswick (1989) p. 855-869.

Al-Jurf, Saladin (1999) "Good Governance and Transparency: Their Impact on Development" *Transnational Law and Contemporary problems* (1999).

Bayley, D. (*1966*) "The effects of *corruption* in a developing nation", *The Western Political Quarterly,* Vol. 19 No.4, pp.719-32.

Boerner, Kira and Hainz, Christa (2004) *The political economy of corruption and the role of financial institutions.* CESIFO Working Paper 1293, October 2004, presented at CESIFO Area Conference, May 2004

Cahn, Naomi and Gambino Anthony (2008) "Towards a typology of corporate responsibility in different governance contexts: what to do in the absence of responsible country governance?" *Georgetown Journal of International Law* Publication Date: 22-JUN-08.

Campos, José Eduardo and Pradhan, Sanjay (1997) Analysis of 1997 World Development Report. Washington DC: World Bank, pp. 102-109.

Chakrabarti, Rajesh (2001) "Corruption: A general equilibrium approach" Social Science Research Network.

Coate, Stephen and Stephen Morris (1995). "On the Form of Transfers to Special Interests" *Journal of Political Economy* 103, 1210-1235.

Fisman, Raymond J. and Gatti, Roberta (2000) Decentralization and Corruption: Evidence across Countries (February 2000). World Bank Policy Research.

Gretchen, Helmke and Levitsky, Steven. (2006). *Informal Institutions and Democracy: Lessons from Latin America*. Baltimore: Johns Hopkins University Press.

Grossman, Gene M. and Elhanan Helpman (2001). *Special Interest Polititcs*, Cambridge, Mass.: MIT Press.

Hidenheimer, Arnold J. (1989) "Perspectives on the Perception of Corruption". Heidenheimer, Arnold J., Johnston, Michael, Le Vine, Victor T. (eds.) *Political Corruption. A Handbook*. New Brunswick (1989) p. 855-869.

Hellman, Joel, S (2000) *Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition Economies*, at 4, 20-24 (World Bank 2000).

Holmes, Leslie (2006) Rotten State*?* Corruption*,* Post-Communism, and Neoliberalism. Durham London: Duke University Press.

Huntington, Samuel P. (1968). *Political Order in Changing Societies.* New Haven, Conn.: Yale University Press.

Joseph, Richard. (1987). *Democracy and Prebendalism in Nigeria: The rise and fall of the Second Republic.* Cambridge: Cambridge University Press.

Kaufmann, Daniel & Aart Kraay (2002) "Growth Without Governance" 3 ECONOMIA 169 (Fall 2002).

Kaufmann, D., A. Kraay and P. Zoido- Lobaton (1999), "Aggregating Governance Indicators." *World Bank Policy Research Working Paper No. 2195* (Washington D.C.: The World Bank).

Leff, Nathaniel H. (1964). "Economic Development through Bureaucratic Corruption". *American Behavioral Scientist*, 8: 291–303.

Mauro, Paolo (1995). "Corruption and Growth." *Quarterly Journal of Economics*. (August): 681-711.

Merat, Jacques and Roth Deubel, André-Noël (2008) Effectivity of Institutions in the Fight against Corruption: the Strategy of Transparency Pacts in Colombia. Mimeo.

Miller, Joel. (2003). *Police Corruption in England and Wales: An Assessment of Current Evidence.* London: Home Office RDS. Home Office Online Report 11/03.

Miller, W. (*2001*). *A culture of* corruption*: coping with government in post- communist Europe.* Budapest; New York, Central European University Press.

Montinola, Gabriella R. and Robert W. Jackman. (2002) "Sources of Corruption: A Cross-Country Study". *British Journal of Political Science* 32: 147-170.

Ney, J.S. (1967). "Corruption and Political Development: A Cost-Benefit Analysis." *American Political Science Review*. 61: 417-427.

Pedersen, Karin Hilmer and Johannsen, Lars (2008) *Corruption: Commonality, causes and consciences. Comparing 15 ex-communist countries.* Paper prepared for the 13th NISPAcee Annual Conference May 19-21 in Moscow, Russia.

Persson, Torsten, Guido Tabellini, and Francesco Trebbi (2003). "Electoral Rules and Corruption" *Journal of the European Economic Association*, 1,4: 958-989.

Punch,. M. (2000) 'Police Corruption and its prevention' *European Journal on Ciminal Policy and Research* vol. 8 no 3.

Rasma, Karlins (2005) The System made me do it. Corruption in post-Communist societies New York, London: M. E. Sharpe.

Roebuck, Julian A and Barker, Thomas (1974) "A Typology of Police Corruption". *Social Problems*, Vol. 21, No. 3 (1974), pp. 423-437.

Rose-Ackerman, Susan. (1999). *Corruption and Government: Causes, Consequences and Reform.* New York: Cambridge University Press.

Shleifer, Andrei and Robert Vishny. (1993). "Corruption". *Quarterly Journal of Economics*, CIX: 599-617.

Scott, James C. (1972). *Comparative Political Corruption*. Prentice-Hall, Inc., Englewood Cliffs, New Jersey.

Skogan, W.G. and T.L. *Meares*, Lawful Policing, in: Annals AAPSS, *2004*, 593: 66–83.

Tanzi, V. and Davoodi, H. R. (2000) *Corruption, Public Investment, and Growth*. Working Paper of the International Monetary Fund, Fiscal Affairs Department (2000)

Tserendondov, Altanzaya (2001) *"Corruption in privatization and effective anti-corruption strategies in transition country-Mongolia"* 10th International Anti-corruption Conference. Prague, 7-11 October, 2001

The World Bank (2000) *Anticorruption in Transition: A Contribution to the Policy Debate.* Washington, D.C. October 4, 2000.

TI UK (2009) *Typology of defense corruption.* Downloaded from http://hdl.handle.net/1765/10772 on May 15, 2009.

Treisman, Daniel. (2000). "The Causes of Corruption: A Cross-national Study". *Journal of Public Economics* 76: 399-457.

Weber, Max (1964). "Die drei reinen Typen der legitimen Herrschaft" in: J. Winkelmann (ed.): *Soziologie*.

Xin, Xiaohui and Thomas K. Rudel. (2004). "The Context for Political Corruption: A Cross-National Analysis". *Social Science Quarterly* 85 (2): 294-309.

ISSUES IN THE MEASUREMENT OF INTERGENERATIONAL SOCIO-ECONOMIC MOBILITY IN NIGERIA

Otto Godly, Ph.D.
Lecturer
University of Port Harcourt
Department of Economics
Nigeria
e-mail: godlyotto@yahoo.com

Abstract

Intergenerational socio-economic mobility is an index for measuring the opportunity structure in a given economy. It is believed that a more freewheeling economy is better than a rigid economy in which each family stays in perpetuity in its socio-economic class of birth. In rigid economies, children born into poor homes have a high tendency to end up as poor parents and start another generation as poor parents to children who may also end up in poverty. In similar vein, those born into non-poor homes tend to remain rigidly in their non-poor socio-economic classes across generations. Inequality is such economies are entrenched and economic outcomes are really not a function of output or talents but arise out of the accidents of birth. This is a matter of concern to many modern economies because of the negative impact of such inequality on society. In Nigeria there are concerns about inequality and poverty. Obviously, inequality is different from poverty but dealing with inequality can help alleviate poverty. To effectively deal with inequality in Nigeria, there is need to properly understand the dimensions as precisely as possible and be in an enhanced position to predict its occurrence more appropriately. This is one essence of intergenerational socio-economic mobility studies. This work attempts to suggest methods that could be used to measure the rate of intergenerational socio-economic mobility i.e. co-efficients of transformation from the economic status of birth to other desirable strata at adulthood in Nigeria. These coefficients provide more precise insight about the occurrence and propensity of socio-economic transformation that is possible within a given economy between two or more generations.

Keywords: *Intergenerational mobility, Intergenerational correlation, Siblings correlation.*

1.1 Background

Intergenerational socio-economic mobility (ISM) studies are very common in economics and sociology all over the world. In Nigeria however, there is paucity of such studies. This is probably because of data constraints. This work is interested in methods and data sourcing procedures available for measuring intergenerational income mobility in Nigeria. Although studies of intergenerational socio-economic mobility serve different purposes, this study examines intergenerational mobility with reference to the equality of opportunity. Intergenerational social mobility is an index for measuring the equalization of opportunities in any economy. According to Van de Gaer (2004), Intergenerational social mobility is an old concern in economics either as a policy objective in its own right or as an instrument leading to greater efficiency. The feeling is widespread that inequalities in economic outcomes, which arise from differences at birth, are a sign of unequal opportunity and should definitely be a cause of concern. There are fewer consensuses about the desirability of further public policy to reduce inequality on outcomes due to other factors. The concern for correction of inequalities at birth is a major reason driving the interest of examining the rate of intergenerational social mobility. Growing inequality is a major concern in Nigeria, while the majority of Nigerians find it difficulty to feed themselves or take care of their health, a few Nigerians have been buying private jets for themselves (see Nnamdi 2010 p.4). Otto (2009) has shown that identifying the rate of intergenerational mobility in Nigeria will more precisely inform policies to address growing poverty and inequality in Nigeria. Status transitions from parents to children are increasingly observed in industry, in politics and in governance. These transitions are done through overt or subtle ways but the exact coefficients in Nigeria are not in public domain. In this work, intergenerational income mobility, intergenerational social mobility and intergenerational socio-economic mobility are used interchangeably. In fact, we can also conceive this concept as intergenerational economic positioning. Therefore this work is about identifying methods and procedures that can be used to measure the opportunity structure in the Nigerian economy. This work is organized in four sections. Section one is introductory, section two reviews related studies in other countries while section three contains the methods and procedures. These are discussed as data set, welfare index and models of estimation. Finally, section four concludes the discourse.

1.2 Literature Review

A major plank of transmitting inequality across generations is the labour market. A brief survey of the basic labour market theories will provide some clarity on the praxis. In the economic literature, three such theories exist.

(i) The Neo classical (orthodox) theory of the labour market

(ii) Dual Labour market Hypothesis

(iii) The Radical or Marxist theories

(i) The Orthodox Theory

This is the most widely accepted theory of the labour markets. The theory is formulated on the assumptions of a perfectly competitive labour market. It assumes that all individuals participate in the market as equals and have free choice, though some people may be more motivated than others. In the early stages of its development, labour was treated as a homogenous entity. Hence economists discussed of the marginal product of labour as if all man hours were the same. The theory's view of employment is derived from the concept of competitive equilibrium where labour receives wages equal to its marginal contribution to output. Any interference with the equilibrium either in the product or labour market itself to distort the prices of factor inputs ushers in unemployment. Much later, however, the neo classical incorporated skill differentials into the notion of labour through human capital theory. In this theory, what is demanded from and supplied to the labour market is not homogenous labour but worker characteristics. Here the value of the workers' work is a function of its investment in income-producing human capital investments – particularly education i.e. the amount earned is a function of the level of education of the worker. In view of the above, prospective employees are faced with a series of human capital investments decisions. If they made the right decisions, they enter the ranks of the employed but if the decisions were faulty, they would be unemployed. The central point therefore, is that the more schooled the prospective employee is, the better his chances relative to the less schooled. The demand - supply postulate of the neo-classical theory obviously implied that wages for graduates of any educational level will drop when supply of that level outstrips its demand. The probability of securing and retaining jobs will also be under pressure when supply for the particular skill is more than its demand. This obviously is the case in Nigeria now. Todaro and Smith (2009) posit that employers facing a surfeit of applicants tend to select by level of education. They choose candidates with higher education for jobs, which can be performed satisfactorily with lesser skills. Under a scenario of surfeit of applicants, extra economic factors sometimes act as leverage. Aside this, the assumption of perfect competition in Nigeria labour market is unrealistic. The features of perfect market are not existent in the Nigerian labour market.

(ii) The Dual Labour Markets Hypothesis

The dual labour markets hypothesis became popular from the results of studies of ghetto labour markets in the United States during the 1960s and early 1970s.

According to this hypothesis, the labour market is segmented into two essentially distinct sectors – formal and informal or primary and secondary. The formal or primary sector offers jobs with relatively high earnings and other attractive working conditions including employment stability. But jobs in the informal sector, are characterized by poor working conditions, low pay and high staff – turnover. It is also characterized by a highly personalized relationship between workers and employers. This hypothesis can explain the problems of the poor, disadvantaged and less connected applicants in Nigeria. The dual labour market hypothesis can also be used to explain the problems of the minority tribes among workers in Nigeria. As a result of discrimination in the labour market, most qualified applicants of minority tribal origin are apparently not employed in the modern sector in spite of excellent performance at job interviews. These applicants resort to the low paying and unstable informal sector with poor working conditions. Ab initio, the non-poor and those with higher social capital are at some advantage. They secure modern sector employment with ease or become employers in the informal sector.

This theory seems very appropriate to explain the issues relevant to this study. The poor, even after education, risk being employed in the informal sector or remaining unemployed for a long time, while those, from better off households, sometimes have their job places ready before concluding their studies. In other cases, the rich are better able to raise capital with which to invest in private ventures where the skills acquired in school may be effectively utilized with the attendant benefits of high earnings. There is large scale earning differentials, even within the formal sector. For instance, earnings in the oil and gas sub sector are not only substantially higher than those of other workers in the same formal sector in Nigeria, their wages are in multiples of their peers. This theory therefore is an advancement of the earlier. Here while the level of education is a major determinant of earning, the sector of employment is also important.

(iii) Marx's theory of the Labour Market

Like the dualist theory, Marx and Marxists believe that society is stratified into classes. Such as the working class, the peasants and the bourgeoisie. In his work the Great Beginning, cited in Ezrinin et al. (1978) Lenin writes; classes are large groups of people, differing from each other by the place they occupy in a historically determined system of social production, by their role in the social organization of labour and consequently by the dimensions of the share of social wealth which they dispose and the mode of acquiring it. In this definition, Lenin points out four salient features, which differentiates classes (income groups), viz;

(i) Their place in a historically determined system of social production.

(ii) Their role in the social organization of labour

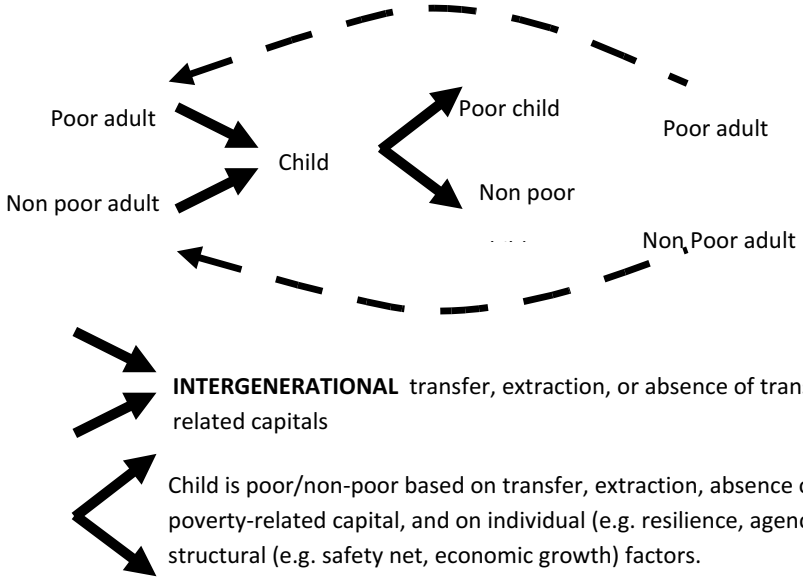
(iii) The share of social wealth they get and

(iv) The modes by which they get it.

It should also be noted that classes are distinguished by their position in society. Some classes are more privileged than others.

The starting point of Marx's analysis is his labour theory of value. According to Marx, all economic value is produced by labour (the working class and peasants). To Marx capital is only congealed labour i.e. labour transformed, land, as a gift of nature is a passive element of production. Only labour is an active agent of production. He noted the bourgeoisie as a class of parasites that exploits labour. To him, labour with technology could produce far in excess of the subsistence needs of its households but is paid wages, which is barely sufficient to reproduce it and retain its services. The excess of the proceeds of his labour is retained by the entrepreneur as profits. Therefore, to him, wages represents only that part of the proceeds of labour, which is necessary and barely sufficient to sustain their services and subsistence. The bourgeoisie retain the excess as profits, though they had little inputs in the generative process. More than this, that your position was historically determined. If your father was a bourgeoisie, you were likely to be bourgeoisie also. If you were from a working class household, you were likely to be one. Marxist, therefore contend that entry into the labour market was not as open and free as suggested by the neo-classical school. They contend that private economic decision – making and expropriation of the surplus value by the bourgeoisie class was responsible for the chaos in the production process, unemployment and social frustration. The process of transfering economic status is shown in Figure 1. The beauty of this theory is increasingly being observed in Nigeria. A survey of the boardrooms of different firms in Nigeria confirms that a high proportion of directors and managers especially in the banks and the petroleum industry are those related with the owners of capital.

Fig. 1 Stylization of Intergenerational Transfer of Economic Status



Source: Adapted from Moore (2004).

In this way, education, neighborhood effects such as social capital and other structures only tend to discriminate entrants into the market and place them in their appropriate household classes. In other words, education further reinforces the stratification of society into the different classes. Children from low-income households have tendencies of acquiring less education and ending up in the same low-income strata as their poor parents. While those from high earning parents are more likely to benefit from more education and in concert with high social capital of their parents end up as high earners. The implication here is that the household background is a major determinant of earning prospects.

Summarily therefore, while the classical school postulate an open labour market with high intergenerational social mobility propensity, the Marxist theorists believe the capitalist system is fraught with low intergenerational social mobility (ISM) indicative of a labour market which is not open and free. This work suggests how to estimate the Nigerian praxis .

2. Review of Existing Literature: Some Case Studies

Intergenerational mobility in the U.S. was about 55 – 60 percent while intergenerational persistence was 0.4 – 0.45 in the 1990s (See Anderberg 2003). Otto (2006) has also shown that intergenerational mobility in Nigeria was 0.73 as at 2005 from a survey of university graduates with 20 years work experience and above. Beller and Hout (2009) concluded from their study, that slower economic growth in America since 1975 and the concentration of that growth among the wealthy have slowed the pace of U.S. social mobility.

Britain is relatively immobile compared to the United States. Bladen, Greg and Machine (2002), observed that the rates of intergenerational social mobility using either time-averaging ordinary least squares techniques approximates 0.5 in Britain. In fact, Dearden, Machine and Read (1997) cited in Anderberg (2003), observed that over the recent decades, there has been a reduction in the rate of social mobility in the United Kingdom. Little wonder that Tony Blair, the Prime Minister of Britain made ISM a key issue in his electioneering campaign for Prime Ministership in 2001. According to him "the mission of any second term must be this; to break down barriers that hold people, to create upward social mobility (see Payne 2004).

Anderberg (2003) reported, that Canada, Germany and Sweden are relatively more mobile intergenerationally than the United States and the Great Britain. Canada has an intergenerational persistence rate of 0.2 while Sweden and Germany have intergenerational persistence rates of 0.3 each. This means that the rate of ISM in Canada is 80 percent while Sweden and Germany are 70 percent respectively. Mazunder and Levine (2003), also state that Finland has an intergenerational persistence rate of 0.3. But Solon (2002) has shown that only studies of the United Kingdom and South Africa have produced estimates greater than those of the United States. If the intergenerational social mobility is low, current inequalities might persist for a long time irrespective of their underlying causes. According to Mazunder and Levine (2003), with an intergenerational persistence rate of 0.4 – 0.6 in the United States, it implies that, for a family living in poverty, it will take their descendants somewhere between 3 to 6 generations, on average before they can expect their earnings to be within 5 percent of the national average.

Wu and Trieman (2004) analyses the effect of family background on occupational status attainment and mobility in contemporary China. According to the paper, a central concern of intergenerational mobility studies is to assess the openness of the opportunity structure of society. The paper observed that previous researchers attributed a weak or insignificant association between fathers and sons occupational status to socialist egalitarian policies.

Wu's paper believes that these conclusions were based on a misguided focus on the urban population, which fails to account for segmentation between the urban and rural populations and positive sample selection of rural-to-urban official movers. By analyzing a national probability sample with rural and urban components together, the study finds a high degree of intergenerational transmission of social-economic status among Chinese adult men from urban origins but also an unusually high rate of down ward mobility into agriculture among those from rural origins i.e. those from families with rural registration (*hukou* status). Men from families holding urban registration status experienced essentially no down ward mobility into agricultural occupations. The study noted the role of the Chinese household registration system in social mobility and used the results to challenge the claim of societal openness under socialist regimes.

Platt (2003) with assistance from the Institute for Special and Economic Research (ISER) examined the intergenerational social mobility of different ethnic groups in Britain between 1971 and 1991. The study focused on social mobility between generations as different groups in Britain experienced it. Using longitudinal data set, this study observed that parents social class had an impact on the children's occupational outcomes and described the different patterns of class mobility experienced by a single cohort of children aged 8 – 15 in 1971 from each of three ethnic groups: White non-migrants, Indians and Caribbeans. The study observed that the relative importance of class origin varies with ethnicity; at the same time, class origins can be found to operate in consistent ways across groups. It also finds that for women the impact of ethnicity is much less salient in determining outcomes than it is for men.

As a longitudinal study, the classes of origin in the cohort of 8 – 15 years olds were identified in 1971 as shown in the table below.

Table 1: Percentage Distribution of Respondents' Parents' Social Class in 1971.

S/No	Class	Among White Non-Migrants	Caribbean	Indian	Entire Cohort
1	Service class	21.3	3.9	7.2	20.9
2	Intermediate class	28.0	12.1	15.6	27.7
3	Working class	45.9	74.8	71.3	46.6
4	Others	4.8	9.2	5.9	4.9
		100.0	100.0	100.0	100.0

Source: Platt (2003) p.9

The first thing to notice is that the class distributions of parents in 1971 varies strikingly by ethnic group. Platt defined class using Goldthorpe Schema reduced to three-class, hierarchical version in which service class includes all professionals, managers and very senior technicians. The intermediate class defined all routine

non-manual, small proprietors, lower grade technicians, and self employed artisans. Working class defined all skilled, semi skilled and unskilled manual wages workers, e.g. Carpenters, Brick Layers, (masons), other daily paid workers etc.

From Table 1 over 21 percent of the white non-migrant group had parents in the service class compared with fewer than 4 percent of Caribbean and roughly 7 percent of Indians – conversely, over 70 percent of Caribbeans and Indians had parents in working class occupations compared to 46 percent of white non-migrants. By the time the study sample's own class was measured in 1991, 26 percent of Indians and 19 percent of Caribbeans were in the service class, while non-migrants had also increased their preponderance in these classes but not at such a rate to 28 percent (see table 2). White non-migrants also had a higher proportion than other groups in working occupations, reversing the 1971 pattern. According to Platt (2003), these results may have been influenced by the much greater rates of unemployment among the minority groups. Fifteen percent of Caribbeans and 9% (percent) of Indians were unemployed compared with only 6 percent of the white non-migrants.

Table 2 showing Percentage Distribution of Respondents' Social Class in 1991

S/No	Class	Among White Non-Migrants	Caribbean	Indian	Entire Cohort
1	Service class	27.8	18.7	25.9	28.1
2	Intermediate class	33.0	34.7	34.9	32.9
3	Working class	26.2	22.9	19.2	25.6
4	Unemployed	5.8	15.0	9.2	6.1
5	Others	7.2	8.6	10.8	7.3
		100.0	100.0	100.0	100.0

Source: Cited from Platt (2003).

By 1991, the cohort interviewed was now aged between 28 - 35 years of age, so the distribution reflects that narrow age range. Metholodogically, Platt's (2003) paper is distinctive because it uses a prospective approach to access parent-child transitions; parents' class is measured at the time the respondents are aged between 8 and 15. This contrasts with popular cross sectional studies, which are essentially retrospective studies of social mobility. These retrospective studies of social mobility depend on the respondent's recall of their parents occupation or income group at a given age or age-range. But the defect in Platt's methodology and many longitudinal studies is that only those cohort members in the original sample set still available at the time of the next study, can have their class transition

measured and in Platt's (2003) case, the original sample was taken in 1971 while the next was in 1991. i.e. after 20 years.

However in Nigeria, a viable option, which is adequate for this kind of work, is the cross-sectional survey especially if done in such a way as to avoid the errors which might be associated with recall of parental status or compensate for memory loss.

3.1 Data Set

As shown above, different researchers have used different data sets for intergenerational studies. These include panel, cross-section and longitudinal data sets. According to Platt (2003), when it comes to measuring intergenerational social mobility or inter class change, the two main approaches so far have been to compare occupational cross sections at different time points, or to use surveys with questions on parental class to trace directly the intergenerational social mobility patterns. Both approaches have shed light on the particular circumstances of the groups. Intergenerational studies with cross sectional data sets are quite many. These studies include Heath and Ridge (1983), Heath and McMahon (1999), Bratberg et al (2005), Behrman et al (1999) among many others.

Robert et. al. (2005), in his work on Canada, noted that the objective of most cross sectional surveys is to produce unbiased (or nearly unbiased) estimates of levels such as totals, or means at a given time point, and in case of repeated surveys, to produce estimates of the net change that occurred in the population between two time points. These estimates are often accompanied by estimated measures of precision. The primary objective of longitudinal surveys is the production of longitudinal data series that are appropriate for studying the gross change in population between collection dates and/or research on casual relationship among variables. In other to increase the cost-effectiveness, statistical agencies very often derive cross sectional estimates from longitudinal survey data assuming that the survey design takes this responsibility into account, and that estimation procedures are developed to satisfy cross-sectional as well as longitudinal requirements. A good example of such double utilization of a longitudinal survey is the Canadian survey of labour and income dynamics (SLID). It was originally designed to provide longitudinal estimates and analysis. However, recognizing the cross-sectional capabilities of SLID, Statistics Canada made it a principal survey for providing annual income data and used it to replace a classic cross-sectional survey of consumers' finances as of 1998. In other to achieve cross sectional representatively, different approaches have been taken in different longitudinal surveys. SLID employs overlapping panels each of six years duration and selected three years apart. The cross-sectional sample for a particular year also includes cohabitants of the longitudinal individuals

from the two panels, i.e. all individuals that are living with the original selected longitudinal individuals at a certain point in time. In this way, only household composed entirely of immigrants who have arrived since the last panel selection are not represented in the sample. The elaborate cross-sectional weighing scheme that includes a non-response adjustment, an optimal combination of the two panels, adjustments for inter-provincial migration and influential values, and post stratification to a number of post-stratum total completes the adjustments towards cross-sectional representatively of the population at a given time.

3.2 Welfare Index

To estimate the rate of intergenerational mobility, the status of origin is compared to the status at destination. Social origin is defined as the status of the household head at the time the respondent was at minimum school leaving age while destination is taken as current status of the respondent. Many sociologists base their studies on occupation however many economists have consistently used income in place of occupation (see Beller and Hout, 2009). In Nigeria, especially in recent times, the use of income (earnings) is justified because earnings in Nigeria is largely a function of the occupation, experience, level of education, sometimes luck, sector of employment etc. Moreso, the Federal Office of Statistics, (now, Nigeria Bureau of Statistics) or even the World Bank uses consumption or income as basis for stratifying society. Income in Nigeria largely comes in the form of money and defines some basic capabilities since money commands variety. With a high income your ability to avoid hunger, illiteracy etc is high because money has command over the commodities serving these needs. Capturing income especially parental income status is easier than using consumption as an index especially if has to do with information of the past as required in intergenerational studies. This is because income especially for paid workers has records. This is also applicable to many vendors involved in Goods Service Orders (GSO). It is possible to know current income and compare with parental income of some past date say 20 years ago. Therefore, the use of income has merit. In the language of Ake (1981), economic needs are man's most fundamental need. Unless man is able to meet this need, he cannot exist in the first place. Man must eat before he can do anything else, before he can pursue culture, get involved in politics or study economics, etc. when an individual achieves a level of economic well-being, such that he can take the basic necessities, particularly his daily food for granted, the urgency of economic needs lose its edge. Never the less, the primacy remains. Income and wealth are more precise indices of socio-economic status in Nigeria today. The World Bank sometimes uses the head count index i.e. share of population living below the poverty line, which is given by the World bank as $1.08 per capita consumption per day. This World Bank standard may be converted to local currencies to

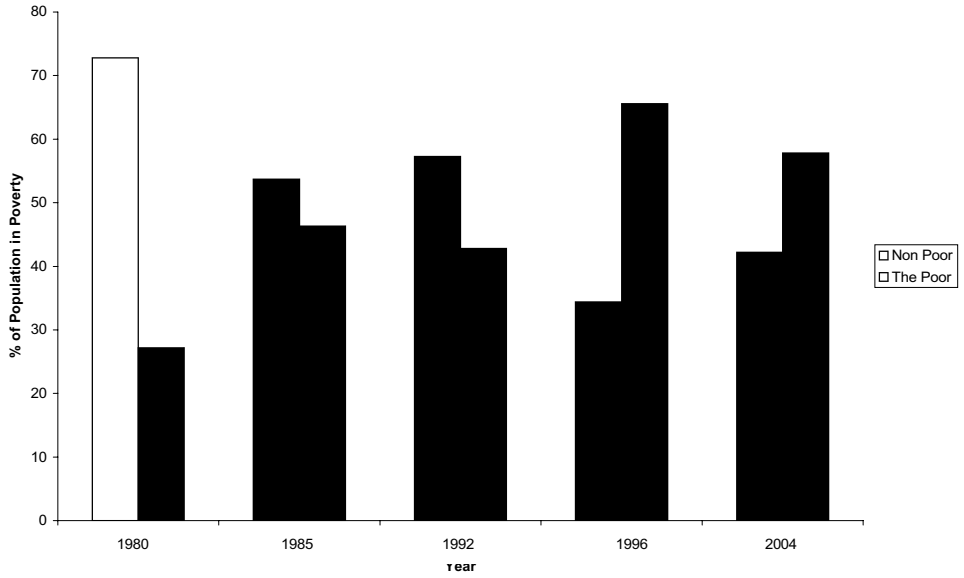
determine the national poverty profile. Poverty profiles may also arise out of national surveys. Thus according to the Federal Office of Statistics, the incidence of poverty in Nigeria is as shown in table 3.

Table 3: Percentage Distribution of the Population in Poverty in Nigeria

Years	Non-Poor	Moderately Poor	Core Poor
1980	72.8	21.0	6.2
1985	53.7	34.2	12.1
1992	57.3	28.9	13.9
1996	34.4	36.3	29.3
2004	42.2	38.1	19.7

Source: F.O.S Pub. (Various years)

Fig. 2 Poverty Trend in Nigeria



Source: Adapted from Federal Office of Statistics (now Bureau of Statistics, Nigeria.) Data in Table 3

Figure 2 is a pictorial account of the data presented in Table 3. viz the percentage distribution of population in poverty which also shows the trends in poverty levels from 1980 to 2004 using Nigeria national survey.

According to Ravallion and Bidani (1994), there are two methods of constructing poverty profiles. These are the Cost of Basic Needs (CBN) and the Food Energy intake (FEI) methods. Both attempt to find monetary values of the poverty lines at which basic needs are met. Based on these methods and

the World Bank recommended $1.08 consumption per capita per day a realistic profile can be constructed for Nigeria. A typical Nigerian family is made up of a minimum of six persons; father, mother and four children (aside aides and relations).

Using the World Bank's $1.08 per capita consumption per day, at the current N150:$1.00 exchange rate, families may be classed as follows: Those whose current consumption falls:

Below ₦30,000 monthly ..... core poor

Between ₦30,000 and ₦60,000 monthly ..... moderately poor

Above ₦60,000 monthly ..... Non poor

It is safe to conclude that because no family would want to consume all its earnings, and because this work uses earnings, we can approximate the classes as follows.

Families earning[1]:

Below ₦40,000 monthly ..... core poor

Between ₦40,000 – ₦80,000 monthly ..... Moderately poor

Above ₦80,000 monthly..... Non poor

Incorporating extended family liabilities, a need arises to double the sums since quite often, the extended families liabilities are as significant as that of the immediate family and its burden is as large as that of the immediate (nuclear) family. Thus family earnings of:

Below ₦80,000 monthly ..... core poor

Between ₦80,000 – ₦160,000 monthly ..... Moderately poor

Above ₦160,000 monthly..... Non poor

3.3 Models of Estimation

To measure the rate of intergenerational mobility, intergenerational correlation and siblings correlation are frequently used. Both rely on the premise that if household background impacts on the future earnings of children, there should be some connection between the fates of parents and children on the one hand and fates of siblings on the other hand. (See Mazunder and Levine 2003, Mcgrew 2004, Anderberg, 2003). In fact, according to Mazunder and Levine (2003), a large and growing literature uses the co-efficient from a regression of the log income or earnings of children (i.e. average children's income at adulthood) on the log income of their parents as a summary measure of the intergenerational

[1] Extended family liabilities are assumed away in this analysis

social mobility and in the language of Mcgrew (2004), intergenerational social mobility is essentially a child-parent status correlation.

The intergenerational elasticity is useful for answering questions such as "What percent of the difference in earnings between families is expected to persist into the next generation?" In other words, what is the impact of parental (or household) economic background on the children's socio-economic outcome? The co-efficient obtained can explain what drives socio-economic successes in such economy; household background or individual efforts? Siblings' correlation is a key concept to which economists have recently paid increasing attention to. According to Solon (1999) "the correlation among siblings income is an omnibus measure that captures the overall impact of family and community background on outcomes in adult life. Thus for most studied outcomes in labour economics, the correlation can be interpreted as the proportion of the variance in earnings due to whatever factors that are shared by Siblings" Siblings correlation is an interesting approach whenever researchers want to control for differences in unmeasured abilities and where the wish is to examine the impact of different family types on outcomes of children. The models are given below

(i) The Sibling Correlation Model

To see how siblings correlation can estimate the impact of household characteristics on economic outcomes in adulthood suppose that the earnings of individual J in family I can be decomposed as follows: (see Anderberg 2003)

$Y_{ji} = a_i + b_{ji}$ .....(1)

Where a_i = the family component common to all siblings

b_{ij} = pure individual specific component (efforts)

let the variance of Y, a, b, be σ_y^2, σ_a^2, σ_b^2.

Thus taking the variance in the equation (1)

$$\sigma_y^2 = \sigma_a^2 + \sigma_b^2 \quad \text{..... (2)}$$

Since, b_{ji} is purely individual specific (i.e. self effort), and thus not related to a_i, the covariance between the earnings of two brothers J and K will then be;

$$\text{Cov}(Y_{ij2}, Y_{ki}) = \text{Cov}\,(a_1 + b_{ji} + a_i + b_{kj}) \text{..... (3)}$$

$$= \text{Var}\,(a_i)\,\sigma_a \text{.....(4.)}$$

Where b_{ji} and b_{ki} are not correlated, with ai. Thus looking at the correlation, we have that

$$\text{Corr}\,(Y_{ji}, Y_{ki}) = \quad \text{..... (5)}$$

Measures the proportion of the variance in earnings in the population (i.e σ_y^2) that are due to factors that are shared by siblings. Such factors include:

(i) Parents Income (Parearn)

(ii) Level of Parents Education (Paredulev)

(iii) Parents Occupation (OCC)

(iv) Employment Sector of Parents (emsec)

(v) Location of upbringing (LOC)

(vi) Inheritable genes (Ihegen)

(vii) Others or residuals (u)

Thus a_i = f(Parean, Paredulev, OCC, emsec, loc, Ihegen etc)

From equation (1)

Yji =f(Paredulev, Parean + OCC + emsec + LOC + Ihegen) + b_{ji} +u

Income is a function of parental background (β) plus individual effort. If there is a high degree of relatedness between the statuses of the siblings across the economy then in some sense it might imply that parental or household background has significant influence on the outcomes of the offspring. These influences may arise out of nurture or nature from their parents and include inherited genes, looks, place of birth and upbringing, level of training , family social contacts, etc which are increasingly being rewarded at the labour market.

(ii) Intergenerational Correlation Model.

Another method, which may be used to estimate the rate of mobility and the importance of family background for predicting earnings in Nigeria is the Intergenerational Correlation model. In this procedure, the average children's income is regressed on the parents income as follows:

Log famen =σ + βlog parean + Ut ..... (6)

Definitions

β is the elasticity of famen with respect to parean. This is a standard model used in many studies all over the world. See Anderberg (2003), Mcgrew (2004), among others.

1 - β is the natural measure of the degree of ISM

When β = 0, society is perfectly mobile intergenerationally

β = 1, there is perfect immobility in society.

Therefore, β is the index of the importance of household background for earning prospects.

Famen = children's average income in adulthood

Parean = Parent Income

Ut = random error

the Statistical Package for Social Sciences (SPSS) can be used for this analysis.

4. Conclusion

In conclusion, a study on intergenerational mobility or persistence in Nigeria is possible through a longitudinal, panel or cross sectional data set. However, due to the paucity of funds and data, cross sectional studies are more convenient. A cross sectional analysis will require the selection of a sample and using an appropriate welfare index such as income, consumption or even occupation compare the social classes of the respondents at origin with their current classes which is referred to as their status of destination at a point in time. The sample size will depend on the specific place of study. This data can be evaluated with the intergenerational or the sibling's correlation model. Intergenerational socio-economic mobility coefficient is an important instrument for measuring the opportunity structure of a given society. Intergenerational mobility is also an instrument towards to greater efficiency in society and there are many more reasons for estimating and identifying the intergenerational mobility coefficient and opportunity structure in Nigeria. This paper is therefore intended to provide a guide for such studies.

REFERENCES

Ake, C. (1981) *Political Economy of Africa* Longman Pub. U.K.

Anderberg, D. (2003) *Intergenerational Social Mobility* Mimeo R.H.C London.

Beller, E. and M. Hout (2009). 'Intergenerational Social Mobility: The United States in Comparative Perspective' *Opportunity in America* Vol. 16 No. 2 updated November 5, 2009. Princeton.

Bidani, B. and M. Ravallion (1994) 'How Robust is a Poverty Profile?'. *The World Bank Economic Review* Vol. 8(1). Washington.

Blanden, J., Gregg. P. and S. Machin (2002) *Education and Family Income* Mimeo, Univesity College London.

Chadwick, L. (2000), *Changes in Intergenerational Economic Mobility in the United States* University of Michigan.

Corak M. and A. Heisz (1999) 'The Intergenerational Earnings and Income Mobility of Canadian Men' *Journal of Human Resources* 34 (2)

Dearden, L. Machin S. & Reed, H. (1997) 'Intergenerational Social Mobility in Britain Cited in *Intergenerational Social Mobility Mimeo* PHC London

Ezrinin G. I. et al (1978) "The Great Beginning" *ABC of Dialectical and Historical Materialism* Progress Pub. Moscow.

Heath, A. and D. Mc Mahon (1999) *Ethnic Differences in the Labour Market: the Role of Educational Social Class Origins.* University of Oxford; Crest Working Paper No.69,

Heath , A. and J. Ridge (1983) 'Social Mobility of Ethnic Minorities' *Journal of BioSocial Science Supplement,* 8:169-84

Mazunder, B and D. Levine (2003) *The Importance of Family and Community: An Analysis of Changes in the Siblings Correlation in Earnings* Federal Reserve Bank Chicago WP2003-24 US.

McGrew, B. (2004) *Intergenerational Social Mobility:* Cardinal Collective WHP: www: Archives/2004/01/00068.html

McManus, P. (2000) 'Parental Resources, Career Credentials and Self Employment outcomes in US and Germany.' *GSOEP Conference Papers*.

Moore, K. (2004) *Chronic, Life-Course and Intergenerational Poverty, and South-East Asian Youth.* Institute of Development Policy and Management. University of Manchester, United Kingdom.

Nnamdi I. (2010). *Daily Sun Newspapers* Vol. 6 No. 1 Lagos, www.sunnewsonline.com.

Otto G. (2009) 'Imperatives of Studies on Intergenerational Mobility in Nigeria' *African Journal of Contemporary Issues.* Vol. 9 No. 1 Yaounde, Cameroon.

Otto, G. (2006) *Public Educational Spending: Benefits Incidence and Intergenerational Socio-economic Mobility in Rivers State.* Unpublished Ph.D. Thesis, University of Nigeria, Nsukka.

Payne, R (2004) *Recent Developments in British Social Mobility.* http://www.sacresonline.org.uk 1614 Payne huntl

Platt, L. (2003) 'The Intergenerational Social Mobility of Minority Ethnic Groups' *ISER Working Papers* no 2003 – 24.

Roberts et al (2005*) Cross-Sectional Inference based on Longitudinal Surveys: Some Experiences with Statistics Canada Surveys* Canada

Shorrocks, A.F. (1978), 'The Measurement of Economic Mobility', *Econometrica* 46, Washington.

Shorrocks, A.F. (1993) 'On the Hart Measurement of Economic Mobility' in *Industrial Concentration and Economic Inequality, Essays* in honour of Peter Hart (Edward Elgar).

Solon, Gary (1999) 'Intergenerational Social Mobility in the Labour Market' *Handbook of Labour Economics* Vol 3. Elsvier Armsterdam

Solon, Gary (2002) 'Cross Country Difference in Earnings Mobility' *Journal of Economic Perspectives*

Todaro M. and S. Smith (2009) *Economic Development* Pearsons Educational India.

Van de Gaer, D. (2004) *Measuring Intergenerational Mobility and Equality of Opportunity.* Paper presented at the Conference of Egalitarianism and Responsibility (CERGY), University of Ireland, Maynooth.

Wu, X. and D Trieman (2004) 'The Household Registration System and Social Stratification in China' *Demography* 41:363-384 China.

Xiaogang Wu (2004) *Occupational Mobility in Contemporary China* ISA Summer Meeting Papers RC 28 Rio Janerio August 79.

Zimmermann, D.J. (1992) 'Regression Towards Mediocrity in Economic Stature' *American Economic Review.*

HOW PEOPLE OF DIFFERENT COUNTRIES CONSIDER AN INFRINGEMENT OF THE LAW: THE COMPARATIVE ECONOMETRIC ANALYSIS

Demidova Olga, Ph.D.
Associate Professor
University – Higher School of Economics, Moscow
Russia
e-mail: demidova@hse.ru

Im Gym Dya
Student of the 4th bachelor grade
University - Higher School of Economics, Moscow
Russia
e-mail: mikimotka@yandex.ru

Abstract

In this research we try to estimate how people of different countries consider an infringement of the law (tax evasion and bribery) using the data for 57 countries of the 5th wave of the World Value Survey (WVS) for the period from 2005 to 2008. We are interested in the relationship between individual features of responders from different countries and their attitude to breaking the law. We also take into account the level of individual's confidence in basic political institutions. For that purpose cluster analysis, ordered probit models, and bivariate probit model were used. With a help of the obtained results we have made some policy implications.

Keywords: *Tax evasion, Bribe, Cluster analysis, Ordered probit model, Bivariate probit model.*

1. INTRODUCTION

The problem of corruption becomes more and more significant all over the world as it influences economic, social and political situations in different countries. It is the subject of multiple scientific research studies, using various mathematical and statistical methods and models. As a result, economists became more competent in the reasons and consequences of corruption behavior in different countries. The most common form of corruption is bribery. Corruption

encourages further development of shadow economy and subsequently supports tax evasion.

A lot of analysts investigated influence of corruption on economic system and made the supposition that bribery is more harmful for the country than tax evasion. In existing literature corruption was considered as a relation between authorities and a criminal, to provide limited services to the individual for the bribe, or considered as an extortion, for example, some citizens were forced to pay certain money to authorities to avoid the pressure from their side. For understanding in what extent people are inclined to break the law, first of all, it is important to find out what makes people act like that? What are the reasons of such behavior? Rosa Ferrer (2008) noticed in her research that one possible reason of breaking the law is the confidence of the offender in avoiding the punishment. Secondly, there is a majority rule or neighborhood effect. In other words, people from the neighborhood make influence on the personal behavior. Also, for example, considering the situation with tax payment, personal behavior is obvious: it appears to be a free-rider problem. Some individuals evade tax payment because they hope that this behavior will not be noticeable in a large group of taxpayers and will not affect decisions of other people. As a result people who usually pay taxes will pay more and tax evaders will have more factors to avoid punishment.

After the brief analysis of the reasons for breaking the law we proceed to more detailed analysis of this subject, namely: what are the determinants of tax evasion and bribery. The object of our research is the data from the 57 countries from the last fifth wave WVS (World Value Survey). Thus, the purpose of this research is studying the relationship between individual features of responders and their attitude to breaking the law; and how socio-demographic characteristics of a person affect the behavior. To reach this purpose we divided all countries into the groups based on the probability of breaking the law. For each cluster we estimated ordinary logit and probit models and compared these results with the results of the pooled model. After that we estimated the confidence of individuals in political institutions and added to our models.

The paper is organized as follows. Section 2 contains a brief review of previous empirical literature concerning political institutions, Section 3 contains full description of data and variables, in Section 4 the separation of countries on four clusters is performed, Section 5 illustrates some econometric investigations. Section 6 concludes the paper with some policy implication suggested.

2. LITERATURE REVIEW

It is well known that social norms, influencing personal behavior, exist in any society. Social norms are important factors in compliance or infringement of the law (Alm, 1995; Naylor, 1989). Posner (2000) defined social norms as signals of personal behaviour (p. 1788).

Also Posner told that people will obey the law and pay taxes as long as this will be a social norm of their life (Posner, 2000). Breaking this norm leads to such inner and outer results as guilty conscience, repentance and gossips (Polinsky and Shavell, 2000).

In the paper of Sugata Marjit (2000) the model with different taxpayers providing the information about their income and representatives of authority is considered. The sum of tax payment directly depends on auditor, checking correctness of the information. Providing the wrong information about the income allows to save on the taxes and benefits both sides, auditor, who receives bribery for keeping silent, and individual as well. But in some cases authorities demand a bribe to avoid pressure. This research shows that bribery encourages tax evasion. According to the conclusions of the paper, the rich people are more inclined to break the law; the poor man just cannot afford it.

There is an opinion that bribe can speed up the process of getting some licenses, documents, accelerate and improve the process of acquisition of some goods, saving time for the individual. In the research of Cristian Ahlin and Pinaki Bose (2007) the standard model of bribery is considered in example of getting a license. The authors divide individuals into two groups: those, who are ready to buy the license, saving the time and efforts, and those, who look for the honest representatives of authorities. If the authorities themselves are not under the control they are able to give license for some sum of money thus increasing the level of bribery. So, the authors demonstrate on this example that it is necessary to improve the monitoring of authorities in the country that can increase the quantity of honest officials and can decrease the number of individuals who wish to give the bribes. This model allowed us to make the following conclusion: decreasing the quantity of bureaucrats we just increase the price of bribe, which is more dangerous for state economy.

Using data from Peru for 2002 and 2003, Jenifer Hunt (2006) shows that people, having a lot of problems or suffering from failures are more inclined to bribery. But imperfection of such analysis is that it is very difficult to determine what exact problems cause the bribery. Thus the level of bribery depends on the kind of circumstances. The goal of author was to demonstrate the connection of negative events in personal life and inclination to break the law. Data shows, that individuals bribe the authorities because they are interested in them, and the

richer the individual is, the more frequently and in bigger quantities he is able to give the bribes. The survey was carried out among 18000 families and during it people were asked some questions of different types such as if the respondent offered the authorities the bribe like money or a present, if he felt obliged to pay if he refused to pay and so on. The difficulty was that in some cases the conscience did not let people tell the truth, but in other cases bribery was the standard of life for people and they gave the authentic information. The results revealed that the most common officials affected by bribery were courts, police and local authorities.

In the paper of Gorodnichenko and Sabirianova (2007) the level of bribery in Ukraine is investigated on the basis of data ULMS. This level is estimated depending on the difference of state and private sector employees' salaries and consumption expenses. Although the difference in salaries is significant, but consuming is the same, so it is evident that state sector employees are more affected by bribery, to consume in such quantity as private sector employees. It was found out that 73% of respondents offered bribes to medical doctors and public officers. Thus this research confirms that state employees are more inclined to bribery.

There are some papers analyzing and comparing this problem between different countries. For example, in research of Gerxhani and Schram (2006) the tax evasion in Albania and the Netherlands is compared. The choice is not accidental. One of the countries (the Netherlands) has stable and well developed institutions and, on the contrary, another one (Albania) entered the process of transition and was struck by poverty and instability. It made underground economy boom. The results revealed that the existing tax institutions in the Netherlands are much better comparing with Albania. Alm and Torgler (2004) provided the comparative analysis of the differences between USA and Europe, and Webley and Cole (2001) compared UK, Norway and France.

Jackson & Milliron (1986) were the first authors who made detailed analysis of breaking the law determinants; they used such independent variables as age, gender, education, income level, marital status, income source, marginal tax rates, fairness, complexity etc. Based on this study Riahi-Belkaoiu (2004) analyzed the relationship between the tax evasion and some main determinates and as a result the following hypotheses were made: there is a negative relation between tax evasion and such individual characteristics as age, common level of education, fairness; there is positive relationship between tax evasion in the country and the income level of a taxpayer.

Another author, Grant Richardson (2006) also carries out the analysis of factors influencing tax evasion and compares the results with the suppositions by Riahi-Belkaoui. The main difference of the model was in the adding of economic,

political and cultural variables, such as the level of economical development, the notions of democracy, culture and religion to the basic variables of Jackson & Milliron. The results of OLS regression analysis showed how economic determinants influenced the level of tax evasion. Concerning the other variables, the higher the level of education, income sources, fairness and tax moral are, the lower the level of tax evasion is in different countries.

The following paper of the same author (Grand Richardson, 2008) is devoted to the demonstration of the relationship between the culture, court system, trust in government, religion and tax evasion. The sample included the data for 47 countries, collected from different public resources such as WEF (World Economic Forum) and World Bank. With a help of ordered probit models the author came to the conclusion that the lower the level of trust in government and law system is, the higher the level of breaking the law is.

Beno Torgler (2003 and 2004) completed two empirical studies using the data from third wave (1995-1997) of WVS for Canada and Asian countries. These papers are identical to the previous paper, but except of the basic variables such as religiosity and trust to political institutions Beno Togler includes such variable as pride, which influences the individual behavior in society. He approved of the importance of this variable with the fact that the more individual is proud of his country the less he is inclined to break the law. Thus, author came to the conclusion that religion, pride and trust affect positively to law obeying.

Consequently, on the base of the considered literature, we can suppose that:

- The rich people are more inclined to break the law
- The more religious the person is, the more he is proud of his country, the less he is inclined to break the law
- The higher is the level of trust to the power and to the law officials the higher is the level of obeying the law.
- More adult and educated person is less inclined to break the law.
- The state employees are more inclined to bribery

We analyzed the inclination for breaking the law (tax evasion and bribery) in different countries, using the data of WVS (World Value Survey) from 2005 to 2008.

3. DATA AND VARIABLES

As it was noted earlier, our purpose is to study of relationship between individual features of responders and their attitude to breaking the law. We used the data from 57 countries, from the last (fifth) wave of WVS (World Values Survey) over the period from 2005 to 2008.

Such countries as Andorra, Egypt, Iraq, Peru, Ruanda, Hong Kong and Guatemala, in which respondents did not answer some questions, were excluded from the sample. Thus, in the research the data from 50 countries, represented in Table 1, was used, and the total number of respondents was about 80 thousand.

Table 1. List of countries

Country	Number of respondents	Country	Number of respondents
Argentina	966	Mali	1301
Australia	1386	Mexico	1500
Brasil	1467	Moldova	1021
Bulgaria	957	Morocco	1180
Burkina Faso	1365	Netherlands	1028
Canada	2133	New Zealand	892
Chile	961	Norway	1014
China	1673	Poland	950
Colombia	2992	Romania	1654
Cyprus	1046	Russian Federation	1875
Egypt	3044	Slovenia	990
Ethiopia	1489	South Africa	2901
Finland	1011	South Korea	1198
France	997	Spain	1180
Georgia	1449	Sweden	994
Germany	2023	Switzerland	1234
Ghana	1491	Taiwan	1224
Great Britain	1004	Thailand	1524
India	1619	Trinidad and Tobago	998
Indonesia	1969	Turkey	1339
Iran	2640	Ukraine	919
Italy	997	Uruguay	984
Japan	1073	United States	1188
Jordan	1171	Viet Nam	1452
Malaysia	1200	Zambia	1408

Survey was conducted in the form of personal conversation with the respondents at the age of 18 years old and older using the appropriate national languages. The advantage of this survey is the wide set of variables.

As the dependent variables (see Table 2) we consider the variables that reflect the violation of law: tax evasion and receiving bribes. The general question to assess the level of tax evasion (bribery) from World Value Survey was: "Please indicate for each of the following statement whether you think it can be justified:

Cheating on tax if you have the chance (Someone accepting a bribe in the course of their duties)". With a 10 point grading scale the answers were given a value between 1 (never) and 10 (always).

Table 2. Dependent variables

Variables	Definition of variable in WVS	Description of variable
Cheat_tax	F116	Cheating on tax (where 1 = never and 10 = always)
Bribery	F117	Accepting a bribe (where 1 = never and 10 = always)

Source: WVS, wave 5, http://www.worldvaluessurvey.org.

The sample includes countries with different culture, geography and economy, therefore, for the analysis of this data it is difficult to compare the income level in different countries; that's why it is important to consider such variable as "social class" (subjective characteristics). Theoretically income level can both increase and decrease level of "tax morals" (to increase inclination to break the law). For example, individuals with high income level in most cases try to avoid tax payments to increase their wealth, especially in the countries with the high income tax. And opposite, individuals with low income are less inclined to risk, because they may consider high probability to be caught and punished. Variable "age" also has a dual nature. On one hand, elderly people in many countries have social support and material aid, but on the other hand, the older the person is, he becomes more experienced in the tax affairs, which in turn allows them to deceive the authorities. Many social psychology studies have shown that women are more obedient than men, then logically to assume that women are less inclined to break the law.

Thus, as the explaining variables we selected the following characteristics of individual: sex (SEX), age (AGE), marital status (MARITAL), education (EDUC), employment (EMPLOYMENT), income level (INCOME), social class (SOC_CLASS), occupation (OCCUPATION) and the presence of subordinates in the workplace (BOSS).

In addition, it is important to analyze the level of trust in political institutions (government, parliament, police and courts), because as was previously noted, the trust in the state, court and legal system affects the enforcement of the laws, and it can be achieved if the government act in accordance with the needs and desires of citizens of its country.

The complete description of variables is represented in tables 3-5.

Table3. Independent variables

Variables	Definition of variable in WVS	Description of variable
AGE	X003	AGE (1- male, 2- female)
SEX	X001	Sex of respondent (1- male, 2- female)
EDUC	X025	Level of education (1 - elementary education, 2 - completed (compulsory) elementary education, 3 - incomplete secondary school, 4 - complete secondary school, 5 - incomplete secondary: university-preparatory type, 6 - complete secondary, 7 - some university without degree, 8 - university with degree
INCOME	X047	Scale of incomes (1 lower step, 2 second step,. . ., 10 tenth step)
SOC_CLASS	X045	Social class (subjective, 1 – upper class, 2 - upper middle class, 3 - lower middle class, 4 - working class, 5 - lower class
MARITAL	X007	Marital status (1 – married, 2 - living together as married, 3 – divorced, 4 – separated, 5 – widowed, 6 - single/never married, 7 - divorced, separated or widow, 8 - living apart but steady relation (married, cohabitation)
OCCUPATION	X052	Institution of occupation (1 - public institution, 2 private business, 3 - private non-profit organization, 4 - self-employed)
BOSS	X031	Are you supervising someone? (0 – no, 1 – yes)
EMPLOYMENT	X028	Employment status (1 - full time, 2 - part time, 3 -self employed, 4 – retired, 5 - housewife, 6 –students, 7 – unemployed, 8 – other)

Source: WVS, wave 5, http://www.worldvaluessurvey.org.

Table 4. Variables of level of confidence

Variables	Definition of variable in WVS	How do you trust in . . . (1 - a great deal, 2 - quite a lot, 3 - not very much, 4 - none at all)
CONF_GOV	e069_11	Government
CONF_POLICE	e069_06	Police
CONF_PARL	e069_07	Parliament
CONF_JUST	e069_17	Justice System

Source: WVS, wave 5, http://www.worldvaluessurvey.org.

Table 5. Binary variables

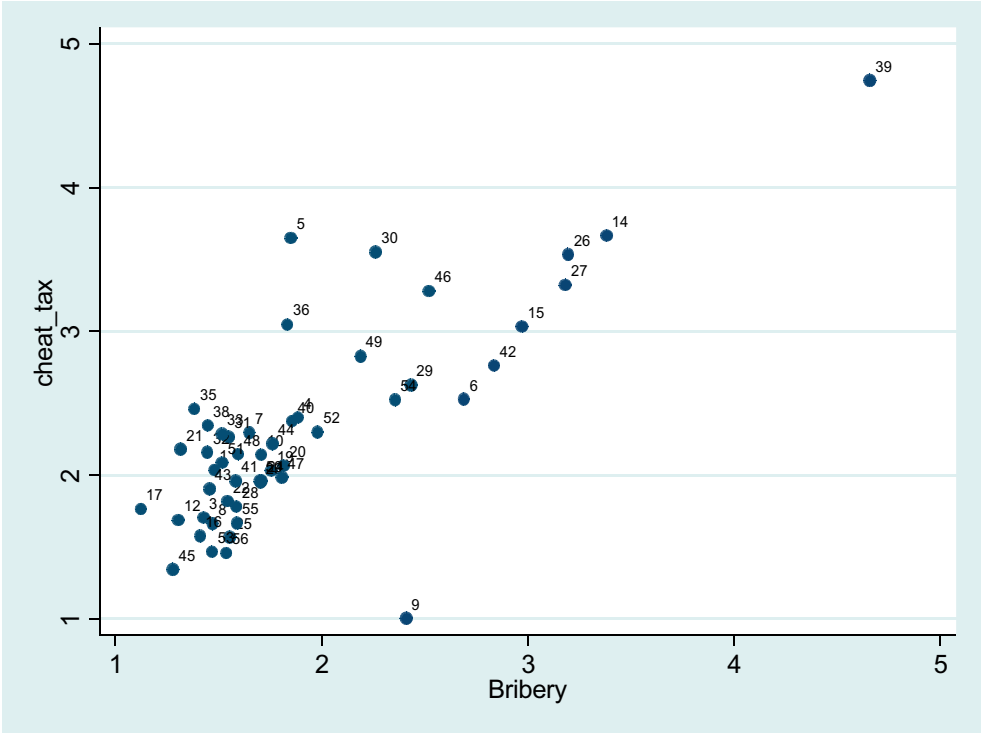
Binary variables	Description of variable
Gender	1 , if Sex = 2 (female) 0, if Sex = 1 (male)
Mar	1, if Marital = 1,2 Else 0
El_educ	1 , if Educ = 1,2 Else 0
Mid_educ	1, if Educ = 3,4,5,6,7 Else 0
High_educ	1, if Educ = 8 Else 0

Inc	1, if Income = 1,2,3,4,5 Else 0
Soc	1, if Soc_class = 1,2 Else 0
Employ	1, if Employment = 1,2,3, Else 0
Occup1	1, if Occupation = 1 Else 0
Occup2	1 , if Occupation = 2 Else 0
Occup3	1 , if Occupation = 3 Else 0
Occup4	1, if Occupation = 4 Else 0

4. CLUSTER ANALYSIS

According to the observations for each of 50 countries examined by us, the average level of tax evasion and bribery was calculated. We created the scatter diagram (Fig.1).

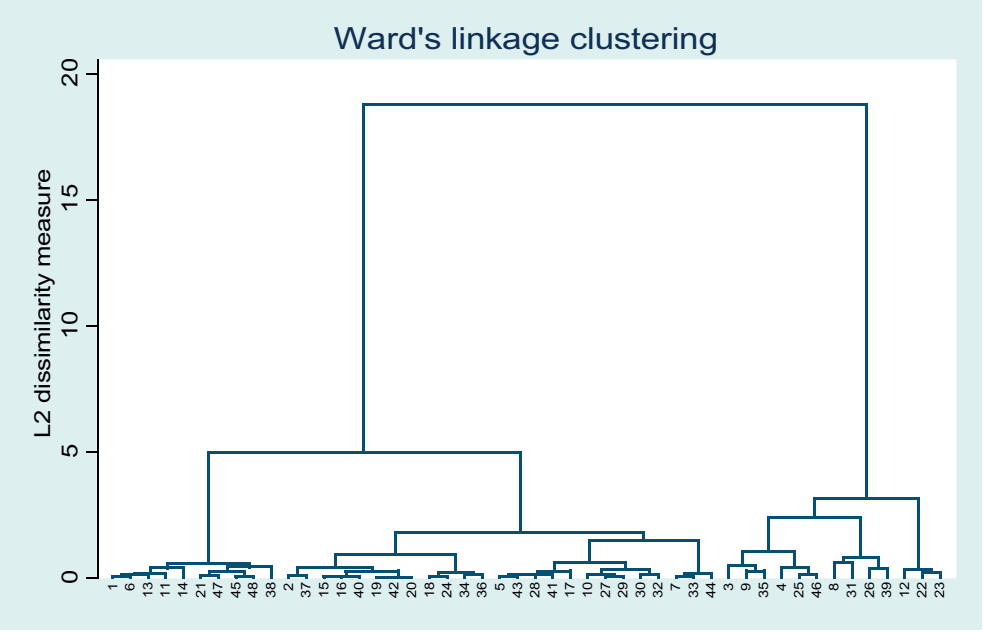
Figure 1. Scatter diagram



Ghana and Serbia (numbers 9 and 39) are different from other countries obviously. It does not make sense to examine the cluster, which contains only one element. Therefore we removed the observations for these countries from the analysis.

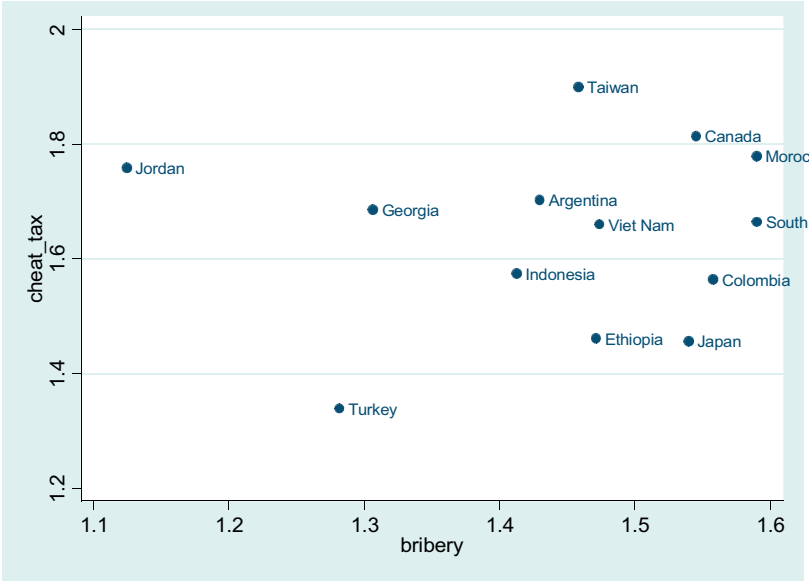
Visually all countries can be divided into four clusters. Since the scale of the attitude of responders to breaking the law in different countries is measured from 1 (it is not inclined to break the law) to 10 (it is inclined), therefore moving the point on the graph more to the right (along the x axis), or higher (along the y axis), means the greater tendency to break the law in the country. Let us recheck the intuitive division of the countries into four groups with the help of different algorithms of clustering. For the beginning we will use all methods of hierarchical cluster analysis, and the results will be represented in the form of dendrogram. Since Ward's method is most universal, then let's concentrate on the represented below tree-like diagram (Fig.2).

Figure 2 . Ward's dendrogram



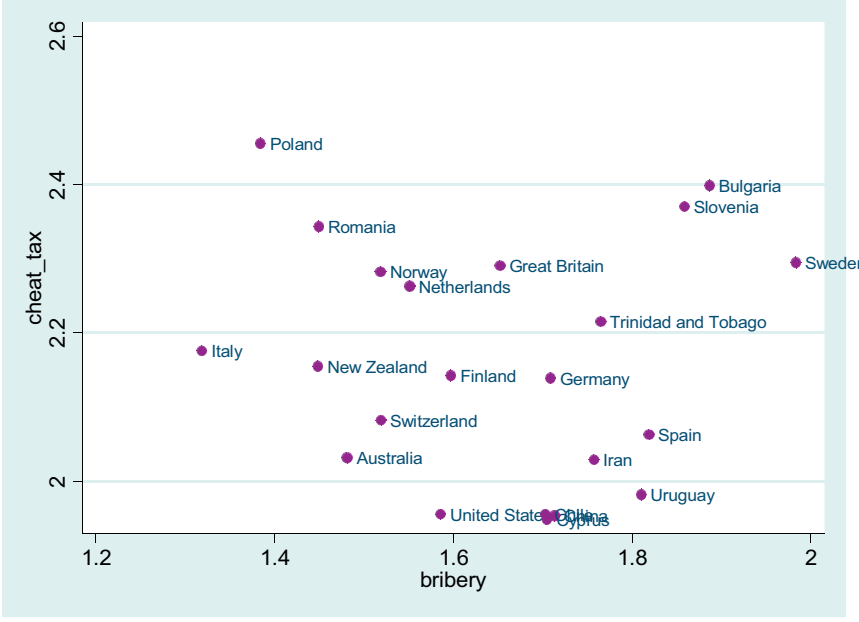
Based on the Ward's dendrogram we clearly distinguished four clusters. For the more precise analysis we will use the method of k-averages, which is based on the calculation of the Euclidean distance between observations and centers of clusters. Since we proposed the partition of the countries into four groups, then, based on the scatter diagram let's try to identify the center of each cluster. After the visual segmentation of the countries we determined the centers of each group: Vietnam, Germany, India and France. As a result, the objects fall within the cluster, the distance to the center of which is minimal. Thus, we obtain four groups of the countries according to the degree of probability to break the law (see Figures 3-6).

Figure 3. First cluster



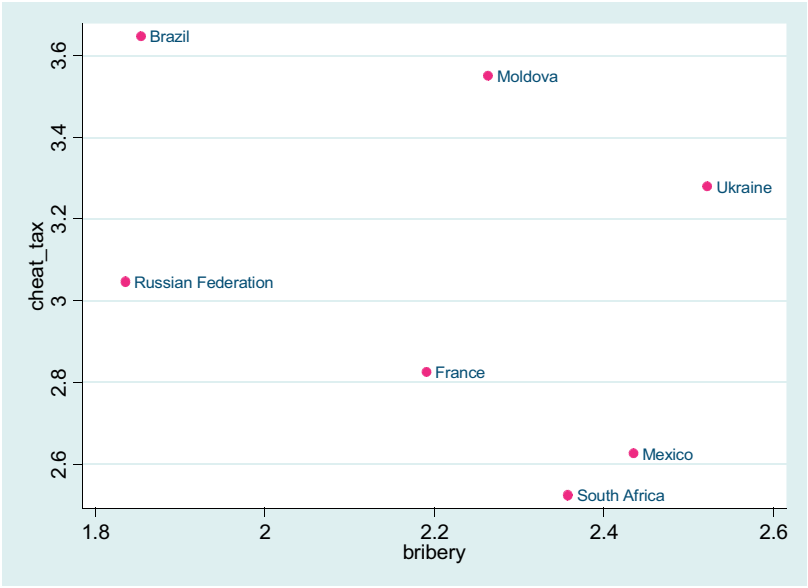
As you can see from the figure 3, the first cluster of countries whose residents are least likely to violate the laws, contains completely different countries of the world: the developed countries (Canada, Japan, South Korea), and the poor ones (Indonesia, Morocco, Turkey).

Figure 4. Second cluster



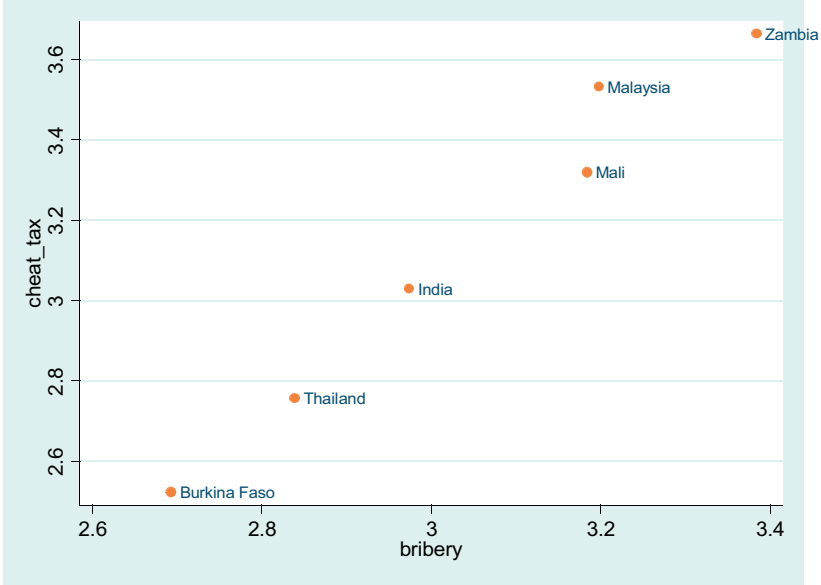
The countries of the second cluster are also very different; it contains, for example, the USA, China, Chile. But it contains mostly European countries.

Figure 5. Third cluster



All three remaining countries from the former Soviet Union: Russia, Ukraine, Moldavia as well as France, Mexico, Brazil, South Africa entered into the third cluster. Residents of these countries are more tolerant to bribes than to tax evasion.

Figure 6. Fourth cluster



The countries, entered to the fourth cluster (Burkina Faso, Thailand, India, Mali, Malaysia, Zambia), which residents are most likely to violate the laws, differ from other countries by a comparatively low standard of life and low level of education.

5. EMPIRICAL RESULTS

5.1. Ordered probit models

For a better understanding of the determinants concerning the attitude of citizens to bribes and tax evasion, we ran a series of ordered probit models.

The standard ordered probit model looks as follows:

Let $-\infty = c_0 < c_1 < ... < c_{m-1} < c_m = \infty$ - a set of points on R,

$\{y_i = k\} \Leftrightarrow \{c_{k-1} < y_i^* < c_k\}$, where y^* - latent variable,

$y^* = X\beta + \varepsilon$,

$\Pr(y_i = k \mid x_i) = F(c_k - x_i'\beta) - F(c_{k-1} - x_i'\beta)$, $k = 1,...,m$, where

$$F(z) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^{z} \exp(-t^2/2)dt$$

The results of ordered probit models estimation are summarized in Tables 6, 7.

Table 6. Results of ordered probit models estimation for tax evasion.

CHEAT_TAX	Cluster 1	Cluster 2	Cluster 3	Cluster 4	Total
Age	-.0025378***	-.0082044***	-.0070074***	-.0035443***	-.0055653***
Sex	-.0994039***	-.148612***	-.014922	-.0400585	-.0937733***
Boss	-.0127397	-.0383755**	-.0632662**	-.0319258	.006265
Mar	-.0981978***	-.0332128**	.0010639	-.1085559***	-.0427111***
mid_educ	.0714466***	-.0061985	-.1148238***	.0099933	-.007148
high_educ	.0499506	-.0213534	-.1086303***	-.1327968***	-.0895856***
Employ	.0527345**	.0220399	.0845296***	.0090094	.0500603***
Soc	.0067324	-.033968*	-.0009471	.1262802***	-.0024003
Inc	.1305624***	.0892142***	.034017	.1799292***	.1346185***
occup2	.040928*	.0701639***	-.0464572*	.0460653	-.0419143***
occup3	.0428806	-.0414465	-.0501033	.1709175***	.2090455***
occup4		-.0243813	-.0950937		-.0346444

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

Table 7. Results of ordered probit models estimation for bribes.

BRIBERY	Cluster 1	Cluster 2	Cluster 3	Cluster 4	Total
Age	-.0054225***	-.0102252***	-.0089385***	-.0022766**	-.0096045***
Sex	-.0695514***	-.0766441***	-.0713871***	-.0401157	-.0842329***
Boss	-.0064756	-.0623783***	-.1043269***	.0206749	.0198657
Mar	-.0978987***	-.0644098***	-.0182602	-.0979733***	-.0509292***
mid_educ	.0186882	-.0929717***	-.1926558***	-.0638021**	-.1812556***
high_educ	-.0658952**	-.168615***	-.1988167***	-.2443373***	-.3351383***
employ	.1217365***	-.0024401	-.0658759**	-.0099557	.0313103***
Soc	-.0794384***	-.0006557	.1700137***	.1932066***	.0302627**
Inc	.1750732***	.0673814***	.0498524*	.1617962***	.1441106***
occup2	.0426193*	.1013227***	.0549299**	.0547945	-.0269014**
occup3	.1904963***	.1086789**	.2320645***	.1591351***	.3492908***
occup4		.0746816*	.3392983***		-.0737697**

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

For accurate interpretation of the received results it is necessary to calculate the marginal effects of explaining factors. We have dropped tables with signs on all marginal effects since they are rather bulky. However it is easy to show (Green W., 2008) that marginal effect $\frac{\partial p(Y_i = 4)}{\partial X_j}$ signs (i = 1, 2 j = 1,…,7, Y_1 = Cheat tax, …, Y_2 = Bribery, X_1 = age, …, X_{12} = occup4 coincides with a sign of X_j coefficient β_{ji} in the model with dependent variable Y_i, the marginal effect sign for $\frac{\partial p(Y_i = 1)}{\partial X_j}$ is opposite to a sign of the coefficient β_{ji}.

Based on the signs of coefficients in tables 6 and 7, it is possible to make the following conclusions:

- The older the individual, the less he is inclined to break the law. The same positive impact on a person has his/her marital status
- Women are less inclined to tax evasion and bribery than men
- People with higher education are less likely to take bribes, and representatives of the third and fourth clusters are less inclined to avoid tax paying
- People with a secondary education are also less inclined to accept bribes
- However, the effect of secondary education in tax evasion is not the same: in the first cluster, people with secondary education are more likely to evade taxes, but in the third cluster they are less likely to do it
- Having a job affects the representatives of the first and third clusters, and they both are more likely to evade taxes, but the representatives of the first

class are more likely to take bribes, but the representatives of the third class are less likely to do it

- People in leadership positions in the second and third clusters are less likely to violate the law, apparently because of fear to lose the job
- The higher income level the individual has, the more he is inclined to accept bribes and evade taxes
- Subjective estimation of the individual's own status also differently affects his/her attitude to the law: an individual with higher self-esteem a) in the first cluster would be more inclined to take bribes; b) in the second cluster would be more prone to evade taxes; c) in the third cluster is less inclined to take bribes; d) in the fourth cluster is less inclined to take bribes and evade taxes.
- Representatives of private business in the first and second cluster have a condescending attitude toward bribery and tax evasion, while in the third cluster they are also prone to bribery, but fear of failure to pay taxes
- Representatives of non-profit occupation are also more prone to bribes, and in the fourth cluster also to non-payment of taxes (compared to working in public institutions)
- Self-employed people in the second and third clusters are also more tolerant to bribery (compared to working in public institutions)

Note that these results confirm that we need to divide countries into clusters. Evaluation of the model summarizing all observations could lead to wrong conclusions. For example, the estimate of the coefficient for the Boss variable is generally insignificant, but for the second and third clusters these estimates are significant and negative, the estimate of the Employ coefficient by the model with the dependent Bribery variable for the first cluster is positive, while for the third cluster is negative.

5.2. Bivariate probit models

The tendency of individuals to break the law may depend not only on their personal characteristics, but also on attitudes towards political institutions. In this regard, we decided to add to our models confidence variables, the description of such variables was given in table 4. However, these variables also depend on the socio-economic characteristics of the individual, so we consider the system of equations, namely bivariate probit model.

$$\begin{cases} Y_1^* = x_1\beta_1 + \alpha Y_2 + \varepsilon_1 \\ Y_2^* = x_2\beta_2 + \varepsilon_2 \end{cases}$$

Where X_1, X_2 are independent variables, α, β_1, β_2 are estimated coefficients,

$(\varepsilon_1,\varepsilon_2 | X_1, X_2)$ - bivariate normal distribution of ε_1 and ε_2 with coefficient of correlation ρ.

The results of bivariate probit models estimation are summarized in Tables 8 - 11.

Table 8. Results of bivariate probit models estimation for the first cluster.

	Tax		
Age	-.0016445**	-.0019491***	-.0020381***
Sex	-.0786556***	-.0818199***	-.0875776***
Boss	-.0173551	-.0168467	-.0238036
Mar	-.0952437***	-.1013151***	-.0955188***
Mid_educ	.0656675***	.0628815**	.0515538**
High_educ	.0269948	.0280718	.0148873
Employ	.0606476**	.0626365***	.0615219**
Soc	.0031655	.0008853	-.005082
Inc	.1474837***	.1466194***	.144892***
occup2	.0194996	.0242531	.013281
occup3	.0555971	.0611695	.0512172
Police	-.1575629***		
Just		-.0989602*	
Gov			-.1619029***
Po	0.307	0.778	0.669
	Bribe		
Age	-.0040749***	-.00427***	-.0043278***
Sex	-.0554707**	-.0576184***	-.0616537***
Boss	-.0145992	-.0125171	-.0195908
Mar	-.0985815***	-.1007376***	-.098417***
Mid_educ	-.0062549	-.0084542	-.0165171
High_educ	-.0821424**	-.0829121**	-.0910102***
Employ	.1104239***	.1104714***	.1113602***
Soc	-.0859502***	-.0855184***	-.0920219***
Inc	.1868381***	.1895445***	.1857369***
occup2	.0411702	.0433946	.0353796
occup3	.1707356***	.1730844***	.1663878***
Police	-.1120961**		
Just		-.106389**	
Gov			-.1246872**
Po	0. 555	0.392	0.754

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

Table 9. Results of bivariate probit models estimation for the second cluster.

	Tax		
Age	-.007244***	-.0073888***	-.0074342***
Sex	-.1110764***	-.112853***	-.1144639***
Boss	-.0623146***	-.0643672***	-.0661103***
Mar	-.0328691*	-.034973	-.0278143
mid_educ	-.0270965	-.0281644	-.0363877*
high_educ	.0048677	.0021777	.0020285
Employ	.0537691	.0527836***	.0591579***
Soc	-.047328***	-.0508023**	-.0433126**
Inc	.0615203**	.0583572***	.0634644***
occup2	.0509586***	.0493452**	.0431478**
occup3	-.0315019	-.0356223	-.0460942
occup4	.1676352***	.1530796***	.2203867***
Police	-.0554718		
Just		.0250364	
Gov			-.1560559***
Po	0.363	0.012**	0.866
	Bribe		
Age	-.0089987***	-.0089734***	-.0089391***
sex	-.0441744**	-.0448482***	-.0436531**
Boss	-.0904673***	-.0913313***	-.0898592***
Mar	-.0650334***	-.0661439***	-.0640139***
mid_educ	-.137638***	-.1360463***	-.1376585***
high_educ	-.184466***	-.189709***	-.1841244***
Employ	.0190268	.0139286	.0196216
Soc	-.0343929	-.0388632	-.0328336
Inc	.0449758**	.0390017	.0459025**
occup2	.0879092***	.0879668***	.0878486***
occup3	.0833361*	.080676	.0835802*
occup4	.2791513***	.2493975***	.2871775***
Police	.020929		
Just		.1248331***	
Gov			-.0131091
Po	0.051**	0.000***	0.737

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

Table 10. Results of bivariate probit models estimation for the third cluster.

	Tax		
age	-.0059759***	-.0059705***	-.0061322***
sex	-.0282807	-.0283214	-.0327549
boss	-.110425***	-.1139334***	-.1205564***
mar	-.0132248	-.0128102	-.0153049
mid_educ	-.0738303**	-.0685016**	-.0771785**
high_educ	-.069532	-.0629279	-.0797862
employ	.0621322**	.0666172**	.0580899*
soc	.0389856	.0377811	.0329039
inc	.0149763	.0163538	.019408
occup2	-.0211869	-.02471	-.0227217
occup3	-.001519	-.00688	.0225737
occup4	-.0553934	-.0456668	-.0660795
police	-.0850092		-.1997808
just		-.0238099	
gov			-.1997808***
po	0.721	0.379	0.627
	Bribe		
age	-.0075631***	-.0074325***	-.0075283***
sex	-.0643341**	-.0643445**	-.0629138**
boss	-.1376463***	-.1344002***	-.1342202***
mar	-.0378574	-.0374203	-.0374451
mid_educ	-.1898859***	-.1877134***	-.1898957***
high_educ	-.1842054***	-.1818672***	-.1830725***
employ	-.0730163**	-.0729006**	-.0726543**
soc	.1737831***	.1730325***	.1764948***
inc	.0278537	.0259241	.0262461
occup2	.0572534**	.0576759**	.0583125**
occup3	.2265631***	.2225475***	.2211041***
occup4	.3636264***	.3688733***	.3639483***
police	.0380251		
just		.0655368	
gov			.0553923
po	0.745	0.190	0.083*

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

Table 11. Results of bivariate probit models estimation for the fourth cluster.

	Tax		
age	-.0022244**	-.0021325**	-.0022367**
sex	.0415884	.0429177	.0414128
boss	.0226659	.0295434	.0172889
mar	-.1807007***	-.1812903***	-.1843512***
mid_educ	-.0836573***	-.0792034**	-.0791166**
high_educ	-.2704956***	-.2628568***	-.263922***
employ	.101616***	.1020483***	.1030845***
soc	.0088838	.0099246	.021131
inc	.2384122***	.2416319***	.2438576***
occup2	.0042856	.0071556	.016602
occup3	.1830078***	.1907172***	.1792582***
police	-.0407457		
just		-.1041234	
gov			-.209371***
po	0.606	0.826	0.627
	Bribe		
age	-.0013428	-.0011555	-.0013237
sex	.0329438	.0358143	.0329568
boss	.0685255**	.0808223**	.0607602*
mar	-.1324373***	-.1337011***	-.1377357***
mid_educ	-.1745671***	-.1671049***	-.168547***
high_educ	-.3962473***	-.3838721***	-.388303***
employ	.0683797**	.0705087**	.0726754*
soc	.1093664***	.1105239***	.1249248***
inc	.2142484***	.2191554***	.2195628***
occup2	.0438493	.0465804	.0574063
occup3	.1893994***	.2007192***	.1800976***
police	-.1087946		
just		-.1844971**	
gov			-.2871057***
po	0.742	0.202	0.101

* - significant at 10%, * *- significant at 5%, *** - significant at 1%.

Note that if the coefficient ρ is insignificant, then the equations in the system can be evaluated separately.

Signs of the coefficients are generally preserved in the bivariate probit models. Significance of some coefficients changed (they are in italics).

All clusters demonstrated the same dependence: an increase in confidence in political institutions (government, police, and justice system) reduced the level of violations of the laws in the country. There is only one exception for the second class).

6. CONCLUDING REMARKS

In this section we remind the main results established after empirical research of residents' inclination to tax evasion and bribes acception in different countries, and suggest some policy implication.

- There is a significant difference for the residents of different countries in these matters, so it is undesirable to try to identify common patterns for all countries, and the pre-clustering is desirable.
- The more individuals trust in the basic political institutions such as government, police, justice system, the less they are inclined to violate the law. Consequently, the activities associated with an increase in the level of trust in political institutions at the same time will reduce the level of bribery and tax evasion.
- Improving the educational level of the population will lead to a similar effect, because people with higher education are less likely to take bribes.
- Because young people are less compliant on the tax evasion and bribery, it is necessary to carry out targeted work with young people.
- Because people with higher income are more likely to take bribes and evade taxes, then we must pay special attention to such people (unfortunately, people tend to hide their true income). The same recommendations apply to population with private business.

It should be noted that further research in violation of the law is needed. One possible proposal for the future analysis is the use of multilevel models, when we can consider (on country level) such independent variables as income tax rate, corruption index, unemployment rate, degree of religiosity in the country, etc.

BIBLIOGRAPHY

1. Alm, J., & Torgler, B., 2004. Culture Differences and Tax Morale in the United States and in Europe. CREMA Working Paper 2004-14
2. Christian Ahlin, Pinaki Bose. Bribery, inefficiency, and bureaucratic delay. Journal of Development Economics 84 (2007), 465– 486
3. Rosa Ferrer, 2008. Breaking the law when others do: A model of law enforcement with neighborhood externalities. Department of Economics and Business, Universitat Pompeu Fabra, Ramon Trias Fargas 25-27.

4. Gerxhani, K., Schram,A., 2006. Tax evasion and income source: A comparative experimental study .Journal of Economic Psychology 27, 402–422
5. Gorodnichenko, Y., Sabirianova, K., 2007. Public sector pay and corruption: Measuring bribery from micro data. Journal of Public Economics 91, 963–991
6. Green William H., 2008. Econometric analysis, sixth edition, Prentice Hall, p.831.
7. Jennifer Hunt. How corruption hits people when they are down. Journal of Development Economics 84 (2007), 574–589
8. Jackson, B. R., & Milliron,V. C. (1986).Tax compliance research: Findings, problems and prospects. Journal of Accounting Literature, 5, 125–165.
9. Korbiel, I., Bremenfeld, S., Opitz, A., 2009. Perceived efficiency of the legal system and trust in political institutions in Eastern and Middle Europe, University of Cologne
10. Sugata Marjit. Harassment, corruption and tax policy. European Journal of Political Economy. Vol. 16 (2000), 75–94
11. Naylor, R., 1989. Strikes, free riders, and social consensus. Quarterly Journal of Economics, 104, 771–786.
12. Polinsky, M.A., Shavell, S., 2000. The economic theory of public enforcement of law. Journal of Economic Literature 38, 45–76.
13. Posner, E.A., 2000. Law and social norms: the case of tax compliance. Virginia Law Review 8, 1781–1819.
14. Riahi-Belkaoiu, A. (2004). Relationship between tax compliance internationally and selected determinants of tax morale. Journal of International Accounting, Auditing and Taxation, 13, 135–143.
15. Grant Richardson. Determinants of tax evasion: A cross-country investigation. Journal of International Accounting, Auditing and Taxation 15 (2006), 150–169
16. Grant Richardson. The relationship between culture and tax evasion across countries:Additional evidence and extensions. Journal of International Accounting, Auditing and Taxation 17 (2008), 67–78.
17. Benno Torgler. Tax morale in Asian countries. Journal of Asian Economics 15 (2004), 237–266.
18. Benno Torgler. To evade taxes or not to evade: that is the question. Journal of Socio-Economics 32 (2003), 283–302.
19. Webley, Paul and Cole, M. and Eidjar, P. (2001) ‚The Prediction of Self-Reported and Hypothetical Tax-Evasion: Evidence from England, France and Norway.' Journal of Economic Psychology, 22 (2), 141-155.
20. World Values Survey – 5th wave, 2005-2008. http://www.worldvaluessurvey.org/

AN ASSESSMENT OF CROATIA'S FREE ZONE BENEFITS WITHIN THE INTERNATIONAL FRAMEWORK

Đula Borozan, Ph.D.
Full Professor
Josip Juraj Strossmayer University of Osijek
Faculty of Economics in Osijek
Croatia
e-mail: borozan@efos.hr

Željko Klepo, M.Sc. (Econ)
Allianz Zagreb d.d.
Croatia
e-mail: zeljko.klepo@allianz.hr

Abstract

Worldwide, as well as in Croatia, free zones (FZs) are recognized as an important instrument of economic growth acceleration due to the positive influence they may have on the foreign direct investments attraction, exports boosting, regional competitiveness advancement, and creation of job opportunities.

The main goal of this paper is to evaluate benefits and contribution of FZs to Croatian economic growth dynamizing. Benefits are here presented in terms of attracted foreign direct investments, in addition to the number and type of newly opened jobs. The qualitative analysis of the data showed that Croatian FZs attracted mainly industries in low-tech, low-skill, and footloose activities, and that they failed to be an attractor for greenfield investments. Furthermore, the number of newly opened jobs is insufficient for affecting unemployment significantly, and for inversion of the negative economic trends into positive ones. Success of FZs is dependent on the quality of the local business setting and leader team, the chosen FZ management model, as well as on the quality of the macroeconomic environment.

Keywords: *free zones, cost, benefits, international arena, Croatia.*

1. INTRODUCTION

Free zones (hereinafter: FZs), as areas where economic activities mostly designated for exports are performed more or less freely, have origins in free merchant sites and cities in ancient Roman Empire, middle ages, and free ports of the British Empire

(Gibraltar, Singapore, and Hong Kong). Due to their privileged status those cities or sites were relieved from levy paying obligations, which triggered their rapid growth and turned them into strong merchant and later industrial centres. Even though free cities gradually disappeared through the ages, and diverse administrative-territorial structures emerged, FZs continued to exist in various shapes until the present day (for the historical overview see Relić, 1998).

The cause of this perseverance lies primarily in the fact that FZs where recognized as an instrument of the accelerated country development, through investment attraction, principally foreign, greenfield-type, and boosting exports and local employment. First 'modern' zone was founded in Ireland in 1959, and since then numerous and various FZs were established (FIAS, 2008). Taiwan and South Korea were among those that early recognized the benefits of creating FZs. These two countries started founding their FZs in the 1960s; in the first years of their operation Taiwanese FZs already achieved remarkable results, which sparked a large number of requests for establishing new ones. South Korea laid legal foundations for creating FZs in 1972, as a means for attracting foreign investments, opening new jobs, developing new technologies, and export-driven production. Large areas were proclaimed as FZs, where foreign investors were offered a wide array of support and incentives, which resulted in rapid development of South Korea. Short time after, this country was dubbed as one of the "Asian Tigers".

Today there are about 3,000 zones worldwide (FATF Report, 2010), which more or less contribute to the economic growth and development of the countries they are situated in. It is estimated that these 3,000 hold merits for more than 68 million of direct jobs and over $500 billion of direct trade-related value added within the zones (FIAS, 2008).

The main goals of this paper are to position Croatian FZs in a wide, international context, and to discuss contributions of the generated direct economic benefits, primarily through analysis of created new jobs, attracted foreign direct investments, and exhibited economic growth. In order to evaluate these contributions appropriately, it is necessary first to explore potential economic effects of FZs on the growth of the host countries' economies, as well as economic effects of FZs in other countries. Therefore, this paper consists of five chapters. After the introduction, the second chapter offers a brief review of potential economic effects, i.e. costs and benefits which FZs can generate in their host countries. The third chapter comprises the preconditions for functioning and realisation of a selection of FZs in various countries, or country groups, accentuating successful zones, which therefore could be considered as role models. The fourth chapter provides an insight into accomplished direct economic benefits of Croatian FZs, and uncovers macroeconomic conditions

which determine their attractiveness and performed results. This is followed by a conclusion.

It should be mentioned that different national and international institutions define export-oriented areas with more liberal business environments in different manners (e.g. special economic zone, foreign merchant zone, export-processing zone), which causes difficulties in international comparison. On the other hand, there are common characteristics which are well reflected by the World Bank definition: "We define export processing zones as fenced-in industrial estates specializing in manufacturing for exports that offer firms free trade conditions and a liberal regulatory environment" (World Bank, 1992, p. 7).

According to the European Commission "FZs are parts of, or premises within, the European Community customs territory, separate from the rest of that territory, in which there is generally a concentration of activities related to external trade; whereas, because of the customs facilities available in them, these FZs ensure the promotion of the aforesaid activities and, in particular, that goods are redistributed within the Community and elsewhere; whereas, therefore, the provision concerning them forms an essential instrument of the Community's commercial policy"[1].

Bearing in mind that Croatian FZs are at the core of this paper, they should be defined according to the Croatian laws. Croatian Free Zones Act (Official Gazette No. 44/1996, Art. 2) stipulates: "A free zone is a part of the territory of the Republic of Croatia, particularly enclosed and marked, where business activities are performed under special and fixed conditions." The definition of the free zone according to the Free Zones Act is more appropriate for the free zone with industrial characteristics, which is a zone type that Croatia aspires to, and which should be dominant in Croatia.

2. COSTS AND BENEFITS GENERATED BY FREE ZONES

Taking into account the potential benefits generated by FZs, policy authorities worldwide have become extremely interested in their set ups and consequently, in attraction of investors. Since the investors will invest their resources and operate in the free zone only if the benefits generated by this location are significant and greater than costs, the authorities are trying to make the location especially attractive. In this context they set different tax incentives or tax exemptions as well as exemptions from customs for raw materials, intermediate inputs and capital goods needed for manufacturing. The incentives range from permanent tax holidays, waiving of all taxes, free repatriation of profits to the provision of infrastructure and exemptions from labour laws (Jauch, 2002). For review of the

[1] Council Regulation (EEC) on Free Zones and Free Warehouses, No 2504/88, June 25th, 1988

main advantages offered to companies in the selected FZs see Cling and Letilly (2001). Furthermore, doing business in a free zone usually is less bureaucratic. It is also beneficial taking into consideration lower costs for communication services and infrastructure (the use of the same is frequently subsidized). These discounts enable firms to cut the manufacturing and business costs and consequently, to make higher profits. But, some experiences (see for example World Bank, 1998) indicate utilities (water, electricity, sewage, and the like) should not be subsidized because such subsidies discourage economically rational use of resources and factors of production, undermine zones' benefits for host countries. Furthermore, the tax incentives should not to be overly generous, and indirect taxation as well as licensing should be rationalized and minimized.

Ever since FZs began to play a prominent role in the national economies in mid-1960s, the issues considering the costs and benefits of FZs have initiated a lot of debate (for review see Cling and Letilly, 2001). The motives underlying the start-up of FZs in Croatia have been derived from at least three favourable effects which they can bring about: employment effects, balance of payments effects and competitiveness effects (Borozan, 2006).

The beneficial employment effects of FZs occur when investments bring new jobs in the country (also in the region) that would not be created otherwise. New jobs can be created directly, through the start-ups, opening new branches or spreading the existed firms, i.e. by employment of new people. Employment effects arise also indirectly, through activating frozen resources located out of the zone. Zone firms usually outsource a part of their business activities that are not their core business and hence create networks of subcontractors. By doing so, the zone facilitates the increase in employment in these firms.

The beneficial effects of FZs on a country's balance-of-payments can be achieved in two ways. If the firms within the zone produce substitutes, i.e. products and services which have been imported, then the production will have favourable effects on the current account of the balance of payments. Because the trade deficit can be covered by selling assets to foreigners (sale of capital assets, real estate, stocks, bonds and the like), the need to sell national assets will be reduced. The multiplication of the positive effects on the balance of payments will be initiated also by the increase in exports of the national economy, i.e. by internationalization of firms located in the free zone.

The beneficial effects of FZs on the nation-competitiveness can be achieved through foreign direct investment, i.e. the phenomena of agglomeration and clusterization, transfer of high technologies and resulting progress in productivity, as well as through spillovers of knowledge, skills and good business practice on firms. Building human capital can be significant if previously unskilled workers benefit from job training and learning by doing (Rhee et al., 1990). In addition,

firms can learn from each other valuable skills and acquire new knowledge. They can learn more about managerial techniques and superior product and process technologies. Thus, they can improve their competitiveness, and because the national competitiveness is based on regional and micro-competitiveness, they can also improve the nation-competitiveness. The improvement of the country's competitiveness contributes to the acceleration of economic growth, improvement of living standard and resolution of many socio-economic problems. By intense international expansion, free zone can also contribute to the export-driven growth and lead to better integration of national economy into the global one. Providing infrastructure outside the zone (like telephony, roads, ports), they can have positive spillovers for the local and national economy by facilitating transportation and communications.

In contrast to the favourable effects and benefits that can be potentially realized by FZs, there are costs and unfavourable effects as well. Unfavourable effects and costs limit the benefits from the zone operating, making it more or less attractive instruments for goal achievement. One should point out, as unfavourable effects and costs generated by FZs, especially the adverse effects on the balance of payments, on employment, competitions and on government budget. These adverse effects are mostly connected to the adverse effects generated by foreign direct investments.

The possible adverse effects of free zone operating on a country's balance of payments position are twofold. First, deficit of the current account can be additionally worsened by repatriations of earnings to the parent firms located in foreign countries. A second concern arises when foreign investors base their manufactures on resources imported from abroad, which also results in a debit of the current account.

Adverse effects on home country's production arise when the zone investors manufacture products that are already manufactured in a home country. Because the manufacturer and in general firm operating in free zone is subsidized by many incentives, the costs of zone firms will be lower. This can endanger the competitive positions of other firms located outside the zone, leading to the reduction of their production, employment and in an extreme case to bankruptcy. Mexico experienced this case and the whole process became well-known as "maquiladorization" of the Mexican economy (ILO, 1998). Long run adverse effects on employment can result also in the case when jobs created through zones are of poor quality and are not cost-effective. Unfavourable effects on government budget arise from the smaller tax incomes, i.e. from tax incentives permitted by government to attract investors in free zone.

3. SELECTED FREE ZONES IN THE INTERNATIONAL ARENA

Because of the potential benefits FZs can generate, FZs market has become particularly competitive, and the economic outcomes that FZs effectuate – even though dependant on the zone type and goals brought upon them – are noticeably different.

The following text puts forward a selective representation of countries and zones which have proven to be fine role models, given their encouraging economic effects, economic efficacy, and sustainable economic growth, in a worldwide context. It is necessary to call attention to a vast variety of diverse zone-types (see FIAS, 2008; FATF, 2010), and to relative public non-transparency of the data on the effects generated by zones, which significantly obscures systematic comparison.

3.1. China

With the China's opening up to the World in 1979, and initiated political and economic reforms[2], special attention was called to establishing exclusive areas for encouraging foreign investments, named Special Economic Zones (SEZ), and shortly afterwards launching economic and technological zones on the coastline. Following the examples of Taiwan and Korea first Chinese SEZ was founded in Shezhen (near Hong Kong); zones in Zhuhai (near Macao), Xiamen (across Taiwan) and Shanto followed.

Shenzhen SEZ was founded near Shenzhen, a city with population over 8 million, and for the SEZ multiple locations were chosen, with area of 326 ha. Financial Action Task Force Report (FATF, 2010) states that 15 free market zones, 17 export production zones, 5 economic and technological zones, 15 high-tech development zones, and 15 borderline economic areas operate in this particular SEZ. The same Report asserts that this zone is characterized by the most liberal economic policy in the whole of Socialist China, which was a motive for inflow of many educated, ambitious, and young man and woman, as well as large multinational corporations such as Toshiba, Epson, Wal-Mart, Sony, IBM, etc. From the World's 500 largest companies 141 have already invested into this SEZ.

Consequently, an innovative business environment was created, and SEZ exhibits highly dynamic economic growth; for example: "from 1980 until 2005 average annual GDP growth in Shenzhen was no less than 27%" (Guo and Feng, 2007, p. 5). While evaluating economic effects of Shenzhen SEZ, Chinese President Hu Jintao pointed out: "The Shenzhen Special Economic Zone (SEZ)

[2] Prime Minister Chou Enlai (1898-1976) launched reforms known as "four modernisations", whose main goal was to quadruple gross domestic product (GDP).

created a miracle in the World's history of industrialization, urbanization and modernization, and has contributed significantly to China's opening up and reform" (China Daily, 2010), and as such has served as a pilot project for all future Chinese SEZs.

Furthermore, Ota (2003, p. 132) states that "China's SEZs represented a unique approach to economic development, inflow of foreign investment, and technology transfer for a country that had long advocated inward-looking self-containment policy under her socialist regime". In the mid-1980s additional 14 coastal cities were opened for foreign investors, and since 1992 all the province centres, and almost all large cities were opened up for them. Attracted by duty and tax privileges, but first and foremost by cheap labour force, many investors from the USA, Canada, Europe, etc. entered into joint-venture long-term business arrangements with Chinese companies. Entering into WTO in 2001 China began gradual legislative reforms, which regulate FZs operation, and motivation measures within Chinese FZs.

Free zone operating is considered to be an extremely important reason for China's transformation into technological and economic global super-power in the past two decades, which rapidly accepts the key role in the globalized World market (details at Ota, 2003; Sebastian, 2007). Moreover, results of Chinese FZs stimulated other, especially Asian countries for a more intense establishment and management of their zones.

However, the latter zones, for the most part, cannot compete with Chinese ones. Analysis has shown that such economic development of the zones, as well as their contribution to China's economic growth and development, is mostly a result of a liberal macroeconomic policy, trade policies, and regional alignments in general (Sebastian, 2007).

3.2. The USA

First Free Trade Zones (FTZs) in the USA began emerging in 1934[3] in the areas of free ports, where they allowed more liberal transport, manipulation, and warehousing of foreign goods. Until 1950 American custom tariffs protected domestic production, which limited the increase in the number of FZs. Liberalization of the custom tariffs (GATT) and other regulations enabled dynamizing of the international trade, which gradually brought up opening of the new zones in the USA as well. In the year 1980 Customs Service enacted a regulation which enabled production in the FTZs. This act, as well as the processes happening all over the World, lead to an increase of the number of FTZs from 98 in 1990, to 250 in 2009, located mainly in the export ports

[3] Legal framework is Foreign Trade Zones Act, 1934.

(Sardisco, 2010). Besides, there are approximately 450 special sub-zones situated next to companies that use goods from imported materials

3.3. The European Union

A concept of some form of FZs was known and utilized in Europe for centuries. Until accepting ten new member countries in May 1st, 2004 Free Warehouses and Free Trade Zones existed in EU.[4] In the beginning of the 1960s there was a sharp increase of the number of free trade zones in the area of the contemporary EU. Certain member states lured foreign investors by offering not only tax reductions, but the financial privileges as well (such as free land, free access to energy sources, reductions in municipal services prices, etc.). This lead to very high business-exchange growth rates, opening up a large number of new jobs in production, rapid increase in exports and decrease in imports, transformation of young, competent emigrants into immigrants, stable and safe budget incomes, etc.

Especially good results in the EU were presented by the Shannon Free Zone. It is a zone established in the 1959 in Ireland; an international business park which covers 243 ha of land next to Shannon International Airport. The largest cluster is situated there, with more than 100 companies, mostly Northern-American, which uses this zone as a bridge for penetrating foreign, mostly overseas markets. Currently there are about 7000 employees at the Shannon Free Zone, which in 2008 generated revenues of US$3.5 billion, almost solely in the services sector (Shannon Development, 2010).

Since 1990s only production for overseas markets was allowed in the European zones, which included FTZs in Hamburg (Germany), Canary Islands (Spain), and Azores and Madeira (Portugal); the rest were allowed only to package or pre-package goods. However, in the "old" EU members many FTZs still exist; according to the FIAS Report (2008) 10 of them in Denmark, 2 in Finland, 2 in France, 8 in Germany, 3 in Greece, 4 in Italy, 2 in Portugal, 4 in Spain (along with 1 free port), 4 in Sweden, 7 in Great Britain, and 1 in Ireland (plus 1 free economic zone).

3.4. Transitional countries of Central and Eastern Europe

After the collapse of the USSR and the socialist economic system in the late 1980s, almost all of the formerly Eastern block countries started opening up FZs. Through utilizing certain forms of FZs some of the countries achieved significant results in attracting foreign direct investments, and in transformation of socialism into market economy.

[4] Conforming to the Council Regulations (EEC) No. 2503/88, from July 25th 1988

During the process of transition these countries, while trying to attract foreign direct investments, mostly developed a model of special business areas with some traits of FZs. Their characteristics were: defined area of operation, high-quality infrastructure, free aid in investment actuation, and financial and fiscal grants. The most significant representatives of the transitional countries which used FZs are Poland and Hungary.

Poland

In order to remove negative effects of the transition, 14 Special Economic Zones (SEZs) were set up in Poland until 1994, and each of them had its own sub-zones. SEZs were separated, but neither detached nor enclosed parts of Polish territory, where privileges were offered for both domestic and foreign entrepreneurs, such as: exceptions from duties and fees, as well as from profit-taxation, co-financing investments, land suitable for building production plants with all necessary infrastructure at discount prices, aid with all the administration formalities in regard to the investment, real-estate taxation exemptions, grants for opening new jobs, grants for additional education or professional retraining, etc. (Commercial and Economic Section, 2010). Investor was obliged to conduct business in the SEZ and to be the owner of the facilities for at least 5 years.

Pomeranian Special Economic Zone has proven to be especially successful in its operations. This zone was established in 2001 by merging two zones: Zarnowiec Special Economic Zone and Tczew Special Economic Zone; it includes 17 sub-zones with the area of total 1,162 hectares, in three different Polish regions (provinces). In the middle of 2007 sixty operating licenses were authorized. In these businesses 870 million US dollars were invested, 13,866 jobs will be created, and the zone will function until 2017 (Pomerania Development Agency, 2010).

Until the accession to the EU in 2004, SEZs were probably the most important ways to attract foreign direct investments. Party because of the good results of the SEZs Poland became the regional economic leader, and leader in attracting foreign direct investments.

By the end of the year 2005, 112,168 jobs were created in SEZ, and in 2006 150 operating licenses for new investors were authorized, which led to additional 21,379 jobs (PAIZ, 2006). In late 2007 SEZs enclosed the area of about 7,500 hectares, with the possibility of expansion to 12,000 hectares (KPMG, 2009). According to the EU regulations SEZs can operate in Poland until the end of 2020.

Hungary

Prominent roles in the transition processes and the acceleration of the economic growth in Hungary were held by privatization processes and the

foreign direct investments. According to Guagliano and Riela (2005) besides privatization, Hungary attracted foreign investors by developing three forms of FZs, those being commercial FZs (customs warehouses), industrial free trade zones, and industrial parks.

Industrial free zones started operating in 1982 with the official goal of attracting export- and high-tech-oriented foreign investments. Every company that acquired licences from the customs and financial authorities could set up its own industrial free zone. The area of the industrial free zone was completely unrestricted. Companies are exempt from paying customs for goods and merchandize used for their own account. These were the reasons for, according to Guagliano and Riela (2005, from Antalóczy and Sass, 2001; Szalavetz, 2004), rapid growth of the number of companies doing business in industrial free zones, and of the volume of their business activities, which lead some of them to highest places in export-, profit-, and trade-of-goods rankings.

Getting closer to the EU created a need for a new, more modern framework, which would allow for a continued economic growth. Even though a large part of the greenfield investments could have been achieved through industrial free zones, multinational companies and local governments started founding industrial parks. First industrial parks were open in 1992 in the cities of Györ and Szekesfehervar. Despite the central government being aware of the importance of industrial parks in attracting foreign investments, it took 7 to 10 years for them to really start operating (Guagliano and Riela, 2005). By the end of the 2007 there were about 200 industrial parks, in various stages of operation, which were situated on 12,500 hectares of land with high-quality infrastructure. Some 199,000 people worked there. During that year production companies in industrial parks generated exports worth 19.72 billion Euro (Hungarian Investment and Trade Development Agency, 2010).

Other transitional countries of Central and Eastern Europe

Other transitional countries of Central and Eastern Europe had incomparably weaker development processes of FZs. In order to attract foreign, but also domestic investors the Czech Republic was developing free economic zones (FEZs), special economic zones (SEZs), and later also industrial parks. Slovakia allowed the founding of special economic zones in 2001, with the financial help of the central government. Some 85% of the investors' expenses for land purchasing and building infrastructure in industrial parks are financed by the Government, and that portion rises to even 95% in regions where unemployment rate is higher than 10% (Vidova, 2010). The Baltic countries also founded FZs to attract foreign investors, but without significant success. Some transitional countries, such as Slovenia or Romania, used FZs to facilitate manipulation of goods in transit in larger sea-, air-, or river ports.

During EU accession negotiations every candidate for membership has, according with its legislation and economic interests, done its best considering the allowed length of the period during which aforementioned zones will exist unchanged, however, in line with the EU regulations. After that period, they should either function as free economic zones focused on cooperation with countries overseas, or stop doing business in the form of FZs and transform themselves into economic zones, whose particular final form will depend on the development level of each specific zone.

4. DIRECT ECONOMIC BENEFITS OF THE FREE ZONES IN THE REPUBLIC OF CROATIA

4.1. Free zones in the Republic of Croatia since 1991

The Republic of Croatia has in 1991 enacted the first Free Zones Act (Official Gazette, No. 053A/1991), which was modelled after similar legislation of countries whose zones generated notable economic results. However, instead of consistent application of the Act, followed by investor support, the Government has in 1993 and in 1994 enacted multiple directives with legislative powers equivalent to acts, by which it outlawed key incentives for new investments.

In 1996 the Croatian Parliament enacted a new Free Zones Act (Official Gazette, No. 44/96). It considerably reduced financial incentives for investments in free zone areas, compared to the previous Act, as well as compared to incentives from similar Free Zones Acts in neighbouring transitional countries. Besides, in 1999 a new Customs Act was enacted (as well as its amendments; Official Gazette No. 78/99, 94/99, 117/99, 73/00, 92/01, 47/03, 140/05, 138/06, 60/08), which noticeably reduced incentives in the area of liberalization of the exchange of goods in the FZs, which additionally shrunk their competitiveness when compared to FZs from the competition countries. From today's perspective, FZs are regulated by the Free Zones Act, which was amended and changed twice (Official Gazette, No. 44/96, 92/05 and 85/08).

Since 1996 in the Republic of Croatia 17 new FZs were founded, 13 of which have succeeded to begin functioning. Some of these FZs are completely or mainly assigned as a function of sea ports, or are situated on important land routes, and therefore serve to facilitate manipulation, warehousing, and exchange of custom-cleared goods. These are Free Zone Zagreb, Free Zone Ploče, Free Zone Split, Free Zone of the Port Rijeka, and Free Zone Pula. However, in some of them, such as Free Zone Zagreb, some production processes are also taking place (Eurocable Group PLC is producing electric cables, Siemens PLC does its research and development, and produces industrial thermometers, pressure sensors, etc.). Free Zone Pula is another example, where company Pola-Textile makes textile products for the Benetton Croatia LLC, situated in the city of Osijek.

Another group of the founded FZs had weak performance in attracting foreign investors, did not manage to finalize (or have not even seriously began) the activities concerning attracting foreign investors to the free zone (e.g. Krapinsko-Zagorska Free Zone, Free Zone Kukuljanovo, Free Zone Obrovac, Free Zone of Splitsko-Dalmatinska County, Free Zone Bjelovar and Free Zone Ribnik). For some, foreign investments in the zone have failed (e. g. Podunavska Free Zone).

Only three FZs, namely Free Zone Varaždin, Free Zone Đuro Đaković in Slavonski Brod, and Free Zone Osijek have succeeded to significantly attract foreign investors, which have established their production plants in the area of the zone.

4.2. Direct economic benefits generated by Croatian free zones

Even though many founders of Croatian FZs express their satisfaction with obtained results, and tend to show off their accomplishments and present them as outstanding and exemplary, in order to evaluate them properly it is necessary to quantify them and compare them with the results of similar institutions in other countries. However, the data about zone achievements are non-transparent. In addition, comparable analytical framework which would enable identification, empirical quantification, and standardized comparison in international context is lacking (see Sawkut et al., 2009). The most important criteria for evaluating FZs arise from the very purpose of establishment of FZs. Cling and Letilly (2001) present four widely defined reasons for establishing and developing FZs, those being: backup and support in implementation of economic reforms strategies, opening workplaces, experimental laboratory for application of new policies and approaches, and attracting foreign investments.

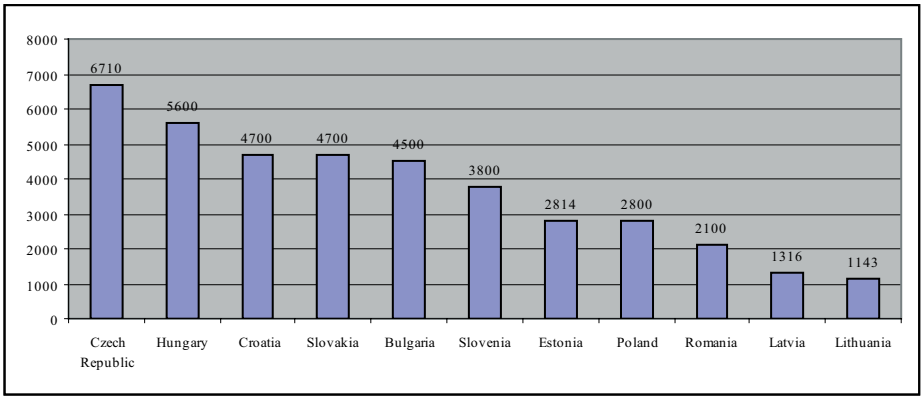
This paper gives special attention to evaluating benefits and contributions of FZs in attracting foreign direct investments and opening new jobs. On the other hand, it is important to emphasize, as Borozan (2006) did, that the experiences accumulated from the zones indicate that the efficiency of an operating zone should not be measured only by the number of the zone clients, the number of newly created jobs, and by the export numbers of the zone firms, but also by the contribution of the zone in creating the region's overall value added, in the increase in intellectual capital and in the improvement of the region's competitiveness. It is equally important how much zone contributes to the increase in the quality of life and economic prosperity of the region in general. Actual width of the economic benefits from the Croatian zones can be estimated only by taking into account the long-term relations between the costs and benefits (considering also ecological, economic, social, and other dimensions).

Unfortunately, a comprehensive study which would evaluate static and dynamic effects of FZs was not done on Croatia. A step in that direction was

performed within the CARDS project entitled "Strategic Plan for the Long Term Development of existing FZs in Croatia" (2006), when the managements of all existing FZs in Croatia were interviewed and the FZs surveyed to gather information on each free zone, in order to obtain an insight into their ongoing activities and future plans (see Kelleher and Budak, 2006). Sporadic studies are also rare, for instance Klepo (2005) made a brief analysis of the Croatian FZs, and the detailed analysis of one of them, the Osijek Free Zone. Exploration of costs and benefits generated by the Osijek Free Zone in comparison with the most successful Croatian FZ, the Varaždin Free Zone, was made Borozan and Klepo (2007). The main causes for that lie in insufficient transparency of the zones' business, and consequently obscureness of the data that would serve as a basis for such an analysis, and in indifference of the management of most Croatian FZs, as well as in their unwillingness for cooperation in such studies.

According to the Croatian National Bank, in the period from 1993 to second quarter of 2010 Croatia attracted a total of 24.7 billion Euro of foreign investments, which makes it better ranked that many European transitional countries. Direct investments per capita are also higher in Croatia than in many transitional countries. The data in Figure 1 show this in more detail.

Figure 1: Cumulative per capita foreign investment 1993-2009 in selected countries (in USD)



Source: Croatian National Bank, www.hnb.hr/publikac/prezent/spf.../fdi_per_capita.xls (accessed August 18th, 2010)

However, it is disturbing that the biggest foreign investments in Croatia were actually brownfield investments, or as some economists have named them "selling off family silver". In that period, virtually the whole banking sector was sold to foreign buyers (15 billion Euro were spent on financial reorganisation and recovery of banks, which were then sold to German, Austrian and Italian buyers for about one billion Euro), Croatian telecommunications company

(51% share sold to German DT for 1.273 billion US dollars), INA, the national oil company (47.1% share sold to Hungary's MOL for 9.6 billion kuna) and Pliva, pharmaceutical company (72.67% share sold to the American company Barr for 15.25 billion kuna).

According to the Croatian National Bank, in the observed period the manufacturing sector accounted for 24.8% of total foreign investments, or, if Pliva and Ina are excluded, for only 11.38%. During the whole post-war period that was analyzed, there were no large greenfield investments. All of them were smaller in scale, both in terms of value and the number of jobs. The largest greenfield foreign investment in FZs (and also outside them) is the one by the Austrian company Boxmark, which has a plant in the free zone Varaždin producing leather seats for car and aircraft industry, as well as for furniture industry. The value of this investment as of 31 December 2009 was 16.5 million Euro, and the plant employs 2,213 people. In 2009 the total production was worth 1,217,299,669.00 kuna, with 90% intended for export.

According to the Ministry of the Economy, Labour and Entrepreneurship, on 1 January 2007 FZs were employing 5,737 people in total. The data presented in the Policy guidelines for the development of FZs in Croatia in the period 2007-2013 (2007) indicate that total investments in FZs amounted to1.27 billion kuna before the document's publication. Out of the total number of 223 registered beneficiaries, 58 have 5,378 employees (Starc i Budak, 2009). For the sake of comparison, in approximately the same period, Poland had almost 200,000 jobs in its special economic zones. Hungary was at the same level with its special economic zones and industrial parks. Furthermore, according to the Ministry of the Economy, Labour and Entrepreneurship there were 13 active FZs in Croatia with more than 263 beneficiaries operating in them and employing 8,347 people (Kekez, 2010). These zones cover the total area of 550 hectares, and still contain 72 hectares of free land available to prospective users. The same source claims that free zone beneficiaries mostly belong to small and medium enterprises, which earn a high proportion of their revenue from production – more than 50 per cent. Manufacturing industries most frequently encountered in Croatian FZs are metalworking and textile industries, rubber products, parts and equipment for car industry, food processing, machines, wood processing, electrical equipment, shipbuilding, as well as warehousing and wholesale trade.

Taking into account static and direct indicators, i.e. foreign direct investments as well as the number and type of newly created jobs, it can be concluded that zones have achieved certain positive economic results in Croatia, but there are a number of less desirable effects:

- the zones in Croatia have fulfilled the fears of free zone critics, primarily those that claimed that zones tend to be the manufacturing site related to low-tech, low-skill, and foot-loose activities,
- some employers in certain zones suppress basic labour rights and pay little attention to environmental protection,
- by employing low-skilled labour the zones have contributed to postponing major economic reforms that should have been undertaken by macroeconomic authorities,
- ultimately, foreign investors are not particularly impressed either with short-term or long-term incentives, i.e. with advantages of doing business in Croatia in general, including Croatian FZs.

In exploring the results of FZs in Croatia, Kelleher and Budak (2006) highlight some interesting points. First, FZs in Croatia are dispersed, rather small and lack adequate space to attract new investors. Second, the management of most FZs has neither resources nor the skills to finance the zone's development, its marketing activities, or to improve the services for the beneficiaries, to create business plans and the like. Last but not least, there is a heavy dependence on own funds for capital investment. Starc and Budak (2009) add to this weak support by state agencies, public administration and local community. Zone management and zone beneficiaries both believe that the legislation is quite straightforward but there is no coordinated policy of free zone development in Croatia. In conclusion, the reasons for such modest results lie not only in specific features of the zones and the chosen zone management model, but also in the fundamental characteristics of the local and macroeconomic environment in which each zone is functioning (Klepo, 2005, Borozan, 2006, Borozan and Klepo, 2007). The following text will focus on uncovering macroeconomic conditions that can determine how attractive FZs will be to investors and for doing business in FZs.

4.3. Macroeconomic conditions in the context of attracting foreign investors to free zones

In the World Economic Forum's Global Competitiveness Report 2009-2010 (WEF, 2009) Croatia ranked 72nd among 133 countries under observation. In only one year Croatia's ranking dropped by 9 places. According to this report, Switzerland is in the first place, followed by the USA, Singapore, Sweden, Denmark and Finland. All the comparable countries in the region are more competitive than Croatia, thus the Czech Republic is 31st, Slovakia 37th, Poland 46th, Slovenia 47th, Hungary 58th, and Romania 65th. Only a handful of countries are ranked lower than Croatia: Bulgaria is 76th, Serbia 93rd and Bosnia and Herzegovina 109th. As can be seen in Table 1, the most problematic factors of doing business in Croatia are those that have an impact on investor's choice of location.

Table 1: Problematic factors of doing business in Croatia according to the Global Competitiveness Report 2009-2010

Problematic factors of doing business	%	Problematic factors of doing business	%
Inefficient government bureaucracy	20.0	Inadequate supply of infrastructure	4.5
Access to financing	16.7	Political stability	1.8
Corruption	15.7	Inflation	1.7
Tax regulations	9.2	Crime and theft	1.1
Tax rates	8.5	Foreign exchange regulations	1.0
Restrictive labour legislation	7.1	Poor public health	0.6
Inadequately educated workforce	6.0	Government instability	0.3
Poor work ethic in national work force	5.7	Total	100.00

Source: The Global Competitiveness Report 2009-2010, World Economic Forum, Executive Opinion Survey

Note: this table shows the most problematic factors of doing business according to Croatian business leaders that were involved in the Executive Opinion Survey. Respodents were asked to pick the five most problematic factors that impede business in their country from a list of 15 factors and to rang them from 1 (the most problematic) do 5. Results are than evaluated according to the respondents' rangs.

In spite of overstaffed, too costly and inefficient state administration which fails to provide value for money, the Government is still reluctant to implement comprehensive reforms of public administration and territorial reorganisation. Neither the steps undertaken nor those announced can be a source of optimism. As foreign banks had acquired majority ownership of the banking sector, banks were reorganised and contributed greatly to the stability of the whole system. However, access to financing is high on the list of problematic factors of doing business in Croatia. To this one might add high banking fees that lead to a weakening economy and impoverished citizens, whereas banks manage to earn disproportionately high profits. Corruption is a burning issue in Croatian society, closely connected with the biggest problem, i.e. state bureaucracy. Although certain measures have been put in place to fight corruption, the results are still unsatisfactory, and the Government is expected to take concrete steps and show consistency in anti-corruption efforts, beginning with its own administration. Understandably, tax regulations and tax rates are closely related; the general view is that tax regulations are complicated, too frequently changed, allowing for a number of exemptions, whereas tax rates are partly responsible for high labour costs and excessive production costs.

The World Bank Report "Doing Business 2010" confirms that Croatian macroeconomic environment is unattractive to investors. According to this report, which takes into account ten important conditions for business operation

in 183 countries, Croatia is ranked quite low at 103rd place. Here are some specific rankings:

- in starting a business, Croatia ranks at place 101, with seven mandatory steps that take 22 days,
- in dealing with construction permits, there are 14 procedures and 420 days required, which puts Croatia in place 144,
- as for registering property, five procedures and 104 days put the country in place 109,
- in terms of enforcing contracts (after commercial disputes), Croatia is 45th country in the world.

The report highlights that Croatia managed to reform only one of the ten topics under consideration, as it has reduced the time necessary to obtain a construction permit.

Attracting foreign investments is part of development strategy in most countries, in both developed and developing economies. UNCTAD (1996) also states that the aim of economic policy measures is indeed to attract foreign companies by providing economic benefits, which should encourage them to behave in a certain way. According to UNCTAD (1996), these measures fall into two groups: those intended to increase the yield generated by individual direct investment, and measures intended to decrease (or spread) the costs or risks of individual direct investment. The second functional division, as defined by UNCTAD, lists a range of incentives according to macroeconomic policy that formulates them.

Croatia has been using fiscal incentives to attract foreign investment (exemption from VAT for a period of time or decreased VAT, signing double taxation agreements, allowing import tax exemption on capital goods, etc.) and occasionally financial incentives (providing companies with finance to cover part of their investment).

Among a number of regional associations, the EU is the only one that explicitly regulates the control of state incentives in its member states. According to the EU principles, state incentives and subsidies disrupt the free and impartial competition policy, thus limiting the functioning and development of the single market. For this reason the EU has set up rules that allow member states to apply state subsidies only exceptionally. Given the large number and range of permitted subsidies it is clear that the main motive for controlling state subsidies at the EU level is not abolishing or banning such measures, but the aim is rather to minimize the unnecessary disruption of market competition in the EU. In order to harmonize incentives that are possible pursuant to the Free Zones Act with the

EU Stabilisation and Association Agreement (Article 70 – Market competition and other provisions) and the EU acquis, the Croatian Parliament passed the Amendments to the Free Zones Act on 9 July 2008. By these last amendments the incentives for existing investors in FZs are decreased gradually, in three steps. The pace of incentive decreases depends on the level of economic development attained in the region where a particular free zone is situated. For the purpose of incentive differentiation this Act has divided Croatia into three different regions (Noth-West, Pannonian and Adriatic Croatia) and the town of Vukovar. It is envisaged that incentives pursuant to the Free Zones Act will be completely abolished by the year 2017. After that all the investors in Croatia, including those in FZs, will be eligible for incentives pursuant to the Investment Incentives Act (Official Gazette 138/06), which is completely harmonized with the EU acquis regarding regional investment incentives provided by the government. Incentives according to the 1998 Free Zones Act and the 2008 amendments are given in Table 2.

Table 2: Comparison of the 1998 Free Zones Act and the Amendments to the Free Zones Act of 2008

	1998 Act	2008 Amendments to the Act		
Period / Area	Whole Croatia	North-West Croatia	Pannonian Croatia Adriatic Croatia	Vukovar
2008 – 2010	0% or 10%*	0%** or 10%	0%** or 10%	0%**
2011 – 2013	0% or 10%*	0%** or 15%	0%** or 15%	0%** or 5%
2014 – 2016	0% or 10%*	0%** or 20%	0%** or 20%	0%** or 15%
2017 -	0% or 10%*	0%** or 20%	0%** or 20%	0%** or 20%

Source: KPMG Croatia, www.kpmg.hr/dbfetch/.../link3_zone.pdf

* Pursuant to the 1998 Act, any free zone beneficiary was eligible for a reduced corporate income tax of 10%. However, if a beneficiary had invested more than a million kuna in infrastructure within the free zone, they were eligible for a 0% corporate income tax in the period of five years, not exceeding the amount of their investment.

** Pursuant to the 2008 amendments, if a free zone beneficiary invests more than a million kuna in infrastructure within the free zone, they are eligible for a reduced corporate income tax of 0% in the period until the maximum level of investment incentives is used up (as foreseen in the regional investment map). This period will end on 31 December 2016 at the latest.

For the most part, Croatia has used the same incentives to attract foreign direct investments as many other countries, including the neighbouring countries in transition. One of the fiscal measures is exemption from corporate income tax or its reduced rates. Many politicians believe that taxes are crucial for drawing

foreign direct investment. Consequently, many countries have reduced their corporate income tax rates. For example, according to KPMG International[5], in the period 1993-2006 the average corporate income tax rate was reduced by 28.7%. Nevertheless, there is no evidence around the world that tax rate is a critical determinant in deciding on a location (Jensen, 2006), and the same goes for Croatia. A certain proportion of free zone beneficiaries in Croatia have used up possible incentives partially or to the full amount, whereas others have not used incentives at all. In the period 2001-2005 the total amount invested in FZs was 1,953,662,289 kuna, and tax incentives claimed amounted to only 188,539,857 kuna (Ministry of the Economy, Labour and Entrepreneurship, 2008). Additional confirmation of the thesis that tax rates alone are of minor importance is the fact that the Czech Republic, with the highest corporate income tax rate (26%) among the observed transitional countries has attracted the biggest share of foreign investment over the past fifteen years, whereas Lithuania, Latvia and Romania, the countries with the lowest foreign inflow, boasted the lowest tax rates (15% and 16% respectively; see Pavlović, 2007). Multinational corporations definitely prefer lower taxes, and with other conditions the same, they will invest in lower-tax countries. However, low taxes by themselves will not have a significant impact on additional inflow of foreign capital.

In addition to fiscal measures, the Croatian Investment Incentives Act provides for financial incentives for large projects of general economic interest, the value of which exceeds 15 million Euro and with more than 100 newly created jobs. There are also incentives for newly created jobs that will employ people registered as unemployed with the Croatian Employment Service. Such measures are quite customary in many transitional countries. If we compare Croatian incentives pursuant to the Free Zones Act and the Investment Incentives Act with financial incentives used by e.g. the Slovakian government to co-finance the initial investment (up to 95% of land purchase and infrastructure costs in industrial parks in the regions with unemployment over 10%), it can be concluded that Croatian incentives are not very competitive.

All the above indicates that a zone's efficiency and effectiveness will depend on synergistic effects of a location rather than on separate policies when it comes to macroeconomic conditions (see Navaretti and Venables, 2006; Pavlović, 2007).

5. CONCLUSION

FZs are one of the rare special instruments of economic policy that enabled a large number of countries to experience a dynamic economic growth and faster resolution of economic difficulties, without substantial state investments or risks.

[5] KPMG International provides analyses of income tax rates since 1993, encompassing 86 countries.

This is confirmed by brief descriptions of FZs in China, the USA or the EU (Ireland, Poland, Hungary) as presented in this paper.

In the area of today's Republic of Croatia, the institutes of free customs zone and free zone have been applied since 1961. In contrast to free customs zones in Croatia, which attracted large amounts of transit goods to sea and river ports and thus promoted their development, FZs failed to fulfil the high hopes vested in them, such as helping in transition from the socialist to the market economy, accelerating the country's economic growth, or solving some of the numerous macroeconomic problems (e.g. unemployment and twin deficit). This is in spite of the fact that as many as 17 FZs have been established since 1996. Taking into account static and direct indicators, i.e. foreign direct investments as well as the number and type of newly created jobs, it can be concluded that zones have achieved certain positive economic results in Croatia. However, there are a number of tradeoffs associated with them: (1) they have predominantly been the manufacturing site related to low-tech, low-skill, and foot-loose activities; (2) some employers in certain zones suppress basic labour rights and pay little attention to environmental protection; (3) the zones have contributed to social peace by employing low-skilled labour, but this has postponed major economic reforms that should have been undertaken by macroeconomic authorities; (4) finally, foreign investors are not particularly impressed either with short-term or long-term incentives, i.e. with advantages of doing business in Croatia in general, including Croatian FZs.

The reasons for such modest results lie not only in specific features of the zones and the chosen zone management model, but also in the fundamental characteristics of the local and macroeconomic environment in which each zone is functioning. The facts that follow can account for this statement in more detail. Croatia has managed to attract considerable foreign investments in the past period. These investments were mostly directed to services (financial services and telecommunications) and buying shares in successful industries such as pharmaceuticals and oil. Although the total amount of foreign investments was respectable, Croatia failed to attract greenfield foreign investors, i.e. those that would channel their resources and know-how into new, large manufacturing plants with advanced technologies, whose production would be export-oriented. Such investments were lacking both in FZs and elsewhere.

Although the number of employees in FZs have increased (from 5,534 in 2005 to 8,347 in the year 2010), this growth is insufficient to make any significant changes in unemployment rates in Croatia or to turn around negative economic trends. Given the status of a candidate country and the agreement with the EU regarding the transitional period for the current way of free zone functioning, it can be assumed that their contribution will not improve. On the contrary, it can be argued that FZs are an obsolete business model with short life span.

In order to keep the current investors and to attract new ones, several urgent measures are required, such as improving the quality of macroeconomic business conditions, encouraging local authorities to improve local business conditions, as well as choosing an adequate zone management model. Furthermore, recruiting high performers and professionals with leadership qualities would help zones to operate properly, without political pressures or party politics. At the same time, Croatia ought to pass measures that would enable FZs to be transformed into industrial parks or other forms of business zones.

REFERENCES

Borozan, Đ.: Challenges to the Assessment of Beneficial Effects Generated by Free Zone: Lessons from Croatia, International Journal of Business Research, Vol. V, No. 1, 2006, pp. 15-20.

Borozan, Đ., Klepo, Ž.: Free Zone – The Source of Socio-Economic Benefits, in: Interdisciplinary Management Research III, Barković, D., Runzheimer, B. (eds), Faculty of Economics in Osijek, Hochschule Pforzheim, University of Applied Sciences, 2007, pp. 75-91.

CARDS project: Strategic Plan for the Long Term Development of existing FZs in Croatia, 2006.

China Daily: Hu Hails Shenzhen SEZ a World 'Miracle', 7.09.2010, China.org.cn, http://www.china.org.cn/china/2010-09/07/content_20875572.htm (assessed October, 28th, 2010)

Cling, J.-P., Letilly, G.: Export Processing Zones: A Threatened Instrument for Global Economy Insertion? Document de Travail, DT/2001/14, 2001.

Commercial and Economic Section of the Consulate General of the Republic of Poland in Guangzhou: Special Economic Zones (SEZ),

http://www.polandguangzhou.com/en/content/280.htm (assessed October, 28th, 2010)

Council Regulation (EEC) on on Customs Warehouses No. 2503/88, from July 25th 1988; on Free Zones and Free Warehouses, No 2504/88, June 25th, 1988; on Establishing the Community Customs Code, No. 2913/92 of 12 October 1992

Customs Act, Official Gazette 78/99, 94/99, 117/99, 73/00, 92/01, 47/03, 140/05, 138/06, 60/08

FATF (Financial Action Task Force) Report: Money Laundering Vulnerabilities of Free Trade Zones, Paris, March 2010.

FIAS: Special Economic Zone: Performence, Lessons Learned, and Implications for Zone Development, The World Bank, Washington, April 2008

Free Zones Act, Official Gazette 053A/1991; Official Gazzete 44/69, 2/05, 85/08

Guagliano, C., Riela, S.: Do Special Economic Areas Matter in Attracting FDI? Evidence from Poland, Hungary and Czech Republic, ISLA, 2005.

Guo, W., Feng Y.: Special Economic Zone and Competivnes, Case Study of Shenzhen, PRC, Asian Development Bank, Pakistan Resident Mission, Islamabad, Series No. 2, November 2007.

Hungarian Investment and Trade Developmen Agency: Industrial Parks in Numbers, http://www.itdh.com/engine.aspx?page=Itdh_IndustrialParks (assessed July, 25th, 2010)

ILO (International Labour Organization): Export Processing Zones: Addressing the Social and Labour Issues, 1998.

Investment Incentives Act, Official Gazette, 138/06

Jauch, H.: Export Processing Zones and the Quest for Sustainable Development: A Southern African Perspective, Environment and Urbanization, Vol. 14, No. 1, April 2002, pp. 101-113.

Jensen, N.M.: Nation-States and the Multinational Corporation, Princeton, New Jersey, Princeton University Press, 2006.

Kelleher, T., Budak, J.: Strategic Plan for the Long Term Development of Existing Free Zones in Croatia, REPORT - Survey Completed by Free Zone Management, Zagreb, November 8th, 2006.

Kekez, I.: Slobodne zone: Manji troškovi poslovanja i nova radna mjesta, Vjesnik online, March 13, 2010, http://www.vjesnik.hr/html/2010/03/13/Clanak.asp?r=gosandc=1

Klepo, Ž.: Slobodna zona – pokretač gospodarskih aktivnosti i poduzetničkih prilika, master thesis, Faculty of Economics in Osijek, Osijek, 2005.

KPMG: A Guide to Special Economic Zone in Poland, 2009.

Ministry of the Economy, Labour and Entrepreneurship: Policy guidelines for the development of FZs in Croatia in the period 2007-2013, draft, August 24th, 2007.

_____ Prijedlog zakona o izmjenama i dopunama zakona o slobodnim zonama s konačnim prijedlogom zakona, Zagreb, June 2008

Navaretti, G.B., Venables, A.J.: Multinational Firms in the World Economy, Princeton, New Jersey, Princeton University Press, 2004.

Ota, T.: Industrial Policy in Transitional Economy: The Role of China's Special Economic Zone in Economic Development (Part I), 2003.

PAIZ: Investment Incentives Available to Investors in Poland, Warsaw, November 2006.

Pavlović, D.: Utjecaj visine poreza na dobit na priljev inozemnih izravnih ulaganja, Ekonomski pregled, 58 (11), 2007, pp. 732-748.

Pomerania Develoement agency Co.: Special Economic Zones, http://www.arp.gda.pl/index.php?strona=310 (accessed October 8th, 2010)

Relić, M.: Valorizacija institucije slobodnih zona u gospodarstvu Republike Hrvatske, Ph.d. thesis, Faculty of Economics, Zagreb, 1998.

Rhee, Y.W., Katterbach, K., White, J.: Free Trade Zones in Export Strategies, Industry Series Paper 36, World Bank, Washington D.C., 1990

Sardisco, R.: Free Trade Zones in the United States, May 5, 2010, eHOW portal, http://www.ehow.com/list_6463325_trade-zones-united-states.html (accessed October 8th, 2010)

Sawkut, R., Vinesh, S., Sooraj, F.: The Net Contribution of the Mauritian Export Processing Zone Using Benefit-Cost Analysis, Journal of International Development, Vol. 21, No. 3, 2009, pp. 379-392.

Sebastian, M.: Role of Trade and Macroeconomic Policies in the Performance of Special Economic Zones (SEZs), Indian Institute of Management Ahmedabad, Research and Publication Department, series IIMA Working Papers, No. WP2007-09-02, 2007.

Shannon Development: Why Invest in Shannon, Ireland, http://www.shannonireland.com/ (accessed October 8th, 2010)

Starc N., Budak J.: Nekoliko pitanja o slobodnim zonama Republike Hrvatske i jedan odgovor, Ekonomska misao i praksa, No. 1, 07.2009.

UNCTAD: World Investment Report, 2006.

Vidová, J.: Industrial Parks – History, Their Present and Influence on Employment, Vol. X, No. 1, 2010, pp. 41-58.

World Bank: Export Processing Zone, Industry and Development Division, 1992.

____ Export Processing Zones, PREM notes, Economic Policy, No. 11, December 1998

____ Doing Bussiness 2010, http://www.doingbusiness.org/economyrankings/

World Economic Forum (WEF): The Global Competitiveness Report 2009–2010, 2009.

MONETARY TRANSMISSION MECHANISM IN NIGERIA
(Additional Evidence)

Nwosa Philip I., M.Sc.
Assistant Lecturer
Bells University of Technology Otta
Deparment of Economics
Ogun State, Nigeria
e-mail: nwosaphilip@yahoo.com

Saibu Olufemi M., Ph.D.
Senior Lecturer
Obafemi Awolowo University Ile-Ife
Department of Economics
Osun State, Nigeria
e-mail: omosaibu@yahoo.com

Abstract

The study examined the various the transmission channels of monetary policy impulses on economic growth in Nigeria. This was with a view to examining the relative effectiveness of the various channels in transmitting monetary policy impulses to real output for the period 1986 to 2009. Using the Vector Auto-regressive (VAR) method of analysis, the result showed that the bank credit channel was most effective in transmitting monetary policy to aggregate output in Nigeria. Other channels (interest rate, exchange rate and asset price) appeared weak in transmitting monetary policy impulses in Nigeria. The study concluded that bank credit channel is most effective in transmitting monetary policy in Nigeria.

Keywords: *transmission channel, asset price channel, bank lending channel, exchange rate channel, interest rate channel, VAR model.*

1. Introduction

Over the past decades, theorist have evolved on the effect of monetary policy on real output. The classical viewed monetary policy as effective in stimulating real output in the short run while in the long run its impact on economic growth is assumed to be neutral. To Keynes, a change in money supply permanently influences macroeconomic variables in the long run by altering the rate of interest and through the marginal efficiency of capital, investment is stimulated

and output is influenced (Molho, 1986; and Athkorala, 1998). In contrast to the Keynesian, the financial liberalization school of thought posit that a higher interest rate would enhance more investment by channelling saving from to more productive investment and stimulate activity in the real sector. This group further argued that a repressed interest rate discourages investment and causes financial crises in the financial sector and consequently declining the level of economic activity (McKinnon, 1973; and Shaw, 1973). Despite these diverging views on the effect of monetary policy on real output either in the short run or in the long run, there seems to be an increasing debate among monetary economists and policy makers on the precise channel through which monetary policy impulses are being transmitted to the real sector.

In Nigerian, government has adopted various monetary policy measures oscillating mainly between the theories of the Keynesians and financial school of thought. The effect of these policies on the Nigeria economy has been investigated by Anyanwu (1993), Bogunjoko, (1997), Nwaobi (1999), Saibu (2001; 2006), Akinlo (2007) and Chimobi and Uche (2010). However, these studies failed to take into cognizance the transmission channels through which such policies impulses are transmitted into the economy. A proper understanding of how policy shocks are transmitted, in terms of describing the exact channel through which monetary policy affect output is key to proper assessment of the effect of monetary policy on economic growth. Also previous studies on monetary transmission mechanism in Nigeria (see Oyaromade (2002); Adebiyi (2006), Ogun (2006) and Uchendu (1997)) have focused on few channels, neglecting the asset price channel in transmitting policy impulses to the real sector.

Acknowledging, the indispensable role of the stock market in emerging countries in capital mobilization and the recent growth of the Nigerian stock market, it is therefore important to examine the significance of the asset price channel in transmitting policy impulses to the real sector. Furthermore, none of the aforementioned studies has painstakingly examined all possible transmission channels in a study. This is important for a comparative analysis of the relative effective of the different channels to enhance effective policy implementation by the monetary authority. It is against this background that this study addresses this issue.

This study is divided into five sections. Section one is the introduction. Section two is the literature review while section three presents the methodology of the study. Section four presents the empirical results of the analysis and their implications, while the last section is the concluding statement and policy recommendations.

2. Literature Review

2.1 Theoretical Review

There are different theoretical underpinnings for the various monetary transmission channels. Mishkin's (1996) provided a descriptive overview of the transmitting channels through which monetary policy impulse is transmitted to the real sector; these channels include:

- **The interest rate channel**: This channel is embedded in the Keynesian *IS-LM* framework; characterized by the assumption that money and bonds are the only relevant financial assets; and changes in these assets are capable of influencing the real cost of borrowing (long term interest rate) which in turn can influence the aggregate output.
- **The exchange rate channel:** The exchange rate channel essentially depends on the traditional interest rate channel in propagating monetary impulses to the real economy. In an open economy characterized by flexible exchange rate, monetary policy affects exchange rates which in turn affect net export and aggregate output
- **The Tobin-q channel**: This channel works mainly through the prices of equities and q is defined as the market value of the firm divided by the replacement cost of capital. According to Tobin (1969) an expansionary monetary policy induces a portfolio adjustment into equities. A rise in the demand for equity increases the market value of firms relative to the cost of replacing real capital assets. Consequently, investment by businessmen increases which in turn enhances the real output.
- **The wealth channel:** This channel is propounded by Modigliani (1963) and according to him an expansion monetary policy increases the stock of money in an economy and induces a switch from money to financial assets. The increase in the demand for these financial assets raises their prices and the value of household financial wealth increases. As financial wealth increases, the lifetime resources of the household increases and consumption spending increase. The increase in consumption leads to increase in aggregate demand and hence increases aggregate output.
- **The bank lending channel:** This channel is developed by Bernanke and Blinder (1988) and it focused on imperfect substitutability between credit and financial asset in the bank's balance sheet on the one hand and between bank credit and other forms of financing in the firm's balance sheet on the other hand, making it possible for monetary policy to affect the economy. Thus an imperfect substitution in banks assets ensures that a tightening (loosening) of monetary policy brings about a constraint (expansion) in bank credit supply, which affects investment and in turn affects real output.

- **The balance sheet channel or financial accelerator channel:** This channel focused on the imperfect substitutability between external and internal financing, where the cost of external financing (borrowing) is dependent on the net worth of the firms, serving as collateral for loans and credit. Consequently, any change in net worth of firms generated directly or indirectly by monetary policy, affects their capacity to borrow, which ultimately influences investment and aggregate output.
- **The expectations channel:** The effectiveness of this channel depends on the credibility of the central bank and works through steering expectations of market participants about future economic conditions. This mechanism is particularly relevant in advanced economies and can enhance other transmission channels (Al-Mashat and Billmeier, 2007).
- **The bank capital channel:** This channel emphasized the prominent role of bank equity capital in the monetary transmission mechanism. According to this channel, a rise in interest rate triggered by monetary policy actions increases the cost of financing (deposit). Leaving the remuneration of the bank assets unchanged due to maturity mismatch resulting from monetary policy action will induce a fall in bank capital. In the event that the bank is close to minimum capital requirement prescribed by law, it is rational for the bank to decrease the supply of loans as raising equity would be costly. The decrease in loan would eventually reduce investment and consequently decline output.

2.2 Empirical Review

Crucial to the effectiveness of monetary policy is how policy impulses are being transmitted to the real sector. Several scholars have therefore examined the channels through which monetary policy is transmitted to real economic variables in Nigeria. Some of these studies are presented below.

Uchendu (1996) examined the channels of monetary policy transmission mechanism in Nigeria. The study found that while the level of interest rates did not accurately reflect genuine demand for credit in the early 1990s as distress borrowing intensified; credit availability could have been influenced by the lending behaviors of banks during the period.

Oyaromade (2002) analyzed the role of bank credit rationing in the monetary transmission mechanism in Nigeria. The granger causality tests on the variable of the co-integrating vector auto-regression (VAR) model indicate that one-way relationship existed between bank credit and real GDP, money supply and prices and between investment and real GDP with the causation running from investment to real GDP. The impulse analysis showed that an unanticipated shock to interest rate caused a significant decline in the level of real GDP and

real GDP also responded significantly to bank credit innovation. The variance decomposition of the estimated co-integrating VAR model revealed that shocks to output and investment were found to be significant in explaining variability in real investment accounting for 35 and 54 per cent respectively for one year forecast variance in investment. Shock to investment and real price level accounted for the highest proportion in price forecast variance. From the finding of the study it was inferred that the two channel of monetary transmission mechanism (the interest rate and credit channel), played significant role in the transmission of monetary Impulse to the real sector in Nigeria.

Adebiyi (2006) examined financial sector reforms and transmission mechanism of monetary policy in Nigeria. Vector auto-regression (VAR) model is estimated for the pre-reform and post-reform periods. Variance decompositions and impulse response functions are examined to see whether there are any changes observed in the monetary transmission mechanism after the reforms. Different systems were estimated in each period using alternate variables as measures of monetary policy shocks. When compared results from the two estimation periods, it was observed that both the responsiveness of prices and output to policy shocks and the magnitude of their forecast error variance decompositions, explained by these variables, have increased since the reforms. There was evidence of the bank-lending channel both before and after the reforms. Of the mechanisms estimated, the exchange rate and lending mechanisms seem to be the most important mechanisms for transmission of policy shocks to both prices and output during the post-reform period.

Ogun (2006) examined the impact of monetary policy on bank lending and the importance of bank credit channel with the deregulation of the financial sector in Nigeria using Structural Vector Auto-regression (SVAR) econometric method for the period 1970-2003 for annual data and 1986:1 to 2003:4 for quarterly data respectively. The study revealed that the bank credit channel was a weak channel in the Nigeria economy and that the major source of variability in economic activity in Nigeria was the nominal exchange rate while the main source of variation in price was bank credit.

An overview of the literature showed that there exists conflict on the precise channel through which monetary policy is transmitted to the Nigerian economy, it is therefore pertinent to re-examine this issue. Also, only selected channels have been investigated (interest rate, exchange rate and the bank lending channel) in Nigeria without examining the asset price channel. In view above this study focus on four channels (interest rate, exchange rate, asset price channel and bank lending channel). The none assessment of balance sheet, the expectation and bank capital channels is due to lack of data.

3. Research Methodology

In line with previous studies (Dale and Haldane, 1995; Granley and Salmon, 1996; Oyaromade, 2002; Alam and Waheed, 2006; and Al-Mashat and Billmeier, 2007) on the transmission of monetary policy, we estimate a VAR model with five variables for the aggregate economy: international crude oil price, exchange rate, output, consumer price index and a monetary policy indicator. The benchmark VAR model for this study is specified below:

$$X_t=\alpha+B_1X_{t-1}+B_2X_{t-2}+.....+B_qX_{t-k}+u_t \ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

Where: $$X_t=\left[CPR \quad EXT \quad MPI \quad CPI \quad Y\right]^1$$

Where X_t is a *k x1* – dimensional Vector of the endogenous variables, α is a *k x1* - dimensional vector of constant and $B_{1.....}$ B_q are *k x k* dimensional autoregressive coefficient matrices and μ is *k*-dimensional vector of the stochastic error term nominally distributed with the following properties;

$$E(u_t)=0$$
$$E(u_tu_t')=\Omega$$
$$E(u_iu_j')=0, \text{ if } i\neq j$$

Equation (1) above can be expressed in matrix form as;

$$\begin{bmatrix} X_t \\ X_{t-1} \\ . \\ . \\ . \\ X_{t-k+1} \end{bmatrix} = \begin{bmatrix} \alpha \\ 0 \\ . \\ . \\ . \\ 0 \end{bmatrix} + \begin{bmatrix} B_1 & B_2 & . & . & . & B_{q-1} & B_q \\ 1 & 0 & . & . & . & 0 & 0 \\ . & . & . & . & . & . & . \\ . & . & . & . & . & . & . \\ , & . & . & . & . & . & . \\ 0 & 0 & . & . & . & 1 & 0 \end{bmatrix} \begin{bmatrix} X_{t-1} \\ X_{t-2} \\ . \\ . \\ . \\ X_{t-k} \end{bmatrix} + \begin{bmatrix} \mu_t \\ 0 \\ . \\ . \\ . \\ 0 \end{bmatrix} \ldots\ldots\ldots\ldots\ldots \quad (2)$$

Equation (2) can be stated more compactly as

$$X_t=\alpha+\sum_{i=1}^{k}\Gamma_iX_{t-k}+u_t \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (3)$$
$$i=1,2,3,\ldots\ldots\ldots k$$

In line with Lütkepohl and Reimers (1992) and Lütkepohl (1993), the impulse response equation below was derived from the VAR equation (2) is given as;

$$\phi_h=(\varphi_{il},h)=\sum_{j=1}^{h}\phi_{h-j}X_j \qquad h = 1, 2\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (4)$$

where $\Phi_0 = I$ and $X_j = 0$ for $j > k$. the impulse response $\Phi_h = (\varphi_{il},h)$ describes the impact of shock in the variable of the system, implying that (φ_{il},h) represent the response of variable i to shock in variable l, h periods ago.

In addition, the dynamic properties of the system are analyzed by variance decomposition –as proposed by Sims (1980). The variance decomposition shows the magnitude of the variation in aggregate output due to shock in aggregate output itself; shocks to monetary policy variables and other variables in the VAR model. The forecast error variance decomposition according to Lütkepohl and Reimers (1992) and Lütkepohl (1993), based on the VAR model of equation (2) is given as;

$$w_{lj,s} = \sum_{h=0}^{s-1} \frac{\theta^2_{lj,h}}{MSE_l(s)} \quad \text{.....} \quad (5)$$

Given equation (1) above, the estimating variables entered the VAR model in the following sequence; international crude oil price *(cpr)*, the exchange rates *(ext)*; monetary policy indicator (i); the consumer price index *(cpi)* and the real outputs *(y).* This ordering is based on the assumption that monetary policy might react to changes in exchange rates but does not respond to contemporaneous changes in other variables within the VAR model while aggregate output is expected to react to changes in other macroeconomic variables in the model. All variables except the interest rates are estimated in logarithms. Furthermore, a common lag length of one for each VAR model is adopted for the VAR models. This is supported by the Schwartz Information Criterion (SIC), which is minimized at -47.5 at this lag length. Although the Akaike Information Criterion (AIC) supports a lag length of two, this is ignored for two reasons. First, there is evidence that the SIC is the most accurate information criterion for a sample size less than 120 (Ivanov and Kilian, 2005). Second, Ivanov and Kilian (2005) also argue that the AIC tends to overestimate the number of lags (Crawford, 2007). The choice of this lag length has the advantage of whitening the errors for each of the individual VAR.

This study used annual data spanning from 1986 to 2009. The choice of period was informed by the fact that 1986 marked the era of financial liberalization and a significant shift in monetary policy orientation and approach in Nigeria.

4. Estimation Results:

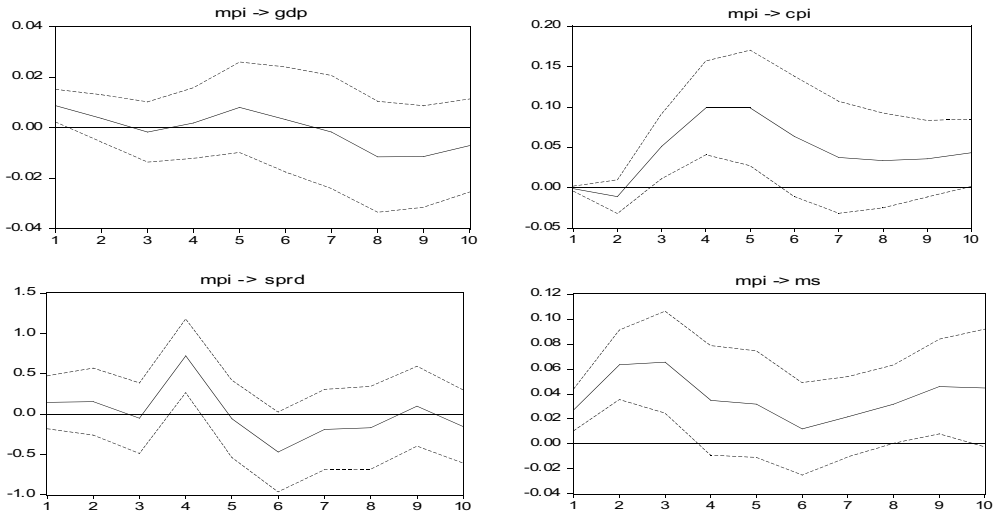
In this section, the estimated result of the various transmission channels is presented, by augmenting the base model with selected variables for examining the respective transmission channels. To examine the transmission channels more

closely this study conducts both the impulse response to indicate the response of aggregate output to monetary policy shocks and the forecast error variance decomposition to indicate the relative importance of monetary policy shocks compared to other shocks such as those from the exchange rate, bank credit and asset price and other variables on aggregate output.

4.1 The interest rate channel

A well-functioning interest rate channel is crucial to passing of monetary policy actions to the economy, including the banking system. Without a functioning interest rate channel, the capacity of the monetary authority in influencing macroeconomic variables is limited. To examine the interest rate channel more closely, we have included the interest rate spread and money supply in the VAR model specified in equation (1) this variables are included between the monetary policy indicator and the consumer price index. The ordering of the variables for the interest rate channel follows the structural assumption that: first, the central bank observes the status of the real world (*cpr* and *ext*); second, the central bank sets its nominal short-term interest rate (*mpi*) that has no contemporaneous effect on the real world but an impact in subsequent periods; third, financial variables (*irs and ms*) adjust to changes in the short-term rate contemporaneously while the *cpi* and *y* response to changes in the financial variables contemporaneously. Selected impulse response functions for the interest rate channel are presented in Figure 1.

Figure 1: Selected Impulse Responses in the Interest Rate Channel Model



A positive shock on the monetary policy indicator rate was followed by a temporary decline in real output and interest rate spread. The temporary negative

response of interest rate spread showed that monetary policy shocks are partially transmitted to real output. Also, there is evidence of "price puzzle" (first diagram on the right). A possible explanation for the occurrence of this phenomenon is that, stock to monetary policy indicator had a positive impact on the money stock *Ms* (as observed on the second diagram on the right), which contains interest bearing assets. Therefore, the positive impact of restrictive monetary policy on the price level can be understood in this VAR model but it remains an open task to specify a model in which the expected negative impact of restrictive monetary policy on prices is revealed (Holtemoller, 2002).

Table 1: Forecast Error Variance Decompositions in the Interest Rate Channel Model

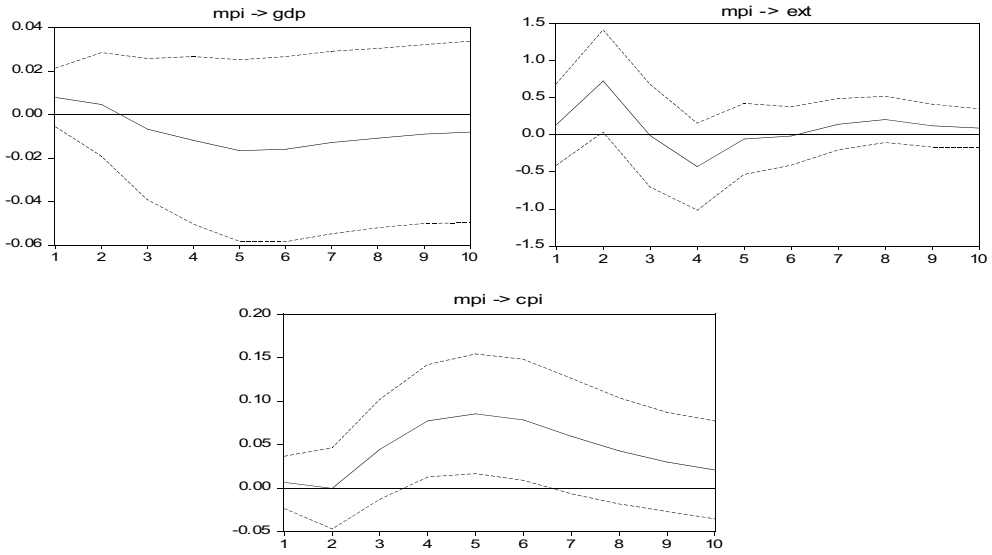
Qtrs	LCPR	LNEER	MPI	SPRD	LMS	LCPI	LRGDP
1	0.456	19.887	22.318	27.184	4.834	8.206	17.113
4	56.873	9.069	3.923	16.027	3.978	2.901	7.229
8	73.370	6.090	4.273	7.141	5.079	1.118	2.933
12	71.617	5.368	5.250	8.288	5.379	1.035	3.063

The forecast error variance decompositions presented on Table 1 indicated that monetary policy shocks are of minor importance for the variance in real output. Innovations in the monetary policy indicator and interest rate spread together had a share of about 20% in the variance of real output in the 4th quarter but declined to about 13% in the 12th quarter. It can also be seen that innovations in international crude oil price had the largest share in the variance of the real output. Innovation to crude oil price accounted for about 56% of variance in real output in the 4th quarter and rose to about 72% in the 12th quarter. The foregoing evidence suggests that the interest rate channel proposed by the money view is rather a weak channel in transmitting monetary policy impulses in Nigeria.

4.2 The exchange rate channel

To identify the potency of the exchange rate channel, we re-arrange the ordering of the variables to avoid initial response of monetary policy to the exchange rate. Thus, the ordering becomes: international crude oil price, monetary policy measure, exchange rate, consumer price index and real output. A selected impulse response function of the exchange rate channel is presented on Figure 2. From the figure two below, some evidence of exchange rate and price puzzle was present. The exchange rate appreciated immediately following the monetary policy shock before declining after the second quarter, and afterwards rose again. However, a hump-shaped negative effect of a restrictive monetary policy shock on real output can be observed, suggesting that the exchange rate channel is confirmed empirically.

Figure 2: Selected Impulse Responses in the Exchange Rate Channel Model



According to the forecast error variance decompositions on Table 2, the impact of exchange rate shock on real output is more than of the interest rate channel. It is observed from Table 2 that shocks to exchange rate are responsible for a considerable part of the variance in real output. Innovations to monetary policy indicator and exchange rate had a joint share of about 33% in the variance of real output in the 4th quarter rising to about 43% in the 12th quarter. A comparative analysis between the interest rate and exchange rate channel revealed that the exchange rate channel is more important in transmitting monetary policy impulses to real sector in Nigeria.

Table 2: Forecast Error Variance Decompositions in the Exchange Rate Channel Model

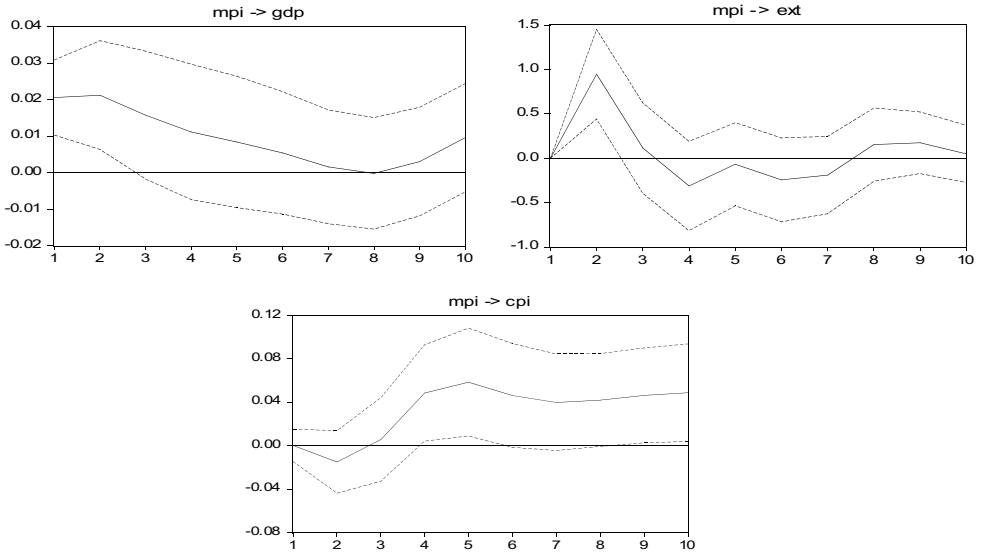
Qtrs	LCDPR	MPI	LNEER	LCPI	LRGDP
1	0.688	5.992	4.134	0.198	88.987
4	0.557	2.721	30.873	0.566	65.283
8	0.393	4.719	36.464	1.379	57.045
12	0.271	3.951	38.760	1.909	55.108

4.3 Bank credit channel

To examine the bank lending channel, the banking lending rate and bank credit are included in the VAR model of equation one. These variables are included between monetary policy indicator and the consumer price index of equation (1). Thus, the ordering becomes: crude oil price, exchange rate, monetary policy measure, lending rate, bank credit, consumer price index and real output. A selected impulse response function of the bank credit channel is presented on Figure 3. From the Figure, some evidence of exchange rate and

price puzzle still persist, however a hump-shaped negative effect of a restrictive monetary policy shock on real output was observed, suggesting the existence of the credit channel. The result is however corroborated with the forecast error variance decomposition estimate presented on Table 3.

Figure 3: Selected Impulse Responses in the Bank Credit Channel Model



From the forecast error variance decompositions on Table 3, shocks to monetary policy indicator on real output is larger compared to those of the interest rate and exchange rate channel. Shocks monetary policy and bank credit had a joint a share of about 55% in the variance of the real output in the 4th quarter before declining marginally to about 44% in the 12th quarter. It can be concluded from the foregoing that bank lending channel plays a more important role than the interest rate and exchange rate channels in transmitting monetary policy impulses to the real sector in Nigeria.

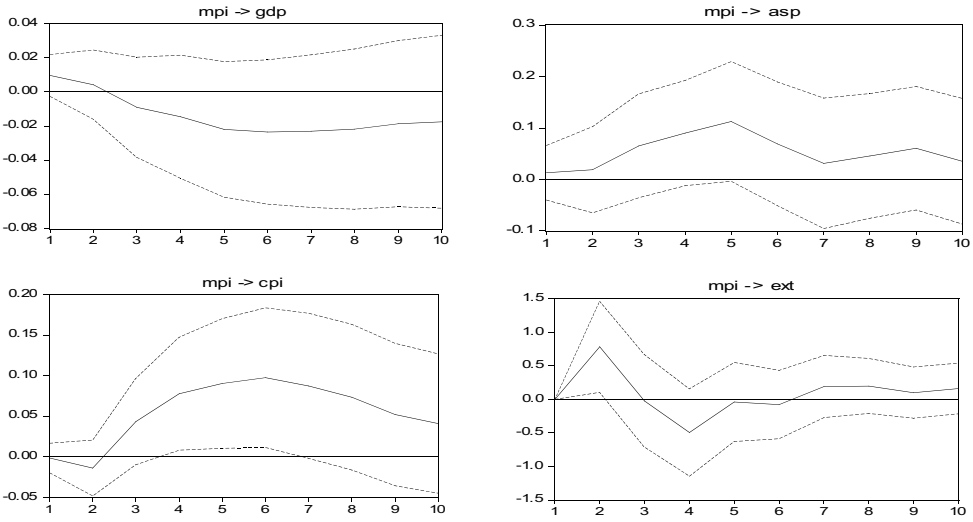
Table 3: Forecast Error Variance Decompositions in the Bank Credit Channel Model

Qtrs	LCPR	LNEER	MPI	LGLT	LCRDT	LCPI	LRGDP
1	5.336	0.003	50.494	10.333	18.066	15.357	0.412
4	3.210	13.016	34.936	9.412	23.073	15.954	0.400
8	20.591	13.779	22.460	6.186	21.201	15.528	0.256
12	17.85	15.314	20.668	5.994	23.788	16.148	0.238

4.4 Asset price channel

In principle, the asset price channel works through the asset market, including securities markets and real estate. In Nigeria, the only recognized asset market is the Nigeria stock exchange established in 1960 and the institution has published annual price index for securities in the annual Central Bank of Nigeria statistical bulletin and in the annual Nigerian stock exchange fact book. To examine the asset price channel, the all share price index is included in the VAR model of equation (1). This variable is included between monetary policy indicator and the consumer price index and the ordering is as follows: crude oil price, exchange rate, monetary policy measure, all share price index, consumer price index and real output. Selected impulse response functions of the asset price channel are presented on Figure 4. Similar to the above results, some evidence of exchange rate and price puzzle persist. However, an immediate output decline was observed following a restrictive monetary policy shock when stock price is included in the model, suggesting the existence of the asset price channel in Nigeria.

Figure 4: Selected Impulse Responses in the Asset Price Channel Model



The forecast error variance decompositions on Table 4 revealed that shocks to real output explain most of the variations in itself. Shocks to monetary policy indicator and all share price index together had a share of about 18% in variance of real output in the 4th quarter before rising marginally to about 22% in the 12th quarter. From the foregoing, the asset price channel appeared a weak transmission channel in transmitting monetary policy impulses to the real sector in Nigeria when compared to the exchange rate channel and bank lending channel.

Table 4: Forecast Error Variance Decompositions in the Asset Price Channel Model

Qtrs	LCDPR	LNEER	TBR	LASP	LCPI	LRGDP
1	9.34	4.131	9.217	6.957	3.188	67.198
4	1.932	24.191	4.367	13.490	7.735	48.286
8	0.963	26.146	10.875	12.759	8.126	41.130
12	0.891	29.043	10.331	11.458	8.792	39.486

5. Conclusion

The empirical evidence reported in this paper explored the relative effectiveness of the interest rate, exchange rate, bank credit and the asset price channel of monetary transmission in Nigeria spanning over the period 1986 to 2009. Different VAR models for respective transmission channels were estimated and it was observed that there was an output decline following a restrictive monetary policy shocks in all the models. However, the forecast error variance decomposition revealed that shock to bank credit in the bank lending channel had a largest impact on real output when compared to other variables in other respective transmission channels, implying that the bank credit channel is most effective in transmitting monetary policy impulse in the Nigerian economy.

The empirical evidence from this study showed that the traditional interest rate channel is not exclusive in explaining transmission mechanism in Nigeria. Based on the forecast error variance decomposition, shocks to both the bank credit and exchange rate in their respective models explained a greater share in the variance of real output compared to the asset price and interest rate in their respective models. The ineffectiveness of the asset channel can be attributed to the presence of unstable inflation rate in the economy. During this period monetary authority cannot easily control the direction of interest rate as a result of the existence of high volatility premium in agent's expectations Lopes (1998). Thus, to ensure effectiveness of the asset price channel, the monetary authority needs to maintain a low and stable inflationary level. Also, the bank lending channel can be made more effective by increased competition between banks, which would enhance the sector's effectiveness in intermediating financial flows and translating the central bank's monetary stance into market rates.

References

Adebiyi M. A (2006): Financial Sector Reforms and the Transmission Mechanism of Monetary Policy in Nigeria. A Vector Auto-regression Mechanism, *China* Finance Research Network (CFRN).

Akinlo, A. E. (2007). The Dynamics of Money, Output and Prices in Nigeria, *Paper* Presented at the Central Bank of Nigeria 2007 Executive Policy Seminar.

Alam T. and M. Waheed (2006): The Monetary Transmission in Pakistan. A Sectoral Analysis: Pakistan Institute of Development Economics. *Munich Personal RePEc Archive (MPRA) No. 2719.*

Al-Mashat R. and A. Billmeier (2007): The Monetary Transmission in Egypt. *IMF Working Paper: Middle East and Central Asia Department WP/07/285.*Central Bank of Nigeria Annual Reports and Statement of Account for Various Years

Anyanwu J. C. (1993) The Effect of Monetary and Fiscal Policy Under Rational Expectation. The Nigerian Case. U. I. Ibadan.

Athukorala P. C. (1998) Interest Rate, Saving and Investments. Evidence from India. *Oxford Development studies Vol. 26. No 2 pp. 153-169.*

Bernanke B. and A. Blinder (1988): Credit, Money and Aggregate Demand. *American Economic Review Vol. 78 pp 435- 439*

Bogunjoko J. O. (1997): Monetary Dimension of the Nigeria Economic Crisis. Empirical evidence from a Co-integrated Paradigm. National Center for Economics Management and Adminstration (NCEMA). *Nigeria Journal of Economics and Social Studies. Vol. 39, No 2. Pp. 145 – 167.*

Chimobi .O.P and U.C. Uche (2010): Money, Price and Output. A Causality Test for Nigeria. *American Journal of Scientific Research. ISSN 1450-223X Issue 8(2002) pp 78-87. Euro Journals Publishing. Inc 2010.*

Crawford C. (2007): The Sectoral Impact of Monetary Policy in Australia. A Structural VAR Approach

Dale S. and A.G Haldane (1999): Interest Rate and Channels of Monetary Transmission: Some Sectoral Estimates, *European Economic Review Vol.39 No.6, pp 611–626*

Granley J. and C. Salmon (1996): The Industry Impact of Monetary Policy Shock.Some Stylised Facts. *Working paper No. 68. Bank of England*.

Holtemöller O. (2004): A Monetary Vector Error Correction Model of the Euro Area and Implication for Monetary Policy. *Empirical Economics, Springer, Vol. 29(3), pp 553-574, 09.*

Ivanov, V. and L. Kilian (2005). 'A Practitioner's Guide to Lag Order Selection for VAR Impulse Response Analysis', *Studies in Nonlinear Dynamics and Econometrics*, Vol.9(1), Article 2.

Leeper E., C. Sims and T. Zha (1996): What Does monetary Policy Do? *The Brookings Papers on Economic Activity, Vol, 2 pp. 1-48.*

Lopes F. (1998): the Transmission Mechanism Of Monetary Policy In A Stabilization Economy: Note on the Case of Brazil, Bank of International

Settlement Policy Papers No.3 pp. 65-73

Lütkepohl H. (1993): Introduction to Multiple Time Series Analysis, Berlin:Springer Verlag, 1993.

Lütkepohl H. and R. Reimers (1992): Impulse Response Analysis of Cointegrated Systems," *Journal of Economic Dynamics and Control, 1992, 16, 53{78*

McKinnon R. (1973): money and capital in economic development. Washington DC: Brooklings institutions

Mishkin F. S. (1996): The Channels of Monetary Transmission, Lesson for Monetary Policy; *NIBER Working Paper No. 5464.*

Modigliani F. (1963): The Monetary Mechanism and its Interaction with the Real Phenomena. *Review of Economic and Statistics. Supplement (February) pp 79-107.*

Molho L. E. (1986) Interest Rate, Saving and Investment in Developing Countries. *IMF Staff Paper Vol. 83, No 1, pp 90-116.*

Nwoabi G. C. (1999): Money and Output Interaction in Nigerian. An economic Investigation, Using Multi-trivariate Co-integartion Technique. *Central Bank of Nigeria Economic and Financial Review Vol. 37, No 3 pp 44-76*

Ogun T. P. (2006): Financial Structure, Bank Credit Channel and Monetary Policy In Nigeria (1970-2003). Unpublished P.hD Thesis. Department of Economics,Faculty of Social Sciences, Obafemi Awolowo University, Ile-ife, Osun –State

Oyaromade R. (2002): Monetary Policy Transmission in Nigeria. A VECM Approach. *The Nigeria Journal of Economic and Social studies: Volume 44, pp. 187-206*

Sims A. (1980): Macroeconomics and Reality," *Econometrica, 1980, 48, 1{48*

Saibu M. O. (2001): The Effect Of Monetary Policy On real Output And Price Level In Nigeria (1990-1997). Unpublished M.Sc Thesis. Department of Economics O.A.U Ile-Ife Osun State.

Saibu M. O. and S. I. Oladeji (2007): Asymmetric Policy Shocks and Real Output Fluctuation in Nigeria. *The International Journal of Applied Economics and Finance,* 1(2) pp 88-96 2007

Shaw E. (1973): financial deepening in economic development Oxford: Oxford University press Tobin J. (1969): A General Equilibrium Approach to Monetary Policy. *Journal of Monetary, Credit and Baking Volume 1 (February), pp 15-29*

Uchendu O. A (1996), The transmission of monetary policy in Nigeria, *CBN Economic and Financial Review* Vol. 34 No. 2

Van den Heuvel J. S. (2007); The Bank Capital Channel of Monetary Policy. *Department of Finance, The Wharton School, University of Pennsylvania.*

Diversity Management – a solution for workplace discrimination in Bosnia and Croatia?

Mario Vinković, LL.M., Ph.D.
Assistant Professor
Faculty of Law
J. J. Strossmayer University of Osijek, Croatia
e-mail: mvinkovi@pravos.hr

Jasmina Bešlagić, LL.M., M.Sc.
Senior Assistant
Faculty of Law
University of Bihać, Federation of Bosnia and Herzegovina
e-mail: jasmina.beslagic@yahoo.com

Abstract

The authors research to which extent diversity management mechanisms may be used as the model for prevention and alleviation of the workplace and employment discrimination effects. Both legal systems under consideration in this paper have been marked by similar events in the recent history, so that workplace and employment discrimination occurs not only as a response to earlier ethnic conflicts and consequences of the post-war period, but also as the root cause of prejudice, value judgements and inadequate openness of the given societies to the European perspective. Can nurturing multiculturalism, valuing diversity and necessary mental transition towards modern democratic values through diversity management give an answer to the problems observed? The authors do not question the existence and the relative quality of the legislative framework in both systems, but they try to determine application possibilities of their mechanisms in everyday life, especially through an interdisciplinary focus of the fight against discrimination.

Keywords: *Employment discrimination, workplace discrimination, diversity management.*

1. Introductory notes

Bosnia and Herzegovina and the Republic of Croatia share a common history of being federal units within the former Socialist Federal Republic of Yugoslavia. The breakup of the former common state at the beginning of the 1990ies exposed both states to social, economic and political transitions as well as armed conflicts

whose basic substrate was built up of ethnic causes. Today, almost two decades after the cessation of armed conflicts, both states tend to become EU member states and on their way to integration they have different positions. Republic of Croatia is likely to become a full member of the EU in the year 2013; full membership negotiations and the harmonisation of national legislation with the *acquis communautaire* are almost completed, and Bosnia and Herzegovina is trying to strengthen building of state institutions and the rule of law as well as to harmonise its national legislative with European and international standards as fundamental prerequisites for the European orientation and the desired membership in the EU as a transnational entity.

Armed and inter-ethnic conflicts have left a trace in both societies, while rooted prejudices, historical circumstances and political conditions have complicated the fight against discrimination on a practical level. Hence, in this paper, through an interdisciplinary focus we will try to determine reasons for a relatively small number of reported cases of workplace and employment discrimination and the modalities of the fight against it. Legislative frameworks of the observed national systems, despite rather high-quality legal solutions, are obviously insufficient for the fight against discrimination whose causes lie in prejudices, intolerance towards diversity, disregard of the individual's right to make his/her own choices and an inadequate degree of "mental transition" citizens of both states should have experienced.

It is clear to lawyers and legalists that legislative frameworks must enjoy support from specific tools *in favorem* the fight against workplace discrimination. One of them is also diversity management, that was defined by Thomas R. Roosevelt as early as in 1991 as "*a comprehensive managerial process for developing an environment that works for all employees*"[1], regardless of their race, skin colour, gender, age, education, personality, life style, sexual orientation, etc.[2] Moreover, diversity management was supposed to restrain the America's response to diversity – assimilation with all of its negative effects.[3]

In the sequel, we will summarily point at legal grounds for the fight against discrimination in both legal systems and the collected data regarding the frequency of court cases in relation with workplace discrimination.

[1] Thomas R. Roosevelt, *Beyond race and gender: unleashing the power of your total work force by managing diversity*, AMACOM, 1991, p. 10.

[2] Ibid.

[3] Ibid., pp. 7-9.

2. Legal framework of the fight against workplace discrimination in Bosnia and Herzegovina

Having regard to international standards in the field of human rights protection,[4] the Constitution of Bosnia and Herzegovina (BiH) guarantees non-discrimination in its Preamble,[5] opening thereby on the national level in Bosnia and Herzegovina space for setting up the highest protection standards. However, in spite of the aforementioned, discrimination in BiH represents an omnipresent phenomenon and a significant social problem.

The main legislative progress in the field of non-discrimination was made at mid-year 2009 by adoption of the Anti-Discrimination Act of BiH[6] (hereinafter referred to as "ADA BiH"), introducing a new concept of non-discrimination in the legal system. This Act is especially important since it was passed at the state level in Bosnia and Herzegovina, by which it additionally ensures equality of its citizens, and with respect to the existing acts and regulations that also prohibit discrimination in certain fields[7], the scope of its territorial application

[4] The Constitution of BiH has a catalogue of most significant international human rights documents incorporated into its text, according to which, *inter alia*, all or particular forms of discrimination are forbidden. Those international sources thereby obtain the constitutional character and the application priority with respect to any national regulation. (International documents contained in the Appendix to Annex VI of the Dayton Peace Accord for Bosnia and Herzegovina).

[5] "The enjoyment of the rights and freedoms provided for in this Article or in the international agreements listed in Annex I to this Constitution shall be secured to all persons in Bosnia and Herzegovina without discrimination on any ground such as sex, race, color, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status." (Article 2(4), the Constitution of Bosnia and Herzegovina (Annex IV of the Dayton Peace Accord for Bosnia and Herzegovina)). Constitutions of administrative territorial units in Bosnia and Herzegovina also contain provisions prohibiting discrimination (the Constitution of the Federation of Bosnia and Herzegovina (FBiH), Article 2(A)(1), "Official Gazette of the Federation of Bosnia and Herzegovina" Nos. 1/94, 13/97, 16/02, 22/02, 52/02, 60/02, 18/03, 60/03, the Constitution of the Republika Srpska (RS), Article 10, "Official Gazette of the RS" Nos. 6/92, 8/92, 15/92, 19/92, 21/92, 28/94, 8/96, 13/96, 15/96, 16/96, 21/96, 21/02, 30/02, 31/03, 98/03 and the Statute of the Brčko District of Bosnia and Herzegovina (BD BiH), Article 13(1), "Official Gazette of the BD BiH" Nos. 17/08 and 39/09).

[6] "Official Gazette of BiH" No. 59/09.

[7] In addition to this Act, there is a significant number of acts existing in Bosnia and Herzegovina that directly or indirectly treat the prohibition of discrimination in the field they govern, and they were adopted either at the state-level of BiH or at the level of its entities, i.e. the BD BiH. One of such acts is the Gender Equality Law of Bosnia and Herzegovina ("Official Gazette of BiH", No. 16/03), the Labour Act of FBiH ("Official Gazette of BiH", Nos. 43/99, 32/00 and 29/03), the Republika Srpska Labour Act ("Official Gazette of the RS", Nos. 38/00, 40/00, 47/02, 38/03, 66/03 and 20/07), the Labour Act of the Brčko District BiH ("Official Gazette

is considerably broader. The Act defines specific forms of protection in discrimination cases, according to which provisions of material character are not of declaratory nature only, but they also realise a level of functional applicability in defined procedures for protection.

Workplace and employment discrimination in BiH is one of the most frequent manifest forms of discrimination. It represents a problem that is very difficult to perceive, and in less developed societies such as Bosnia and Herzegovina, it is a very noticeable and complex problem, especially with respect to the lack of sensibility in the society to identification of discrimination, a high tolerance level present in discrimination cases, which is accompanied with numerous difficulties in relation to opposing this social phenomenon. In addition to this, the problem of unemployment throughout BiH is an overwhelming problem that brings a potential employee or the one already working into an even more unfavourable position and opens space for perpetuation of new discrimination cases and hiding of the existing ones.

Within the framework of national legislations, the provisions which prohibit workplace and employment discrimination have lately undergone certain changes in the normative sense. The reason for that may be found in the request for harmonisation of national regulations with the ones in the EU, but also in a powerful influence of an Anglo-Saxon approach to labour relations.[8] However, legislators in BiH have accepted such trend successively and fragmentarily, so that on practical levels the same fields and institutes are regulated in very different ways in different parts of BiH. Therefore, we can talk about the lack of harmonised regulations in BiH treating the area of discrimination.

Labour relations in BiH are regulated on the level of its entities and the Brčko District BiH, so that there co-exist the Labour Act of the Federation of BiH

of the BD BiH", Nos. 7/00, 08/03, 33/04, 29/05, 19/07 and 25/08), the Criminal Law of BiH ("Official Gazette of BiH", Nos. 3/03, 32/03, 37/03, 54/04, 61/04, 30/05, 53/06, 56/06, 32/07 and 8/10), the Criminal Law of the FBiH ("Official Gazette of the Federation of Bosnia and Herzegovina", Nos. 36/03, 37/03, 21/04, 69/04 and 18/05), the Criminal Law of the RS ("Official Gazette of the RS", Nos. 49/03, 108/04, 37/06 and 70/06), the Criminal Law of the BD BiH, ("Official Gazette of the BD BiH", Nos. 10/03, 45/04 and 06/05), etc.

[8] It is specific for the Anglo-Saxon approach to labour relations that considerably greater attention is paid to collective labour relations, whereas within individual labour relations anti-discrimination legislation is of special importance. Furthermore, in American legislation, formal and material legality of decisions made by employers is not taken into account that much, but significant attention is paid to possibly prohibited discrimination effects of some decision. For details, see Potočnjak, Željko: Zabrana diskriminacije, uznemiravanja i spolnog uznemiravanja u radnim odnosima, in: Potočnjak, Željko et al. (ed.), *Radni odnosi u Republici Hrvatskoj*, Pravni fakultet u Zagrebu and Organizator, Zagreb, 2007, pp. 47-48.

(hereinafter referred to as: "LA FBiH"), the Labour Act of the Republika Srpska (hereinafter referred to as: "LA RS") and the Labour Act of the Brčko District BiH (hereinafter referred to as: "LA BD BiH"). However, labour legislation in BiH, with certain obvious shifts to a positive direction, left unregulated a series of important institutes in relation to workplace and employment discrimination, like *mobbing*, harassment or sexual harassment. A positive example of labour legislation in BiH is the LA RS[9], which contains provisions governing specified forms of violating dignity of employees, as well as a series of other provisions implying a certain progress in satisfying European and international standards in general as to the prohibition of discrimination and the protection against discrimination.

2.1. Prohibition of workplace and employment discrimination according to the Anti-Discrimination Act in Bosnia and Herzegovina

Due to legal gaps generated by shortcomings of *lex specialis* regulations in the field of labour law in BiH, the ADA BiH plays a very important role in achieving the equality of citizens throughout the whole territory. It is a regulation that regulates the non-discrimination issue in an integral and direct way, including the definition of the term discrimination and its forms, regulation of exceptions to the principle of equal treatment, specification of the scope of application, procedures for protection, institutions competent for protection and misdemeanour sanctions in cases of violation of its provisions.

In terms of the ADA BiH, discrimination shall be: "*every different treatment including every exclusion, limitation or preference based on real or assumed features towards any person or group of persons on grounds of their race, skin colour, language, religion, ethnic affiliation, national or social origin, connection to a national minority, political or any other persuasion, property, membership in trade union or any other association, education, social status and sex, sexual expression or sexual orientation, as well as every other circumstance with a purpose or a consequence to disable or endanger recognition, enjoyment or realisation, of rights and freedoms in all areas of public life*".[10]

The Act defines two fundamental forms of discrimination, i.e. direct and indirect discrimination[11], and "other forms of discrimination" include harassment

[9] Article 111, LA RS.

[10] Article 2(1), ADA BiH.

[11] "Every different treatment on grounds defined in Article 2, i.e. every action or failure to act when a person or a group of persons is put into a less favourable position unlike some other person or group of persons in similar situations shall be considered to be direct discrimination." (Article 3(1), ADA BiH) "Every situation, in which an apparently neutral person, criterion or practice has or would have the effect of putting a person or group of persons into a less favourable position compared with other persons shall be considered to be indirect discrimination." (Article 3(2), ADA BiH).

and sexual harassment[12] as very frequent forms of workplace harassment, and *mobbing*[13] as an exclusively workplace-related form of discrimination.[14]

Provisions defining the scope of application of the ADA BiH are of special interest for discrimination in the field of work and employment. They refer to "all public bodies, all natural and legal persons in public and private sector, in all spheres, especially: employment, membership in professional organisations, education, training, housing, health, social protection, goods and services designated for public and public places together with performing economic activities and public services".[15] This Act shall apply to actions of all public bodies at the level of the state, entity, canton and Brčko District of Bosnia and Herzegovina, municipal institutions and bodies, and legal persons with public authorities, but also to the action of all legal and natural persons in all spheres of life, especially the following fields that are important for our analysis: employment, work and working conditions (including access to employment, occupation and self-employment, as well as working conditions, remuneration, promotions and dismissals), training (including initial training and continuous professional training, all sorts and all levels of professional training, advanced professional training, additional qualifications and requalification, including gaining practical working experience), membership in professional organizations, including membership in organizations of employees or employers or any other organisation whose members perform certain vocation, involvement in such organisations and benefits given by these organisations.[16]

From the given legal provisions it can be seen that the scope of application of the ADA BiH was set in compliance with relevant EU directives, and in particular segments it was set even broader than the scope specified by international standards. By enumerating scopes of application, the legislator used the *exempli*

---

[12] "Harassment shall be considered discrimination in every situation when behaviour is related to one of the grounds mentioned in Article 2 that aims for or has an effect of violating person's dignity and creating an intimidating, hostile, degrading, humiliating or offensive environment." (Article 4(1), ADA BiH). "Sexual harassment shall be considered every form of unwanted verbal, non-verbal or physical behaviour of sexual nature which aims for or has an effect of violating dignity of a person, especially when it creates a fearful, hostile, degrading, humiliating or offensive environment." (Article 4(2), ADA BiH).

[13] "Mobbing shall be considered every form of non-physical harassment in the workplace with repetitive actions that have a humiliating effect on a victim and aim for or have degradation of employee's working conditions or professional status as a consequence." (Article 4(3), ADA BiH).

[14] In addition to the aforementioned "other forms of discrimination", the Act also defines segregation, instruction to discriminate and assistance to others in discrimination, as well as incitement to discriminate, as forms of discrimination. (Article 4(4), (5), and (6), ADA BiH).

[15] Article 2(2), ADA BiH.

[16] Article 6, ADA BiH.

causa approach, offering and broadening the opportunity for protection of citizens also in cases of discrimination that have not been specified *expressis verbis*.[17]

For every person who believes that he/she has been discriminated against in some way, the ADA BiH provides for a possibility to initiate administrative and legal proceedings for the protection of his/her rights.[18] In addition to the protection against discrimination in the existing procedures, special lawsuits for the protection against discrimination are also defined: a lawsuit for determination of discrimination,[19]a lawsuit for prohibition of discrimination,[20]a compensation lawsuit,[21] a request to publish a verdict in favour of a discriminated person in the media at the expense of a respondent (in case when discrimination is committed through media),[22] and a class-action lawsuit for protection against discrimination.[23]

According to the ADA BiH, legal actions for the protection against discrimination shall be prosecuted before a competent court of general territorial jurisdiction of first and second instance[24] and in accordance with the rules of civil procedure[25], if not otherwise determined by the related act. During proceedings, the court may issue a temporary injunction that could refer to insuring the proofs for which there exists fear based on reasonable grounds that they will not be presented or that their later presentation will be lingered, or insurance measures that include securing opponent's property with the goal of securing the claim, as provided for by procedural acts. The aim of this provision should also refer to a stay of execution of some actions or behaviour until the final judgement is passed, which could, if taken, cause unrecoverable damage to the party.[26]

---

[17] Vehabović, Faris, Izmirlija, Midhat, Kadribašić, Adnan, *Komentar Zakona o zabrani diskriminacije sa objašnjenjima i pregledom prakse u uporednom pravu*, Centar za ljudska prava Univerziteta u Sarajevu, Sarajevo, 2010, p. 32.

[18] Article 11(1) and (2), ADA BiH. Protection against discrimination defined in this way practically enables the potential existence of two simultaneous proceedings, i.e. administrative and legal, on the same basis, which may results in the possibility of reaching a different verdict in the very same case, but in two different proceedings, which may complicate the procedure referring to protection against discrimination. For details, see: Vehabović, Faris, Izmirlija, Midhat, Kadribašić, Adnan, op. cit., pp. 98-99.

[19] Article 12(1)a, ADA BiH.

[20] Article 12(1)b, ADA BiH.

[21] Article 12(1)c, ADA BiH.

[22] Article 12(1)d, ADA BiH.

[23] Article 17, ADA BiH.

[24] In the FBiH, the RS and the BD BiH, those are municipal and cantonal courts, basic and district courts, and the Brčko District Basic and Appellate Court, respectively.

[25] Civil Procedure Act, "Official Gazette of the FBiH", Nos. 53/03, 73/05, 19/06, Civil Procedure Act of the RS, "Official Gazette of the RS", Nos. 58/03, 85/03, 74/05 and 63/07, and Civil Procedure Act of the BD BiH, "Official Gazette of the BD BiH", Nos. 8/09 and 52/10.

[26] For details, see Vehabović, Faris, Izmirlija, Midhat, Kadribašić, Adnan, op. cit., pp. 108-110.

In proceedings conducted for the purpose of the protection against workplace discrimination there is a deviation from the basic civil procedure rule by which the burden of proof lies with the plaintiff. In this case, the burden of proof is on the respondent.[27] The reason for this lies in the fact that the discriminated person is an employee in a less favourable position with respect to the employer, and he/she most often does not have all necessary proofs at his/her disposal to convince the court that discrimination has occurred. To a great extent, the given provision makes the position of the discriminated person during the proceedings more favourable and it encourages making a decision on instituting proceedings for protection against discrimination. The provision implies that the burden of proof initially lies with the employee, who must make it plausible, i.e. raise reasonable doubt as to whether he/she has been or was discriminated on some of the foundations of the prohibition of discrimination. If he/she makes that plausible, the burden of proof is shifted to the employer who must prove that statements and allegations are not true and there has been no discrimination. If we take the aforementioned into account, it is clear that here we deal with the principle of a shared burden of proof.

Provisions prohibiting victimisation are of great importance when it comes to procedures in relation with protection against discrimination. Prohibition of victimisation implies prohibition of punishing or sanctioning or placing into a less favourable position a person who initiated legal proceedings for protection against discrimination or has participated in it.[28] As a rule, that is a victim of discrimination or a witness in proceedings, although such provisions should, in view of the subject of protection, also include persons who refused to behave in a discriminatory manner or rejected an instruction to discriminate. In terms of its scope, in addition to the protection against cancellation of employment contracts, protection should also extend to other forms of victimisation, such as salary cuts, failure to provide professional training and promotion, etc.[29]

2.2. Research on the frequency of lawsuits for employees' legal protection in cases of discrimination on the basis of the Anti-Discrimination Act in Bosnia and Herzegovina

Initiation of judicial proceedings against workplace and employment discrimination is definitely an ultimate but also most appropriate way to protect employee rights in cases of discrimination in BiH. One of the fundamental goals for passing the act was establishment of a mechanism for protection of citizens against discrimination procedures and behaviour and enabling a great number of people to initiate such proceedings in cases of discrimination based on prohibited

[27] Article 15(1), ADA BiH.
[28] Article 18, ADA BiH.
[29] Potočnjak, Željko, op. cit., pp. 84-85.

legal foundations. However, even after eighteen months after the date of entry into force of this Act, official and unofficial data inform about a small number of proceedings instituted before competent courts in BiH concerning workplace and employment discrimination cases, and even a smaller number of such cases that have ended up by passing the final judgement.

The goal of this research is *inter alia* to determine dynamics of the development of case law in view of judicial labour cases before competent courts in BiH initiated on the basis of the ADA BiH and based upon the obtained data to gain knowledge on the applicability of the Act. Moreover, on the ground of collected data the goal of our research is to assess possibilities and the importance of implementation of diversity management as a form of gradual prevention and mitigation of workplace and employment discrimination and ways of encouraging "mental transition" in the observed societies.

Record-keeping and data collection in discrimination cases is of multiple importance. First, such data represent a basic indicator of the frequency of discrimination occurrence in a certain society, thus an indicator of the condition of the society as a whole, but also of the overall social engagement in the field of elimination of this phenomenon. Furthermore, data on discrimination cases represent a basic factor for creating policy, legal acts and measures dealing with the prohibition of discrimination, since only only on the basis of actual data it is possible to estimate in which direction the current programmes should be corrected and directed Also, certain statistical data are indispensable to judicial proceedings in discrimination cases when the plaintiff tries to render that discrimination actually occurred, in order to shift the burden of proof to the respondent. Record-keeping and data collection in discrimination cases are of great importance for the process of scientific research for the purpose of setting up, development and explanation of certain theoretical discrimination hypotheses.

Bearing in mind the importance of record-keeping and data collection in discrimination cases, within the ADA BiH, the legislator paid special attention to this question. Namely, competent institutions in BiH are obliged to regularly keep records of all reported cases of discrimination and to deliver collected data to the Ministry for Human Rights and Refugees of BiH.[30] In addition to that, the Act provides for establishment of special records in legislative, executive and judicial bodies for the purpose of registering cases of discrimination determined in criminal, civil, non-litigation and enforcement proceedings.[31] For the purpose of record keeping and data collection on cases of discrimination, the Act also provides for the establishment of the central database for committed acts of

[30] Article 8(1), ADA BiH.
[31] Article 8(4), ADA BiH.

discrimination in BiH the Ministry for Human Rights and Refugees, which was supposed to issue a Rulebook on methods for collection of data on cases of discrimination in Bosnia and Herzegovina within 90 days upon the entry into force of the ADA BiH.[32]

2.3. Research results in relation to the frequency of lawsuits for employees' legal protection in discrimination cases

For the purposes of research and on the basis of ADA BiH provisions that relate to keeping records of discrimination cases, requests for access to information[33] on cases pertaining to workplace and employment discrimination have been submitted to twenty five courts on the territory of BiH,[34] Ministry of Justice of BiH, Ministry for Human Rights and Refugees of BiH, and the Institution of Human Rights Ombudsman of BiH.[35]

Out of twenty five courts the request for access to information was sent to, twenty four courts responded to the request and approved access to the required information, whereas Sarajevo Municipal Court did not respond to the request in question. In addition to Sarajevo Court, neither information on the frequency of this type of proceedings before competent courts in Banja Luka, Mostar and Zenica were available due to a specific way of keeping records of judicial labour disputes.[36] A somewhat different way of keeping records in the latter courts would definitely change the overall picture of the research results, since these are courts with a significant inflow of cases[37] in comparison with courts that submitted the requested information. According to information obtained from competent

---

[32] Article 8(5) and (6), ADA BiH.

[33] Freedom of Access to Information Act in the FBiH, "Official Gazette of the FBiH", No. 32/01.

[34] A random sample of twenty five courts from the whole territory of BiH was selected for the purpose of this research, i.e.: Bihać Municipal Court, Bugojno Municipal Court, Cazin Municipal Court, Goražde Municipal Court, Livno Municipal Court, Mostar Municipal Court, Orašje Municipal Court, Sanski Most Municipal Court, Sarajevo Municipal Court, Široki Brijeg Municipal Court, Tuzla Municipal Court, Velika Kladuša Municipal Court, Zenica Municipal Court, Banja Luka Basic Court, Doboj Basic Court, Gradiška Basic Court, Mrkonjić Grad Basic Court, Novi Grad Basic Court, Prijedor Basic Court, Sokolac Basic Court, Teslić Basic Court, Trebinje Basic Court, Višegrad Basic Court, Vlasenica Basic Court, and Brčko District BiH Basic Court.

[35] The research covered the period from the date of entry into force of the ADA BiH to 15 October 2010.

[36] CMS system or records (an electronic case management system).

[37] In response to our request, these courts pointed out that they were not able to provide information on these cases, since the way way of keeping records referring to judicial labour disputes did not allow them to do so. Namely, all cases of this type are classified as labour disputes, regardless of the act used as a basis for filing a lawsuit, so that special records of judicial labour disputes initiated on the basis of the ADA BiH do not exist. Thereby, alternative access to the required information was not offered.

courts, data referring to the frequency of lawsuits filed for legal protection of employee rights in discrimination cases on the basis of the Anti-Discrimination Act in BiH can be presented in tabular form as follows:

No.	Competent court	Form of discrimination	Phase of the proceedings
1.	Bihać Municipal Court	Mobbing (1 case)	First instance ruling
2.	Gradiška Basic Court	Discrimination (1 case)	First instance ruling
3.	Sokolac Basic Court	Discrimination and mobbing (1 case)	First instance ruling

Since the research results that were offered certainly do not represent the true image and the real situation in case law,[38] the same request was also submitted to the Ministry for Human Rights and Refugees of BiH[39] (that was not able to supply the requested information)[40] and the Institution of Human Rights Ombudsman of BiH[41] (its Office in Sarajevo offered a piece of information that there exists one case referring to the matter being researched and that it has been registered with the relevant Office),[42] which put an end to our search for official data requested on the basis of submitted requests for access to information.[43]

From the conducted research we can draw a conclusion that dynamics of the development of case law in view of judicial labour cases before competent courts in BiH initiated on the basis of the ADA BiH does not progress as expected and desired. The reason for that certainly lies in the fact the present level of development of the BiH society as a whole does not create either freedom and a sufficient dose of civil bravery, or sensitivity to recognise and report discrimination

[38] Let us remind ourselves here of the aforementioned Article 8(4) of the ADA BiH, that provides for special records in discrimination cases.

[39] With respect to the obligation from Article 8(5) of the ADA BiH.

[40] Ministry for Human Rights and Refugees of BiH informed us that a Rulebook on methods for collection of data on cases of discrimination in Bosnia and Herzegovina is underway (although its deadline expired 15 months ago), and that it has data on citizen complaints on the basis of human rights violations, but it does not have any data on discrimination cases before courts in BiH.

[41] Ministry for Human Rights and Refugees of BiH referred us to the Institution of Human Rights Ombudsman of BiH. Obligations in relation to keeping records of discrimination cases by the Institution of Human Rights Ombudsman of BiH are provided for in Article 8(1) of the ADA BiH.

[42] In view of research that has already been conducted through competent courts in BiH which showed somewhat different results, it is obvious that the data from the records kept by the Human Rights Ombudsman in BiH are incomplete, and hence not authentic.

[43] The data released at the Round Table dealing with the issue of the implementation of the ADA BiH, that was organised by OSCE and held in Trebinje at the end of 2010, stated that association "Stop mobbing" recorded 122 employee complaints of *mobbing*, out of which only seven initiated legal proceedings for the protection of their rights, but none of them has been completed yet. Data found at: http://www.trebinjedanas.com/node/2791 (22 December 2010).

cases as first steps towards the total elimination of discrimination. Due to the fear of losing a job or a position, stigmatisation, lack of support and other similar phenomena, numerous discrimination cases remain uncharacterised, thereby also unreported to competent institutions, authorities or organisations dealing with issue referring to the fight against discrimination, i.e. workplace and employment discrimination, and even a smaller number of such cases is likely to end up in court.

When it comes to the ADA BiH and its provisions, it will be welcome to point out at shortcomings which to a certain extent disable achievement of the fundamental goal – elimination of discrimination. These are primarily provisions referring to definition of certain forms of discrimination, which in turn complicates the procedure for proving them. Furthermore, these are provisions that open up possibilities of the co-existence of administrative and legal proceedings on the same case and in a particular case of discrimination, opening thereby the possibility of making completely different decisions in relation to the same question. And finally, these are provisions limiting the circle of persons covered by the prohibition of victimisation, so that they have discouraging effects on persons that intended or intend to contribute to its elimination in particular cases of discrimination. A significant problem noticed in research is the problem of keeping records of discrimination cases by legislative, executive and judicial authorities in BiH. Although the Act stipulates the obligation to keep records of discrimination cases, it seems that bodies in charge have neither necessary methodological knowledge nor corresponding software that would classify the given cases by forms of discrimination and types of disputes. The consequence of such condition is that a tendency of the number of discrimination cases to increase or decrease and indicators showing representation of particular forms of discrimination cannot be followed, which also implies that a proper response of competent institutions in the direction of the fight against discrimination and changes of the current legislation cannot be made, and scientific knowledge resulting from processing of the collected data cannot be identified.

Research results, though not completely precise, point out that the number of proceedings instituted before competent courts in BiH concerning workplace and employment discrimination cases is almost insignificant. It should be taken into account that the Act legally exists for a little bit more than eighteen months and the evaluation of effects of a normative framework can take time. In addition to that, it is necessary to educate and train employees and potential employees on their rights and ways to accomplish legal protection and to develop general awareness of unsuitability of discriminatory behaviour and the necessity to fight against this social phenomenon. In that sense, diversity management as a practical tool in hands of employers can have a preventative function and affect a decrease

in discrimination in a work environment and gradual perception of harmfulness of such behaviour to human relations, business rating, and market success.

3. Legal framework for the prevention of workplace and employment discrimination in the Republic of Croatia

In this part of research we shall not deal in detail with normative analysis of provisions pertaining to Croatian labour and anti-discrimination legislation, since papers published on that topic are available in English[44], but we shall only point out summarily the fundamental legal framework of the fight against workplace and employment discrimination. In addition, the respective Croatian legislation is harmonised with the European legislation, i.e. relevant directives, so that in many parts it conforms to previously specified definitions of discrimination in the BiH legislation. We shall briefly point out a number of questionable and, in our opinion, disputable issues that are in contrast to the European acquis communautaire or casuistics of the European Court of Justice.

The process of horizontal harmonisation of national legislation in the field of labour and prohibition of discrimination seems to have been mostly completed by the date of entry into force of the Labour Act[45] of the Republic of Croatia, i.e. 1 January 2010. By the decision on passing a new Act with respect to the Labour Act of 1995, the Government undoubtedly tried to avoid all problems arising as a consequence of the Croatian "*nomotechnical phenomenology*" referring to frequent amendments of the existing fundamental law in the field of work and workplace relations, and thereby also difficulties in relation to particular and fragmentary regulation as to the prohibition of discrimination in many national regulations. A new text of the act should therefore be considered not only as an attempt to achieve a higher level of harmonisation with the *acquis communautaire*, but also as a clear aim to bring order into nomotechnical rules in the field of workplace relations.[46] In 2003, former labour legislation

[44] See Potočnjak, Željko, Grgić, Andrea, Relations Between the Anti-Discrimination Act, the Constitution and Other Acts Prohibiting Dicrimination, in: Šimonović Einwalter, Tena (ed.), *A Guide to Anti-Discrimination Act*, Goverment of the Republic of Croatia, Office for Human Rights, Zagreb, 2009, pp. 129-144; Uzelac, Alan, Proceedings Before the Court, in: Šimonović Einwalter, Tena (ed.), op. cit., pp. 95-107; Selanec, Goran, Šimonović Einwalter, Tena, Scope of the Anti-Discrimination Act, in: Šimonović Einwalter, Tena (ed.), op. cit., pp. 23-30; Vinković, Mario, New Croatian Anti-Discrimination Legislation – Harmonisation with the Acquis or even more? in: Klima, Karel, Sander, G. Gerald (eds.), *Grund- und Menschenrechte in Europa,* Schriften zu Mittel- und Osteuropa in der Europäischen Integration, Band 10, Velag Dr. Kovač, Hamburg, 2010, pp. 97-123.

[45] Labour Act, Official Gazette, No. 149/09.

[46] Vinković, Mario, Horizontalna harmonizacija hrvatskog (radnog) zakonodavstva – kamo je nestala zabrana diskriminacije i zaštita majčinstva/roditeljstva? in: Rožman, Krešimir (ed.), *Novi Zakon o radu – Detaljni komentar novih odredaba*, Rosip d.o.o., Zagreb, 2010, p. 331.

was enhanced by provisions on the prohibition of workplace and employment discrimination by amending the then Labour Act.[47] The provisions in question in their substrate followed *mutatis mutandis* solutions of relevant EU directives, but a severe deficit of procedural rules was noticed that considerably challenged a possible degree of protection a person looking for employment and an employed person could get in proceedings before an employer or a competent court. As a general novelty in the then workplace relations, provisions on the prohibition of discrimination, harassment and sexual harassment were also dependent on the level of interpretive capacities of Croatian judges and a degree of their education with respect to the said issues. A certain number of final judgements by which employed persons and persons looking for employment asked for protection against discriminatory behaviour, i.e. unequal treatment, harassment and sexual harassment, apparently witnessed an inadequate level of awareness of possible protection, as well as possible distrust in institutional forms of that protection.[48] Amendments to the then Labour Act in 2004 legally regulate the issue of the prohibition of discrimination in the employment and workplace procedure as well as normatively formulated definitions of direct and indirect discrimination, harassment and sexual harassment that are *inter alia* designated as forms of gender discrimination. Moreover, as an expression of reception of Article 141 of the EC Treaty, the latter act also regulated the right to equal pay for male and female workers for equal work or work of equal value. The basic shortcoming of provisions provided for in the then Labour Act, especially when it comes to reference to legal grounds underlying the prohibition of discrimination, was represented by a *numerus clausus* system and the abolition of the provision on giving preference to the under-represented sex when within the framework of the employment procedure both a female and a male candidate equally satisfy all the requirements for the job. The abolition of the aforementioned provision after only a year of its legal existence repealed the previously established legal framework to combat sexual segregation in the employment procedure.[49]

As a consequence of the conducted mutual horizontal harmonisation of Croatian laws, the new Labour Act contains only basic rules concerning the protection of the dignity of employees and provisions referring to the prohibition of unequal treatment of pregnant women, while the protection of employees against harassment, sexual harassment and discrimination, as well as definition

---

[47] Labour Act of 1995. Published in: Official Gazette, Nos. 38/95, 54/95, 65/95, 82/01, 114/03, 142/03, 30/04.

[48] Vinković, Mario, Horizontalna harmonizacija hrvatskog (radnog) zakonodavstva – kamo je nestala zabrana diskriminacije i zaštita majčinstva/roditeljstva, op. cit. , p. 332.

[49] Cf. Vinković, Mario, Gender Equality and the Process of Harmonisation of the Croatian Labour Law, Croatian Yearbook of European Law and Policy, No.1/2005, pp. 204-205; Vinković, Mario, New Croatian Anti-Discrimination Legislation..., op. cit., p. 100.

of related institutes, are now regulated by a special act and autonomous sources of law applied to a particular employer.[50] Namely, in July 2008 Croatia passed a separate Anti-Discrimination Act (hereinafter referred to as: "CROADA")[51]. Adoption of the Act in the Croatian Parliament was accompanied by numerous *pro* and *contra* public discussions. The Act was strongly opposed by the Catholic Church supported by conservative political circles which allegedly recognised in it a legal framework that enables same-sex couples to adopt children. After long discussions, even taking off the Act from the agenda of the Croatian Parliament, disputes were finally resolved by the Government of the Republic of Croatia, with a short and resolute explanation that passing the Act represents the fulfilment of necessary prerequisites for the full membership of the Republic of Croatia in the European Union. By making any further arbitration as to its contents impossible, it *de facto* caused tempestuous public debates as well as media interest to terminate.

Together with the Gender Equality Act[52] and the Same Sex Cohabitation Act,[53] CROADA creates a fundamental normative framework for combat against discrimination in all spheres of public and private life. Although it entered into force as late as 1 January 2009, due to everyday practice and an almost complete absence of judicature, despite provisions of earlier regulations prohibiting discrimination, especially in the field of work, a question arises whether the Act has accomplished its mission or whether it represents only a first step in a long-term fight against discrimination in Croatia.

CROADA shall apply to the conduct of all state bodies, bodies of local and regional self-government units, legal persons vested with public authority, and to the conduct of all legal and natural persons, and what is *inter alia* most important for our analysis, in the field of work and working conditions, access to self-employment and occupation, including selection criteria, recruiting and promotion conditions, access to all types of vocational guidance, vocational training, professional improvement and retraining.54 By virtue of the numerus clausus system, the Act prohibits discrimination pursuant to 17 legal grounds: race or ethnic affiliation or colour, gender, language, religion, political or other belief, national or social origin, property, trade union membership, education social status, marital or family status, age, health condition, disability, genetic origin, native identity or expression, and sexual orientation, thereby significantly expanding legal grounds for prohibition with respect to legal grounds for discrimination in

[50] Cf. Article 130 of the Labour Act of 2009.
[51] Anti-Discrimination Act, Official Gazette, No. 85/2008.
[52] Gender Equality Act, Official Gazette, No. 82/2008.
[53] Same Sex Cohabitation Act, Offical Gazette, No. 116/2003.
[54] Cf. Article 8 of the Croatian Anti-Discrimination Act.

the EU (gender, race, ethnic affiliation or colour, sexual orientation, age, religion and disability). Indeed, due to a new legal status of the Charter of Fundamental Rights of the EU, by the entry into force of the Lisbon Treaty, the prohibition of discrimination in the EU takes on a much broader dimension, but case law will pro futuro show whether a transition of the prohibition of discrimination from the existing level to a higher interpretive and normative level will take place and how long it will take. CROADA contains formerly adopted definitions of direct and indirect discrimination, harassment and sexual harassment, encouragement to discrimination and a failure to make reasonable adaptation are determined as discrimination and segregation is anticipated as a form of discrimination. By the letter of the law, segregation represents "a forced and systematic separation of persons on any of the grounds as to the prohibition of discrimination", by which the national legislator takes it a step further from the European acquis communautaire that does not define it at all. However, in our opinion, such subsumed definition significantly limits the fight against segregation which is a result of indirect discrimination. In contrast to that, ADA BiH defines segregation as "an act by which a natural or legal person separates other persons on the basis of one of the grounds precisely given as to the prohibition of discrimination", not giving thereby the need that such act is a result of coercion.[55] In this way, BiH legislation constructed a normative framework of better quality in comparison to relevant CROADA provisions for which it cannot be stated with certainty that they can achieve the same level of efficiency. Selanec recalls that CROADA does not define "a forced and systematic" separation, but it lets this challenge to Croatian courts, so following this, "forced" and "systematic" should not be linked to intentional separation and a threat of some force.[56] A forced separation can be perceived, as he points out, as any separation accompanied by some unwanted effect[57]. Unlike ADA BiH that labels mobbing as a form of discrimination and defines it as "every form of non-physical harassment in the working place with repetitive actions that have a humiliating effect on a victim ..."[58], CROADA does not mention mobbing expressis verbis. Hence, legal protection against mobbing in Croatia can be offered only based upon provisions referring to the prohibition of harassment and by linking such harassment to some of the legal grounds for the prohibition against discrimination. A step away from the European legislation was made by CROADA by standardising the concept of intersectional (multiple) discrimination, the concept of repeated discrimination and the concept of prolonged discrimination. However, former practice and

[55] Cf. Article 4(4) of the ADA BiH.

[56] Selanec, Goran, Forms of Discrimination, in: Šimonović Einwalter, Tena (ed.), op. cit., p. 51.

[57] Ibid.

[58] Cf. Article 4(3) of the ADA BiH.

experience show that, due to a series of circumstances, sanctioning workplace and employment discrimination will be aggravating, so that the question poses itself to which extent it will be possible to identify the given, especially severe forms of discrimination.

CROADA provides for institutional mechanisms of protection by defining the Ombudsman of the Republic of Croatia as the central body for suppression of discrimination, that *inter alia* collects and analyses statistical data in relation with discrimination. In terms of process, CROADA considerably enhances mechanisms to combat discrimination by regulating types of individual court proceedings for protection of the rights to equal treatment (filing a lawsuit seeking the protection of an individual personal right that has been violated on account of discrimination and filing a lawsuit seeking that the issue of discrimination be decided on as the main issue – action for determination of discrimination, action for prohibition of discrimination, action for the elimination of discrimination or its effect, action for damages caused by discrimination and action for the publication of the determination of discrimination) and collective anti-discrimination court proceedings (associational action for protection against discrimination).[59]

3.1. Number of workplace and employment discrimination cases in the Republic of Croatia

Being aware of difficulties we faced while collecting data on the frequency of court cases in relation with workplace and employment discrimination before courts in Bosnia and Croatia as well as deficiency of data that could have been given by the Human Rights Ombudsman of Bosnia and Herzegovina, we resorted to a different methodological approach when collecting data in the Republic of Croatia. CROADA specifies the role of the Ombudsman as the central body responsible for suppression of discrimination, which shall, in addition to collection and analysis of statistical data on discrimination cases, receive reports of all the natural and legal persons, provide necessary information to natural and legal persons that have filed a complaint on account of discrimination with regard to their rights and obligations and to possibilities of court and other protection, examine individual reports and take actions if court proceedings have not been initiated yet, warn the public about the occurrence of discrimination, conduct mediation with the consent of the parties involved, conduct surveys concerning discrimination, provide the Croatian Parliament with opinions and recommendations and propose appropriate legal and strategic solutions in relation to discrimination.[60] Collection of data on court cases related to discrimination in the Republic of Croatia is difficult due to long-term procedures referring to

[59] See Uzelac, Alan, op. cit., pp. 99-107.
[60] Cf. Article 12(29) of the CROADA.

collection of such data, but also due to methodology insufficiently developed for processing court cases related to discrimination. Since we made a conclusion that the Croatian People's Ombudsman's report very precisely summarizes discrimination cases reported to and processed in that Office, we decided to use available statistical data and in that way gain an insight into the actuality of the application of normative solutions, but also a partially limited number of cased related to workplace and employment discrimination.

457 complaints in the field of labour and civil servants relations were filed with the Croatian People's Ombudsman Office in the period from 2006 to 2010 referring to violation of employee rights, including two cases of mobbing.61 In 2009, the Ombudsman Office opened 172 case files pertaining to suppression of discrimination, 169 of which were reports of a discriminated or other natural or legal person and 3 court proceedings were initiated by the Ombudsman himself. Out of the total number of case files, 56 of them, i.e. 32.55%, referred to discrimination in relation to labour and labour conditions (employment, professional training, and retraining).[62] 18 cases, i.e. 10.46% of the total number of cases, referred to discrimination in relation to access to goods and services, whereas 4 cases or 2.33% of the total number of cases referred to trade union membership and activity in civil society organisations/political parties or any other organizations.[63] Concerning legal grounds for the prohibition of discrimination, it can be noticed that 31.39% of the aforementioned cases referred to discrimination on grounds of race, ethnic affiliation or colour and national origin, 9.88% to sexual discrimination, 3.50% to trade union membership, 5.81% to disability, and in as many as 25.58% of cases legal grounds for discrimination were not stated.[64]

A field study conducted in Croatia in May and June 2009 by Eurobarometer (on a sample of 1000 respondents)[65], also implies a high level of perception of the frequent occurence of discrimination in Croatia. Even 53% of respondents believe that discrimination on grounds of sexual orientation is very widespread (higher than the EU average of 47%), whereas other most common grounds of discrimination include age (47%), disability (44%), gender (42%) and

---

[61] *Croatian People's Ombudsman's annual activity report for 2010*, Table 8, p. 8. Available at: http://www.ombudsman.hr/dodaci/IZVJESCE%20ZA%202010.pdf. (1 March 2011).

[62] *Croatian People's Ombudsman's Report on occurence of discrimination for 2009,* pp. 6-8. Available at: http://www.ombudsman.hr/dodaci/IZVJESCE%20O%20POJAVAma%20DISKRIMINACIJE%20ZA%2009.pdf (1 March 2011)

[63] Ibid., p. 9.

[64] Ibid., p. 8.

[65] See at: http://ec.europa.eu/public_opinion/archives/ebs/ebs_317_fact_hr_hr1.pdf (27 February 2011).

ethnic affiliation (41%).[66] In the opinion of Croatian respondents, potential discriminatory elements that could place a candidate into a less favourable position with respect to some other person in the employment procedure are age (48% of respondents), disability (34%), gender (31%), name and family name (25%) and finally sexual orientation (24%).[67] When it comes to sexual discrimination, we should take into account the information released by the Gender Equality Ombudswoman Office which states that in the year 2010 complaints referring to harassment and sexual harassment in the workplace were lodged exclusively by women that were exposed to such discriminatory behaviour in their workplace on a daily basis by their supervisors, colleagues and subordinates.[68] The Office points out that in a certain number of cases, due to the fear of losing a job, lack of support in the workplace (refusal to testify, isolation) and a non-existent representative in charge of the protection of the dignity of employees, reported complaints lodged for harassment and sexual harassment have been withdrawn.[69] It is also pointed out that in view of the aforementioned, but also due to the fear of victimisation, threat and risks related to long-running legal actions, it is not possible at all to determine the actual range of conduct which may be characterised as harassment and sexual harassment of women in the workplace,[70] and that sexual harassment cases of workplace and employment discrimination pertaining to women mostly refer to pregnancy and gender insensitive job vacancy advertisements preferring employees of a certain gender (in spite of legal prohibition).[71] The survey conducted by the Gender Equality Ombudswoman Office on the existing difference in pay between men and women for equal work or work of equal value gives strong support to the starting assumption that the gender pay gap in the Croatian labour market is not a consequence of deliberate or systematic unfavourable treatment of women, but of a horizontal segregation in the labour market .[72]

When it comes to discrimination against persons with disabilities, in its Annual Activity Report[73], the Office of the Ombudswoman for Persons with Disabilities stresses that sanctions should be introduced for employers who do not act in accordance with provisions set out in the Act on Vocational Rehabilitation

[66] Ibid.
[67] Ibid.
[68] Annual activity report of the Ombudswoman for gender equality for 2010, p. 12. Available at: http://www.prs.hr/docs/rh_prs_izvjesce_2010.pdf (26 February 2011).
[69] Ibid.
[70] Ibid., p. 13.
[71] Ibid., p. 17.
[72] Ibid., p. 27.
[73] *Annual activity report of the Ombudswoman for persons with disabilities for 2010.* Available at: http://www.posi.hr/download/konacno_izvjesce_2010.pdf (1 March 2011).

and Employment of Persons with Disabilities,[74] i.e. who, in spite of the legal provisions, do not want to employ persons with disabilities, and the existing quota-based system for employing such persons should be enhanced.[75] Despite the existence of the legal framework for protection, the disabled persons can hardly find a job. The Ombudswoman for persons with disabilities herself was criticised not long time ago, when she did not want to employ a person with disabilities as her deputy trying thereby to justify herself by saying that the law does not specify anywhere that her deputy should be a person with disabilities.[76]

Econometric analysis conducted by experts of the central Croatian civil society organisation dealing with mobbing (Association Mobbing, Zagreb[77]) among identified victims of workplace harassment showed that 62% of respondents perceived themselves as victims of workplace mobbing.[78] The average age of victims is 44 years, and there is a higher percentage of female victims (64%) and government employees (52%).[79] Also, there is a greater chance of mobbing in smaller companies, i.e. the ones with less than 250 employees, and its consequences to the greatest extent affect a lack of motivation (76%) and concentration at work (71%) and cause general employee dissatisfaction (89%) which in as many as 70% of cases results in quitting the job.[80]

Data used in our research suggest that discrimination and workplace harassment are frequent phenomena. Due to consequences of the great economic crisis and a high unemployment rate, i.e. the fear of losing a job or income of existential importance, stigmatisation, lack of support in the workplace and a complex and long-running procedure of obtaining legal protection on the one

---

[74] Act on Vocational Rehabilitation and Employment of Persons with Disabilities, Offical Gazette, No.143/02, 33/05.

[75] *Annual activity report of the Ombudswoman for persons with disabilities for 2010*, op. cit., p. 69.

[76] *Ombudswoman for persons with disabilities does not want to employ a blind person*, Slobodna Dalmacija, 14 October 2008.

[77] Empirical research encompasses a database of 2009, i.e. 400 respondents identified as mobbing victims with respect to several basic sociodemographic features: gender, age, education and type of a company they work in. Since the analysis includes persons who reported to the association as victims, it is pointed out in the analysis that, due to a subjective opinion, broad data might occur. However, as the corrective factor, only those respondents were taken into account who said that within the period of previous six months they had been exposed to negative acts in the workplace on a daily basis or at least once a week (doing jobs that do not have anything in common with their usual job, setting irrational deadlines, teasing, excessive control of the job done, practical jokes, etc.). More detail about the said research in pdf format can be found at: http://www.antimobbing-net.org/images/stories/documents/ekonometrijska_analiza_antimobbing.pdf (20 February 2011).

[78] The research covered 400 respondents from the database provided by Association Mobbing for the year 2009. See Ibid., p.2.

[79] Ibid.

[80] Ibid., pp. 2 and 5.

hand, and deep-rooted prejudices, stereotypes and employers ignorant of the fact that the said behaviour and/or its tolerance may *pro futuro* cause harm on a long-term basis on the other, discrimination, harassment and sexual harassment in the workplace, as problems that are constantly deepening, require considerations on the usage of technologies and practical tools that would prevent or at least mitigate the given problems.

4. Why Diversity Management in Bosnia and Croatia?

A relatively small number of lawsuits by means of which employees try to get protection in cases of discrimination, harassment, i.e. mobbing and sexual harassment in the workplace, insufficient data on protection of employees in proceedings by employers[81] and the present assessment of a large number of cases that go unreported, causes a question to arise as to the need for an interdisciplinary approach to the said phenomenon. Quality of normative solutions is just a first step in the fight against discrimination and its forms in the workplace. A far more complex problem is implementation of the existing normative solutions and development of practical tools that would enable a gradual transition from the culture of prejudice and stereotypes, the culture of intolerance and repudiation of the right to diversity to the culture of appreciation for diversities, the culture of equality and tolerance, as major building blocks of professional and business ethnics. Moreover, workplace environment without mobbing, harassment and discrimination of employees has far-reaching and palpable effects on employee productivity, job satisfaction, and thereby also business success and employer's market position. In our opinion, *diversity management* is therefore a significant practical "tool" which should be used *in favorem* creating a motivating work environment and gradual mitigation of effects of discriminatory behaviour in the workplace.

Application possibilities of *diversity management* for the purpose of combating workplace discrimination have been studied neither in Bosnia and Herzegovina nor in Croatia.[82] The reasons for this might be found in the fact that in the beginning

[81] In Croatia, we just have the data referring to the Hrvatske pošte company, which has been successfully settling labour disputes since 2007, including conciliation in cases of mobbing, discrimination and sexual harassment in the workplace. Office of Legal Affairs of Hrvatske pošte sees conciliation as "a good tool in business" and affirmation of the Croatian Conciliation Act (the first Conciliation Act in Croatia was passed as early as in 2003, but the new Conciliation Act entered into force in January 2011 – Official Gazette, No. 18/2011), but since 2007 it has solved 118 cases of conciliation in labour disputes, and managed to settle 66% of the said labour disputes. The data released at the Round Table "Conciliation - practical experience and possibilities for enhancement", organised by the Croatian Employers' Association, Osijek, 24 February 2011.

[82] An exception is one professional paper published in Croatia. See: Bjelić, Dragana and Mirosav, Zoran, Diskriminacija i "diversity management" u radnom pravu, Radno pravo, No. 10/2007.

of the 1990-ies *diversity management* was a top issue in American and, a bit less, in British literature, but it remained on the margins of literature in continental Europe.[83] It emerged as a response to noticeable diversity of the American labour force, a response that was supposed to revoke previous practice of assimilation of diverse people that proved to be wrong. In the process of assimilation, "diverse people" feel inhibited, they are afraid of excelling, they are not oriented towards strengthening their personal and professional qualities as well as expressing new ideas, but they are constantly trying to adapt to the environment that does not accept diversities.[84] They are actually trying to hide their cultural specificities in the work environment and assimilate tradition, types of behaviour and expression and the dominant value system, i.e. the one of the majority. By defining *diversity management* as a "process" that works for all employees we stress its "evolutionary nature" and give space to companies to develop mechanisms that would gradually enable creation of "natural capabilities" for "drawing on" the potential of all employees.[85] Hence, diversity includes everything, independently of age or gender, professional background, capabilities, sexual orientation, geographic origin, education or hierarchical status by the employer.[86] In conditions of a European perspective of Croatia and Bosnia, and taking into account the fact that today the European labour force, enjoying freedom of movement, is full of diversities just like the American, *diversity management* should be observed in new light. We need a tool that would give sense to the normative foundation, that would, on a practical level, have capacity for a successful fight against prejudices and stereotypes, the capacity that could overcome past problems and build a successful business and professional environment void of discrimination and disregard of diversity. In purely economic terms, profit and business success are important for business, just like a value system promoted by the legislative framework and codes of conduct or other autonomous sources. Diversity is very often an advantage for market position, so that there are no business obstacles for using this "tool".

An interdisciplinary focus raises the need for legal mechanisms and national systems of labour law, with respect to all local specificities, to find modes aimed at overcoming deep-rooted prejudices as a pledge of building modern European societies. In Croatia and Bosnia, soon we'll not meet only diverse people that belong to formerly warring ethnic groups and entities but, in a European perspective, a far more complex concept of diversity. In this sense, free movement

[83] Cf. Barbosa, Iris and Cabral-Cardoso, Carlos, Equality and diversity rhetoric: one size fits all? Globalization and the Portuguese context, Equality, Diversity and Inclusion: An International Journal, Vol. 29, No. 1, 2010, p. 98.

[84] Roosevelt, loc. cit.

[85] Ibid., p. 10.

[86] Ibid.

of workers will definitely change the present perception, but it will be necessary for the said societies to show that they are mature and ready to accept the European idea of "unity in diversity" in everyday life and business relations. In her recent talk about the position of women in the domestic market and the need to introduce the institute of a union equality representative, the British Minister for Women and Equality, Ms Harriet Harman, pointed out that "equality and the absence of discrimination are hallmarks of a modern society, as well as important for the economy so that it can draw on the talents of all".[87] Diversity and inequality are very important features of modern societies that affect and form human resource management systems.[88] In the time of crisis and recession, encouragement of equal opportunities for all, fight against discrimination and integration of talents of employees of diverse identities are more important than ever.[89] Diversity management makes it possible for organisational entities and companies to reflect social and societal diversity of the community[90] and absorb consequences of demographic changes and pronounced migrations. It is the fact that gender diversity issues have drawn the most attention in Europe, even here as well, but it is necessary to work on issues as to accepting diversities in workplace environment in relation to race and ethnic affiliation, age, sexual orientation and gender identity, disability, individually, but also in case when the aforementioned diversities cumulate. The legal framework in Croatia identifies multiple discrimination as a severe form of discrimination, but it is necessary to work out practical models for mitigation of the effects of discrimination in the workplace and attempts of its gradual elimination.

Recent survey conducted for the purpose of studying contents of *diversity management* on webpages of Portuguese companies sublimates a conclusion that the given contents are mostly "imported", i.e. represented on webpages of American and British companies.[91] It is therefore necessary to focus on the importance of diversity management not only for managers but also for the workforce in general.[92] The importance of acceptance and perception of *diversity management* as an important tool, and not only as a process or part of human resource management, lies in education and the necessity requiring all business

[87] See Bennett, Tony, New ways of promoting equality and diversity in the workplace, The role of the union equality representative, Equal Opportunities International, Vol. 28, No. 5, 2009, p. 444.

[88] Barbosa and Cabral-Cardoso, op. cit., p. 99.

[89] Bennett, op. cit., p. 445.

[90] Barbosa and Cabral-Cardoso, op. cit., p. 100.

[91] Ibid., p. 105.

[92] See *Best Practice in Diversity Management*, United Nations Expert Group Meeting on Managing Diversity in the Civil Service, United Nations Headquarters, New York, 3 - 4 May 2001, p. 2. Available in pdf format from: http://unpan1.un.org/intradoc/groups/public/documents/un/unpan000715.pdf (20 January 2011).

schools[93] and Faculties of Economics in Croatia to pay due attention to the aforementioned topics. Moreover, law students should also become familiar with the importance and potential of diversity management, since we proceed from the assumption that diversity management has to be considered in a broader context that has an interdisciplinary focus and a capability of being used as a specific and adaptable tool. Here we especially refer to the possibility of encouraging employment of competent and diverse people as significant leverage in the fight against stereotypes in the society and workplace environment and a reflection of perception of evidently present and even more pronounced social diversities. This is a gradual and long-running process, but it is worth a try, as it was done in the USA some two decades ago. Perhaps the first step could be a broader education and profiling campaign pertaining to (here) a new interdisciplinary branch of education and lifelong learning, i.e. Human Resources Law, in which diversity management mechanisms would occupy a significant part.

5. Concluding remarks

Based upon the collected statistical data on the frequency of court cases in relation with discrimination, harassment, sexual harassment and mobbing in Bosnia and Croatia, we tried to gain insight into the actuality of the application of normative solutions and point out a large number of cases that go unreported and thus unsanctioned. They are consequences of the fear of losing a job or a position, stigmatisation, and even a socially tolerant attitude toward workplace discrimination. In brief, the sum of national solutions reflects a normative framework of a relatively good quality for the fight against workplace discrimination, but it is not a sufficient form of combat against the present social stereotypes, prejudice, and challenges faced by the societies in question in a social, political and economic, post-transition European perspective. *Diversity management*, as a primarily economic instrument, is considered to be a well-adaptable and insufficiently affirmed tool used to combat discrimination. It is a "tool" that has a significant interdisciplinary application which outgrows the framework of management and economy and realises its practical results in a gradual transition from the intolerant society to a society promoting tolerance and the fight against workplace and employment discrimination.

[93] Cf. Barbosa and Cabral-Cardoso, op. cit., p. 110.

Bibliography

Annual activity report of the Ombudswoman for gender equality for 2010, p. 12. Available at: http://www.prs.hr/docs/rh_prs_izvjesce_2010.pdf .

Annual activity report of the Ombudswoman for persons with disabilities for 2010. Available at: http://www.posi.hr/download/konacno_izvjesce_2010.pdf .

Barbosa, Iris and Cabral-Cardoso, Carlos, Equality and diversity rhetoric: one size fits all? Globalization and the Portuguese context, Equality, Diversity and Inclusion: An International Journal, Vol. 29, No. 1, 2010.

Bennett, Tony, New ways of promoting equality and diversity in the workplace, The role of the union equality representative, Equal Opportunities International, Vol. 28, No. 5, 2009.

Best Practice in Diversity Management, United Nations Expert Group Meeting on Managing Diversity in the Civil Service, United Nations Headquarters, New York, 2001. Available in pdf format from:http://unpan1.un.org/intradoc/groups/public/documents/un/unpan000715.pdf .

Bjelić, Dragana and Mirosav, Zoran, Diskriminacija i "diversity management" u radnom pravu, Radno pravo, No. 10/2007.

Croatian People's Ombudsman's annual activity report for 2010, Table 8, p. 8. Available at: http://www.ombudsman.hr/dodaci/IZVJESCE%20ZA%202010.pdf .

Croatian People's Ombudsman's Report on occurence of discrimination for 2009, pp. 6-8. Available at: http://www.ombudsman.hr/dodaci/IZVJESCE%20O%20POJAVAma%20DISKRIMINACIJE%20ZA%2009.pdf .

Potočnjak, Željko, Grgić, Andrea, Relations Between the Anti-Discrimination Act, the Constitution and Other Acts Prohibiting Dicrimination, in: Šimonović Einwalter, Tena (ed.), *A Guide to Anti-Discrimination Act*, Goverment of the Republic of Croatia, Office for Human Rights, Zagreb, 2009.

Potočnjak, Željko: Zabrana diskriminacije, uznemiravanja i spolnog uznemiravanja u radnim odnosima, in: Potočnjak, Željko et al. (ed.), *Radni odnosi u Republici Hrvatskoj*, Pravni fakultet u Zagrebu and Organizator, Zagreb, 2007.

Selanec, Goran, Šimonović Einwalter, Tena, Scope of the Anti-Discrimination Act, in: Šimonović Einwalter, Tena (ed.), *A Guide to Anti-Discrimination Act*, Goverment of the Republic of Croatia, Office for Human Rights, Zagreb, 2009.

Selanec, Goran, Forms of Discrimination, in: Šimonović Einwalter, Tena (ed), *A Guide to Anti-Discrimination Act*, Goverment of the Republic of Croatia, Office for Human Rights, Zagreb, 2009.

Thomas R. Roosevelt, *Beyond race and gender: unleashing the power of your total work force by managing diversity*, AMACOM, 1991.

Uzelac, Alan, Proceedings Before the Court, in: Šimonović Einwalter, Tena (ed.) *A Guide to Anti-Discrimination Act*, Goverment of the Republic of Croatia, Office for Human Rights, Zagreb, 2009.

Vehabović, Faris, Izmirlija, Midhat, Kadribašić, Adnan, *Komentar Zakona o zabrani diskriminacije sa objašnjenjima i pregledom prakse u uporednom pravu*, Centar za ljudska prava Univerziteta u Sarajevu, Sarajevo, 2010.

Vinković, M., *Gender* Equality and the Process of Harmonisation of the Croatian Labour Law, Croatian Yearbook of European Law and Policy, No.1/2005.

Vinković, Mario, New Croatian Anti-Discrimination Legislation – Harmonisation with the Acquis or even more? in: Klima, Karel, Sander, G. Gerald (eds.), *Grund- und Menschenrechte in Europa,* Schriften zu Mittel- und Osteuropa in der Europäischen Integration, Band 10, Velag Dr. Kovač, Hamburg, 2010.

Vinković, Mario, Horizontalna harmonizacija hrvatskog (radnog) zakonodavstva – kamo je nestala zabrana diskriminacije i zaštita majčinstva/roditeljstva? in: Rožman, Krešimir (ed.), *Novi Zakon o radu – Detaljni komentar novih odredaba*, Rosip d.o.o., Zagreb, 2010.

Legislation:

Act on Vocational Rehabilitation and Employment of Persons with Disabilities of the Republic of Croatia, Offical Gazette, Nos.143/02, 33/05.

Anti-Discrimination Act of the Republic of Croatia, Official Gazette, No. 85/2008.

Civil Procedure Act, "Official Gazette of the FBiH", No. 53/03, 73/05, 19/06,

Civil Procedure Act of the RS, "Official Gazette of the RS", Nos. 58/03, 85/03, 74/05 and 63/07.

Civil Procedure Act of the BD BiH, "Official Gazette of the BD BiH", Nos. 8/09 and 52/10.

Constitution of the Federation of Bosnia and Herzegovina (FBiH), "Official Gazette of the Federation of Bosnia and Herzegovina", No. 1/94, 13/97, 16/02, 22/02, 52/02, 60/02, 18/03, 60/03,

Constitution of the Republika Srpska (RS), "Official Gazette of the RS" No. 6/92, 8/92, 15/92, 19/92, 21/92, 28/94, 8/96, 13/96, 15/96, 16/96, 21/96, 21/02, 30/02, 31/03, 98/03.

Freedom of Access to Information Act in the FBiH, "Official Gazette of the FBiH", No. 32/01.

Gender Equality Act of the Republic of Croatia, Official Gazette, No. 82/2008.

Gender Equality Law of Bosnia and Herzegovina ("Official Gazette of BiH", No. 16/03).

Labour Act of the Republic of Croatia, Official Gazette, No. 149/09.

Labour Act of FBiH ("Official Gazette of BiH", Nos. 43/99, 32/00 and 29/03).

Same Sex Cohabitation Act of the Republic of Croatia, Offical Gazette, No. 116/2003.

Statute of the Brčko District of Bosnia and Herzegovina (BD BiH), "Official Gazette of the BD BiH" Nos. 17/08 and 39/09.

The Criminal Law of the BD BiH, "Official Gazette of the BD BiH", Nos. 10/03, 45/04 and 06/05.

The Criminal Law of BiH, "Official Gazette of BiH", No. 3/03, 32/03, 37/03, 54/04, 61/04, 30/05, 53/06, 56/06, 32/07 and 8/10.

The Criminal Law of the FBiH "Official Gazette of the Federation of Bosnia and Herzegovina", No. 36/03, 37/03, 21/04, 69/04 and 18/05.

The Criminal Law of the RS, "Official Gazette of the RS", No. 49/03, 108/04, 37/06 and 70/06.

The Labour Act of the Brčko District BiH, "Official Gazette of the BD BiH", No. 7/00, 08/03, 33/04, 29/05, 19/07 and 25/08.

The Republika Srpska Labour Act, "Official Gazette of the RS", No. 38/00, 40/00, 47/02, 38/03, 66/03 and 20/07.

Ivana Barković Bojanić (born in 1972) is an Full Professor at the Faculty of Law in Osijek. She is currently teaching the course of Economic Policy and Entrepreneurial Management at the undergraduate level, as well as she is engaged at the postgraduate specialist studies at the Faculty of Law in Osijek and the Faculty of Economics in Osijek. She has published a significant number of scientific papers in domestic and international publications covering issues from the field of macroeconomics, economic policy, gender economics and entrepreneurship. In addition, she is the co-author of the book „Nobel prize in economics" – 2nd edition (2004) and the author of the university textbook „Theory of Growth" (2006). Her scientific activity has been also reflected in active participation at national and international conferences. She is currently a senior researcher of the project "Theory and Practice of Institutional Approach to the Regional Development" financed by the Croatian Ministry. In May 2006, she has become an executive editor of the Journal of Law and Social Sciences of the Faculty of Law Osijek. She also served as a Vice-Dean for Science and International Cooperation of the Faculty of Law in Osijek (2007-2009).

Mira Lulić was born in 1970 in Osijek. In 1993 she graduated from the Faculty of Law. She was awarded a master's degree in 1999 at the Faculty of Law of the University in Split and in May 2005 a doctoral degree at the Faculty of Law of the University in Zagreb. She is an Associate Professor at the Department of International Law at the Faculty of Law in Osijek. She teaches the course of International Law and International Protection of Minorities. In her scientific career she has been actively participating in numerous scientific conferences in the field of International Law. She published the book "Decolonisation and Creation of Statehood" (2005) and a wide range of scientific papers in the field of International Law. Since February 2007, she is the main researcher of the project **"**Minority Rights Protection in Contemporary International Law and National Legislations**",** approved by the Croatian Ministry of Science, Education and Sports. She is a member of the Croatian Assosiation for International Law, Croatian Institute for Local Government, Croatian Society for Maritime Law, Humanitarian International Law Assembly and The National Association for Ethnic Studies and also an Associate of the Croatian Academy of Law Sciences.